Combating Illegal Music Piracy:
A Case Study of Warner Music Group

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Abstract

This paper will address the topic of illegal music piracy and its affect on the music industry, specifically Warner Music Group. In recent years, music companies have been faced with the consequences of the global spread of the internet. The ease of illegal file sharing and the increasing prominence of low-revenue music options such a streaming websites and YouTube have changed the way music companies must operate to stay profitable. An analysis of the financials of Warner Music Group reveals the difficulty of operating a music business in the current technological climate. This thesis deals with the future of the music industry and recommends options music companies can utilize to remain relevant in the face of the age of the internet.

EXECUTIVE SUMMARY

Warner Music Group (WMG) is one of the largest music recording and publishing companies in the industry. However, with the increased use of the internet to download and consume music, the company has suffered a loss of revenue, and must remain innovative to combat illegal downloads and provide music to the consumer. WMG should take the following steps to remain a major player in the music industry:

- Alter current pricing practices
- Promote music on free or subscription streaming websites
- Promote music consumption with mobile phone programs
- Sign more artists to expanded rights contracts

COMPANY OVERVIEW

WMG is a family of record labels that operate in more than fifty countries worldwide, as well as a prominent music publisher. It is the third largest recording company, one of the "big four" along with Sony Music Entertainment, Universal Music Group, and EMI. It is the only stand-alone music company to be publicly traded on the New York Stock Exchange (Symbol: WMG).

Warner Music Group was founded in 1958 as Warner Bros Records, an offshoot of the Warner Bros movie studio. In the past 50 years, the company has merged several times, most notably with Time Inc, to become Time Warner, which in turn became AOL Time Warner. WMG has acquired and sold countless record companies and other subsidiaries through the years, slowly forming the contemporary group that remains successful to this day. WMG mainly operates in two areas: music recording and music publishing.

Among the recording groups that WMG owns are Atlantic Records, Warner Bros Music Inc, Rhino Entertainment, and WEA International. Each of these groups has several labels assigned to it. These labels market their artists' music and music videos, manage brands, seek out new talent, and maintain contracts with current recording artists. Revenue is produced through the marketing, sale and licensing of music in physical and digital forms. WMG has a diverse catalog of music, including 28 of the top 100 US best-selling albums of all time. WMG also has expanded its business into merchandising, touring, sponsorships, and concert promotion. WMG has signed these "expanded rights" contracts with approximately half of its current artists. The Recorded Music business generated revenues of $2.624 million in 2009.[1]

WMG owns Warner/Chappell Music, one of the largest music publishers in the world. Music publishers are responsible for attaining publishing contracts, which assigns compositions copyrights. The compositions are then licensed by the publisher. The publisher is responsible for ensuring that the owners of the song receive all required royalties, whether the piece is used on the radio, film, or television. It also promotes the use of the songs in their catalogue for use. Warner/Chappell Music owns a catalog of more than 1 million songs by 65,000 artists. This catalog includes favorites such as "Happy Birthday to You" and "Walking in a Winter Wonderland."[2] The Music Publishing business generated revenues of $578 million in 2009.[3]

[1] Warner Music Group Annual Report 2009.
[2] Warner Music Group, http://www.wmg.com (accessed March 2, 2010).
[3] Warner Music Group Annual Report 2009.

Current Performance

WMG generated revenues of $3.176 billion during 2009. This is a 9% decrease from 2008, about $315 million. However, revenues from the sale of digital music increased by 10% ($64 million) to $703. Similarly, the revenues from physical music sales decreased by 9% (or $271 million) to $2.624 million. This reflects the shift in the market towards the relevance of digital sales, and the contraction of the music market in general.[4]

Warner Music Group Corp. posted a $17 million loss for its fiscal first quarter of 2010. WMG has undergone a net loss in the past four fiscal years, with a net loss for 2009 of $100 million. These losses are due to the struggling economy and the continued decline of compact disk sales.

WMG executed a bond offering for $1.1 billion, which brought to light WMG's relatively strong financial position in comparison to its closest competitor, EMI. This bond offering was used to retire debt, along with $335 million in cash. WMG is a highly leveraged company, with over 1.56 billion in debt.

Digital music sales played a vital role for WMG in 2009. Digital revenue increased 10% to $703 million. It now accounts for 22% of total revenue. In the US, it accounts for 36% of total US recorded music revenue.[5] Atlantic Records was the number one label in the US for the second year in a row. Atlantic became the first company to have digital music sales account for 50% of its revenue.[6] In addition, non-traditional

[4] Warner Music Group Annual Report 2009.
[5] Ibid.
[6] Ibid.

music revenue rose to account for 10% of total revenue.[7] These sectors are increasingly important to the company, and WMG should seek to grow within these areas to increase future revenue.

WMG outsources its manufacturing, packaging, and distribution to Cinram to keep costs low. It also outsources financing and accounting activities, and other miscellaneous back-office jobs.

Competitive Position

Due to the fact that Warner Music Group is the only one of the four major music companies to report financials for music-specific business, it is difficult to draw a direct comparison between it and its competitors. However, it is safe to assume that WMG and its competitors all operate in the same business environment, and therefore have relatively similar financials, strengths, and weaknesses, especially regarding the introduction of digital music into the music industry.

MUSIC PIRACY

In the Industry

From calendar years 1990 to 1999, the U.S. recorded music industry grew at a compound annual growth rate of 7.6%. However, in 1999 the music industry began to see a decline in the sale of physical music, due to the growing trend of music online and the aging appeal of CDs. It is estimated that annual dollar sales of physical music products in

[7] Ibid.

the US have declined at a compound annual growth rate of 10% since 1999. In 2008, the business declined by 28% on a value basis.[8]

Sales continued to decline in 2009. Physical sales were down 13%, while total sales (including digital) were down by 9%. The market is smaller worldwide due to the contracted global economy and the market for pirated music.

It is estimated that 40 billion songs were illegally downloaded in 2008. In the past, The Recording Industry Association of America (RIAA) and the major record companies, including WMG, have pursued litigation of individuals found to be sharing and downloading music illegally. Many people were found guilty and sued for thousands of dollars. In one recent case, a woman from Minnesota who admitted to illegally downloading 24 songs was fined nearly two million dollars-more than $72,000 a song. A judge called the ruling “monstrous and shocking” and reduced the fine to $54,000.[9] Recently, the companied and the RIAA have stopped bringing individuals to court, and instead are holding Internet Service Providers responsible for tracking, prohibiting, and blocking music piracy.[10]

Other measures are being taken to reduce music piracy. One of the most controversial ways is Digital Rights Management, or DRM. DRM is technology that limits the use or access of digital content. DRM has been very popular in the past, but now is rapidly disappearing due to its unpopularity with music consumers.

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[8] Warner Music Group Annual Report 2009.

