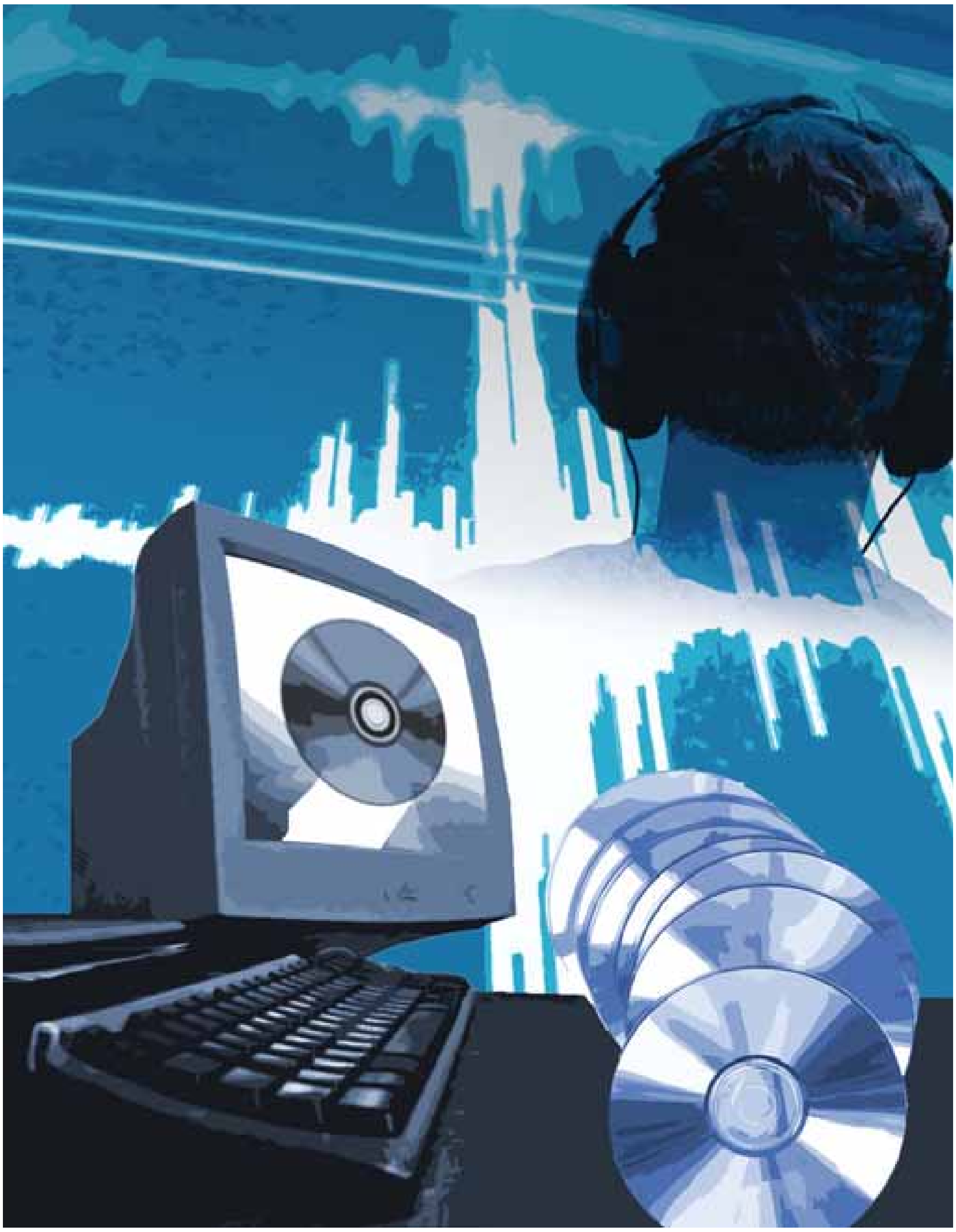
Online Music in Europe

Market assessment and forecast



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court decision. Broadly speaking it has three alternatives:

- A new decision that clears the merger.
- Clearing the merger with "remedies" (mandated disposals).
- Prohibiting the merger in which case the joint venture would have to be dissolved.

