The Industry LifeCycle™

How five dominant players in the music industry found themselves in Death Valley.

1	**The Depleted Industry™:** Disintegrating organizations incapable of creating new Intellectual Capital — increasingly focused on preventing others from innovating superior value for consumers.
2	**The Industry Bypass™:** Entrepreneurial initiatives based on new Intellectual Capital that provides superior value creation for consumers, threatening to obsolete Status and Depleted organizations.
3	**The Emerging Industry™:** New entrepreneurial organizations with innovative Intellectual Capital that attract consumers, talent, resources and capital away from Status and Depleted organizations.
4	**The Growth Industry™:** Entrepreneurial organizations based on superior Intellectual Capital whose marketplace momentum increasingly displaces Status and Depleted organizations in industry.
5	**The Status Industry™:** Formerly entrepreneurial organizations that have now become bureaucratic; talented individuals capable of creating new Intellectual Capital are suppressed and eliminated.

This is a profile of an industry that has recently suffered very publicly under the pressures of creative destruction: the music industry, and, more specifically, the recorded music industry.

The road to Death Valley.

For the purposes of this case study we'll be focusing particularly on how five big record companies, which are responsible for over 70 percent of CD sales globally, have found their survival threatened by the forces of commoditization on one side, and by innovations coming from outside their ranks on the other. They are caught in what we have termed "Death Valley." Though music CDs may seem to have little in common with financial services, we will see that, from the perspective of creative destruction and The Industry LifeCycle™, there are many parallels between the two industries.

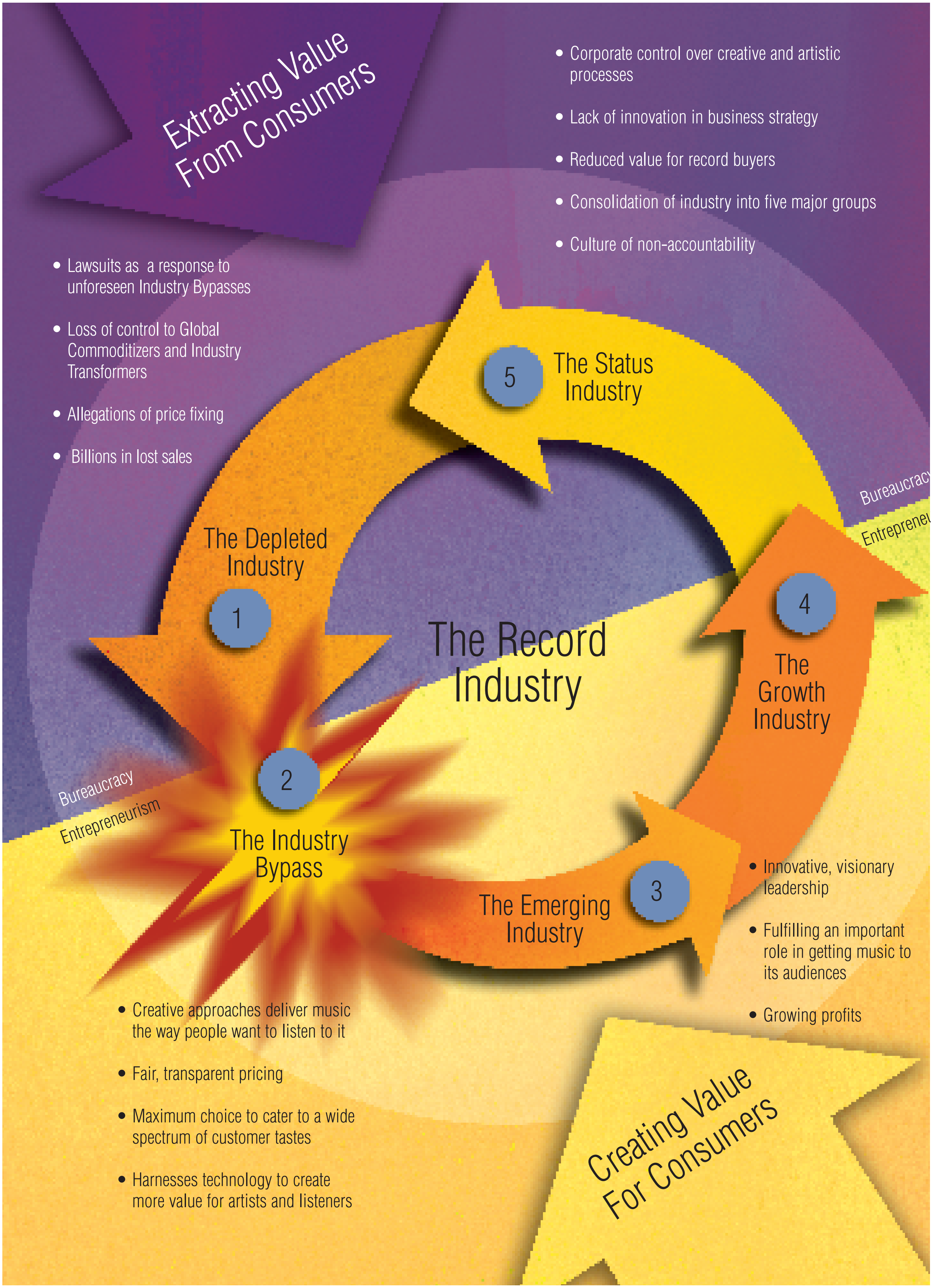
You don't have to look far these days to hear about the troubles in the music industry. When the industry sued Napster, its challenges became headline news. Its ongoing battles against file-sharing and unauthorized duplication of CDs — made easy with CD burners and MP3 technology — all represent attempts of an industry to protect or buy time for itself in the face of an onslaught of technology it didn't see coming. The struggles with technology have also brought to light many other issues consistent with the definition of a Depleted Industry. In fact, it's been widely debated as to whether downloading is the cause or merely a symptom of decline in an industry whose business model many argue no longer serves customers or artists. Whatever the reasons, CD sales from the five big record company groups have reportedly fallen by $2 billion since 1999.[1] With a business model that seems unsustainable on many fronts, several insiders have publicly questioned whether the industry can survive much longer in its current form.

