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Restructuring the Recording Industry: Are EMI's Problems a Warning Sign for Others in the Music Industry?

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PART I

History

For more than forty years, EMI has been one the most innovative companies in the recording industry. Today it is part of the major five, together with Sony, Vivendi Universal, BMG and Time Warner AOL.

EMI, which stands for Electric and Musical Industries, was created in England in 1931 by the merger of The Gramophone Company and The Columbia Gramophone Company. In the same year EMI Scientist Alan Blumlein patented the technology for stereo sound. By 1940, the company was leading the music industry in appointing its first A&R managers—among them George Martin, who went on to sign the Beatles. The company became a truly multinational corporation when it acquired Capitol Records in 1955—one of the largest record labels in the U.S. whose roster included Nat King Cole, Frank Sinatra, and Peggy Lee. (O'Connor, 2002) EMI's expansion continued uninterrupted into the 1990s, when it bought Virgin Records from Richard Branson in 1992.

By the summer of 1998, however, sales began to decrease, and EMI began to restructure most of its corporate entities and carry out major changes in its management strategies. First, EMI re-engineered its distribution plant in Jacksonville, Florida, consolidating both distribution and manufacturing into one building. Then, in July 2000, it revamped its policies concerning catalog, moving away from a three-tiered catalog program to an ongoing discount of 4% (with an extra 30 days dating for front-line catalog) and a 7% discount for mid-price titles. (Anonymous, 2001) EMI was able to offer these incentives thanks to its vast catalog. This move was extremely important, since the company at the time generated 85% of its profits from recording sales. Finally, in September 2000, EMI and Time Warner began talks on a $20 billion merger. (Masson, 2001) It was the first sign that EMI as a company was ready to consolidate itself with a general entertainment

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corporation. However, on October 5, 2001, it was announced that merger talks had ended due to the European Competition Commissioner's report on the possibility of antitrust violation. Later that same year, Time Warner announced a $135 billion merger with AOL. With the collapse of the Time Warner/EMI merger, rumors soon abounded in the industry about a possible merger between EMI and BMG. Once again, the potential for an investigation by the European Competition Commissioner ended all negotiations between the two parties. The Commissioner, Mario Monti, had made it quite clear that he would not accept further consolidation among the top record labels and warned that, if the negotiations continued, he would deny both mergers. The commissioner's objections were based on several potential outcomes of the mergers. Among them, he feared that the new corporate entity would constitute an "impregnable manufacturing and distribution collective with oligopolistic tendencies including the fear of price fixing." (Masson, 2000) This, in turn, would create little incentive for the major record companies to compete on price, thus passing costs onto the customer in the form of higher retail prices. The commissioner also mentioned that the resulting structure of the recording industry would create greater barriers for independent companies (independents currently control 20% of the market) to compete against major labels or enter their traditional markets. A smaller number of major record companies would also reinforce the trend toward higher promotion and marketing expenditures, creating further barriers for entry.

Last January, EMI faced the need for a further restructuring in light of the failed mergers, the economic downturn in its largest market—the United States—and the damage inflicted by Napster and similar computer file swapping sites. EMI's pre-tax profit before goodwill and exceptionals for the year up to March 31, 2002, was 160 million pounds ($213 million). (Potter, 2001) Despite the company's strong performance in Europe this result was below analysts' forecasts, which previously ranged from 160 to 207 million pounds. Furthermore, during the second half of the 2001 fiscal year EMI suffered from the continuing economic downturn in Latin America, Asia—where some Japanese album releases were moved to the following fiscal year to cut costs, and a lackluster market for recorded music in the United States. Thus, in October 2001, EMI was forced once again into a management change (Alain Levy replaced Ken Berry) announcing a restructuring provision of approximately 100 million pounds ($143 million). (Masson, 2002) Part of that restructuring process included the firing of

some 6,000 employees and the elimination of various labels and artists from their roster. (Before this restructuring, EMI had some 70 labels and 1,500 artists). On February 15, 2002, top executives announced that EMI would no longer exist as a single label, but divide itself into two worldwide brands: Capitol and Virgin.[1] Following this announcement, analysts downgraded the stock over concerns about EMI's direction and the possibility of loss in pretax profits for 2001 of 229 million pounds and in cash flow of about 345 million pounds—about 20% less than the previous year. (Masson, 2001)

What caused a powerhouse of the recording industry such as EMI to fall into such great financial difficulty and be forced to take such drastic measures to remain solvent?

