



**KPMG ANALYSIS**

## Digital Music Retailers Hope to Bundle Success

March 9, 2007

By Dave Pelland, Managing Editor, Technology Insider

Record labels are redefining the "album" as a digital bundle that often includes ringtones and ring-back tones, videos and games. They hope such content will shift consumer demand away from single-track downloads -- currently dominated by Apple's iTunes Music Store -- to sales through mobile carriers and subscription services.

"Our challenge now is finding new product configurations," said Rio Caraeff, general manager, Universal Music Mobile North America, at the Digital Music Forum organized by Digital Media Wire and the Consumer Electronics Association.

"Is the album relevant in the digital future?" Caraeff asked. "The question we're dealing with is what the products of the future are going to be for us."

Though digital content sales account for about 20 percent of domestic revenue, record labels are searching for new product configurations because sales of downloaded music have failed to keep pace with declines in CDs sales, which peaked at \$13.2 billion in 2000, according to the Recording Industry Association of America.

At the end of 2005, the latest year for which figures are available, CD sales were \$10.5 billion, while downloaded single-song sales were \$367 million and downloaded album sales were \$13.6 million.

Mobile content, including ringtones, full-length songs and videos, accounted for \$422 million in sales.

As the recording industry shifts toward digital distribution, labels are experimenting with products and formats that extend beyond a three-minute song file or 30-second ringtone.

Thomas Hesse, president of global digital business and head of U.S. sales for Sony BMG Music Entertainment, said more than 75 digital-content products were created for Justin Timberlake's CD releases in 2006 and 2004. Products included "clean" and "explicit" versions of digital tracks, ringtones and wallpaper images for cellphones.

"Ultimately, this is about selling music in different configurations, across different windows at different price points to different clients," Hesse said. "Some customers [want] all-physical [products], some all-digital, and most a mix. But there needs to be a coherent approach.

"The digital revolution is not a gradual change. It's not a change from one format to another -- it's more fundamental than that."

The music industry says it's pleased with sales growth for authorized digital music. According to David Card, vice president and senior analyst at research firm JupiterKagan, legal downloads generated an estimated \$800 million in sales last year. JupiterKagan projects the amount to double over the next five years.

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Digital music subscription services such as RealNetworks' Rhapsody service, which allow consumers to download music to PCs and transfer it to portable music players, accounted for an estimated \$180 million in revenue last year, which is expected to reach \$750 million in five years.

In addition to promoting product bundles, record labels hope to introduce variable pricing models designed to increase the price new or popular releases and reduce the cost of back-catalog downloads.

While record labels have advocated variable pricing, Apple has resisted it, saying consumers prefer the simplicity and predictability of song files being offered for 99 cents and digital albums for about \$10.

In a pilot project, PassAlong Networks, which offers music downloads and operates more than 40 download services for consumer brands, plans to offer songs from artists managed by Canadian firm Nettwerk Music, including Sarah McLachlan, Avril Lavigne and Barenaked Ladies, for prices ranging from 29 cents to \$1.39 per download.

Dave Jaworski, co-founder and CEO of PassAlong Networks, said prices for MP3 files from these artists will rise and fall depending on each track's popularity.

"This is a period in which the music industry has a chance to experiment," Jaworski said. "We're not sure where all of this is going to go, but we'll let the market decide."

But music industry executives acknowledge that two factors are inhibiting growth: the complexity of buying music through a wireless handset and the inability to play downloaded songs on all portable devices.

In response, wireless carriers are streamlining handset menus so consumers can find and order tracks in two or three clicks, and are bundling related content so consumers can order different products in a single transaction.

"One key in the mobile space is making the purchase experience really simple," said John Burris, vice president of wireless data at Sprint-Nextel Corp. "If someone wants the latest Akon song, a ringtone and a ring-back tone, they're not going to go to three retailers for that. The more that we can make it easy for people to buy this experience, the more we'll see this market take off."

The issue of a protected universal format is a tougher challenge because, from the record labels' standpoint, the convenience of transferring digital content to several devices needs to be balanced with not allowing those copies are distributed online.

Another challenge for wireless music retailers is "sideloading," which describes consumers transferring existing song files from PCs directly to their handsets.

"There's a behavior shift going on now, so anything that encourages people to enjoy digital music on their phones is inherently a good thing," said Matt Schwartz, manager of mobile operations and business development for Verizon Wireless.

"That music could come from piracy networks, so it's a double-edged sword, but now the benefits outweigh the negatives because if consumers don't adopt this behavior, this market won't work at all."

Handsets' physical constraints may also inhibit wireless carrier music sales. The quality of sound is lower than for devices specifically designed for music, and the perceived awkwardness of using a cell phone and a portable music player that have been melded together is another hurdle.

In addition, "if someone is using a phone to listen to lots of music, their ability to use the phone as a phone will be affected due to limited battery life," says Sanjaya Krishna, a Tysons Corner, Va.-based senior manager in KPMG's IT advisory practice.

Another factor that could influence the American online music market is the introduction of Apple's iPhone, scheduled for release in June. The device, which will be offered by AT&T's Cingular, is expected to allow consumers to download digital content to a wireless handset without a carrier.

"Apple is playing a role we haven't seen thus far in the digital music ecosystem," Krishna says.

"They're going to be a branded hybrid content aggregator and third-party host for their wireless carrier partner, enabling music to get on to their own end-user device."

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