In the beginning, innovation and value creation.

In the Emerging and Growth stages of the current LifeCycle, record companies made money by bringing new, engaging, exciting, and inspiring music to listeners by anticipating trends, discovering and nurturing new artists, recording their work, and marketing and distributing it. In the 1950s and 1960s, big established record companies balked at emerging musical styles like rock and roll and R&B. This created the opportunity for a variety of smaller, innovative, specialized record labels with unique visions to grow and prosper. They built followings by bringing this music, which caught on with listeners despite the protests and warnings from the big labels, from coffeehouses and underground clubs to people who were hungry for alternatives to the limited genres that the established record companies were offering.

Big money attracts corporations.

As the industry grew, big money-making opportunities started to attract outside investors. Corporations with deep pockets but little knowledge of the recording industry began to rapidly buy up record companies and parts of the distribution chain. The whole industry underwent an intense period of consolidation


Extracting Value
From Consumers
• Corporate control over creative and artistic processes
• Lack of innovation in business strategy
• Reduced value for record buyers
• Consolidation of industry into five major groups
• Culture of non-accountability
• Lawsuits as a response to unforeseen Industry Bypasses
• Loss of control to Global Commoditizers and Industry Transformers
• Allegations of price fixing
• Billions in lost sales
5
The Status Industry
The Depleted Industry
1
The Record Industry
4
The Growth Industry
Bureaucracy
Entrepreneurism
2
The Industry Bypass
The Emerging Industry
3
• Innovative, visionary leadership
• Fulfilling an important role in getting music to its audiences
• Growing profits
• Creative approaches deliver music the way people want to listen to it
• Fair, transparent pricing
• Maximum choice to cater to a wide spectrum of customer tastes
• Harnesses technology to create more value for artists and listeners
Creating Value
For Consumers

and vertical integration during the 1980s and 1990s, which left five big groups — Universal, Sony, BMG, Warner, and EMI — controlling about 75 percent of global music sales.[2]

The CD life-support bubble.

