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**The Effects of Changes in Technology in the Music Industry:
A Case Study of Warner Music Group and Uomo Media**



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Submitted to The Department of Economics

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I hereby recognize and pledge to fulfill my responsibilities as defined in the Honor Code and to maintain the integrity of both myself and the College as a whole.

Danae Binder

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Table of Contents

I.	<u>Chapter One: Introduction</u>	1
II.	<u>Chapter Two: Literature Review</u>	3
III.	<u>Chapter Three: Empirical Analysis</u>	16
	1. Industry Overview.....	16
	2. Background of Firms.....	18
	3. Strategies of Firms.....	20
	4. Business Models.....	21
	5. Revenue Streams.....	23
	6. IPR.....	27
	7. Responses to Changes in Technologies.....	27
	8. Competition.....	30
	9. Growth.....	31
IV.	<u>Chapter Four: Conclusion</u>	34

List of Tables

Table 3.1.....	17
Table 3.2.....	24
Table 3.3.....	25
Table 3.4.....	26
Table 3.5.....	27

List of Figures

Figure 2.1. Structure of Major Labels' services prior to the MP3 Crisis.....	6
Figure 2.2. Intermediaries within the music industry	11
Figure 3.1. Worldwide recorded music sales.....	18
Figure 3.2. WMG's Goodwill.....	29
Figure 3.3. Revenue Contribution in the Sound Recording Industry from 2005-2010.....	33

ABSTRACT:

This study examines how changes in technology have affected new entrants in the music industry. Since 1990, the Internet has changed the way music is introduced, promoted, produced, and distributed. To understand the changes the recording music industry has faced, it was important to show a historical background of the industry as a whole. The industry has seen negative growth since 1999, due to drivers such as digital piracy, the recessionary economic environment, bankruptcies of retailers, and overall maturation of the CD format. Major firms, like Warner Music Group, have had to make changes in their business model to stay competitive. The lack of barriers to entry, mainly due to changes in technology, has enabled smaller companies, such as Uomo Media to gain a slice of market share. Financial data, annual reports, and consumer reports were used to find quantitative evidence of success and growth. Findings showed that although Uomo Media's market share has grown consecutively since its inception in 2004, WMG has acquired and took advantage of new technologies. In an industry that is always changing, growing, and evolving, it is imperative for firms to recognize the advantages of changing and expanding into different and new channels.

CHAPTER ONE: INTRODUCTION

The overarching goal of this project is to understand how new technologies have affected new entrants in the music industry. Since 1990, the Internet has changed the way music is delivered. Through the Internet, music files can be acquired using an MP3 (MPEG layer 3) format. MP3 downloads are 1/10 of the size of a CD (compact disc). MP3s and file-sharing changed the way music could be distributed to consumers. The Internet also changed the way music could be introduced, advertised, and promoted. Innovation in software changed how music was produced. Instead of booking studio space, musicians, provided with the right software, could produce and record their music on their own, upload it digitally, and distribute through the Internet. When all of the stages of making, advertising, and selling music can be done independently, where do these changes leave major record labels?

To explore this overarching goal, it will be important to raise the following questions: Are barriers to entry higher or lower when technologies are developed /introduced? How do new technologies affect the competition between new entrants and incumbent firms? How do incumbent firms respond to new technologies? How do new technologies evolve?

To comprehend the new developments within the music industry, two music firms will be compared, Uomo Media, Inc. and Warner Music Group. Warner Music Group was founded in 1958 as Warner Bros. In 2011, Warner Music Group was acquired by Access Industries. At this time, it shifted from a publicly traded company to a privatized company. Uomo Media, Inc. was founded in 2004 as “First Source Media, Inc.” In 2007, the sole purpose and name of the company changed and Uomo began investing in music publishing, digital music, production, and talent management services because they believed these opportunities would cause them to be more profitable.

Through the evidence from the literature review, there is ample indication that with barriers to entry in the music industry, more firms emerged. This will cause the major record labels to respond in different ways. One way incumbents in the music industry can retain market share is through mergers and acquisition of other labels. The next chapter reviews the literature on the recording music industry and how changes in technology have affected new entrants and incumbent firms in the industry.

CHAPTER TWO: LITERATURE REVIEW

Innovations in technologies affect firms and consumers. The music industry is a highly oligopolistic industry, with three major firms dominating global market share (Universal Music Group, Sony Music Entertainment, Warner Music Group). New technologies pose a threat to these major labels' competitiveness, mainly through the illegal copying and sharing of digital files (MP3s), also known as peer-to-peer file sharing. Peer-to-peer file sharing uses each client that downloads music as a host, so there is no central server of a file library. When a client downloads a song, that song can be uploaded by other clients. The primary way major labels have tried to prevent file sharing is through legal enforcements. This literature review will discuss how major music firms have been traditionally structured, how they reacted to the MP3 crisis, how they have been restructured due to changes in technology, how barriers to entry come into play, and the overall impact that technology has had on new entrants and incumbent firms in the music industry.

Disruptive technologies can hinder the performance of firms in an industry. A technology is said to be disruptive if it shifts the trajectory of the market and can "leave existing competencies obsolete." (Dyerson & Pilkington, 2005, p.391) Disruptive technologies may open a specific market to new entrants, but only if those new entrants collaborate with incumbent firms. If a new technology is mandated (for example, by the government), it can be disruptive if it cannot evolve from older technologies.

New technologies can be beneficial to a market if the right steps are taken to adopt them. If firms work together to introduce new technologies, they can create "new market niches" in a traditional industry (Dyerson & Pilkington, 2005, p.391). This cooperation of firms is

sometimes referred to as coepetition and is accomplished through joint ventures and joint licensing (Dyerson & Pilkington, 2005).

Dyerson and Pilkington (2005) discuss the forces of renewal in mature industries. If there are high rates of entry and exit in an industry, then technological changes will be present more than if there were lower rates of entry and exit. The high levels of technological changes in these industries mean that for incumbent firms to thrive, they cannot be reluctant to take advantage of technological opportunities, regardless of whether or not it is outside of the firm's technological trajectory. Unfortunately, this is not what usually happens. When these incumbent firms do not update their technologies, entrepreneurs and innovators can exploit that market and takeover. This creates a "fast turnover of firms" (Dyerson & Pilkington, 2005, p. 392). Therefore, incumbents have a difficult time maintaining dominance for long periods.

