MusicRow
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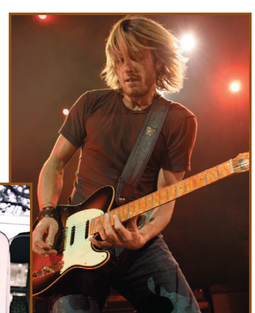
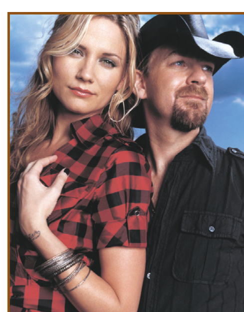
Special Report

Embracing Change

The New Rules Of Engagement





August 2007

The Digital Age: A Brief History

Think Tank Forward by David M. Ross

Once upon a time, years ago, the music was locked up behind bricks and mortar. Labels controlled where, when and how consumers were able to access it. Then came the Internet and the rise to power of the mysterious Lord Digital. Soon afterwards the digital lord spawned MP3, and in so doing, cleverly cemented his control over music in the Internet domain.

Labels soon felt the disruptive power of MP3. The locks were broken forever, and the music business model which was producing great wealth began to unravel. Consumers behavior began changing as they eagerly embraced the new digital offerings, but the labels remained steadfast in denial. Little by little cracks appeared in the relationship brought on by the consumer's newfound ability to experience and share music differently than ever before. Labels responded by choosing litigation as a means to suppress change and fight the growing wave of illegal downloads.

Unit sales tumbled, but industry gurus called it "another cycle." Label advisors recommended Digital Rights Management promising, "It will return everything to normal." Regrettably, DRM didn't improve business, but it did make everyone angry. Sales got worse, revenues continued dropping and mass merchandisers demanded to sell the music at lower prices to boost demand. The industry capitulated and watched margins plummet. People lost jobs, record stores closed, major labels disappeared, but still the business mostly kept to the old ways. Yes, there were experiments with new media and Internet marketing, but few if any companies adjusted their fundamental underpinnings. Multi-platinum sales were becoming scarce, but many defiantly clung to the old model, built to support a multi-platinum world.

Most confusing was the fact that music was more popular than ever. Digital music players were driving consumption of music to new heights. Successful artists were still making money on tour, through sponsorships and from music publishing, but companies relying exclusively upon record sales for revenue were finding it harder to survive. If revenue streams were like cards in a deck, then to survive companies were needing a selection of cards to hold a winning hand.

By mid-2007 with YTD country music sales down 29.3% and overall industry sales down 14.2%, industry and artists were realizing that change was inevitable. New rules of engagement were needed to channel Lord Digital's power to create prosperity and peace.

Inside The Think Tank

During July 2007 *Music Row* hosted three weekly think tank sessions with **Todd Cassetty—**President Hi-Fi Fusion/Verberate; **Scott Heuerman—**Director of Business Development for Musictoday; **Jim Beavers,** Songwriter, Sony/ATV; and **David Gales—**Principal Consultant, The Gales Network. In addition to strong technology backgrounds, the group possesses experience with small, mid-size and large record labels, management, publishing, marketing, record promotion and many other facets of the country music industry.

GOAL: To examine the associated costs and profits required for country music success at various sales levels and identify a new tool set to help tomorrow's country industry partners adapt to the changing marketplace landscape.

Jim Beavers–Songwriter, Sony/ATV Music Publishing

In every other industry, almost without exception, the end-consumer is king. I rarely hear us talk about what our customers want. Instead we talk about what the artist wants to say, radio wants to play and retail wants to pay.

Big songs and big ideas will beat a big budget every time.

David Gales–Principal Consultant, The Gales Network

No ingredient is more important to a viable, profitable, sustainable music industry model than artists with clearly defined, authentic brands. This is an area of focus that, in recent years, has been unevenly applied in Nashville.

By reallocating creative assets to embrace new recording technology, investing in more efficient product distribution and re-evaluating promotion and marketing expenditures, we can make our current business model somewhat more workable. However, the real asset shift needs to be in mindset. Our future depends on a dramatically different approach where we develop musical brands and exploit them in many different ways, rather than simply through albums or singles."

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Scott Heuerman–Director of Business Development for Musictoday

Artists and organizations walking away from traditional deals with big money attached, in favor of control and a bigger share of the back-end revenue are going to re-define this business.

The advantage will be to the artist or organizations that change before they are forced to. Already there are developing and established artists that are thriving because they have structured their businesses to better fit the needs of their fans.