At the same time, the introduction of the compact disc in the early 1980s created a 15-year boom in profits, as people converted their collections from vinyl and cassette to more expensive CDs. This influx of revenue took the pressure off the industry to innovate or find new ways to create value within its business model, much as the long bull market did in financial services. It also fostered a culture of non-accountability. The industry was already prone to this because no one really knows what makes a hit record, so it's easy to escape blame when a record flops. However, without excess revenues and rich corporate backers to draw on, market forces would eventually have weeded out the unsuccessful players. In financial services, lack of transparency played a similar role in allowing non-accountability to flourish — a trend which regulators are now, perhaps overzealously, trying to reverse.

Relative complacency propelled the music industry from the Growth stage through the Status stage and quickly into the Depleted stage. In a recent article in *The New Yorker*, the head of a record label owned by Universal was quoted as saying: "The CD kept the whole business on artificial life-support. Without it, the old record industry would have died in the early eighties, and a new, more modern industry would have replaced it. But the CD preserved the status quo. The record business became a commodity business, not a content-and-creation business."[3]

Less for more — depletion sets in.

One of the characteristics of a Status Industry is that it stops innovating and decides to rest on its laurels. Customer needs become secondary to preserving the status and salaries of executives and delivering short-term profits for shareholders. Once an industry reaches the Depleted stage, this gives way to outright value extraction. There is significant evidence that during the fat 1990s, big record companies stopped creating new Intellectual Capital and started finding ways to extract value from their customers. For example, from the 1950s through to the late 1980s, record companies' biggest source of revenue from recorded music was the "single." People would hear a single song, buy it, and get what they paid for, plus an extra "b-side" as a bonus. Listeners trusted record companies and certain disc jockeys to be "taste makers" for them, bringing them new, interesting music that they would want to buy and introducing them to artists they would want to support. Once CDs took hold, record companies stopped selling singles in North America. People had to pay for an entire album to get the hit song they wanted. Marketing efforts began to focus on how to get consumers to pay 15 dollars or more based on exposure to one or two songs. Many people also felt that the quality of the records put out by the big labels was on the decline.

This changed the experience of record buyers and how they perceived their relationship with record companies. Confidence began to give way to cynicism. People began to perceive the industry as being greedy and indifferent. This was reinforced when it became clear that the industry was not going to make good on its initial promise to lower the price of CDs once more manufacturing facilities came on line, even though CDs were soon cheaper to produce than vinyl records. As we know from the financial services industry, when customers begin to feel like they're being duped, lawsuits ensue. In 2002, the Big Five paid $143 million to settle a class action lawsuit that alleged price fixing for CDs. They never admitted guilt.[4] The increasing perception that CDs were too expensive, and that the industry didn't care, opened the door for Napster to become a successful Industry Bypass™ in 1999.

Customers were not the only ones becoming disillusioned with changes in the industry. "Brain drain" became an issue, as some of the most creative and passionate people within the big companies began to feel that a business model increasingly dictated by accountants and lawyers prevented them from nurturing new artists and producing the best music. Many left to start or join smaller independent labels or to seek other ways to use their talents more effectively.

Corporate control.
After consolidation, and the reprieve that the introduction of the CD provided, the need to generate profits at a level that corporate shareholders had become accustomed to demanded a shift in the culture within the industry. The goal became to produce quick hits that would sell millions in the first few months, driven by huge marketing budgets. The days where the strategy was to develop artists and their long-term relationships with a growing base of fans over a number of albums were over. The easiest way to create hits is to try to clone artists who have already achieved commercial success. The range of tastes that record companies would commit their marketing budgets to serving became much narrower. Record companies began to more exclusively target teens and young adults, considered to be the most lucrative markets. Unfortunately for them, these are also the most computer-literate and Internet-savvy consumers, so when technology made file-sharing, downloading, and CD burning easy and cheap, the companies found themselves faced with a big problem.