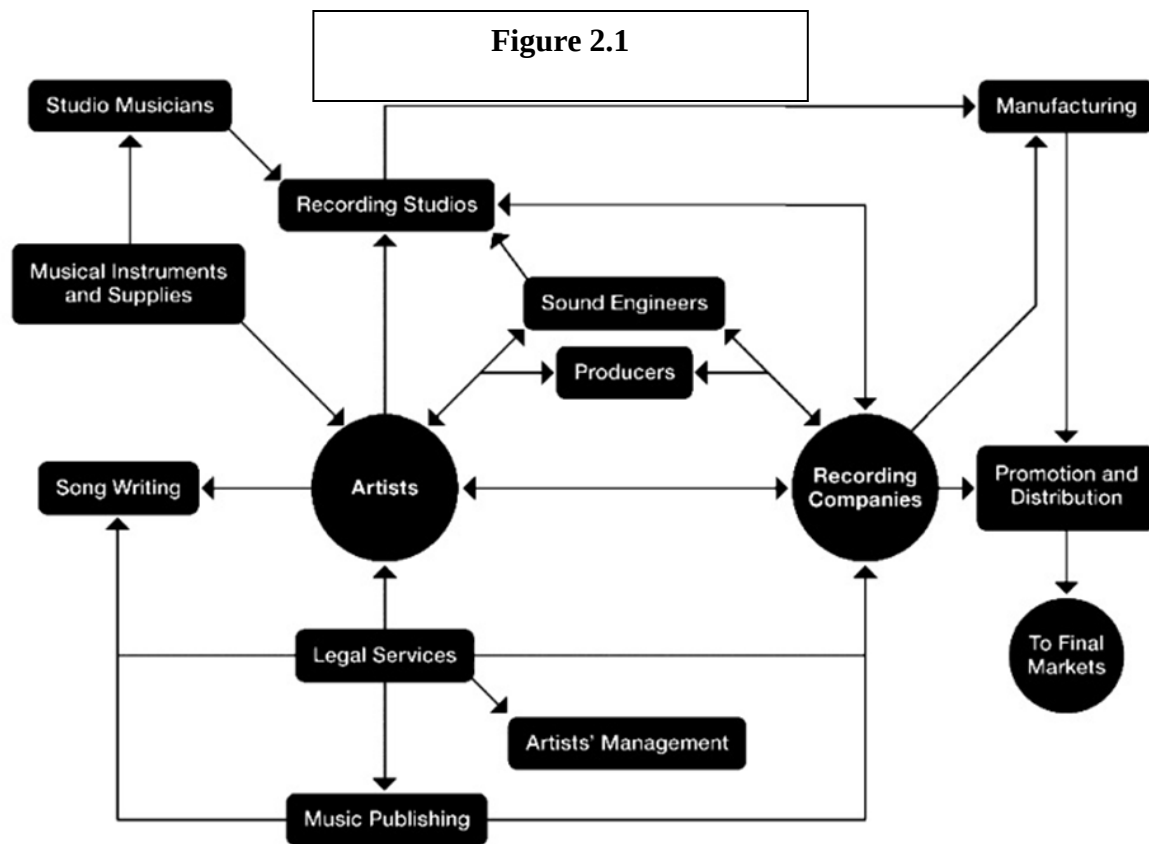
Again, disruptive technologies are "radical changes in technology that can unsettle incumbent firms" (Dyerson & Pilkington, 2005, p. 394). New technologies may initially seem inferior, but over time they have the ability to improve faster and spill into new markets. Incumbents get blindsided by immediate customer demands. These immediate demands cause incumbents to maintain the status quo, when they should be challenging it through new technologies. Autonomous (independent) innovation favors the entry of new firms.

Overall, incumbent firms can handle new technologies and innovations of other firms by innovating, designing and creating complementary assets. Regulation can also have effects on technological development in an industry. Smaller, independent firms that obtain new technology can operate under larger firms with collaborative agreements to be sustainable. This is known as systematic innovation (Dyerson & Pilkington, 2005), because the new technologies

are used by smaller firms that are cohering with larger firms, the competition between the two is more methodical.

Structure of Major Record Labels Prior to MP3 Crisis

It is important to understand the structure of major music labels prior to the MP3 Crisis. Figure 1 shows the different pathways music is distributed through the major record labels and also shows all the services provided by those labels. It is quite clear that major record labels were vertically integrated prior to the crisis. Every part of their production process was done “in-house”. Prior to the MP3, “The Majors” embraced technological innovations. They could sell the same music over and over with higher profit margins (Hracs, 2012).



Source: Alexander, 1994

Figure 2.1. Structure of Major Labels' services prior to the MP3 Crisis

Within the history of the music industry, surprisingly market power has shifted between major record labels and independent firms since the industry's establishment in 1890. These shifts can be explained by horizontal integration (merger of companies). This accounts for high levels of industry concentration. New technologies contributed to these waves of new entry. New technologies, as discussed prior, have lower production costs. Smaller music firms proved to be strong competitors with existing firms. They introduced innovative products that became popular. Eventually, the old structure eroded and lowered market concentration (Alexander, 1994).

Release behaviors can inadvertently benefit smaller firms. Larger record companies spend more on production than smaller, independent firms. Smaller record companies will get pressing and distribution deals (P&Ds) with larger companies. This shows consumers that larger companies have put their seal of approval, so to speak, on a record to be mass produced. But now, the number of distributors have decreased, so they can demand exclusivity, special pricing, and special dating. An independent firm may lose contractual control over an artist because of their relationship with a distributor (Alexander, 1994).

As stated in the previous article, larger firms own distribution companies. Smaller, independent firms do not and would distribute through said larger companies. Alexander found that “smaller, new entrants have not yet been able to exploit this technology in terms of market share,” which is still evident today (Alexander, 2002, p.151).

A benefit of digital technologies is their decreasing costs. Reproduction and distribution costs have decreased because of digital technologies. It is much easier to copy smaller, invisible files than CDs. When an album is distributed digitally, it is paperless, so no album art needs to be printed and packaged along with a CD. The MP3 format has almost as good quality of a CD but takes up 1/10 to 1/20 the size. MP3s reduce filing size in two ways, by “discrete sampling of continuous sound waves” (Alexander, 2002, p.153) that create samples that are passed through high and low band filters.

How have these digital distribution systems evolved? Napster.com and MP3.com relied on central servers to “guide the distribution of digital products” (Alexander, 2002, p.156). MP3.com servers stored and distributed files, whereas Napster.com showed sites where files were hosted and left the choice of which to download to the client. Gnutella and Freenet (two

peer to peer networks) used no central servers (decentralized). Here is how it works: each computer that has the software becomes a server for continuous peer-to-peer connections. Tracing is difficult because every time a client logs in, they have a new address. The music industry has had a hard time litigating these types of software companies (Alexander, 2002).

Major Labels' Reaction to MP3 Crisis

Major music firms' first reaction to digital distribution was mixed. Firms tried to encrypt their products, making any type of sharing impossible. This approach failed on all accounts, because consumers could only listen to a CD and could not import it on their computer. Now record companies are betting on SDMI, the Secure Digital Music Initiative to help keep their control over music distribution. At this point, many believe that "the only way to make music that cannot be copied is to make music that cannot be heard." (Alexander, 2002, p.158)

Alexander also argues that new distribution technologies (like the Internet) threaten the status quo in the industry. Napster and MP3.com were prosecuted because they obtained central servers for the distribution. But, new software has emerged that does not require central servers (Gnutella and Freenet). The new software uses the peer-to-peer system where each user acts as a client and a host, with no central server. (Alexander, 2002) This makes software creators and users harder to prosecute.

The music industry has reacted to the digitalization of the music industry through lawsuits. Not only did music firms' go after Napster.com and MP3.com, but they also punished their customers who they found downloaded illegally. Napster.com and MP3.com used a central server system, so it was fairly easy to find evidence to prosecute them, but with the decentralized

peer-to-peer style of sharing, it has been harder for music industries to prosecute what they cannot find (Alexander, 2002).

Property rights allow private investors to receive profits generated by their innovation rather than free-riders profiting. “Therefore, new entries must step over economic/administrative thresholds to be accepted” through product differentiation, for example (Crampes and Langinier, 2007, p.3). New entries then must be innovators. Crampes and Langinier (2007) argue that if there are positive externalities that exist from the innovator (new entrant) to the follower (the incumbent), there will be an increase in innovation rather than the innovation being harmful (Crampes and Langinier, 2007).

Intellectual Property Rights (IPRs) are constraints designed to limit entry into industries where existing firms are the innovators (Crampes and Langinier, 2007). These legal constraints are the same across all industries, when in reality not all externalities created by new entry have negative effects on incumbent firms (Crampes and Langinier, 2007).