[9] Jammie Thomas-Rasset, "Brainerd Woman's Fine for Music Piracy is Slashed," *Star Tribune*, January 22, 2010, http://www.startribune.com/local/82453582.html?elr=KArks:DCiUUU7DYaGEP7vDEh7P:DiUs (accessed March 10, 2010).

[10] *The Los Angeles Times*, "A New Tune," December 20, 2008, http://articles.latimes.com/2008/dec/20/opinion/ed-riaa20 (accessed February 2, 2010).

The industry as a whole is lobbying for legislation to protect intellectual property, as well as educating the public about the illegality of music sharing. In addition, the industry is exploring new ways to remain profitable on the internet. In the past, music companies "were very heavily dependent on litigation, rather than making decisions on their business that would allow them to thrive."[11] The heavy emphasis on lawsuits has been detrimental to the music industry, as many people have become angered about huge corporations targeting individuals, often with outrageous punishments. The music industry has recognized that music piracy is inevitable in the current internet age, and has changed its approach. Instead of discouraging music piracy, the industry has begun to encourage legal ways to obtain, share, and listen to music online.

Warner Music Group and Piracy

WMG has four key initiatives to combat piracy: technological, educational, legal, and the development of alternatives. WMG uses technology to block, track, and degrade the process of illegally sharing music. WMG has teamed up with the RIAA to educate the public about the illegality of file sharing. Legally, WMG has brought suits up against individuals and those who distribute software to enable file sharing, such as Napster. Finally, WMG has generally supported the use of legal ways to buy and share music online.

WMG announced in 2007 that it would sell its music DRM-free on Amazon, and in 2009 WMG and all other major record companies' music became available DRM-free on iTunes. DRM was unpopular with many consumers of music, because it limited the

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[11] Steve Knopper, *Appetite for Self-Destruction: The Spectacular Crash of the Record Industry in the Digital Age* (New York: Free Press, 2009), 240.

use and accessibility of the songs. WMG, along with other record companies, lobbied iTunes to change their policy of a flat fee of $.99 for single songs. In response, iTunes agreed to offer single songs at prices ranging between $.69 and $1.29. However, many cite this as a reason that WMG has experienced a decrease of digital sales, which grew only 8% in 2009 as opposed to 20% in 2008.[12]

WMG has had an ongoing battle with YouTube concerning the use of their songs in videos. In late 2008, WMG either muted or pulled those videos that contained its music off of the site. WMG claimed that YouTube was not paying enough in royalties. This was a hugely unpopular move for consumers and artists alike. A backlash towards WMG encouraged the company to work with YouTube to reinstate their videos on the site, which happened nearly nine months later in 2009. As a result of their new agreement, WMG is receiving more payment, will be allowed to sell their own advertising, and can directly link to the artist’s website.[13]

Most recently, WMG has announced that it will cease stop licensing songs on streaming websites. The majority of the users on these websites do not pay to listen to songs, a trend that Bronfman claims is not positive for the industry.[14] These websites are incredibly popular for users but generate almost no revenue for the record companies. Instead, WMG will focus on streaming songs on sites that require payment. It is too soon

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[12] Jason Ankeny, "iTunes Variable Pricing Cited for Slowing WMG Music Sales," Fierce Mobile Content, http://www.fiercemobilecontent.com/story/itunes-variable-pricing-cited-slowing-wmg-music-sales/2010-02-10 (accessed March 2, 2010).

[13] Eliot Van Buskirk, "Epicenter Mind Our Tech Business Warner’s Music Returns to YouTube Following Nine Month Hiatus," *Wired Magazine*, September 28, 2009, http://www.wired.com/epicenter/2009/09/warner-music-group-signs-youtube-deal/ (accessed March 2, 2010).

[14] Ian Youngs, "Warner Retreats from Free Music Streaming," BBC News, http://news.bbc.co.uk/2/hi/8507885.stm (accessed March 2, 2010).

to tell if this will encourage more legal sales of music, or if there will be a similar backlash to the YouTube announcement.

THE FUTURE OF THE MUSIC INDUSTRY

In the words of Stan Cornyn, a former Warner Music Group executive: "In the race to adopt new technologies, the music industry historically has finished just ahead of the Amish."[15] The music industry has been struggling for many years to maintain their relevance and to keep up with the changes in the business environment. It rarely takes measures to prevent obstacles, but must instead react to obstacles once they have already become difficult to overcome. Cornyn was one of the first in the industry to recognize that the CD could not be sustainable on its own, and experimented with ways to improve it in the 1990's. Some of his failed ideas were CDs+ Graphics, Laserdisc, and CD-V.[16] Although his endeavors were unsuccessful, Cornyn was an early campaigner for innovation in the music industry, which had been stagnant for many years until the introduction of music on the internet. Many argue that the music industry was close to death at the time of the introduction of the CD, which revitalized the industry, as consumers needed to buy music in an entirely new medium. However, with the advent of digital music, the CD itself is now becoming irrelevant.

Sony Music Entertainment's President of Global Digital Business, US Sales and Corporate Strategy Thomas Hesse believes that the percentage of people that primarily buy their music online will increase in the next few years. Currently, 5% of consumers

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[15] Mike McCready, "The Future of the Music Industry," Huffington Post, http://www.huffingtonpost.com/mike-mccready/the-future-of-the-music-i_b_173481.html (accessed May 2, 2010).
[16] Knopper, 114.

account for 80% of music downloads.[17] At the Digital Music Forum held in early 2010, Hesse has claimed that Sony Music will see a drastic decrease in CD sales, which currently account for 60% of the business. Hesse predicts that by 2013, CD sales will only account for 20% of Sony's music business[18], a decrease that can be expected to be similar for all of the "Big Four" music companies. This is illustrated by the fact that Wal-Mart, the world's largest retailer, reduced shelving space for music by 20% in 2007, with predictions that it would decrease music shelving by another 20% the following year.[19]

The music industry can be compared to another troubled industry: the pharmaceutical industry. Both of these industries need substantial funds to continue operations. Pharmaceuticals spend billions on research and development in order to create new life-saving drugs, while music companies spend huge amounts of money on A&R, or Artists and Repertoire. This is the part of the business that is responsible for scouting out new talent and developing current artists. Without the budget for these activities, both industries would falter, and the product would be difficult to provide to the consumer. They must spend large amounts of money on many different drugs or artists in the hopes that one will be successful and profitable, which will fund the development of future drugs or artists. Additionally, there are new, cheap alternatives in both industries, in the form of generic drugs and digital music. Both of these industries need to find ways to fund themselves in order to keep new drugs or artists in the pipeline.

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[17] Jacqueline Emigh, "Digital Music Forum: Sony Music chief foresees the endgame for CDs," BetaNews, http://www.betanews.com/article/Digital-Music-Forum-Sony-Music-chief-foresees-the-endgame-for-CDs/1267383796 (accessed May 2, 2010).

[18] Emigh, "Digital Music Forum."