EMI

UK-based EMI began its current incarnation in 1996 when it demerged from Thorn EMI, a diversified conglomerate with interests including defence and consumer electronics. In 1998, EMI sold its high street chains HMV and Dillon's bookstore leaving the company almost exclusively focused on the record business.

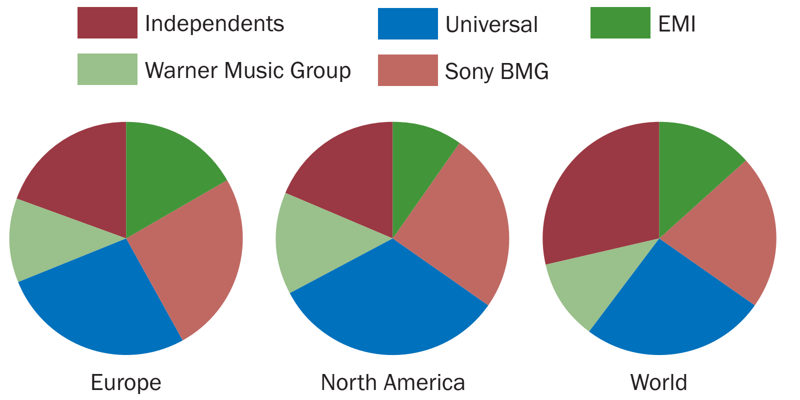
As one of the two majors not affiliated to larger media groups it has seemed likely that EMI will merge with another company at some point. Within the last ten years EMI has been the focus of a number of takeover bids that have involved Seagram, AOL Time Warner and BMG. However, a mixture of regulatory hurdles and disagreements over detail have prevented any of these deals coming to fruition. Most recently it has been linked with a takeover of Warner Music though the talks were reported as ending when Warner rejected the offer from EMI. It should be noted that any proposed merger with another major has been cast into doubt by the July 2006 ruling from the CFI and both Warner and EMI have signalled that they will not be pursuing the matter for the time being.

Warner Music Group

The other non-affiliated major, Warner, was formed in February 2004 when the Warner Music Group demerged from AOL Time Warner. The company is the smallest of the majors and has been holding fourth place both globally and in Europe for some time.

Since even before its separation from AOL Time Warner, the Warner label has been the subject of takeover interest from EMI. For Warner, a private purchase involving another company might leapfrog regulatory issues thrown up by any potential merger with another music company and allow a quicker exit for the investment group led by Edgar Bronfman Jr.

Music market share 2004



Source: Screen Digest

Independents

Outside the Big 4 there are a number of independent record companies that are not individually significant on a global scale but that collectively account for a significant percentage of sales. The independents very greatly in size and scope from Naxos the world's largest classical label to one man band operations like Make Some Noise.

As the history of the record industry shows the Big 4 have always been very active in maintaining their oligopoly. They have done this in the past by acquiring the more successful independents, in particular those with a strong A&R (artists and repertoire) history. Screen Digest sees no reason for this trend to stop in the near future.

Distribution Channels

Physical products are distributed directly from a record company to a retailer or sold directly to a wholesaler. The latter serves a number of outlets and acts as a middle man. In general the more fragmented a country's retail landscape the more likely that a higher proportion of distribution will go through a wholesaler. Developed physical markets tend to have a small number of retail chains with a large number of outlets that buy directly from the record companies, while smaller labels and stores tend to rely on third party distribution..

In digital markets things follow a similar pattern i.e. the majors negotiate directly and the indies often rely on a wholesaler. Similarly in most European markets the majority of both physical and digital sales are handled by a relatively small number of companies; but, where the big players in the physical space (HMV, Virgin, Amazon etc) deal directly with the customer, in the digital environment customer relationships are more varied. While some, like iTunes and Napster, deal with the consumer directly, many of the big services are run by third parties such as 7 Digital,

Threats

There are a number of issues that might negatively affect the continued development of online music in Europe. Some are general issues reflecting obstacles that potentially affect the industry worldwide, whilst others are more specifically European. Broadly speaking they can be divided into three categories:

- Business model issues
- Technical issues
- Regulatory issues

Service models and pricing

The industry as a whole has taken a good deal of time to adjust to the digital re-interpretation of the traditional retail business model. This process is not yet complete and there are a number of issues outstanding between content owners and their digital partners.