A problem anticipated by consumers and record companies alike is the act of free-riding. Free-riding, generally, is the idea that individuals will act for their own good and not for other groups’ interests. In music, this creates a problem when a client of a peer-to-peer file sharing software decides to not make their files available to peers, thus ruining the double sided role that the client plays in the decentralized form of file sharing. As free-riding increases, fewer clients are providing music (Alexander, 2002). “The increased cost (less bandwidth, in this case), in conjunction with the diminished benefits, leaves everyone worse off.” (Alexander, 2002, p.158) If free-riding remains an option for consumers, the music industry will be less profitable. This could, in turn, cause the collapse of the network and industry (Alexander, 2002). Major record

labels reacted to the MP3 Crisis by signing fewer artists to their label. This lowered levels of musical creativity and diversity. Because there were fewer artists to a label, the artists that already exhibited popularity and success (and profits) were the focus of promotion for firms (Hracs, 2012).

Illegal downloads have had a negative impact on the Recorded Music Industry (RMI). An entire generation of music consumers have grown up with illegal downloads normalized within their culture. Programs like Napster (established over 10 years ago), Lime Wire, Bit Torrents, eDonkey, Gnutella, and Morpheus, to name a few have made a huge impact on the traditional music business. This social norm of illegal downloading has percolated onto the youngest generation. As they age their view of illegal downloading may change slightly, but they are not likely to drastically change their view. Hendricks (2011) argues that downloading music is here to stay, but that the issue lies in whether consumers favor illegal or legal downloading (Hendricks, 2011).

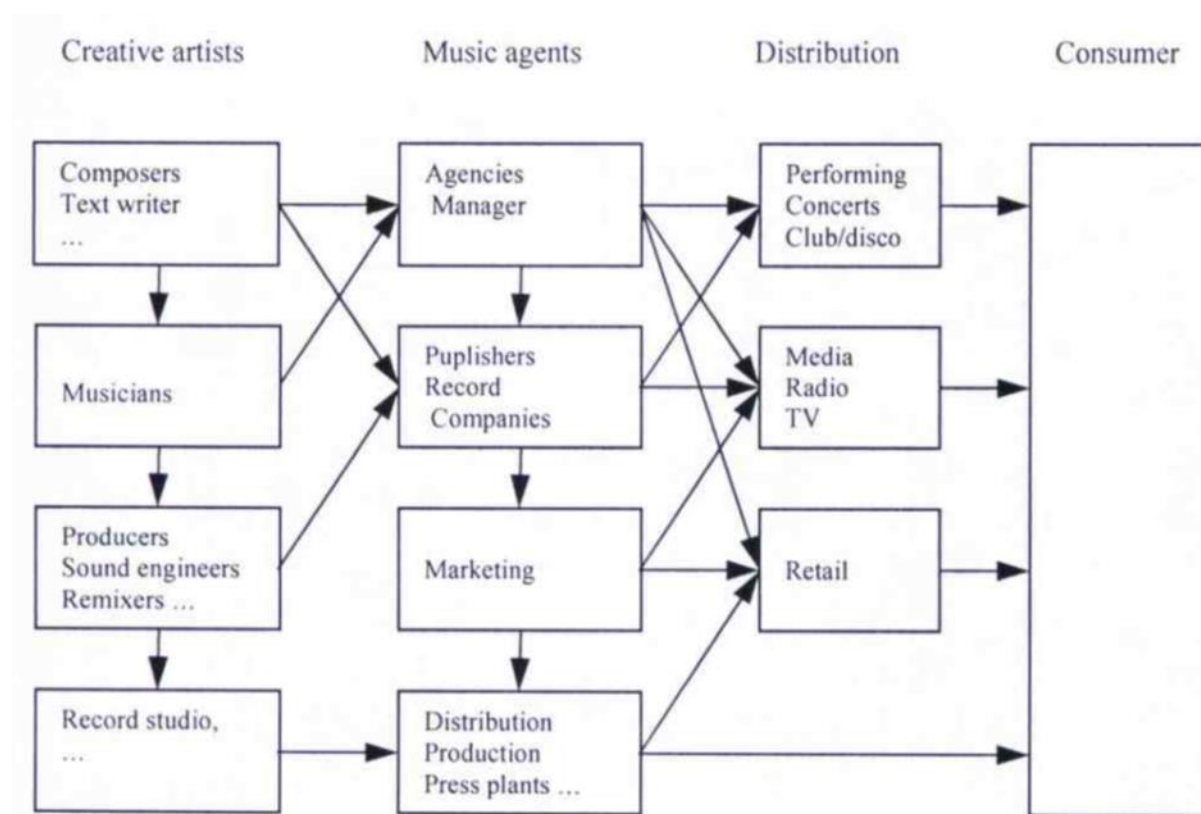
There are reasons that new innovations succeed and leave older technologies in the dust. First, cost and accessibility are important. Second is the idea of relative advantage, when a consumer accepts a new technology as a replacement for an old one because it is better. Essentially, it leads to a substitution effect. If there is a cost advantage in the new technology, then the substitution effect is larger than it would be if the new technology was more expensive than the existing one. Most innovations are more expensive than the preceding technology (and are more difficult to use). This can hinder sales of new technologies. Recorded music did not have this problem. Downloading music (whether legal or illegal) has a cost advantage. Also, the consumers of recorded music have minimal difficulty understanding the concept of downloading music. These advantages were so obvious that the recorded music industry was not prepared for

the piracy take over. The only mechanism the RMI could use was a defensive one, by lashing out at their customers. (Hendricks, 2011)

Changes in Structure due to New Technologies:

New technologies in the music industry are affecting the intermediaries in the structure of large firms' business models, mainly of music publishers and record companies. Dolfsma (2004) argues that although intermediaries will not disappear, they will be reshaped or new intermediaries will be added. The figure below illustrates the path the music takes when the Internet is considered. (Dolfsma, 2004)

Figure 2.2



Source: Dolfsma, 2004

Figure 2.2. Intermediaries within the music industry and relationship with each other as it has developed along with the internet

The restructure of the music industry has also affected music retailers like Tower Records and FYE because new distribution channels emerged. These traditional distributors of music not only lost control of how music was distributed, but also the production process of music itself (Hracs, 2012, p.449). This restructure also led to a redistribution of market power. Now, major firms take direction from these new distribution channels (Apple iTunes Store, Amazon.com) for pricing and distribution (Hracs, 2012).

Tapscott (2010) argues that the music industry will not be successful by selling songs for a dollar a pop. It must move into the 21st century and obtain a new business model by using innovative technology (Tapscott, 2010).

A business model Tapscott proposes is the idea that music should not be a product you buy, but a service you pay for and receive a subscription. Rather than purchasing by song or album, the listener would pay a small amount (\$4 monthly) to access all songs, similar to Netflix. Artists and contributors would be paid by their popularity. Your preferences would be saved and tailored to your liking. The listener would receive a plethora of personal services. It is viewed as an open music model. According to Eddie Schwartz, President of songwriters Association of Canada, “This proposal would do more than eliminate the problem of so-called ‘stealing’ of music. It would enable musicians, songwriters and their agents to be fairly compensated for their work. And with more artists able to make a living, there would be an explosion of creativity and everyone would be winners” (Tapscott, 2010, p. 231).