Todd Cassetty–President Hi-Fi Fusion/Verberate

We hear it all the time—"You have to spend $500,000 to break an artist at radio" …or $1 million…or whatever. Today's record contracts should include detailed scalability instead of committing so much up front. In other words, outline agreements so that they flow like a decision tree. If the first single does X, you move forward to Y. If Y is a success, then Z. If all parties know what's expected, labels reduce their financial risk on the front end and artists will always know where they stand. Benchmarks make for good business.

There is no more "standard operating procedure." R.I.P. S.O.P.

—Thoughts From The Think Tank—

Five New Rules Of Engagement

and ways to use them...

Redistribution of Risk and Reward.

Less up front fees in exchange for greater back end participation.

—So the publisher can say, sure I'll give up some promotional royalties, but give me a point on the record.

—We need to create scalable deals with adjustable core services and expenses. Traditionally you get in business with an artist for multiple albums—the investment is a building process. But look at the movies. They are often one project deals. Maybe the music biz model will get closer to that. It could mean one album or even one single deals. But like films there will be options attached. No studio puts money up against something if they don't have the option to do *Superman 2,3 and 4.*

Artist development costs must be flexible and scaleable.

One size does not fit all artists.

—The audience is becoming interested in an interactive experience as opposed to a presented experience. People are already showing each other TV shows on their cell phones. Fidelity is not high on the list of young consumer issues for audio or video. For example, you're better off having a low cost camera and being able to add new video content on a constant basis. If you aren't using a computer to do it, then you aren't using the new tools. Bottom line: Videos often cost too much. They need to be adapted to a broader variety of applications for use across a wide range of technology. Don't think only in terms of one music video and two channels.

—The market has spoken. They aren't against albums, but they are pro choice. Some people want albums, but a great many want singles. Some don't even want singles, they want master tones or ring backs or wallpapers. Flexibility is the key. We have reams of research that says people enjoy consuming music. We have to disabuse ourselves of the notion that the only way we can serve it to them is in an album format. Whether that means three singles bundled with a ticket or a ticket bundled with a t-shirt or an album with a ticket to a movie. We have to be open because there is not enough margin in our product anymore to make it a stand-alone.

Redefining relationships and the balance of power.

Deal points are no longer sacred.
Everything is negotiable.
No rules is the new rule.

—Smart managers are seeing themselves as brand managers. They develop and invest in the artist, which is the brand. The power is going straight to the managers because they steer, control and nourish brand growth. Eventually the manager will go to the record label and say, "Hey we are going to handle most career aspects. Therefore you have to take a lower cut on your end, for assuming less risk." The fallout in this town from that kind of change could be astronomical. Labels will have to reprogram their own DNA.

—There is still a lot of rigid habitual behavior that needs to get broken up. And it may not happen voluntarily. Deal points are no longer sacred. It's about redefining the specific terms of what each relationship will be, who invests what amount and handles what functions.

—Many in the creative sectors feel the A&R function at the labels has lost its ability to work in this town.

The artist is a brand.

Identify your brand.

—Artists need to identify their brand and constantly reinforce it. Good examples are Dierks Bentley, a modern day drifter, young hip but a little dangerous; Kenny Chesney with the beach party; Toby Keith, the patriotic badass; and witty, topical Brad Paisley. But there is also a group of male one hit wonders that don't have strong brands and therefore can't translate that one hit into a career.

—Loretta Lynn identified her brand as the Coalminer's Daughter and it has carried her for 50 years. Identifying the brand doesn't mean that it is the only concern, but if you look at artists that have endured, they all had what we now call a brand; Johnny Cash was the man in black; Waylon the outlaw…

—You can't afford to be in business with somebody that you have to teach to be an artist.

Profitability.