[19] Knopper, 214.

The reason I draw this comparison is to show how essential a music company's artists are to their bottom lines. Without profits from music sales, they cannot fund new artists, which is what will ensure that a company can operate into the future. Without research and development budget for pharmaceuticals, the companies cannot afford to create drugs which could potentially improve the quality of life for people all over the world. Although the distinction between life-saving drugs and music is somewhat drastic, it just shows that without profitable music companies, the outlook of the music industry is bleak, with little to no innovative new artists or music.

Contributing Factors

How did this happen to the music industry? It is a conglomeration of many factors, including the decrease of cost to produce music and the monopolization of radio. The cost to produce, record, manufacture, and distribute music has dropped to almost nothing, thanks to an increase in technology and its accessibility to anyone. As MySpace or YouTube can prove, anyone can share their own music with a computer and a microphone. Music companies used to be necessary to provide the funding for start-up artists to professionally record their music, but now they are finding that they are becoming irrelevant in that area.

Clear Channel has the clear majority of radio stations, owning more than 1,200 in the United States. Clear Channel had the opportunity to dictate the type of music that would play on the radio, meaning that music companies produced the same kind of music in order to capitalize on what would be profitable. Independent labels often had to pay radio stations to play their more obscure music. Music became stale, similar, and uninteresting, creating a huge opportunity for the internet to provide consumers with new, interesting, original music. The shift started in the late 90's, before the record executives even knew that music could be shared so easily. In 1997, the music-sharing website MP3.com gained predominance and a lot of public attention for offering music files for free to the public. The effect was immediate: in that year, "'MP3' surpassed the word 'sex' as the most-searched-for term through internet search engines such as Yahoo! and Alto Vista."[20] Bob Thiele, who has been in the music industry for more than 20 years, says about the sudden shift: "before anyone was quite aware of what was happening, file-sharing replaced radio as the engine of music culture."[21]

Predominance of Internet and Satellite Radio

With the growing number of people turning to the Internet to get access to different kinds of music, tastes evolved, changed, and became widely varied. The Internet offered every kind of music for every kind of person. The Internet had endless amounts of music to discover, which the radio could no longer offer. "The music industry, which depends on large numbers of people with similar interests for its profit margins, now had to deal with an ever-growing numbers of fans with increasingly diverse and eccentric interests."[22] The music companies could no longer provide the consumer with the music that they demanded.

Consumers are instead turning to radio options such as Sirius XM satellite radio, and online options such as Pandora and Lastfm. Many consumers are willing to pay annual or monthly fees in order to have access to a wide selection of music in their homes, cars, and at work. These services are generally free of advertisements, which

[20] Knopper, 119.
[21] Michael Wolff, "Facing the Music," *The New York Magazine*, June 10, 2002. http://nymag.com/nymetro/news/media/columns/medialife/6099/ (accessed May 2, 2010).
[22] Wolff, "Facing the Music."

traditional radio cannot offer. There are also free streaming versions of online companies, which generally have short ads between songs and on the website itself, as well as some restrictions on the music, such as the amount of songs that can be skipped per hour.

Pandora is one of the most popular internet radio sites in the United States. It was founded ten years ago, and allows for consumers to create personalized stations based on ratings of songs and artists. Pandora's founder, Tim Westegren, claims that "This business needs to reinvent itself…it's about the audience."[23] With a heavy emphasis on the musical needs and wants of the consumer, Pandora has been immensely successful. Pandora has generated about $40 million annually from advertising revenue from those users that don't pay for ad-free service. This revenue mostly goes back to pay royalties for the artists. As well as having a customer focus, Pandora is willing to use artists on their site that are unrepresented by any music company. This allows for artists to gain recognition and fans without the use of a music company, which has been the trend for all internet-based music endeavors. Pandora uses more than 80,000 artists on their website, 70% of which are unsigned, independent artists.[24] Pandora and other internet radio services have had a big impact on the relevance on traditional radio, as well as providing further obstacles for music companies to overcome in order to promote their artists to the public.

Satellite radio was an exciting new forum for music several years ago, but has recently begun to experience some problems as other, less-expensive alternatives are

[23] Lara Cooper, "Pandora Founder Says Future of Music Industry Has No Middle," Noozhawk, http://www.noozhawk.com/local_news/article/101009_pandora_founder_music_industry/ (accessed May 2, 2010).
[24] Cooper, "Pandora Founder Says Future of Music Industry Has No Middle."

developed, like internet radio stations discussed above. Sirius XM has huge expenses, nearly $450 million in 2008. This includes $100 million to Howard Stern and $30 million to Major League Baseball in order to broadcast all of their games.[25] But because of the increasing availability of alternatives that are often cheaper and very comparable, Sirius XM has been faced with the challenge of remaining profitable amidst a recession. Consumers are able to pay several hundred dollars once for a portable internet radio, a few dollars a month for mobile phone apps, or nothing at all to take advantage of free streaming radio on the internet. Mobile devices are making it especially hard for Sirius XM to compete. For example, the iPhone has an application for Major League Baseball games to be streamed live, as well as score updates and video clips, for only $10, while Sirius XM charges $10 each month for the same service.[26] Satellite radio is still affecting the music industry, as it must pay royalties and hosts a wide range of artists, but it is also facing problems in competing with the internet, and may not be a viable music resource for too much longer.

Obstacles to be Overcome by the Music Industry

Essentially, the music industry has to try to find a way to sell their product even though it can be obtained for free. “Most agree that the currency of exchange for recorded music will be the attention of the fans instead of their money.”[27] Instead of trying to sell the physical music to make a profit, many companies are trying other ways to profit from their artists, including Warner Music Group. They are changing their

[25] Olga Kharif, "Serious Threats to Sirius Radio," Business Week, http://www.businessweek.com/technology/content/mar2009/tc20090327_877363.htm (accessed May 2, 2010).
[26] Ibid.
[27] Wolff, "Facing the Music."

contracts to include touring, merchandising, and sponsorship, and will receive a percentage of those revenues. This is proving to be successful, as many artists are seen as personas, rather than just someone who creates music. Warner Music Group has implemented this using what they call "expanded rights" contracts for about half of their artists.

Music companies also need to cut costs. The days of glitzy parties, lots of perks and astoundingly high salaries are over. Consumers are no longer as willing to pay for music: that is the bottom line. The music industry is evolving from a glamorous, expensive industry to one that is driven by YouTube videos and file-sharing. One glitzy release party was recently described by the *Wall Street Journal* as costing $2.2 million dollars for a new artist named Carly Hennessey, who sold less than 400 CDs.[28] Music companies need to be more efficient when spending their money, investing less on unknown artists, and using more cost-effective ways to promote artists, such as viral campaigns and website advertising.