Barriers to Entry:

Because barriers to entry in the music industry are low and growth in the Internet business is fast, incumbents’ competitive advantage in the industry will not last. New firms have

the possibility of entering and obtaining a large share “of the existing or the new created market” (Dolfsma, 2004, p.229).

Incumbent firms may be complacent in adopting new technologies. Major firms may become locked-in because they may have invested in the wrong channel, using the narrow scope of technology approach. This incurs more risk, but also more profit. Unfortunately, for the major firms, sticking with the CD was not in their favor. They merged into the digital world a little too late. Basically, incumbents face challenges as new entrants have opportunities because products can easily be reproduced and transformed. (Dolfsma, 2004)

The Impact:

Hendricks (2011) states “we are entering a new age of media characterized by more consumer choice and control, at least for those who can afford it.” Record music industry sales have decreased by one-third in the last 12 years. Some artists make big deals with big box distributors (Wal-Mart and Target) at the expense of record labels and music retailers. Some artists bypassed big boxes and big labels altogether. Consolidation of firms has led to only four major recording music companies worldwide including: Universal Music Group, Sony BMG, Warner Music Group, and the EMI Group (Hendricks, 2011, p. 120). Since then, Sony BMG acquired EMI Group.

To explore the impact of digital file sharing on the music industry, Michel (2006) undertakes an empirical analysis of the industry. The regression analysis used in the study measures how file sharing affects CD purchases. He concludes that computer owners decreased their purchases of CDs from 1995-2003 (Michel, 2006). This suggests that there could be a

relation between downloads and CD expenditure. Computer owners buy less CDs because they can download music files (legally or illegally).

When looking at the impact that technology and the Internet have had on the music industry, most arguments are built on the idea that the Internet is to be blamed for the current crisis within the music industry. But, Patokos (2008) argues how the Internet has helped the music industry, specifically through the impact of consumers, artists, and record companies. Consumers get more access to information through the Internet, so they do not have the need for music media to know what is new or to seek opinions on the latest works. Artists can use the Internet to promote an artist's work through sites like MySpace and Purevolume. Already, over-exposed artists may see a decrease in success, since more artists become known through these new electronic channels. Record companies' distribution became more efficient, but they have also seen mergers and alliances with other record companies. Manufacturing costs have been reduced through MP3 distribution (Patokos, 2008).

Hracs (2012) aims to understand the ongoing transition in the music industry. The article focuses on technological changes and its implication for work in the music industry. It demonstrates how technology has overcome major labels' market power and how it has been distributed to a "broad set of actors" (Hracs, 2012, p.443).

These new technologies make independent production a viable option. Digital technologies allow musicians to record from home with a personal computer. Recording costs are lower, from prices of recording software to recording equipment (Hracs, 2012).

Conclusion:

Many factors come into play concerning the contemporary challenges in the music industry. The goal of this project is to understand how changes in technology have affected the music industry. A major objective of the literature review undertaken in this chapter has been to set a foundation for the empirical section. In the empirical section, two firms will be used to show the effect of digitalization within the music industry.

CHAPTER THREE: EMPIRICAL ANALYSIS

To understand the impact of technology on firms in the music industry, two firms will be studied- Warner Music Group (WMG) and Uomo Media Incorporated (Uomo). We will be looking at the companies' histories, their business strategies, their business model, important company financials, including ways that revenue is earned. We will also be looking at how each company protects music, through intellectual property rights and copyrights, technology and research and development, each company's competitive advantage and overall growth.

I. Industry Overview

The recording music industry in 2009 was a \$25.4 billion industry, according to IFPI. Over the years, firms have acquired extensive music catalogs of all of the artists' songs under that firm's label. Year after year, firms are collecting revenue from the music catalog, since it contains long-lived assets. Hence, catalog profits are higher than new release sales also because most of the costs (development costs) have already been incurred whereas new release costs are more recent costs and may have not been profitable yet. During the first three quarters of 2010, 44% of music sales were from recordings more than 18 months old, with 34% percent being more than 3 years old (*Warner Music Group Annual Report*, 2010).

The top five countries for music sales in 2009 were the U.S., Japan, the U.K., Germany, and France. These countries made up for 75% of sales in the recorded worldwide music industry. Table 3.1 shows the percentage breakdown of domestically produced music compared with internationally produced music sales in 2009. The United States has the highest domestic sales, partly because of the US's advances in new distribution channels of music.

Table 3.1

Country	US	Japan	UK	Germany	France
International	7%	22%	61%	---	---
Domestic	93%	78%	39%	---	---

Table 3.1. Domestically Produced Music vs. Internationally Produced Music Sales in 2009

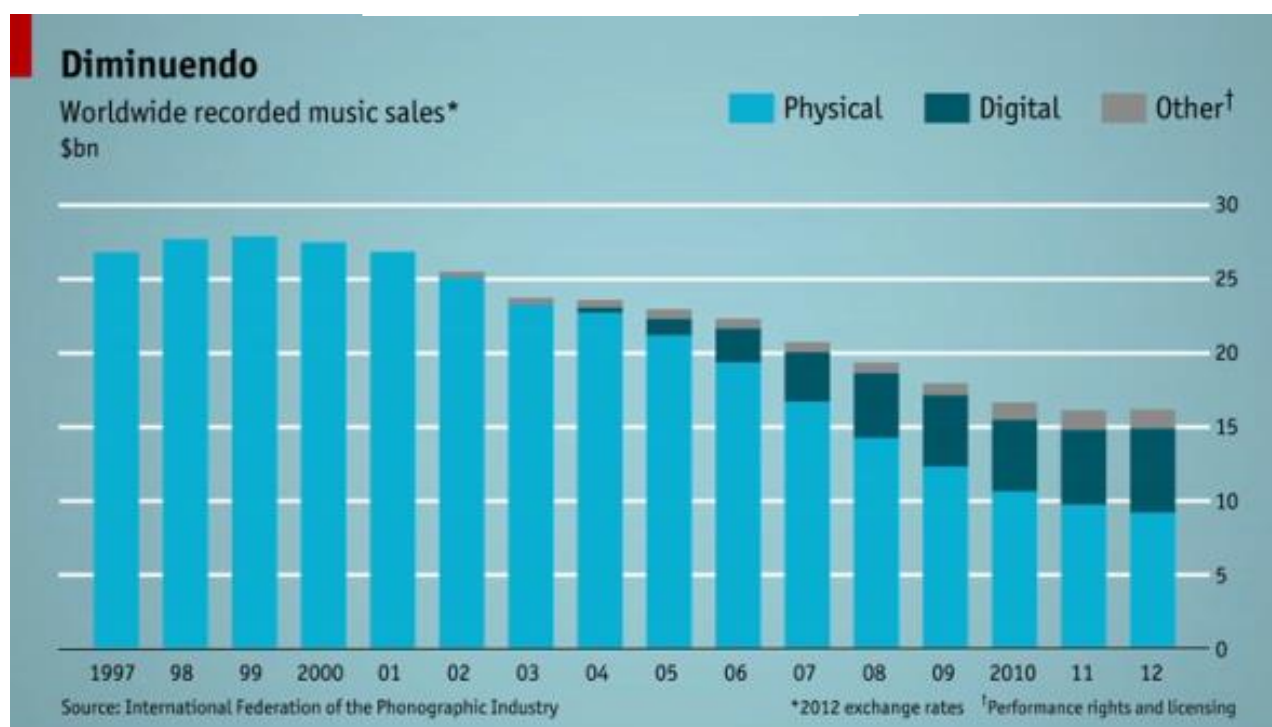
Distribution has shaped the industry as a whole, mainly shifting from specialty shops to mass-market retailers and online shops. Combined, they accounted for 48% of sales in 2009 (*Warner Music Group Annual Report*, 2010).