Economic downturn and September 11

EMI's story is somewhat emblematic of trends in the entire music industry. Since 1996 recording companies have seen a decrease in the profitable margins experienced throughout the 1980s. 2001 was one of the worst years on record for the industry, due in part to the worldwide economic downturn, a lack of major hits, and rampant piracy. In the 1980s, the recording industry enjoyed one of its most profitable decades in history thanks to the conversion from LP to CD. With the economic downturn of the early 1990s, however, the music industry had to rationalize its operations. During this period many of the major recording companies were sold to conglomerate multinational corporations with diverse interests in the entertainment sector. For example, in 1988, CBS Records was sold to the Japanese electronic giant Sony for $3.5 billion. In keeping with its expansion into various sectors of the entertainment industry, Sony purchased Columbia and TriStar Pictures, the film division of CBS, in 1989 for $4.5 billion. (Walcholtz, 2001) RCA, in turn, joined forces with Bertelsmann Music Group (BMG), a division of the German publishing/entertainment company Bertelsmann AG. The most dramatic example of a record company merging with diverse entertainment-based corporations was the union of the Universal Music Group with Vivendi and Canal+ of Paris. Vivendi was able to purchase Universal from Seagram Inc. (a Canadian company renowned as the world's leading distributor of liquors) for $40 billion in June 2000. (Walcholtz, 2001)

These purchases/mergers were probably facilitated by the economic boom of the late twentieth century. In that period, the Dow Jones industrial

average reached a high of 12,000 while the NASDAQ industrial average (trading technology-based stocks) reached a high of 5,000. (Yahoo, 2002) However, this economic gain had a darker side. In 1999, Asia—and especially Japan, the third largest music market, began a downward economic slide that affected also more volatile areas such as Latin America. The direct consequence of this economic slowdown was a slackening of the demand for music. Thus, in 2002 EMI reported that the 19% decline in its operating profit was largely due to weakness outside the U.S. (White, 2002) Soon, the United States economy—affected by reduced consumer confidence—also began to show signs of cooling. But the greatest shock came on September 11, 2001, with the terrorist attacks on New York and Washington. After the attacks, the Dow Jones average lost 3,500 points from its high of 11,765 on January 2000 and the NASDAQ nearly half of its value[2]. Among major-label and major-media stocks, the EMI Group, AOL Time Warner, and Sony all suffered a decline of at least 30% in their stock price. Drops in Viacom and Vivendi Universal stock were somewhat mitigated by a fourth-quarter rally that raised the Dow Jones Industrial Average and NASDAQ Composite to pre-September 11 levels. The economic downturn was directly reflected in a decrease in music sales. Whereas 'NSync, Backstreet Boys, Britney Spears, Eminem and Limp Bizkit all posted debut-week album sales of more than 1 million units in 2000, only one act—'NSync—managed the feat in 2001, with opening-week sales of 1.88 million for its "Jive Set Celebrity." (Garrity, 2002) New albums from Spears and the Backstreet Boys failed to match 2000 sales marks, and new albums from established acts like Michael Jackson, Garth Brooks, Madonna and Jewel, while posting solid sales, did not prove to be major break-out hits.

Although the economy has a major influence on the shape of the recording industry, other factors also influence the way in which the industry is developing. Many record companies are merging with corporations that present diverse portfolios in the entertainment industry including computer and video games, film, electronics and the Internet. Music is now seen as only part of diversified conglomerates that compete to gain hold on shrinking leisure time.

Napster, pirates or prophets of your leisure time?