Broadly speaking, the slowest part of the industry to adapt has been the specialist bricks-and-mortar retailers such as HMV and Virgin in the UK and Media Markt and Saturn in Germany. In general these companies, whose traditional focus is selling entertainment, have yet to make any real mark on digital sales and lag behind iTunes, MusicLoad and even Napster; though there is some territorial variation. In France, for example, retailers FNAC and Virgin claimed a 30 per cent share of the market share—equal with iTunes—in 2005; though recent reports suggest that FNAC has slipped to third place behind Virgin (with 30 per cent) and iTunes (with 50 per cent). Where traditional retailers have launched a branded digital service it has invariably been run third party such as OD2/Loudeye or Phonofile.dk—the same third parties that power many of the music services run by ISPs.

Whilst the appearance of third party digital music services has removed the need for traditional retailers to develop digital distribution systems in-house, it had also made it hard for the retailers to produce a service they can market uniquely. The fact that many of these retailers are already struggling for online customers against the likes of Amazon, Play.com, iTunes and Napster only exacerbates the problem.

One alternative would be for the major retailers to purchase a digital music services company, whilst another option sees the traditional retailers investing in in-house development of their own bespoke online services. However, the commercial incentive for a retailer either investing in an acquisition or developing the systems and aggregating the content for their own online stores is still relatively weak—online sales make up roughly 3 per cent of European revenues, retailer's margins are lower than physical sales and the market is dominated by Apple's walled garden environment.

On the other hand, failure to invest may result in retailers being left even further behind in the increasingly important digital space. This leaves the big retailers the option of trying to leverage their physical sales clout to negotiate for digital content, while leaving the technical running of the store to a third party. This could be one of the specialist companies that run third party services or a large content delivery platform from a company like Akamai.

The small companies that presently run and maintain these services on behalf of traditional retailers and ISPs—and others like them including Tune Tribe and 7 Digital—have developed considerable expertise in both aggregating and distributing content. These companies have settled in the niche between:

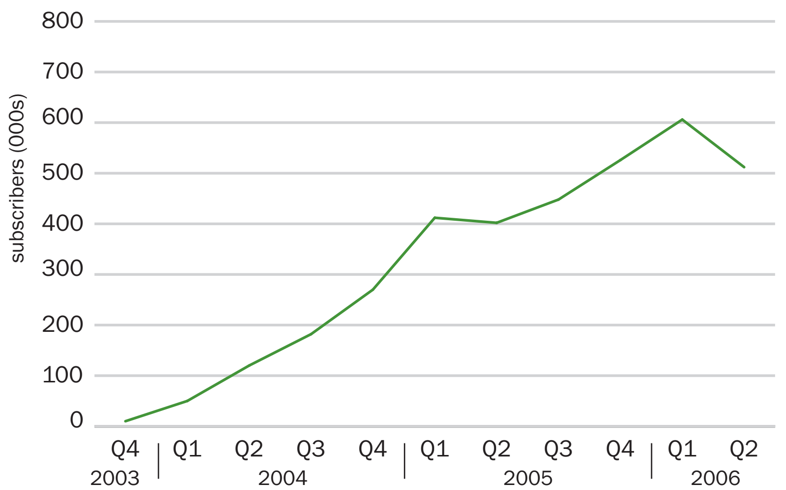
1. large communications companies that consider music as a small value-added component of multi-billion euro fixed-line and mobile customer acquisition strategies and are therefore not adequately equipped to aggregate content and establish an

Major music retailers and their 3rd party suppliers

Denmark	Bilka	Phonofile Denmark
	fotex	Phonofile Denmark
	El giganten	24-7 MusicShop
France	Fnac	Fnac/MPO
	Virgin	Virgin
	Cora	OD2/Loudeye
Germany	Media Markt	24-7 MusicShop
	Saturn	24-7 MusicShop
	Karstad	
Greece	Virgin	OD2/Loudeye
Italy	Media World	OD2/Loudeye
Sweden	Ahlens	InProdicon
	Bengans	InProdicon
Switzerland	Migros	OD2/Loudeye
UK	Woolworths	DX3
	Tesco	24-7 MusicShop
	HMV	MusicNet
	Virgin	MusicNet
	Littlewoods	24-7 MusicShop