Since 1999, the music industry has seen negative growth. Generally, it is believed that digital piracy was the main cause of this decrease. Other drivers of this decrease should also be taken into account, like the overall recessionary economic environment, bankruptcies of retailers, and the growing competition for retail shelf space, along with the overall maturation of the CD format (*Warner Music Group Annual Report*, 2010).

In an environment like this, how does a firm succeed? As Warner Music Group (WMG) stated in their 2010 Annual Report, “Notwithstanding these factors, we believe that music industry results could improve based on the continued mobilization of the industry as a whole against piracy and the development of legitimate digital distribution channels” (*Warner Music Group Annual Report*, 2010, p. 25).

The figure below illustrates the overall decrease of sales in the worldwide music industry, but also shows the increase of those sales being digital sales and performance rights and licensing. Over the past ten years, physical compact disc revenue was cut by more than half. The industry as a whole is ten billion dollars smaller than it was just a decade ago (Economist.com, 2013). Figure 3.2, at the end of the text, also shows the revenue breakdowns more specifically from 2005 through 2010.

Figure 3.1



Source: Economist.com, 2013

Figure 3.1. This figure shows the decline in physical recorded music sales, but also illustrates the increase in digital and performance rights and licensing revenues in the music industry as a whole.

II. Brief Backgrounds of Firms

In order to have a better perspective on the competitive strategies of WMG and Uomo Media, it may be helpful to briefly review their history. Warner Music Group (WMG) was

founded in 1929 by Jack Warner, the president of Warner Bros. At the time WMG was known as the Music Publishers Holding Company. Its primary goal was to acquire copyrights as a way to retrieve music inexpensively for films. This proved to be successful, so Warner Brothers Records was established in 1958. After the success of Warner Brothers Records, smaller subsidiary firms were launched- Atlantic Records and Elektra Records. Atlantic Records was launched in 1947 by Ahmet Ertegun and Herb Abramson. Based in New York, Atlantic Records was primarily a jazz and R&B label. Elektra Records was founded in 1950 by Jac Holzman as a folk music label. In 2004, Elektra and Atlantic Records merged and became known as the Atlantic Records Group. Also in 2004, Warner Music Group was sold from Time Warner Inc. and became known as “the only stand-alone music content company with publicly traded common stock in the U.S. in May 2005” (*Warner Music Group Annual Report*, 2008, p. 14).

Uomo Media, Inc. (Uomo) was founded as “First Source Data, Inc.” on June 10, 2004. The original company’s goal was to develop and provide online marketing management of services and products. As stated in Uomo Media, Inc.’s *Condensed Notes to Interim Unaudited Consolidated Financial Statements*, “the company’s original operations include: capital formation, organization, website construction, target market identification, research costs, promotional materials costs, and marketing planning” (2008). Their prior goals were to gather, manage, and analyze market information. First Source Data, Inc. also provided consulting services, including but not limited to design and online advertising, marketing campaign management, and advisory services (*Uomo Media Annual Report Inc.*, 2008).

On September 25, 2007, the purpose of “First Source Data, Inc.” changed. The company began providing music publishing, digital music, production, and talent management services because they believed these opportunities would enable them to be more profitable. On October

30, 2007 the name was changed to Uomo Media, Inc. (Uomo) and two subsidiaries were added in Canada- Uomo Productions Inc. (January 16, 2008) and Uomo Publishing, Inc. (April 22, 2008) (*Uomo Media, Inc. Annual Report, 2008*).

III. Firms' Strategies

Warner Music Group's (WMG) overall strategy is to discover and promote artists and their brands. It is important to have artists and songwriters with enduring value that expands the value of assets by attracting other artists and songwriters with market potential. Currently, the strategy is to align a business model with the business drivers of partners. They plan to do this by creating a model that will create value to a consumer that will bring that consumer back to the product time and time again in a lifetime. It is also a goal to find artists and songwriters that can achieve long-term success, with staying power and market potential (*Warner Music Group Annual Report, 2008*).

Uomo Media, Inc.'s (Uomo) strategy is to attain revenue from all aspects of the entertainment-related intellectual property chain. This is seen in their business model, where the goal is to expand traditional models by creating a brand around intellectual property assets. In 2008, they integrated emerging and established revenue streams that were separated prior by combining production, publishing, talent management, and distribution of digital content (music), into a single platform (*Uomo Media, Inc. Annual Report, 2008*). According to Uomo Media Inc.'s website, "Management's expertise includes a label imprint venture with Sony BMG, as well as managing clients that have produced lead singles for numerous international artists such as Britney Spears, Canadian Idol and Rihanna. Additionally, our experience includes

managing marketing budgets for Fortune 500 clients such as Sony Ericsson, Starbucks, Coke, and ING” (2009).

IV. Firms’ Business Models

In chapter 2, business models of the music industry was discussed. Recently, those traditional business models have been abandoned to make way for technology’s effect on music sales and the way those sales are distributed. In general, it can be seen that the music market is becoming a more complex and sophisticated marketplace (DMR 2009). Music companies have been trying to offer music in as many ways as possible, ranging from download stores to subscription services, licensing of music in games and films, merchandising, brand partnerships, ad-supported streaming sites, and public performance rights (DMR 2009).

“Music access” has been a large part of why business models are changing. A common goal in the market place is to allow consumers to have access to music wherever they are, whatever they are doing. This can be seen through partnerships with technology companies. An example of this is the Nokia “Comes with Music” phone, which takes advantage of subscription services and ownership. The new goal of the music industry is to reach consumers wherever they are, no longer to sell music on a shelf. These “access” services are the most important current development in the music industry (DMR 2009). WMG and Uomo have both reacted to these changes in technologies with their business models. According to John Kennedy, Chairman and Chair Executive of IFPI dismissed the idea of independently produced music in the *2009 Digital Music Report*,

The idea that the digital world somehow diminishes the importance of music companies is simply a myth. On the contrary, in a world where a multitude of aspiring artists are

competing for visibility among millions of consumers, the music company role can only become more important in the digital future. The investment, skills, services, and creative advice that labels provide remain as a core function of the music business as ever (2009).

Warner Music Group's (WMG) business model has been shifting to better align with technological advances in the music industry, specifically to align with their digital partners. This way, content can be monetized better. In 2008, bundle deals were introduced, where the purchase of a device entitled the listener to music access. Examples of these bundle deals include Nokia's "Comes with Music" and Sony Ericsson's "Play Now Plus". They are also interested in being a part of all aspects of the value chain, from discovering and signing an artist to producing and promoting an artist and their products (*Warner Music Group Annual Report*, 2008). Michael Nash, executive vice president, digital strategy and business development, Warner Music Group, states "Music is extremely important to this economy and is also the driver of a wide range of larger industries. These industries are thinking about how to partner with the music industry in new ways. The health of the music industry is going to contribute to the health of this trillion-dollar economy" (DMR 2009).

WMG has also been an advocate to the 360° deals. In a 360° deal, the firm has more brand rights to an artist and can provide them with more support in their career, by promoting them for a longer period of time and actively finding new ways to promote an artist, through tours, fan clubs, merchandising, and sponsorship. In this sense, WMG is not only producing an artist's music, but producing that artist's brand (*Warner Music Group Annual Report*, 2008).