According to many insiders, "recorded music will cease to be paid for by the end consumer. It will instead either be free (built into the cost of marketing other products) or built into the cost of other services you pay for such as your Internet and cable TV bill or your mobile phone service."[29] This is becoming the case, as seen with Sirius radio, mobile phone ringtones, and music download services on mobile phones. One such program, Comes With Music by Nokia, has been introduced in Australia and Singapore with great success, and should be introduced in the United States in late 2010.[30] Android

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[28] Ibid.
[29] McCready, "The Future of the Music Industry."
[30] Jacqueline Emigh, "Nokia's Comes with Music to launch in both US and Australia this year,"

smartphones have introduced Shazam as their answer to music access on mobile devices. This service allows for unlimited downloads, a program that can recognize songs when they are played, playlist creation, and can connect users to the musician's webpages. Shazam has the availability for music to be stored on phones, rather than be played in a streaming capacity, in order to overcome the problem of bad cellular connections that could disrupt music streaming.[31] Music recognition programs have been one of the most popular application downloads for the iPhone, and are also available for the Android, BlackBerry, and other smartphones and mobile phone devices.[32]

With the growing number of smartphones in the market, it is predicted the mobile phones will play an important role when consumers are buying, discovering, and listening to music. It is an example of how music can successfully be provided to the end user legally and for a fee. Although the profit margins on these endeavors are not as high as other traditional methods, such as CD sales, it can still represent an important emerging market sector that music companies should exploit. Because these markets are relatively new, rapidly expanding, and already very successful, music companies should explore subscription services, applications, and music storage on mobile devices because it is likely that they can become very profitable in the near future.

RECOMMENDATIONS

Alter Pricing Practices

BetaNews, http://www.betanews.com/article/ Nokias-Comes-with-Music-to-launch-in-both-US-and-Australia-this-year/1235653973 (accessed May 2, 2010).
[31] Emigh, "Digital Music Forum."
[32] Ibid.

WMG has several options when it comes to pricing that it can exploit to maintain revenue. First of all, it should lower prices of physical music products, such as CDs. However, this may be impossible to do, as many retailers set their own prices. Online prices are often set without even consulting with the company. One famous example is when Coldplay's CD *A Rush of Blood to the Head* was released by EMI, it was supposed to be sold for $13. Without warning, iTunes slashed the price to $11.88. When an EMI representative called Apple to ask them to change the price, the answer was that they could either accept the price or take it off iTunes altogether.[33] In order to overcome this obstacle, WMG should try to price its products according to demand. Popular, established artists have fanbases that are willing to spend money on new releases, and are likely to buy entire albums. Warner Music Group should make its less popular music cheap and accessible, so that consumers who would not be willing to buy a whole CD can buy one or two songs. This may not have the same margin, but it is better than no profit at all. In general, "music companies should profit by selling million of small, niche items"[34] rather than focusing on large profits for every artist.

Another thing that WMG can consider is adding additional product to the CDs to make them more attractive to consumers. Extra tracks, concert footage, eye-catching packaging or band memorabilia can induce people to buy the actual product, rather than the cheaper alternative online. Another option is to bundle songs together online. If people are looking to buy a specific song, they may be willing to pay extra if it comes with additional songs, even if they were not considering buying the other songs initially.

[33] Knopper, 177.
[34] Knopper, 238.

This will increase revenue and artist recognition, and may encourage consumers to buy their music in the future.

Another idea that music companies have been toying with is making internet providers charge their users for obtaining music for free online. They ISP would put all of the money collected together, and then distribute it to artists, labels, and songwriters.[35] Warner Music has hired a consultant to push this idea, which is simple and straightforward enough. However, it is unlikely that this idea will ever come to fruition, as internet service providers have no legal obligation to do so, and would be unwilling to cut into their own revenue or pass the charge onto their users.

Reconsider Streaming Music

Streaming music sites such as Last.fm and Pandora allow customers to listen to music for free, interrupted occasionally by advertisements. These sites also offer "premium membership" for a fee, but the majority of listeners prefer to listen for free. Although record companies may not make any significant amount of money off of these sites, it may be beneficial in the long term to continue to offer WMG music. Streaming music sites should be embraced, or the company may face a disadvantage in the future.

Streaming music online allows the consumer to hear the music on a legal site, which increases awareness of the artists. The user may be persuaded obtain the music they hear, especially if they are exposed to unfamiliar artists. This increases the amount of people who may download music legally, as people are more willing to buy music that they are familiar with and they know they like. A great example of this is when Radiohead offered their album on their website, pay only what you want. Most people

[35] Knopper, 243.

didn't pay, but a good amount did, and record sales for the CD were higher than expected due to the exposure to the public beforehand. In addition, streaming websites allow the listeners to hear new or obscure music. The non-traditional music market is a growing segment for WMG, already accounting for 10% of revenue, and allowing more customers to hear it can increase the market share for non-traditional music.

Focus on the Mobile Phone Market

WMG has already started to tap this market, but the opportunity for growth is enormous. Many smartphones are being sold with wireless access to music and the ability to download music for a fee. Sales of smartphones grew by 15.1% in 2009, and are expected to continue with huge sales numbers.[36] With such large growth in the market, WMG should take advantage and aggressively promote its music services on smartphones. Additionally, WMG should market phone extras for its artists. Many people are willing to pay a premium to get the perfect ringtone or wallpaper of their favorite band. It is also a surprisingly large money maker. Ringtone revenue grew from $68 million in 2003 to $600 million in 2006, and will continue to grow, especially overseas.[37] As an added bonus, ringtones are not a threat to intellectual property, as it is nearly impossible to copy or share a ringtone. Warner Music Group created a joint venture in South Korea with telecom company SK Telecom in 2006 to offer ringtones of their music.[38] The South Korean market has very strong ringtone sales, and Warner Music

[36] Andy Patrizio, "Smartphones a Hot Seller, Up 39 Percent in Q4," Internet News, http://www.internetnews.com/stats/article.php/3863436/Smartphones+a+Hot+Seller+Up+39+Percent+in+Q4.htm (accessed March 2, 2010).
[37] Knopper, 234.
[38] Knopper, 235.

Group should use this success as a basis to expand to other markets where ringtones are especially popular.

In addition to ringtones, Warner Music Group should make its artist's music available to users of smartphones and programs that can allow access of their music to consumers. Programs like Shazam, Comes with Music, and other similar programs have enjoyed great initial success. These programs allow consumers to obtain music on their phones legally, create playlists, and listen to their favorite songs. What may be the most exciting part of these programs is the software that allows these smartphones to recognize music. If a consumer hears a song that they love in a store, in a movie, or elsewhere, they can use their phones to recognize the artist and song. This allows consumers to discover new artists with very little promotion from music companies. As long as a company such as Warner Music Group is able to get their music played in public, many more people will be able to learn about the artist, and may even be persuaded to buy their music.