On November 2001, the U.S. Court of Appeals for the 9th Circuit affirmed a preliminary injunction against Napster, finding that it was likely to be liable for contributory and vicarious copyright infringement. (A&M

Records Inc. v. Napster Inc., 239 F.3d 1004 (9th Cir. 2001)). Napster was found to be a vicarious infringer because it had the right and ability to supervise use of the service and because it benefited financially from the infringing activity. Many in the record industry and the RIAA (Recording Industry Association of America)—who spearheaded the attack on Napster—viewed this a victory for the traditional method of distributing, selling and collecting royalties. However, what Napster had done was to show to the recording industry the potential for Internet-based music distribution and sales, even if the sector was struggling from a lack of venture funding and self-sustaining profits. As a result, the major record companies are currently developing new Internet-based methods of selling recorded music. In 2001, media giants and their music divisions have began to emerge as consolidators of Internet space. Vivendi Universal, parent to Universal Music Group (UMG), acquired MP3.com in May 2001 for $300 million, along with EMusic.com and Rollingstone.com. Universal also acquired from BMG an additional 50% of GetMusic to give it controlling interest in the company. (Garrity, 2001) Vivendi consolidated its Internet properties into a single operating unit called Vivendi Universal Net USA. BMG, not to be outdone, acquired myplay.com and created its own Internet music-operating unit called BeMusic, which includes online retailer CDnow and BMG's music club. (Garrity, 2001) The five major record companies have also been spending millions of dollars in research and development for digital music-subscription services. Warner, BMG and EMI announced a joint venture with Real Networks to create a subscription service known as MusicNet, while Universal and Sony announced a rival joint-venture subscription service known as Pressplay. (Marr, 2002)

To merely blame the Internet for the decrease in record sales would be presumptuous. In recent years, the entertainment industry has gone through some major changes. To begin with, as Harold Vogel writes, leisure time in recent years has expanded very slowly or not at all. (Vogel, 1992). Apart from the introduction of the Internet, there has been an explosion of options available to people on which to spend their free time. The recording industry, which had a quasi-oligopolistic status several years ago within the electronic entertainment industry, together with TV, film and radio, must now compete with new entertainment products and services for the public's time and discretionary income—especially in the 17-25 year-old market, the backbone of the entertainment industry. The entertainment market today is fragmented into several competing segments, including

cable television, satellite radio, film, Internet, video/computer games and, conceivably, sports. The video game industry has recently evolved to include two new products to rival Nintendo's market-dominating Gameboy: Playstation by Sony and X-box by Microsoft. These two options have helped the industry evolve into a $9.4 billion per year entity in the United States. In December 2001 sales surged 50% higher than the previous year to $670 million. (Kunii, 2002) In contrast the growing market for cable television, which has seen its share of mergers (Disney and ABC Capital Cities joint venture) and takeovers since deregulation has failed to capture a bigger market, but still dominates most people's leisure spending because of higher costs. In fact cable rates rose 36 percent over that period, while overall consumer prices rose less than 15 percent. Cable firms say higher programming costs have exceeded their rate increases, with increased expenses of seven percent expected this year (US News & World Report, 2002). Radio, the traditional promotional avenue for the recording industry, has also witnessed a profound evolution—since the inception of FM some fifty years ago—via the introduction of satellite radio. XM Satellite Radio gained 28,000 subscribers in December, 2001 with 30,000 total since its inception (US News & World Report, 2002) The only other competition is Sirius Satellite radio, which only recently began operations. Although these two companies have not yet posed a direct threat to the traditional radio format, many companies are now considering digital radio as a method of countering the introduction of satellite radio. Finally, although the VCR took 25 years to become a fixture in most homes, DVD players—first sold in 1997 and now in 25% of U.S. homes—could reach that status in only five years. Analysts predict sales of 20 million units for 2002, up from 16.1 million in 2001, and 7.9 million in 2000. (US News & World Report, 2002) Affordable DVD models that also record are not far off and the film industry is closely watching how the music industry is dealing with downloading, both via recordable CDs and the Internet, before wholly adopting the new platforms. Analysts believe that the conversion from VHS to DVD will affect sales of CDs dramatically.

The reduction of leisure time and the proliferation of available avenues of entertainment have affected the operation and structure of recording companies. Many of these companies have answered this change by reducing the size of their staff and their artist roster. Recently reductions in artist rosters have included major artists who traditionally add marquee value to a company.