V. Firms' Revenue Streams

There are different ways in which WMG earns revenue. WMG has been broadening the ways they receive revenue, especially since the creation of the 360° deals. This includes sponsorship, fan clubs, websites, merchandising, tours, ticketing, and artist management. This is beneficial for artists so they can grow in all aspects of their career. In their 2008 annual report, WMG also receives revenue from digital downloads, single tracks and albums, online subscription services, interactive webcasting, video streaming and downloads, and mobile music. In 2008, digital sales, including singles and album purchases, were higher in the U.S. than WMG's overall recorded music album share in the U.S. WMG also receives revenue through joint ventures such as Bad Boy Records with Sean "P. Diddy" Combs (*Warner Music Group Annual Report*, 2008).

Uomo Media, Inc. has not been profitable since its incorporation. They earn revenue from four different facets of the company- music publishing, recorded music, digital distribution, and talent management. Within music publishing, revenue is earned from fund advancing, administration, creative, and licensing. The recorded music sector has catalogue acquisition, talent acquisition, and distribution arrangements (*Uomo Media, Inc. Annual Report*, 2008).

Table 3.2 shows sound recording industries' revenues from 2005 to 2009. Overall, the revenues have decreased, except for a small spike in 2006. Record production and distribution has decreased, along with licensing revenue, sales of recordings, and studio recordings. Music publishers' revenues have increased overall, along with licensing of rights to use musical compositions, and sound recording studios. Since numerous sectors from the sound recording industries have decreased, it is self-explanatory why the industries' overall revenues have

decreased as well. What is not self-explanatory, is the increase in the music publishing sector and the sound recording sector's increases in revenue. When comparing with Figure 3.1, it can be seen that publishing rights have increased over the past few years, which may explain the increase in licensing rights. Sound recording studios' revenues have increased due to something not shown in the table.

Table 3.2

Kind of business	2005	2006	2007	2008	2009
Operating revenue.	88,931	93,214	94,986	95,359	90,946
Motion picture and video Industries	72,991	76,394	79,797	80,089	76,098
Motion picture and video production and distribution ¹	56,826	59,170	61,911	62,161	58,010
Domestic licensing of rights to motion picture films	15,076	15,231	14,939	13,337	12,747
Domestic licensing of rights to television programs	9,408	9,156	10,085	9,395	9,979
International licensing of rights to motion picture films	6,205	7,017	7,456	7,093	6,488
International licensing of rights to television programs	3,111	2,873	2,977	3,490	3,359
Sale of audiovisual works for wholesale, retail, and rental markets	7,560	10,360	12,313	12,254	10,499
Motion picture and video exhibition ¹	11,654	12,326	12,705	12,782	13,262
Feature film exhibition revenue	7,757	8,108	8,483	8,545	8,947
Admissions to domestic films	7,558	8,059	8,421	8,476	8,868
Admissions to foreign films	199	(S)	62	69	79
Food and beverage sales	3,284	3,543	3,711	3,722	3,808
Postproduction services and other motion picture and video industries ¹	4,511	4,898	5,181	5,146	4,826
Audiovisual postproduction services	2,362	2,607	2,736	2,674	2,643
Motion picture film laboratory services	453	(S)	436	420	324
Duplication and copying services	(S)	1,045	(S)	1,091	1,157
Sound recording industries	15,940	16,820	15,189	15,270	14,848
Integrated record production and distribution ¹	10,110	10,642	9,082	8,953	8,665
Licensing revenue	(S)	1,512	1,299	1,441	1,392
Sales of recordings	(S)	(S)	7,454	6,917	6,496
Music publishers ¹	4,335	4,645	4,466	4,715	4,593
Licensing of rights to use musical compositions	2,207	2,322	(S)	2,887	2,862
Print music	1,771	1,926	1,667	1,254	(S)
Sound recording studios ¹	703	831	854	810	748
Studio recording	461	509	508	505	445

S Data do not meet publication standards. ¹ Includes other sources of revenue not shown separately.

Source: U.S. Census Bureau, "Service Annual Survey 2009: Information Sector Services," January 2011,

<<http://www.census.gov/econ/www/servmenu.html>>.

Source: U.S. Census Bureau, 2012

Table 3.2. Motion Picture and Sound Recording Industries- Estimated Revenue and Sources of Revenue: 2005-2009, in millions

A firm's sales indicate goods sold. In this chapter, sales will be shown in monetary form, by using the revenue of a firm (Williams, Haka, Bettner, & Carcello, 2010). Table 3.3 shows the sound recording industry, defined by the United States Census Bureau as "establishments primarily engaged in producing and distributing musical recordings, in publishing music, or in

providing sound recording and related services” (2007), as a whole and compares the two firms’ market shares of the industry. This is a good framework for this study to show the differences in overall size and power that these firms’ obtain. The industry sales totals were taken from the data in Table 3.2. Sales of WMG and Uomo Media vary substantially. As stated before, Uomo is a new entrant in the music industry and by 2009 had a 5.8% market share in the sound recording industry. The firm’s market share has increased steadily since 2006. The same cannot be said for WMG’s market share, since a 1.5% drop took place between 2008 and 2009. Overall, though, 2009 had greater market share in 2009, than they did in 2006, even though their sales were lower in 2009 than in 2006, as the industry sales decreased yearly, excluding 2007 to 2008. The main observation that can be used from this table is that even though Uomo Media’s market share is a fraction of the size of WMG’s market share, Uomo increases yearly, unlike WMG.

Table 3.3

Fiscal Year	Industry Sales	WMG Sales	WMG Market Share	Uomo Sales	Uomo Market Share
2006	16,820,000	3,516,000	20.9%	510400	3.0%
2007	15,189,000	3,385,000	22.3%	659555	4.30%
2008	15,270,000	3,491,000	22.9%	-----	-----
2009	14,848,000	3,176,000	21.4%	858137	5.8%

Table 3.3. Sales and Market Share Comparison

Return on Assets (ROA) is the profitability of a firm relative to their total assets. This is found by dividing net income by total assets (Williams, Haka, Bettner, & Carcello, 2010). When

comparing the ROA (return on assets) ratio between WMG and Uomo, in Table 3.4, neither firms have seen positive returns on assets since 2007. Where Table 3.3 placed Uomo and WMG in different sectors when their size was compared, their return on assets, or lack thereof, is a closer measurement of the two firms. Table 3.4 shows that neither firm has done well with converting their investments into profit.

Table 3.4

Fiscal Year	ROA: Warner	ROA: Uomo
2006	1.33%	-.102%
2007	-0.46%	-1.22%
2008	-1.23%	-16.415%
2009	-2.34%	-.52%

Table 3.4. ROA Comparison

A firm's earnings before interest, taxes, depreciation, and amortization is referred to as the EBITDA margin. This indicator is a good way to compare profitability between companies because it does not include accounting or financing decisions (Williams, Haka, Bettner, & Carcello, 2010). When comparing the EBITDA margins between WMG and Uomo, Table 3.5 is fairly simple to observe and compare the companies' profitability. WMG shows profitability from 2006 to 2009, whereas Uomo does not. Since WMG is an older, more established firm, it could explain its profitability. Uomo, on the other hand, was established in 2004 as "First Source Data, Inc." with a different strategy and purpose and as stated earlier in the chapter, has not been profitable yet.

Table 3.5

Fiscal Year	EBITDA: WMG	EBITDA: Uomo
2006	13.62	-2.5
2007	12.44	-197.58
2008	12.06	-----
2009	11.52	-43.66

Table 3.5. EBITDA Comparison

Overall, these data points show the profitability of Uomo and WMG. Even though the sound recording industries' revenues have fallen, Uomo has exceeded in gaining market share yearly. This is evidence of the few barriers to entry that are in place due to changes in technology. Uomo is having no problem expanding.