Smartphones are the new frontier: they have only recently been introduced on the market, and the possibilities for music companies are endless. With such a large market with access to their music, they should explore other ways to promote their artists using smartphones. Additionally, as the market for smartphones is expanded, more and more people will be able to take advantage of these programs, and will be able to expand their musical knowledge. Especially as most of the people downloading songs are generally younger and the most tech-savvy consumers, they will be the same consumers that will be the most likely to use the smartphone programs to acquire new music, which provides Warner Music Group and other music companies huge growth potential in coming years.

"Expanded Rights" Contracts

Expanded rights contracts have proven to be hugely successful in the past for WMG. Currently, the company has expanded rights contracts with about half of its artists. By signing more of these contracts, WMG is entitled to a share of the profits from touring, merchandise, and other activities. These activities are extremely lucrative, and can help bolster the bottom line. By signing more artists to these contracts, WMG has a larger stake in their success, and is more motivated to get them airplay and performance opportunities. Both parties will work together to ensure success.

There are several different degrees of expanded rights contracts, ranging from full ownership over all aspects of an artist, to limited involvement from the record company. At one end of the scale is what is called a 360, or equity, deal. With this kind of contract, the artist's career is completely under the control of the music company. The artist gets a large amount of money up front, in exchange for absolutely no creative control over themselves or their music. The artist essentially becomes a brand of the music company.[39] The company is highly invested, and therefore is looking to promote the artist heavily for many years in order to make as much profit as possible. An example of a 360 artist is Madonna, who recently signed a contract with Live Nation, a subsidiary of Clear Channel radio. Madonna received an estimated $120 million in exchange for a percentage of her concerts and her music sales.[40] This deal in itself is interesting, because Madonna left her Warner Music Group, her label of twenty-five years, in order to sign a deal with a company that has no experience in promoting artists, but was simply a company that

[39] David Byrne, "David Byrne's Survival Strategies for Emerging Artists — and Megastars," Wired Magazine, http://www.wired.com/entertainment/music/magazine/16-01/ff_byrne?currentPage=all (accessed May 2, 2010).
[40] Knopper, 245.

produced and promoted concerts. This may be a choice that becomes more popular in the future if Madonna's deal is successful, as a company like Live Nation may be able to provide services that a music company can no longer provide with its lowering revenues and other financial issues.

Other contracts may allow the artist to maintain the ownership of their songs, while some contracts dictate that once an artist creates a song, it is the property of the music company. Warner Music Group usually maintains the ownership of songs as part of Warner/Chappell Music, which is one of the largest music publishers in the world. Warner/Chappell Music collects royalties from the songs in its collection, which is an important revenue driver of Warner Music Group. There are other forms of contracts, that allow the music company to only manufacture and distribute the music, or that allow for a music company and artists to share profits based on a set of pre-determined factors. Each of these options have their pros and cons, but the trend in recent years has been for the record company to become more involved in the artist's career, in order to receive more of the profits generated. This is not the best plan for all artists, as it involved significant investments from the music company that will hopefully be recovered with the promotion and marketing services that the company can provide. However, many established music acts have been switching to this kind of contract. These expanded rights contracts often work to the advantage of both parties involved: the music company gets a larger revenue stream and the artist benefits from the full force of the music company working to promote them as an artist, which increases recognition, a larger fan base for the artist, and higher profits.

CONCLUSION

Warner Music Group and the music industry in general face a seemingly insurmountable task: to change the way they operate in order to remain relevant and profitable in the face of heightened competition with the availability of legal and illegal music on the internet. The slowdown of the industry in recent years has become very apparent. Album sales in 2007 were down 15%, with steep declines in every genre. Tower Records, the music megastore, has closed, along with 2,700 other music retailers since 2003.[41]

Mark Williams, who worked for Interscope Records in the A&R department, sums the future up well. "People at the majors have been looking for an answer. The obvious answer is 'there is no answer.' Big labels are going to become smaller and smaller."[42] Warner Music Group and the other big music companies need to face the facts: their current business is unsustainable. There is no way they can continue to be profitable indefinitely, and the tide has already turned. The big companies need to shift their emphasis from CDs to digital options such as online radio, mobile devices, and expanded rights contracts. These recommendations will earn the companies the revenue they need to continue to fund the search for new talent. However, the days of huge net profits are over. CD sales are going to continue to decline, and music companies need to deal with the loss of their major revenue driver.

The internet has undeniably affected the music industry. At the moment, it seems as if the internet has destroyed the music industry. However, that may not be the case.

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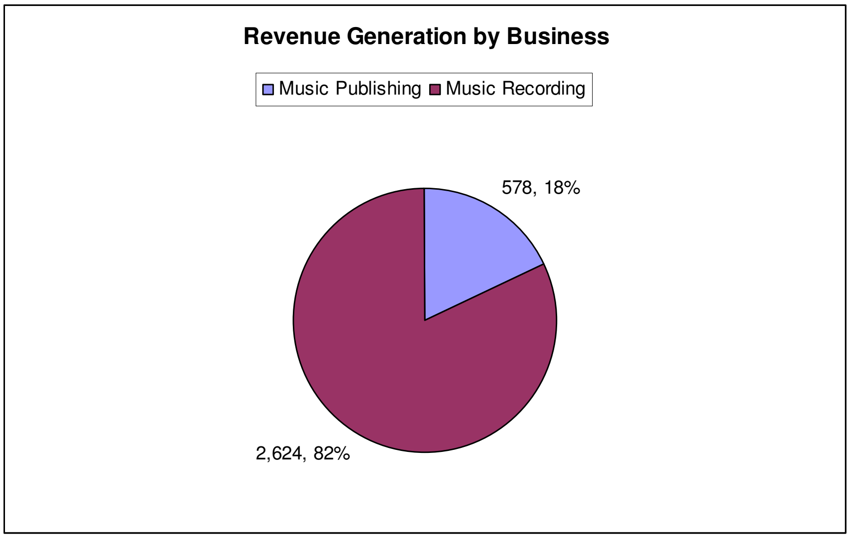
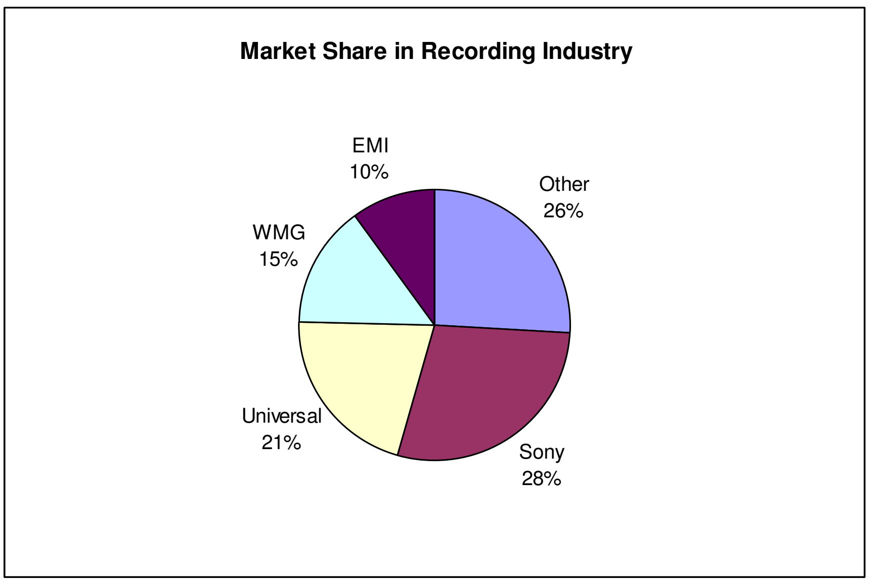
[41] Knopper, 240.
[42] Knopper, 248.