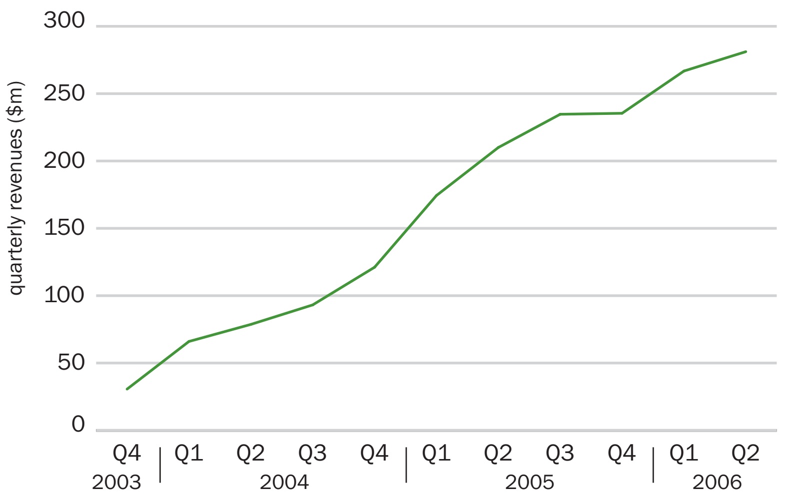
Source: Screen Digest

Napster worldwide subscribers



Source: Screen Digest

Napster quarterly revenues



Source: Screen Digest

To Go'. Standard Napster subscriptions cost £9.95 and €9.95 in the UK and Germany respectively, while Napster To Go costs £14.95 in the UK and €14.95 in Germany. In comparison to Napster's product range in the USA, where the company has already deployed its next generation of services, these European services are quite impoverished. There are two planks to Napster's US strategy: first was the launch in May 2006 of its advertising funded, free-to-listen service; second, was the subsequent launch of Napster-branded portable devices in June. The former allows users to listen to any track up to a total of five times, at no cost; after the fifth time they are prompted to either buy the track as a single track download or subscribe to one of Napster's rental services. The company views this as a promotional strategy, a way to monetise their promotional activity, generating traffic for napster.com while improving customer acquisition.

The early signs are that this strategy is working well. In the two weeks after the free service launched, the company reported a 15 per cent increase in track sales. Napster was offering two portable devices by mid 2006. The smaller of the two, with a capacity of 256MB and black and white screen, was available for free to anyone who takes out a year-long subscription to Napster To Go, while the larger 1GB player, colour screen player cost $50 when bundled with the same annual subscription. Bundling hardware in with the subscription not only has the effect of making Napster To Go look like better value in comparison to rival subscription services from the likes of Real and Yahoo, but also removes the hardware barrier to entry—supplying iPod users and those without a compatible device with the necessary equipment to use the service. As of July 2006, neither of these promotional products had launched in Europe, where despite services from HMV and Virgin in the UK, Napster has, in effect, had exclusive control of the subscription market. This will change with the launch of Jamster's dual-download PC/mobile phone service that is expected to launch in Germany in August and in the UK soon after that. However, while the Jamster store potentially has the higher hardware user base, both services may well be affected by the tendency of European consumers to eschew the subscription model.

Musicload

T-Online subsidiary Musicload launched in October 2003 and is ultimately owned by Deutsche Telekom, the German incumbent telco. For some time it was the most popular download store in Germany, only losing out to the ITMS toward the end of 2005. T-Online reported 15m tracks downloaded in Germany in 2005 while Apple reported 15.5m tracks sold. Musicload currently runs stores in Germany, Austria and Switzerland. In addition to its own brand stores, the service runs online stores for a number of third parties including CokeFridge (the German equivalent to the MyCokeMusic), German cable networks RTL and Prosieben. These third party stores are clearly branded as being "powered by Musicload". The service also was integrated into the digital media mall of Windows Media Player 11.

Though Musicload has expanded beyond a pure online music play to include ringtones