The way the music industry has received revenue has been changing. Figure 3.3, located on page 33, shows the distribution of revenues in the music industry as a whole and how the percentages have been changing.

VI. Intellectual Property Rights

Uomo Media Inc. (Uomo) has no patents or trademarks. They intend to acquire entertainment-related intellectual property rights, including publishing and copyrights (*Uomo Media, Inc. Annual Report*, 2008).

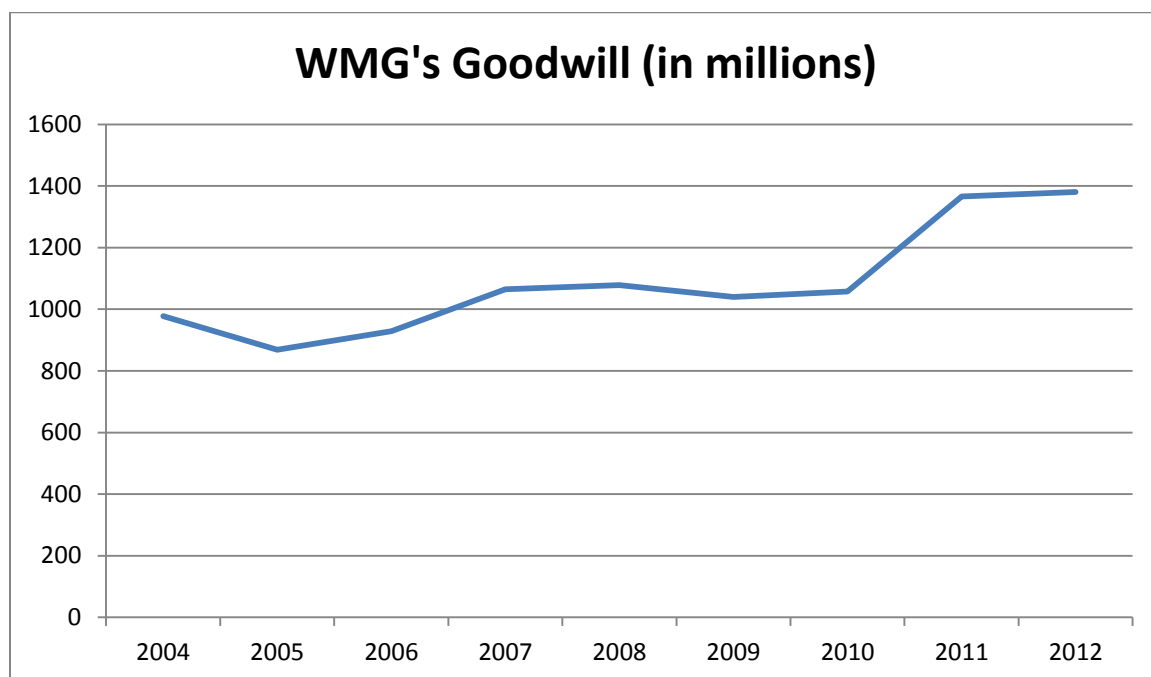
VII. Response to Changes in Technology in the Music Industry

WMG is committed to keeping up with the times through technological advances within the music industry. As stated in WMG's annual report in 2008, "WMG grew revenue by 39% to

\$639 million (or 18% of total revenue) in fiscal 2008, and in our U.S. Recorded Music business, digital represented 28% of total revenue” (p.4). WMG’s subsidiary, Atlantic Records has also taken advantage of digitalization, by being the first major label to accrue more than 50% of music sales from digital products. Atlantic also had the most albums sold digitally over physical albums sold by any of the other U.S. major music labels. WMG also recognizes that social networking websites such as MySpace could help increase their revenue stream as a “powerful way to monetize content” (*Warner Music Group Annual Report*, 2008, p.5).

Warner Music Group started offering DRM-free audio downloads, meaning there are no restrictions to how many times a file is shared, on Amazon in December 2007. WMG is considered to be a leader in the transition into the digital era by focusing on their distribution channels, and also by “establishing a strong partnership portfolio” and by introducing and updating products and initiatives (*Warner Music Group Annual Report*, 2008, p.10).

Goodwill accounts for the value of intangible assets of a firm. It measures the overall value of a firm instead of just tangible assets (Williams, Haka, Bettner, & Carcello, 2010). WMG’s Goodwill, the value of intangible assets, shows the firm’s value through the changes in technology within the music industry. From 2010 to 2011, they had an increase from \$1,057,000 to \$1,366,000.

Figure 3.2**Figure 3.2.** *WMG's Goodwill*

Since Uomo Media (Uomo) is dedicated to the promotion of digitalization, their spending on research and development reflects that. From 2006-2007, they spent \$19,200. From 2007-2008, they spent \$9600, but from 2008-2009, they spent nothing on research and development activities (*Uomo Media Inc. Annual Report, 2008*). Unfortunately, WMG's Research and Development costs could not be found. However, their investments were. In 2008, their investments were \$155 million. In 2009, it dropped to \$18 million, and dropped to \$9 million in 2010. These decrease in investments show that WMG is cutting back on their investments, maybe in technological aspects as well.

The Internet has exposed fewer barriers to entry to new competitors in content industries. These industries responded to this new issue created by technology with more technology, digital rights management (DRM). Neuman (2010) describes DRM technologies as technological

measures that give creators of the content control over the use of media by their consumers, forgoing legal rules, such as copyright law, that have historically protected relations between consumer and producers of creative content. In the most basic sense of digital rights management, “its purpose is to limit consumers’ ability to copy and distribute protected works” (p.180).

Digital rights management may not be law, but over the past 20 years the content industries have dictated how digital media can be used once purchased and in their possession. The Audio Home Recording Act (AHRA) required some digital media devices to obtain special government-mandated copy-protection technology. In 1998, the Digital Millennium Copyright Act was passed, gave DRM restrictions implemented by private firms the “force of law” by creating criminal and civil penalties for those who bypassed the limited ways allowed to enjoy purchased digital media (Neuman, 2010).

As discussed in the literature review, new technologies that are mandated may be disruptive if the technologies do not evolve from older technologies. So is the case with digital rights management. The design control was placed in the hands of the government because it was believed that the future of the content industries may be in jeopardy without some sort of interaction from the government (Neuman, 2010).

VIII. Competition

Warner Music Group competes based on price, marketing and promotion, and recording artist and songwriter signings. WMG depended on technological development, “selection and viability of new technologies”, and pressure from competitors from their technological development (*Warner Music Group Annual Report*, 2005).

Uomo Media, Inc. is dedicated to being a contender in the music industry. First, by positioning themselves as a vertically integrated company, they wish to be seen as a multi-platinum new media company through the implementation of a business model that contradicts the old marketplace. They believe they have a competitive edge as they are the only ones doing this. This can differentiate Uomo by being innovative (ideas). Because Uomo Media Inc. is a smaller firm, they have fewer disadvantages in comparison to larger companies. Because of their small size, the firm is more flexible and is not at the point where they need to fight being stagnant (*Uomo Media Inc. Annual Report*, 2008).