Warner Music Group and the other major music companies need to find the ways that they can make money from digital music. The internet has ushered in a new era, where artists have the freedom to make their music, unburdened from the demands of the music companies or the radio. They are able to make music for their listeners, and their listeners are able to have access to that music thanks to the internet. This is the basic idea behind music: to provide a product to those that want it. The question is whether Warner Music Group and other music companies will help the spread of music from artists to consumers, or hinder future growth.

APPENDICES



(WMG Annual Report 2009)



Percentage of Sales by Format

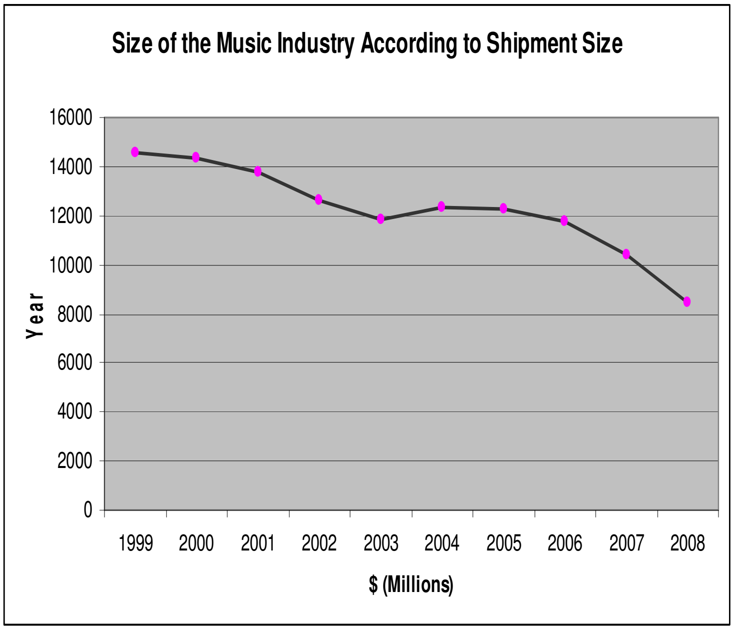
Format	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Full-length CDs	83.2	89.3	89.2	90.5	87.8	90.3	87.0	85.6	82.6	77.8	%
Full-length cassettes	8.0	4.9	3.4	2.4	2.2	1.7	1.1	0.8	0.3	0.4	
Singles (all types)	5.4	2.5	2.4	1.9	2.4	2.4	2.7	3.4	2.4	3.8	
Music videos/Video DVDs	0.9	0.8	1.1	0.7	0.6	1.0	0.7	1.1	0.4	0.8	
DVD audio	NA	NA	1.1	1.3	2.7	1.7	0.8	1.3	1.2	1.0	
Digital Download	NA	NA	0.2	0.5	1.3	0.9	5.7	6.7	11.2	12.8	
SACD	NA	NA	NA	NA	0.5	0.8	1.2	0.0	0.6	1.1	
Vinyl LPs	0.5	0.5	0.6	0.7	0.5	0.9	0.7	0.6	0.7	1.0	

(RIAA)

Total U.S. Dollar Value

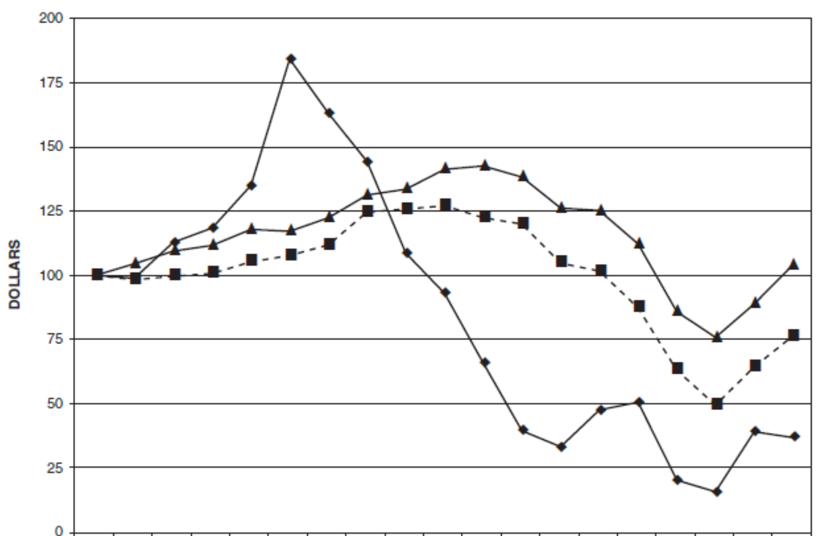
The figures below (in millions) indicate the overall size of the U.S. sound recording industry based on manufacturers' shipments at suggested list prices.

1999	$14,584.5
2000	$14,323.0
2001	$13,740.9
2002	$12,614.2
2003	$11,854.4
2004	$12,345.0
2005	$12,296.9
2006	$11,758.2
2007	$10,372.1
2008	$8,480.2



(RIAA)

COMPARISON OF CUMULATIVE TOTAL RETURN AMONG WARNER MUSIC GROUP, NYSE MARKET INDEX AND PEER GROUP INDEX



	5/11/05	6/05	9/05	12/05	3/06	6/06	9/06	12/06	3/07	6/07	9/07	12/07	3/08	6/08	9/08	12/08	3/09	6/09	9/09
WARNER MUSIC GROUP	100.00	98.78	112.87	118.47	134.99	184.36	163.15	144.29	108.70	92.88	65.72	39.43	33.13	47.50	50.56	20.09	15.63	38.92	36.79
PEER GROUP INDEX	100.00	98.20	99.57	100.79	105.26	107.68	111.77	124.74	125.72	127.17	122.43	120.03	104.75	101.59	87.35	63.01	49.33	64.35	76.28
NYSE MARKET INDEX	100.00	104.49	109.35	111.64	117.89	117.21	122.38	131.19	133.61	141.34	142.65	138.25	126.19	125.29	112.13	85.82	75.86	88.84	104.12