What role do artists have in a label?

Being signed to a major label is the dream of every artist. However, the reality of signing with a major label may be different from the dream, especially in an economy that is in a slump. In 1999, the $10 billion merger of Polygram and Universal affected some three thousand employees and hundreds of artists. It was predicted that the company would cut at least three quarters of its 1998 roster in an effort to save the newly merged company some $300 million in costs. (Potter, 2001) EMI has followed Alain Levy's restructures of Polygram/Universal and begun to restructure its management and artist roster (including major artists) in a similar manner. David Bowie did not exercise an option to continue to record with EMI. Warner music recently released perennial rock star Rod Stewart after 26 years. For major labels, the price of supporting big name artists—the high marketing costs, demanding contracts, etc.—is often above the risk-reward ratio for an unknown artist. Furthermore, unknown acts often have lower royalty rates than established artists, creating higher returns for the label. The most extreme manifestation of this recent trend toward releasing major artists was EMI's dissolution of Mariah Carey's one-year-old contract. EMI purchased Carey's contract from Sony in April 2001 for a reported $80 million to $100 million, with a signing bonus of $21 million. (Newman, 2002) The purchase was based on Carey's strong album sales, including *Music Box*, which sold 23 million copies with Sony records. (Newman, 2002) Carey's only album for Virgin, *Glitter*, was released on September 11 and failed to sell more than two million copies. (According to SoundScan the album only sold 506,000 units in the U.S. and 2 million units worldwide.) EMI, which had previously announced that it did not pay off artists, reportedly paid $29 million for the termination of her contract. (Newman, 2002) Such artist purchases have been common in recent times. EMI, like many other major labels have paid high transfer fees for artists and have seen lower than expected returns. In 1996 Warner Bros. reportedly paid R.E.M. $80 million. Since then, however, the group's sales have declined. Last year, Arista renegotiated its pact with Whitney Houston for $100 million, even though Houston still had albums remaining on her existing contract. As of this writing no album has been produced. (Benz, 2002)

Many analysts feel that the Carey case is a natural evolution of major labels' treatment of artists. With today's economic realities, artists' careers appear to become shorter and shorter. Several artists have been trying to

reevaluate their roles in the industry by forcing a change in contractual agreements between themselves and their labels.

Artists want changes in contracts

In a strange twist of fate, while EMI was reducing the length of Mariah Carey's contract, Courtney Love has been challenging the legality of California's seven-year contractual code, as part of her lawsuit against Vivendi's Universal Music Group and Geffen Records. A section of Love's suit contends that the present code 2855(B) is unfair since it keeps recording artists tied to contracts longer than other workers in California. In December 1999, Love decided to stop recording for Geffen. Last year, Geffen Records sued Love, seeking millions of dollars in damages for five undelivered albums. Love countersued last year, and last October Judge Fukimo Wasserman allowed most of Love's charges to proceed to trial, including fraud, breach of fiduciary duty, and faulty accounting. She also asked for an annulment of her contract, contending that her recording contract was "unconscionable" and illegal. (Holland, 2001). Furthermore, Love has been joined by AFTRA (American Federation of Television and Radio Artists) and the newly formed RAC (Recording Artists Coalition, which includes Don Henley, Carol King and Sheryl Crow) to press for changes in the California code. In a state, which is closely linked with the entertainment industry, the proposed elimination of the seven-year statute has been supported by several political figures—including Governor Gray Davis—which gives it high visibility in a state closely linked with the entertainment industry.

Economic downturn, introduction of file-swapping sites on the Internet and the expansion of alternative entertainment outlets have placed a great burden on the record industry and artists in 2001. The industry has reacted to these external factors in several ways. The most noticeable reaction has been the elimination of excess operating expenditure, primarily in the form of employees and artists, a reaction that can be clearly seen at EMI. Corporate merging has been increasing over the past few years, especially between the major labels, including the proposed mergers of EMI to BMG and Vivendi Universal. Finally, many record companies have begun to expand into music delivery over the Internet to counteract rampant downloading piracy. The results of these changes have been less than impressive. Artists have reacted by leaving the major labels and forming their own companies or by challenging the traditional relationship between themselves

and their companies, especially their contractual agreements. Stock prices have dropped considerably for the major companies and regulatory bodies, both in the United States and Europe, have not endorsed these solutions.