IX. Growth

Uomo Media, Inc. intends to grow mainly through acquisitions of established composers' back-catalogues (*Publishing*, 2009). Uomo's strategy to grow through acquisitions is reminiscent of what was popular in the music industry from the late 1990's, consolidation. This was a way major firms could "claim bigger market share, streamline their options by cutting overlapping positions and payroll, and explore new revenue streams" (Kot, 2009, p.7). A merger between PolyGram and Universal left five multinational conglomerates to run an, at the time, \$14.6 billion per year industry. One of the consequences of this strategy was an increase in the price of music. The prices of compact discs reached \$19, an all-time high. At the same time, manufacturing costs of compact discs decreased because along with consolidation, came a pressure to make a higher profit. Multinationals were run by their shareholders, who wanted returns to justify their investment (Kot, 2009).

There are many different factors that contribute to lower barriers to entry in the music industry. Uomo Media Inc. changed from a consulting firm to an entertainment managing firm

fairly easily with few barriers. Although Uomo only possesses a small share of the market, they have only been established since 2004. WMG remains one of the “big 3” recording firms and will remain so through acquisitions and mergers with other firms. Uomo hopes to do so also through mergers and acquisitions, as stated in their annual report. But, how has technology affected these barriers? As stated previously, illegal file sharing and piracy have contributed to drastic falls in the music industry’s revenues as a whole. Looking back, it may be easier to enter the music market now, but the market itself is half of what it used to be. There is a clear trade-off here. New firms can have small market share of a smaller market, or no market share of a large market, if not for piracy and illegal file sharing.

Both firms’ strategies mentioned earlier in the chapter were to expand from the traditional business model. Uomo’s strategy has been successful in the sense that the firm has gained market share. WMG has been successful in keeping their large market share and having a positive EBITDA. Research and development from the two firms show that through the years, the money used for R&D has been dwindling, which is not a good sign for an industry continuously going through changes. With all things considered, WMG has a more sound strategy, since taking advantage of new distribution channels and consumers’ access to music through the Nokia “Comes with Music” and Sony Ericsson’s “Play Now Plus”. This is evidence of WMG responding and thriving in new technologies.

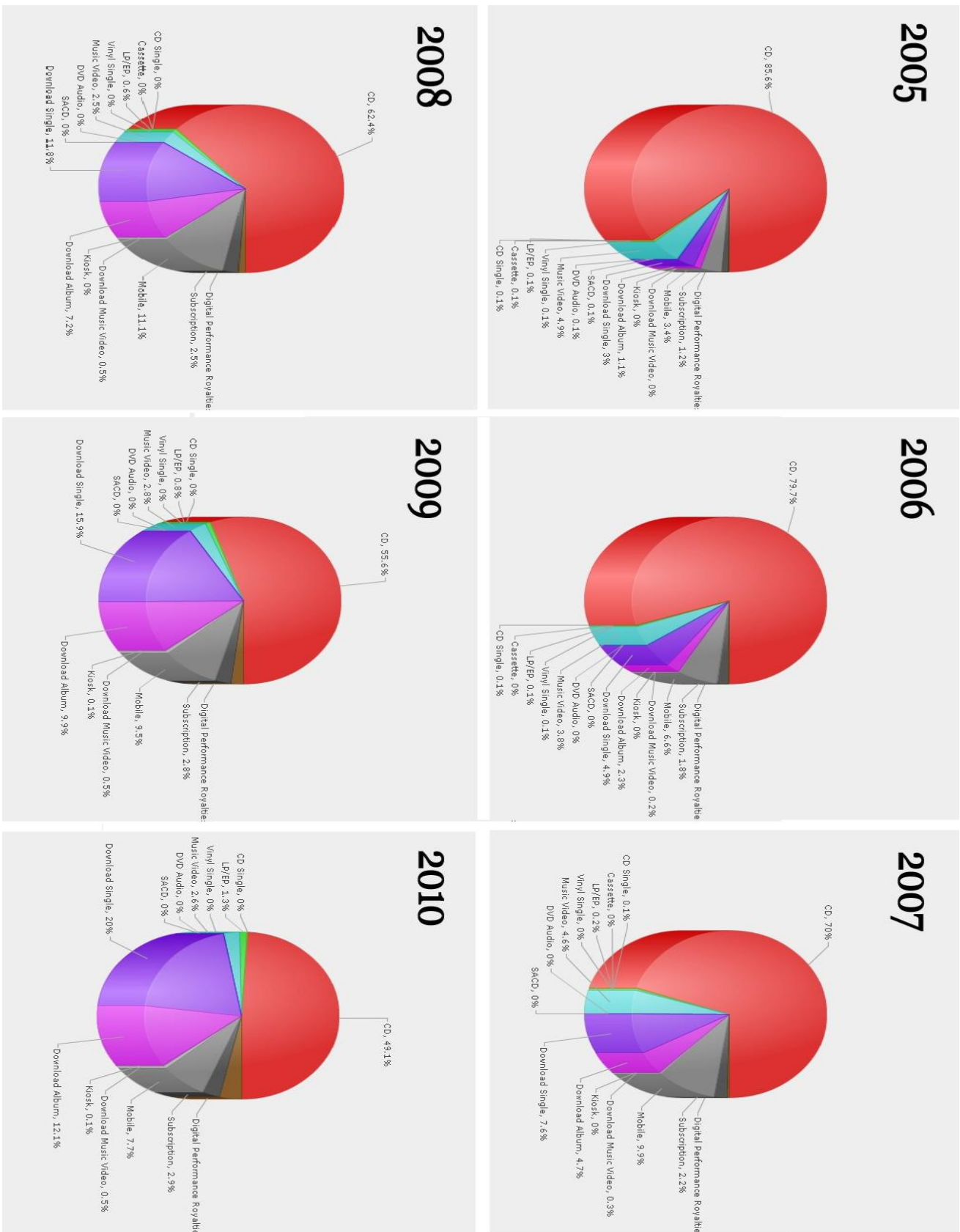


Figure 3.3. Revenue Contribution in the Sound Recording Industry from 2005-2010
Source: Digitalmusicnews.com, 2011

CHAPTER IV: CONCLUSION

The purpose of this study was to understand how changes in technology have affected new entrants in the music industry. Two firms in the music industry were studied and compared: Warner Music Group, a member of the “Big 3” multinational music firms and Uomo Media, Inc., a relatively new entrant in the music industry. Empirical data was found through both firms’ annual reports, the statistical abstract of the United States for information on the industry as a whole, and data from Mergent Online. Performance indicators were used to evaluate the success and other implications of the firms.

The literature analysis of the study suggested that when new technologies are introduced, there are lower barriers to entry for new entrants, along with the notion that larger incumbent firms have a difficult time adopting new technologies. My research suggests that there were lower barriers to entry for Uomo Media, Inc. (founded in 2004). It also argues that, although Warner Music Group is, by definition, an incumbent firm, their technological aspects have been continuously expanding, which contradicted the literature review. Because WMG is a larger firm, they have more options when it comes to acquiring new technologies.

The popularity of piracy and illegal-file sharing complicated this research. In the literature review, destructive technologies were discussed. In the music industry, piracy and illegal-file sharing were a part of this. The music industry revenue has decreased by half in the past decade, mainly because of the increase of illegal downloads and distribution.

Overall, what was discovered in this study was that if music firms intend to keep a competitive advantage, they must adapt to new technologies by changing their business models to one that takes advantages of new technologies, such as the Internet. Other ways music firms adapt is through how consumers connect to music. Music now reaches consumers through film,

video games, social networking sites, and ad-generated sites. Firms may receive more revenues through licensing and ad-generated revenues. In an industry that is always changing, growing, and evolving, it is imperative for firms to recognize the advantages of changing and expanding into different and new channels.

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