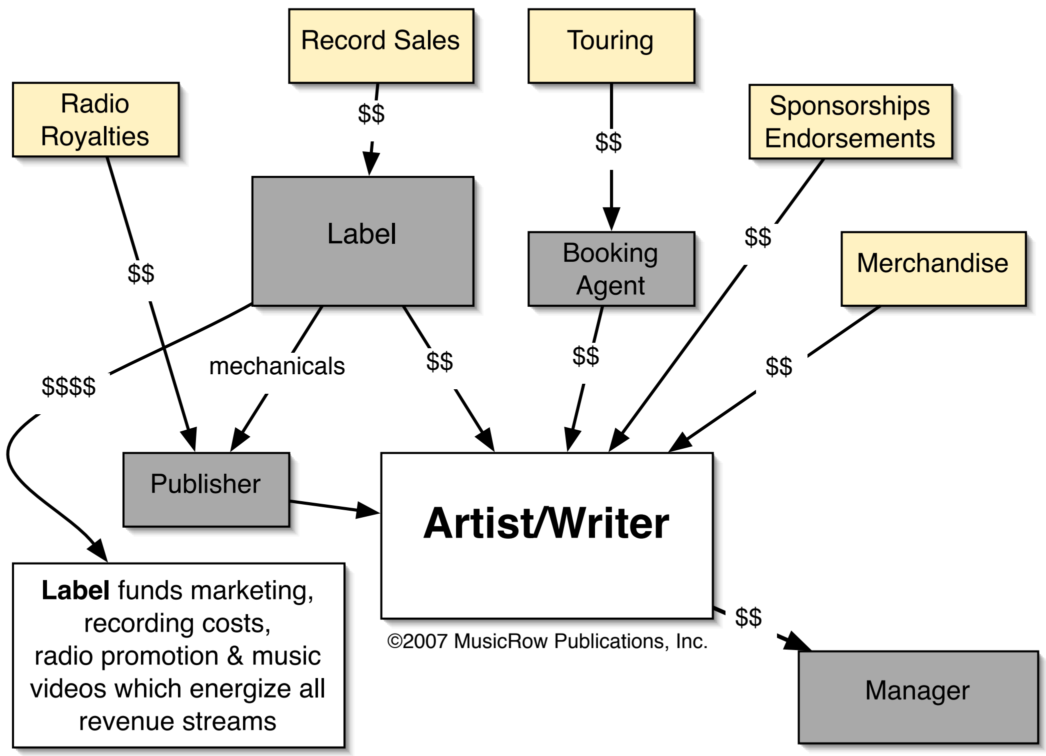
The new #1 party to celebrate.

—For first time people outside the music business seem to have a better handle on how to exploit music. We are seeing media marketers like Starbucks eat our lunch. That's scary. It isn't just about models, it is about rebuilding how we view our industry. It will still be music centric, but that's about all we can take from the old industry. It's going to require a massive change of point of view.

—Everyone is obsessed with getting a No. 1 radio hit in Nashville. You don't hear about that anywhere else in this business. Profitability should be the new No. 1.

—One thing hurting revenue is the exorbitant costs of supplying an antiquated distribution mechanism that the industry hasn't done enough to renovate. We are still waiting for digital to catch up with physical sales like it is up to some external entity to do it. Music is one of the most exquisitely designed digital products on the planet, but we are still moving these pieces of plastic around at ridiculous costs and inventory...

Music Industry
Traditional Revenue Model



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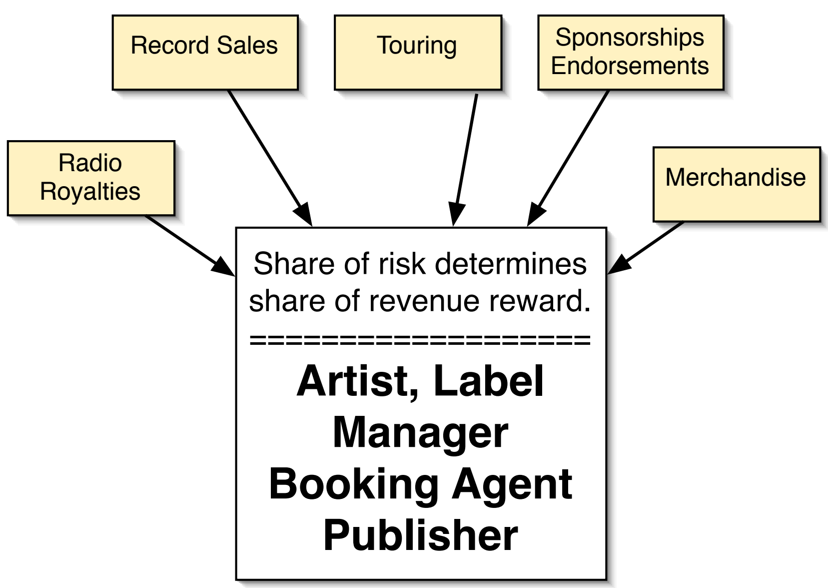
Music Industry
New Rules Of Engagement
Revenue Models



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Big Machine's Scott Borchetta Playing By The New Rules

by David M. Ross

Scott Borchetta, has played by the rules, broken the rules, bent the rules and at times made the rules. A tough competitive spirit, Borchetta came up through the radio promotion ranks, becoming MCA Sr. VP Promotion in 1995. In 1997 he helped anchor the birth of DreamWorks Records Nashville as its Sr. Exec. of Promotion & Artist Development and played a major role in the success of artists such as Toby Keith and Darryl Worley. Armed with experience in a variety of label situations, Borchetta took the plunge about two years ago and formed Big Machine Records, named for his love of NASCAR Super Truck division racing in which he races. Elated to finally be in the driver's seat, the promoter graduated to President/CEO. In many ways, the new venture is living up to the hype. Seventeen-year-old Big Machine artist Taylor Swift was the perfect prototype for new ideas. Young, talented, photogenic and a genuine member of the MySpace generation, Swift used the Internet to fully leverage her Platinum success. Soliciting some real world response, Music Row asked Borchetta to comment on some of the ideas presented in this Think Tank report.

