



# *Worth Noting*

*Volume IV, Issue VIII, 12<sup>th</sup> May 2004*

***Worth Noting is the journal of research and conferences company L21. It is focused on issues of relevance and interest to senior executives.***

It seems music record piracy is on rise.

The legitimate music industry argues that piracy is the greatest threat to not only the music industry but to musicians and the development of local talent. Many consumers will argue that record companies have for years been complacent, greedy and arrogant and pirated music is simply justified payback against the industry.

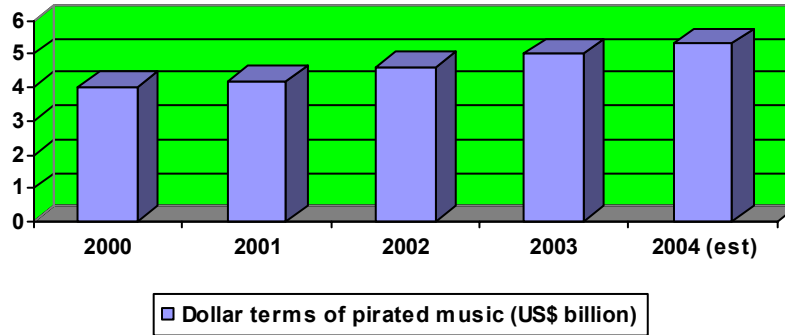
In this edition of Worth Noting, we look at the facts about piracy and what this might mean for the music industry in particularly developed markets.

## **Music piracy – How widespread is it?**

Whether you think piracy matters or not, there is no doubt that it is a huge underground industry. A massive two out of every five records sold worldwide is pirated (40%). Pirated copies sold amount to almost 2 billion units worldwide and seizures by authorities, which has quadrupled since 2001, still only amount to only about 50 million units. In other words, authorities only seize about 2-3% of illegal copies in the market.

Not only is piracy here to stay – as an 'industry' it is growing.

### Growth in Global Music Piracy



Source: IFPI, 2003

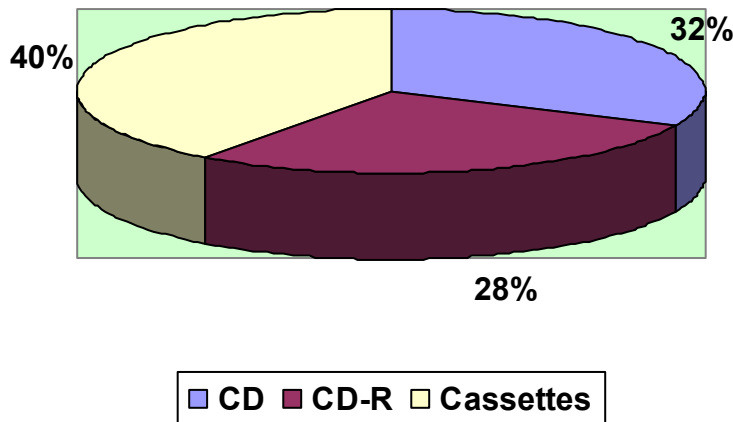
To put it in context, this global underground industry is bigger than any legitimate national industry except for the U.S.A. and Japan.

There are basically three kinds of pirated music:

- Old style cassettes
- Music burned onto CR-Rewritables
- Pressed CDs (what we buy from record shops)

The rough share of types of pirated music is as follows.

### Form of global Pirated Music



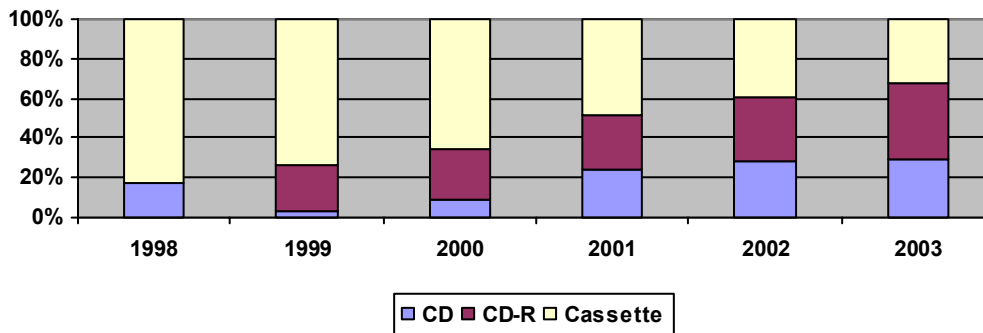
Source: IFPI, National Groups 2003

Cassettes are the most common in non-developed markets in the Middle East, Asia, Africa and Eastern Europe.