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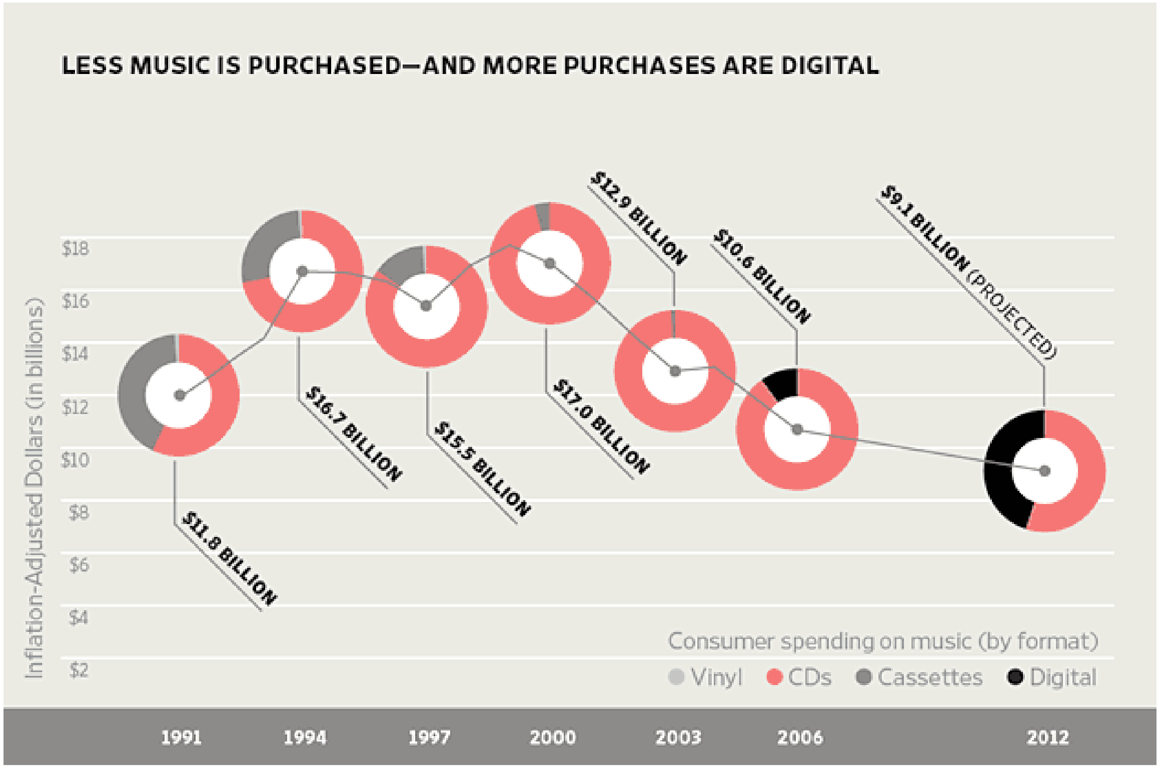

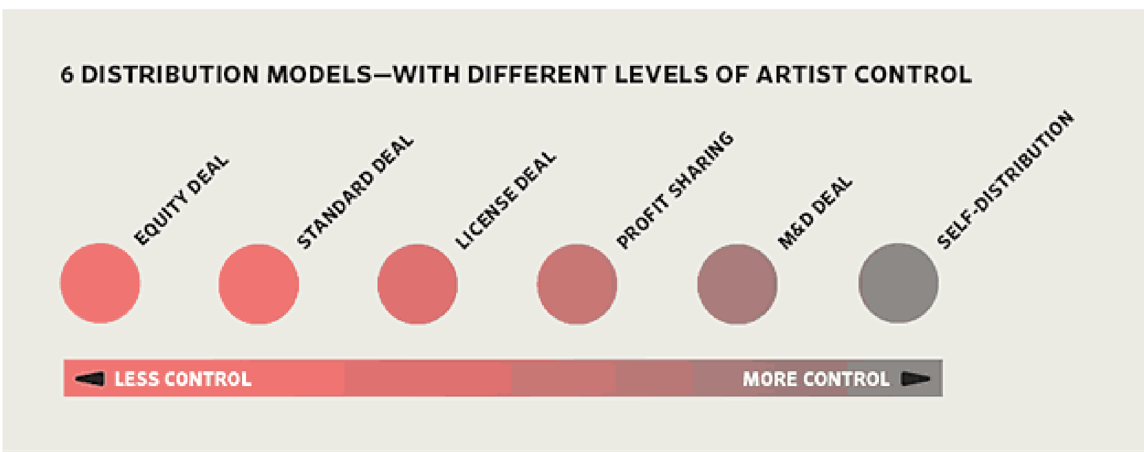

Figures from: Byrne, "David Byrne's Survival Strategies for Emerging Artists — and Megastars."

Balance Sheet

	September 30, 2009	September 30, 2008
	(in millions)	
Assets		
Current assets:		
Cash and equivalents	$ 384	$ 411
Accounts receivable, less allowances of $135 and $159 million	544	538
Inventories	46	57
Royalty advances expected to be recouped within one year	171	174
Deferred tax assets	29	30
Other current assets	48	38
Total current assets	1,222	1,248
Royalty advances expected to be recouped after one year	209	212
Investments	18	155
Property, plant and equipment, net	100	117
Goodwill	1,040	1,085
Intangible assets subject to amortization, net	1,317	1,539
Intangible assets not subject to amortization	100	100
Other assets	64	70
Total assets	$4,070	$4,526
Liabilities and Shareholders' Deficit		
Current liabilities:		
Accounts payable	$ 219	$ 219
Accrued royalties	1,185	1,189
Accrued liabilities	339	312
Current portion of long-term debt	—	17
Deferred income	113	117
Other current liabilities	16	17
Total current liabilities	1,872	1,871
Long-term debt	1,939	2,242
Deferred tax liabilities	172	237
Other noncurrent liabilities	230	262
Total liabilities	4,213	4,612
Commitments and Contingencies (see Note 17)		
Shareholders' deficit:		
Common stock ($0.001 par value; 500,000,000 shares authorized; 154,590,926 and 154,012,885 shares issued and outstanding)	—	—
Additional paid-in capital	601	590
Accumulated deficit	(786)	(686)
Accumulated other comprehensive income, net	42	10
Total shareholders' deficit	(143)	(86)
Total liabilities and shareholders' deficit	$4,070	$4,526