MR: The country music label business model was geared to multi-platinum expectations. As a result large upfront payments to producers, lavish recording budgets, expensive music videos, radio promo visits, free shows and tour support were easy to rationalize. What about now?

Scott Borchetta: Living this label now for two years and seeing what it costs, even at our level with 14 employees and being very frugal, is an eye opener. The days of inflated up front spending have already ended. Companies still participating in that system; well, draw your own conclusion. They are dead men walking. To play this game a successful label must have at least one platinum selling artist or else they are in trouble. There's not a promotion department in town that isn't worth a million bucks—salaries, expenses, etc. And that's just to keep them going for a year. The artist costs and everything else is extra. We've been fortunate in that we broke even our first year and will be profitable in our second year. Thankfully, we've added Trisha, and Taylor will be double platinum this year. For some of the companies in town, those lean early years mean it will take them more than one platinum record to dig out. Luckily we don't have four or five years of debt to pay off. I'm not taking anything for granted, but as lean as we run and with the product we have coming out, our next 18 months are going to be fantastic.

MR: Discuss the importance of the artist brand.

Scott Borchetta: Some of the emerging record and management companies are starting to look similar although there are things we can do as a record company that they aren't good at and vice versa. The point is we are both looking at artists as brands—whether it's a new discovery, development mode like Taylor Swift or a brand like Trisha Yearwood which has a lot of value that still remains untapped. What we can offer as a label that management companies can't, is real marketing power in the record business. There's always been a consultant piece to the puzzle that I've provided. And now that component does have a value and return on investment. So we have a conversation with our artists early on. If you come here you get the brainpower and blood of this whole company. In exchange, when we take you from 0 to 200 miles an hour, we are going to share because you probably can't get to 200 miles per hour without us. If they don't get it, then we shake hands and say, "Good luck." We also have to be willing to walk away.

MR: Should booking agencies share some of the artist investment costs traditionally borne by the labels since agencies benefit greatly when a label is successful with an artist?

Scott Borchetta: Any of the agencies will tell you that until your act gets to an established position, it costs more money for them to generate contracts than they get back from these small paying dates. CAA has been extraordinarily fair with Taylor in the start up process. They see what is coming later. But in the real world, there is going to have to be a different way of doing things. If it costs so much to create contracts, then fix your contract, find a cheaper way. There will need to be different levels. You can't take a dollar where there isn't one.

MR: Is audio and video quality still important?

Scott Borchetta: We are at the lowest fidelity moment in our lifetime, right now. It's about sharing the moment, not about quality. People are listening to MP3s on cellphones and watching video on YouTube. Plug in and see what's going on. It will get better because that is how we will continue to turn people on. "Have you seen it in high-def? Heard that track in surround?" But it makes no sense at all for me to spend that way early on.

MR: Should we be more focused on profits and sales, instead of airplay parties?

Scott Borchetta: It is always nice to high-five everyone, but the real victory is in the consistency of building these wonderful careers. Career celebrations are probably more important within a small group. I loved the moment that we were able to share with the town when Taylor went gold. That was a big moment for us as a company and for her. But while it is a nice achievement there are a lot of records that go to No. 1, that are anything but profitable. I've been part of some of them too. I don't really care about parties, but I do care about my artists being happy.

MR: Has the music industry reacted well to the changes around us?

Scott Borchetta: As an industry we've done a tragically terrible job of preserving what we do. We haven't fought back. I'm not trying to save an old dead technology because digital discs are going to be around for a long time. Whether they are prerecorded and packaged with music or they have DVDs on them or whatever...they are going to be around for a while. Shame on us as an industry because we've allowed the evening news to say "CDs are dead." And we didn't go and fight them. CDs aren't dead, we are still selling them millions at a time. Why don't we have a campaign with Kenny Chesney, Taylor Swift, Big & Rich, and Carrie Underwood saying, "Hey I've got an iPod in this hand and a CD in the other, CDs are still cool." If our cool kids are saying it—people will believe it. Taylor Swift still buys CDs and iPods and I see little girls in her line that say, "I downloaded three songs and loved it so much that I went and bought the CD." Another issue is the fact we don't have many record stores left. The experience we all grew up with of spending the afternoon browsing music in a record store, doesn't exist anymore. So let's wake up. Yeah, sales are down. But how many stores do we have? I wouldn't be surprised if some smart young business person finds a way to open 25 or 30 wildly successful new CD stores. Because there is an audience for them.