Waking up in a new world.
When Napster came along, the Big Five were "caught flat-footed." Many record industry executives have gone on the record saying that they were completely taken by surprise when, suddenly, their prime source of revenue was being offered for free on the Internet. From a technology-savvy consumer's perspective, this was a great advancement. Not only was the music free, songs that weren't being played on local radio could be downloaded for sample listening, and a much wider selection was available than many people could find at their local record stores. Also, they could just get the songs they wanted without having to pay for a whole album. Teenagers, the biggest target market for pop music, were also the most likely to download. Suddenly, the industry's biggest fans had become its biggest enemies.

The industry was unable to respond in any way except by taking legal action, which further alienated a large portion of its target market — people who felt they had finally found a way to get music the way they wanted it. In hindsight, it's hard to imagine how the Big Five could have been so strategically unprepared for the flip-side of the digital revolution that had given them such a windfall in the 1980s and early 1990s, especially since they have parent companies in the technology industry, like Sony and AOL. However, it stands as proof of just how internally focused and blind to the evolving demands of their customers record companies had become.

By late 1999, when the Recording Industry Association of America (RIAA), representing the Big Five and some smaller independent companies, sued Napster and successfully had it shut down, it was clear that the industry had entered the Depleted stage of The Industry LifeCycle. Since 1999, the big record companies have blamed declining sales on the "piracy" taking place over peer-to-peer (P2P) networks on the Internet. They have pursued legal action in efforts to shut down these networks. But the nature of the technology itself has made it difficult because P2P networks also have many legitimate uses, and it's difficult to identify anyone to sue. As a result, the RIAA has turned to punitively going after individuals who steal music. These defensive tactics and the industry's poorly executed communications around them have further alienated customers, resulting in nicknames like "the Evil Empire." Meanwhile, a recent Harvard study found that there is no evidence that downloading has any effect on CD sales, positive or negative.[5] Still, the RIAA and Big Five publicists prefer to quote from an earlier study that blames downloading for $700 million in lost sales.[6] Worse for the industry is that many people seem to be downloading happily out of spite. And even those who aren't (some estimate that 50 million Americans have downloaded music illegally) don't necessarily think it's a bad thing. The industry's treatment of fans and artists over the years has created a situation where the big companies' pleas for sympathy, even on behalf of the artists who are losing royalties, fall on deaf or cynical ears.

Out of touch, out of control.
One characteristic of a Depleted Industry is that it can no longer control the forces of it's own evolution. The forces of commoditization have taken hold in the music industry in a

way that makes what's happening in financial services look mild by comparison. Having neither the size to control their own strategic direction or the wherewithal to provide the kind of unique listening experiences music fans are increasingly demanding, the big record companies are floundering in Death Valley. Global Commoditizers with interests that may or may not intersect with their own now control many aspects of their fate.

Surrounded by indifferent 500-pound gorillas.

Though the Big Five control three-quarters of CD production, they're just a drop in the bucket to their parent companies. In 2002, all five companies together sold about $20 billion worth of music. By comparison, a single parent company, Sony, sold about $42 billion in electronics and computer products alone, which gives you a sense of how tiny Sony Music's contribution is to the overall corporation's bottom line.[7] Bertelsmann, the parent of BMG, another of the Big Five, cared so little about its music division that it invested $90 million in Napster in 2000, allegedly contributing eight months to the company's lifespan and costing the record industry, including BMG, $17 billion in lost sales. Several BMG executives were outraged by Bertelsmann's decision, and at least two resigned as a result.[8]

The distribution channels the Big Five rely on to sell their products are also huge commoditizers for whom music is just another in a vast sea of line items. In a recent PBS Frontline special, called "The Way the Music Died," an executive from one of the big record labels explained that "big box" stores like Wal-Mart, Best Buy, and Target account for 50 percent of his company's total sales, but that music is only *one-tenth of one percent* of Wal-Mart's revenues and maybe three to five percent of Best Buy's. The same is basically true for all of the Big Five. This means that what sells in Wal-Mart has a significant impact on what the big record companies produce.[9]

Radio, a long-time, essential marketing outlet for record companies has also become commoditized, with Clear Channel and Viacom having monopolized the industry and playlists to maximize advertising sales. These two companies alone control 42 percent of radio listeners in the U.S., and Clear Channel prides itself on being the Wal-Mart of radio.[10] Commercial radio is no longer interested in playing new music. It prefers proven hits, which sell more ads. MTV is another way to reach potential buyers, but this means having to invest in a high-end video, which only makes sense for acts that have the potential to sell millions of records. All of these forces pressure record companies to move more and more towards producing commoditized music to fit existing formats and away from anything truly innovative.