Consolidated Statements of Operations

	Fiscal Year Ended September 30, 2009	Fiscal Year Ended September 30, 2008	Fiscal Year Ended September 30, 2007
	(in millions, except per share data)		
Revenues	$ 3,176	$ 3,491	$ 3,383
Costs and expenses:			
Cost of revenues	(1,698)	(1,832)	(1,811)
Selling, general and administrative expenses (a)	(1,118)	(1,233)	(1,161)
Other income, net	—	3	73
Amortization of intangible assets	(225)	(222)	(206)
Restructuring costs	—	—	(50)
Total costs and expenses	(3,041)	(3,284)	(3,155)
Operating income from continuing operations	135	207	228
Interest expense, net	(195)	(180)	(182)
Minority interest income (expense)	4	(5)	(5)
Gain on sale of equity-method investment	36	—	—
Gain on foreign exchange transaction	9	—	—
Impairment of cost-method investments	(29)	—	—
Impairment of equity-method investments	(11)	—	—
Other income (expense), net	1	(8)	—
(Loss) income from continuing operations before income taxes	(50)	14	41
Income tax expense	(50)	(49)	(49)
Loss from continuing operations	(100)	(35)	(8)
Loss from discontinued operations (see Note 5)	—	(21)	(13)
Net loss	$ (100)	$ (56)	$ (21)
Net loss income per common share:			
Basic earnings per share:			
Loss from continuing operations	$ (0.67)	$ (0.24)	$ (0.05)
Loss from discontinued operations	—	(0.14)	(0.09)
Net loss	$ (0.67)	$ (0.38)	$ (0.14)
Diluted earnings per share:			
Loss from continuing operations	$ (0.67)	$ (0.24)	$ (0.05)
Loss from discontinued operations	—	(0.14)	(0.09)
Net loss	$ (0.67)	$ (0.38)	$ (0.14)
Weighted average common shares:			
Basic	149.4	148.3	146.2
Diluted	149.4	148.3	146.2
(a) Includes depreciation expense of:	$ (37)	$ (46)	$ (40)

Consolidated Statements of Cash Flows

	Fiscal Year Ended September 30, 2009	Fiscal Year Ended September 30, 2008	Fiscal Year Ended September 30, 2007
		(in millions)	
Cash flows from operating activities			
Net loss	$ (100)	$ (56)	$ (21)
Loss from discontinued operations	—	21	13
Loss from continuing operations	(100)	(35)	(8)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Gain on sale of equity investment	(36)	—	—
Gain on foreign exchange transaction	(9)	—	—
Gain on sale of building	(3)	—	—
Impairment of equity investment	11	—	—
Impairment of cost-method investments	29	—	—
Depreciation and amortization	262	268	246
Deferred taxes	—	(3)	(2)
Non-cash interest expense	62	46	60
Non-cash, stock-based compensation expense	11	11	10
Minority interest (income) expense	(4)	5	5
Other non-cash adjustments	—	(3)	(4)
Changes in operating assets and liabilities:			
Accounts receivable	(8)	28	73
Inventories	10	2	3
Royalty advances	(20)	(6)	18
Accounts payable and accrued liabilities	40	(16)	(78)
Other balance sheet changes	(11)	7	(21)
Net cash provided by operating activities	234	304	302
Cash flows from investing activities			
Repayments of loans by (loans to) third parties	3	(3)	(14)
Investments and acquisitions of businesses	(16)	(132)	(212)
Acquisition of publishing rights	(11)	(25)	(25)
Proceeds from the sale of investments	125	25	18
Proceeds from the sale of building	8	—	7
Capital expenditures	(27)	(32)	(29)
Net cash provided by (used in) investing activities	82	(167)	(255)
Cash flows from financing activities			
Debt repayments	(1,379)	(17)	(17)
Proceeds from issuance of Senior Discount Notes	1,059	—	—
Deferred financing costs paid	(23)	—	—
Returns of capital and dividends paid	—	(42)	(79)
Other	—	—	2
Net cash used in financing activities	(343)	(59)	(94)
Effect of foreign currency exchange rate changes on cash	—	—	13
Net (decrease) increase in cash and equivalents	(27)	78	(34)
Cash and equivalents at beginning of period	411	333	367
Cash and equivalents at end of period	$ 384	$ 411	$ 333

Historical Revenue by Business Sector

	For the Fiscal Years Ended September 30,			2009 vs. 2008		2008 vs. 2007	
	2009	2008	2007	$ Change	% Change	$ Change	% Change
Recorded Music							
Revenue	$2,624	$2,895	$2,835	$(271)	-9%	$ 60	2%
OIBDA (1)	336	416	421	(80)	-19%	(5)	-1%
Operating income from continuing operations (1)	$ 153	$ 233	$ 249	$ (80)	-34%	$(16)	-6%
Music Publishing							
Revenue	$ 578	$ 623	$ 570	$ (45)	-7%	$ 53	9%
OIBDA (1)	161	162	160	(1)	-1%	2	1%
Operating income from continuing operations (1)	$ 93	$ 91	$ 98	$ 2	2%	$ (7)	-7%
Corporate Expenses and Eliminations							
Revenue	$ (26)	$ (27)	$ (22)	$ 1	-4%	$ (5)	23%
OIBDA (1)	(100)	(103)	(107)	$ 3	-3%	4	-4%
Operating loss from continuing operations (1)	$ (111)	$ (117)	$ (119)	$ 6	-5%	$ 2	-2%
Total							
Revenue	$3,176	$3,491	$3,383	$(315)	-9%	$108	3%
OIBDA (1)	397	475	474	$ (78)	-16%	$ 1	—
Operating income from continuing operations (1)	$ 135	$ 207	$ 228	$ (72)	-35%	$(21)	-9%

Net loss

	For the Fiscal Years Ended September 30,			2009 vs. 2008		2008 vs. 2007	
	2009	2008	2007	$ Change	% Change	$ Change	% Change
OIBDA	$ 397	$ 475	$ 474	$(78)	-16%	$ 1	—
Depreciation expense	(37)	(46)	(40)	9	-20%	(6)	15%
Amortization expense	(225)	(222)	(206)	(3)	1%	(16)	8%
Operating income from continuing operations	**135**	**207**	**228**	**(72)**	**-35%**	**(21)**	**-9%**
Interest expense, net	(195)	(180)	(182)	(15)	8%	2	-1%
Minority interest income (expense)	4	(5)	(5)	9	—	—	—
Gain on sale of equity-method investment	36	—	—	36	—	—	—
Gain on foreign exchange transaction	9	—	—	9	—	—	—
Impairment of cost-method investments	(29)	—	—	(29)	—	—	—
Impairment of equity-method investments	(11)	—	—	(11)	—	—	—
Other income (expense), net	1	(8)	—	9	—	(8)	—
(Loss) income from continuing operations before income taxes	**(50)**	**14**	**41**	**(64)**	**—**	**(27)**	**-66%**
Income tax expense	(50)	(49)	(49)	(1)	2%	—	—
Loss from continuing operations	**(100)**	**(35)**	**(8)**	**(65)**	**—**	**(27)**	**—**
Loss from discontinued operations, net of taxes	**—**	**(21)**	**(13)**	**21**	**-100%**	**(8)**	**62%**
Net loss	**$(100)**	**$ (56)**	**$ (21)**	**$(44)**	**79%**	**$ (35)**	**—**

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