PART II

Is success still possible?

At the present time, the economy is still sluggish so a recovery to previous highs seems far off. However, few doubt that the U.S. economy will rebound in the next 12 months. The combination of deep interest rate cuts by the Federal Reserve and last year's tax-rate reductions should have the intended effect of refueling the economy. These measures notwithstanding, it is more difficult to make long-term projections about the revenue and profits of record companies than for other firms, because they depend on hits and sales of specific releases, which are often difficult to predict. In addition, one has to take into account that artists often do not meet deadlines (as witnessed with Michael Jackson's recent release). Therefore, a turnaround in the music industry is by no means a sure thing. Finally, we should remember that many of the major labels rely heavily on secondary markets such as Asia and Latin America to boost profits. These markets have recently shown a propensity to be highly volatile.

All this suggests a number of possible scenarios for music companies such as EMI, as well as for individuals involved in the music business. The first scenario involves the continued growth of oligopolistic trends in the music industry, especially between companies that have the greatest share of the music market. Music companies are increasingly merging with conglomerates in which music is only a part of the corporation's overall portfolio. These new multi-entertainment companies are likely to create barriers to the entry of smaller companies into the market, especially as far as the distribution and publishing of music are concerned. This, in turn, might lead to price fixing concerns in the industry. Furthermore, it is likely that many of these companies will continue to downsize their labor force and artist rosters to increase their stock value in the eyes of investors and possible merger partners. In a labor-intensive sector such as music, many analysts are worried about the disruptive effects of laying off as much as 20% of the combined workforce of such companies.

In this new environment, it is likely that record companies will no longer develop deep artist rosters but rely on the acquisition of a few artists

who provide the greatest profit margins for the company. As seen in the previous section, the changes at EMI are consistent with this trend. While this can seem to exploit artists in some cases such deals have made sense. For example Columbia Records re-signed Aerosmith in the mid-90s after the group's successful run at Geffen—especially since Columbia retained Aerosmith's catalog from the band's previous stint at the label. Industry observers suggest that Virgin will make money on its long-term deal with Janet Jackson, which was rumored to be between $50 million and $70 million (Clark-Meads, 1996). Furthermore, major record companies will look toward artists who can provide the greatest profit in ancillary or secondary markets, especially if these companies are involved in those sectors. One recent example of how far companies are willing to exploit artists in other entertainment areas is Britney Spears' new video game. Established artists will be not only judged by their musical talents, but also by how they look physically and by their potential to enter into other forms of commerce. Similarly, the record industry will judge new music and artists on their overall ability to gain profits. Finally, the industry will rely more and more on international sales, and not only on the traditionally safe markets of the US, Japan, and Europe.

As a consequence of these oligopolistic trends, record companies' marketing expenditures in the future will increase, especially in relationship to the total unit cost of production. It is also likely that only a few companies will monopolize music publishing—the European Commission had warned that a Warner/EMI merger would result in the combined company having market share of 30% to 80% in relevant markets. (Masson, 2000) Furthermore, these mega-entertainment companies could act as one-stop centers, bypassing the current collective licensing arrangements for mechanical and/or performance rights. These larger companies would have the greatest leverage in outbidding competitors for big name artists, the acquisition of other publishers and the purchasing of catalogs, all of which require significant capital outlay. Finally, companies will be spending ever-greater amounts of capital on music protection. Label heads point out that file-sharing, CD-burning, and bootlegging are increasingly cutting into album sales. The industry has to develop legitimate online services to eliminate the pirate companies, which currently operate 100% of the Internet trade. The five major music groups—BMG, EMI, Warner Music, Sony Music and Universal Music—who together control 75% of global music sales, grouped into two camps to launch online music ventures. But some ana-

lysts fear that the new platforms—MusicNet and Pressplay—will just end up as PR stunts, given the initial reluctance of record companies to change. Furthermore, the protection technology may not be distributed to all parties in the music industry, further creating barriers between those who are protected and those who are not.