Nonetheless, in an effort to survive, the Big Five have desperately been trying to find online business models that work for them — something capable of turning the tide. How do they make customers want to pay record companies again for something they can now get for free? Trapped by the demands of their own failing business model and the forces of commoditization, and being so out of touch with the pulse of music listeners, it seems unlikely that this transformation will come from inside their ranks.

Unique, customer-driven experiences.

In fact, what we're seeing is that the most innovative and promising new models are coming from the periphery of the industry where business models are more flexible, responsive, and tuned in to the deep-support needs of consumers. Many have seen the scope of the opportunity offered by the failings of the current industry to harness the potential of digitized music and the MP3 format. However, few have been able to do what it takes to capitalize on this opportunity in a commercially viable way. Still, the number and variety of experiments is tremendously exciting and will undoubtedly yield some successes. One of the early front runners is Apple, a company long known for its ability to "think different."[11]

Apple takes a bite.

Apple's customer-centered approach to music focuses on many of the right things, as its early success is proving. The combination of the iPod, the undisputed benchmark for MP3 players, and the iTunes music store, the first legitimate online music distribution service to show signs of large-scale commercial success, has caught on with consumers and forced the industry to pay attention. Music lovers want to be able to take advantage of the possibilities technology offers to create their own mixes of songs, share music, and have their music with them wherever they go. Apple made this easy and elegant with an integrated solution combining hardware, software, and service. As a result, while Apple's quarterly Mac-based revenues were up 19 percent in June 2004, its music-based revenues grew by a staggering 162 percent. Music-related products now comprise nearly half of the company's revenues. Sales of the iPod have gone up 183 percent over last year.[12]

One of the keys to its success is that Apple was able to negotiate with all the Big Five record companies to carry their songs. People don't want to have to go to different sites to get songs from different companies. The platform that wins will be the one that offers the most choice. On July 12, 2004, the iTunes music store announced that it had sold 100 million songs. Analysts are already predicting that it will generate nearly $7 billion in revenue by 2008.[13] If iTunes continues to catch on and make itself accessible to an expanding range of independent record labels and artists, it has the potential to democratize distribution, similar to what eBay has done for anyone wanting to sell something. Big marketing budgets can promote artists offline, but people will easily be able to sample from artists who don't have the backing of a major record label. This may facilitate further Industry Bypasses, allowing independent labels and key taste makers who have more direct relationships with specific audiences to have easier access to a greater number of potential listeners.

A place where there will always be room for customized value creation and innovation in the music industry is in the area of taste making. With the sheer variety of music being produced in the world today, there is a need for people who are talented at connecting listeners to new music that is to their particular taste. The legitimization of the online distribution of music and massive uptake of the Internet as the major source of music allows people access to all kinds of taste makers. Internet radio is already gaining in popularity as a forum for discerning listeners. Unlike mainstream "terrestrial" radio, Internet radio stations are free to cater to an infinite number of niche markets and tastes.

One of the most intriguing fledgling ventures that combines taste making with other forms of deep support is the Starbucks Hear Music Coffeehouse, which allows visitors to listen to music from an "extensive digital library" and then mix and burn their own custom CDs — all while enjoying a Starbucks beverage. Starbucks intends to have staff on hand to guide people through the process and help them find new music they like. Starbucks is betting that people who already like the experience they create, and the music compilations they have been distributing for years in their stores, will respond positively to the opportunity to take this experience to a more customized level.

The increasing proliferation of highly creative, customized approaches to connecting listeners with the music they want will make it even more imperative that the big record companies dramatically shift their thinking. The alternative is to become obsolete. In any case, it is fairly clear that in just a few years, big record companies will not be doing business in the same way they do now.