Although many of these features point towards a bleak future for independent labels and artists involved in alternative and non-profitable forms of music, many in the industry also look at the potential benefits from these changes. With increasing standardization of product by these emerging entertainment industries, entrepreneurship will be the key for development of new music and music companies—especially through independent labels. Traditionally, as the market share of certain independent labels rises, major labels acquire those companies, often at a big premium to their fair market value. Recent examples include Priority Records (bought by EMI) and Interscope (bought by Universal). Universal has also entered in negotiations to buy the 40% of Def Jam it didn't own. (Anonymous, 2001) Joint ventures and partnerships are beginning to be seen as a way both parties can coexist in the industry and tap the creativity and resources of top independent entrepreneurs who aren't willing to cash out their companies. Such current 50% ventures as LaFace, Bad Boy, and Loud (all with BMG) have been quite successful for both partners. (Marr, 2002) Furthermore, technology such as the Internet will provide a cheap way of manufacturing, distributing and receiving music without the need to utilize traditional methods dominated by the major labels. In terms of improving margins, online distribution is the ideal format for the top music groups to increase profit margins by cutting costs (not making the CD, sending it out or getting retailers to sell it). In the meantime, EMI and other major labels are looking to exit manufacturing and distribution to cut costs. This offers independent labels the opportunity to deal with a deregulated market, rather than one dominated by the majors.

Contracts and the role of artists still remain one of the most contentious issues for the industry. The mainstream media has pointed to the buyout of Carey's contract as a perfect example of the problems faced by artists nowadays. Even though there is no correlation between Carey's buyout and artists' current attempt to repeal an exemption in California state law, the seven-year statute is a much deeper issue. Simply put, the question is, "Do recording artists deserve the same treatment under employment laws which govern other employees?" Historically, recording deals are made

when an artist is at the top of a career and can, therefore, command top dollar. However, the artist may have already peaked commercially and that can cause problems for the record company. The major record companies expect an artist to sell at least 10 million copies of an album consistently. A direct consequence of this situation has been for well-established artists to start their own labels after they have earned enough equity from working with a major label, as David Bowie did. Artists and creativity are the cornerstone of the industry and major record companies cannot ignore possible new artists and trends in place which affect market share or cash flow. No one expects big artist deals to completely disappear, partly because labels will use them to add marquee value and global market share.

But what of EMI? If EMI cannot merge with any of the other major record companies, it may be open to hostile takeover by another entertainment corporation. It is rumored that Viacom, Disney and News Corp. are among companies considering such a takeover. BMG recently said it was not interested in buying EMI because it did not represent good value, and the other three contenders are currently facing financial problems of their own. Of course, acquiring EMI would come at a high cost. With EMI's value at anywhere between 5 and 7 pounds per share ($7-$10), any bidder would have to acquire major venture capital to offer shareholders a fair market price. Furthermore, clearing regulatory hurdles in the U.S. and Europe would still need major corporate restructuring. Some analysts predict that the company may need to sell Virgin Records to bypass regulators.

CONCLUSION

No matter what happens to EMI, the music industry will survive these latest changes. In the 1970s, sales stalled as the appeal of cassettes waned and many predicted the end of the traditional system of music delivery. The industry survived and rebounded in the late 1980s with the introduction of the CD. External factors will always play an important role in how a company functions in times of economic stagnation, but with the increase in entertainment outlets the music industry has to find the next trend. Whether that may take the form of online music delivery, new or old artists, or adventurous entrepreneurs, the question will still remain, what will it sound like?

Endnotes

[1] The company will continue its EMI Classics label.

[2] The Dow Jones Industrial Average reached 8,235.81 on September 21, 2001 and declined further to 7,784.60 on July 22, 2002. The NASDAQ reached a two year low of 1,387.06 on September 24, 2001 from a high of 5,132.52 on March 10, 2000 (Yahoo, 2002).

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