Lessons to take home.

What can entrepreneurs in other industries learn from what has happened in the record industry? First, once an industry becomes Depleted, even its biggest players can quickly find themselves in Death Valley. The process may be slower in some industries, but the dynamic is the same. Entrepreneurs who have the ability to stay in touch with customer needs can capitalize on this fact, but only if they are able to think beyond the limits of the dying business model. Unique Process entrepreneurs have the ability to be the taste makers of their industry by introducing clients and customers to new, customized forms of value that fit their needs.

Sources And Notes

For further reading and discussion.

1 This statistic comes from a report by Forrester Research and is cited in an article by Ted Drozdowski in *The Boston Phoenix* entitled, "The Empire Strikes Back" (Sept 26-Oct. 2, 2003 issue).

2 This 75 percent estimate is conservative. Some say as much as 85 or 90 percent of the record business rests in the hands of the five big global players. The rest is divided up between thousands of small independent labels. Soon, the Big Five record company groups will shrink to four, as Sony is in the process of merging with BMG. The merged company will be the second largest of the remaining four, with Universal being the biggest.

3 This quote is from Lyor Cohen, head of Island Def Jam, a record label owned by Universal. He was interviewed by John Seabrook for an article entitled "The Money Note" in *The New Yorker* (July 7, 2003), which provides an interesting overview of the history of the industry and how it arrived at the challenges it faces today.

4 This lawsuit was cited as a reason for concern when the merger between BMG and Sony was being discussed. Despite past allegations of price fixing, the Federal Trade Commission and the European Union approved the merger between the two giants. Though past music company merger attempts in 2000 and 2001 were rejected by the EU, the authorities were reported to have softened their stance due to the recent growing challenges the record industry has been facing.

5 This study, entitled "The Effect of File Sharing on Record Sales: An Empirical Analysis," by Felix Oberholzer of Harvard Business School and Koleman Strumpf of UNC Chapel Hill, was only released in March 2004 but has already been widely discussed and critiqued. In the abstract, they summarize their findings as follows: "Downloads have an effect on sales which is statistically indistinguishable from zero, despite rather precise estimates." Further, they go on to say that "the sales decline over 2000-2002 was not primarily due to file sharing. While downloads occur on a vast scale, most users are individuals who would not have bought the album even in the absence of file sharing."

6 See note 1. This number comes from the same Forrester Research study. The Recording Industry Association of America (www.riaa.com) estimates that each year, the industry loses $4.2 billion to piracy worldwide.

7 These statistics come from an article in *Wired* magazine, entitled "The Year The Music Dies" by Charles C. Mann (February 2003).

8 Interestingly, Bertelsmann, along with venture capital company Hummer Winblad, which also invested $15 million in Napster, is now being sued by Universal Music, Capitol Records, and others over these alleged losses.

9 PBS Frontline has put together an excellent website devoted to the content of this show entitled "The Way the Music Died." See the section on "The Wal-Mart Effect" for insights on the impact of large commoditized retailers on the record business.
http://www.pbs.org/wgbh/pages/frontline/shows/music/perfect/walmart.html

10 These statistics were compiled by the Future of Music Coalition and are published in an article at *www.futureofmusic.org* entitled "Radio Deregulation: Has It Served Citizens and Musicians?" In an interview with Bill Moyers on the PBS show "Now," Randy Michaels, head of Clear Channel's radio division, is heard on tape making an entrance at a broadcaster's conference shouting, "Wal-Mart is open people!" The conversation goes on to explain how Clear Channel is acting like a Global Commoditizer. The transcript is available at *www.pbs.org/now/transcript/transcript_clearc.html*.

11 If you go to *www.apple.com/thinkdifferent/*, you'll see a statement from Apple that illustrates Apple's attitude as an Industry Transformer.

12 Numbers are from Apple's third-quarter results, released on July 14, 2004.

13 From "Online media 'will generate $7bn by '08?'" MacWorld Daily News. Wednesday, July 14, 2004.