CR-Rs are most common in our markets where CD burners are omnipresent and cassette players have all but gone the way of beta video tapes.

**The real growth format and the current threat in global markets are pressed CDs.** While burning onto CD-R is time consuming, pressed CDs can be produced cheaply, en masse and mechanically.

### Global Piracy by Format



Source: IFPI, National Groups, L21 Analysis

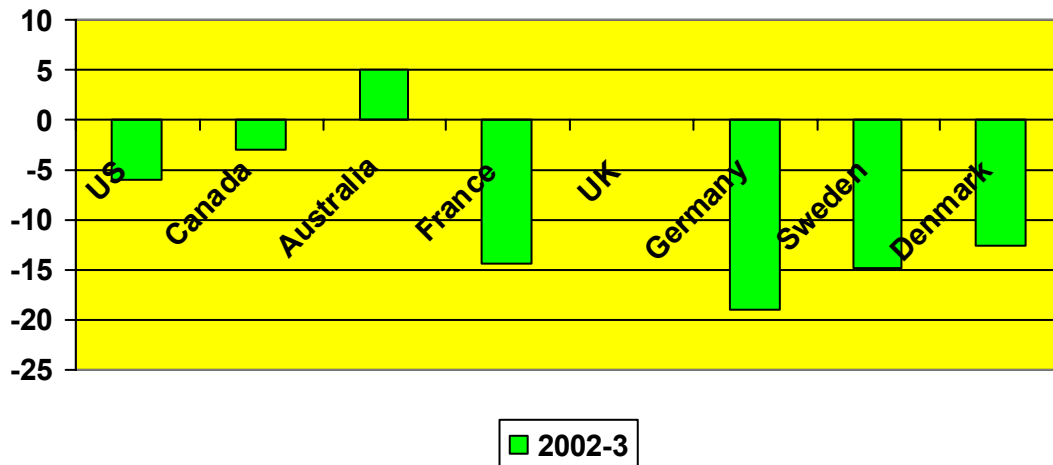
Cassette tape piracy occurs overwhelmingly in less developed markets of Asia, Africa, Middle East and Europe. Countries in these places exhibit piracy levels of about 50%. That is, one in two cassette tapes are pirated copies.

CD-Rs are more relevant for our market. In countries such as Australia, U.K., U.S and Western European countries, pirated music is less than 10% of music sold.

This begs the question about Western markets: Is pirated music a massive problem for legitimate record companies or is the underground industry just a menace for legitimate record companies that are already doing quite well?

## Music Piracy and Western Markets

### Sales Increase (Decrease) in Percentage 2002-3



Source: *The Recording Industry World Sales 2003 Report*

Australia was the only Western market to experience an increase in music sales for the period. Is this the result of music piracy?

There are a number of unpredictable factors that go into music sale statistics. For example, the rise and rise of performers such as Delta Goodrem, Powderfinger and of course Guy Sebastian was a significant boon for the Australian industry. The point is that sales go up and down for a number of reasons. In Western markets where pirated music is less than 10% of total sales, broad statistics are unlikely to give us solid clues as to the impact of piracy on legitimate sales.

Moreover, there is an important oversight in the above statistics. They do not take into account legal music downloads. Hence, buying music legitimately to download from the Internet is also a factor that will impact on sales of physical CDs.

Besides, alternative research has showed that between 1997-2002, legal music purchase (both pressed CDs and online) has increased 30%. This tends to suggest that decline in sales of CDs is impacted by legitimate online sales. Poorly performing record companies cannot simply blame piracy.

The availability of music online whether illegal or legitimate is, we believe, the crucial driver behind the shaping of the future record industry. Why? Not only did rebel sites such as Napster herald a new age of online piracy; but illegally and legal downloading and purchasing of music online is becoming an increasing habit for music consumers. This, in turn, is changing the cost and distribution structures of the whole music industry in developed economies.

More telling research should focus on the individual habits of music consumers. Some consumer groups have argued that freely available music actually increases consumer exposure to different performers and might actually increase sales of legitimate CDs.

Is this true? Research suggests otherwise.

There have been several reports that have done this, although the research and results are somewhat piecemeal.

In Western markets, music piracy is most often perpetrated at the individual level. That is, we might copy a friend's CD, or illegally download music from the Internet.

Summaries of surveys are below:

Forrester Research – Europe (2003): 40% of people who download buy less music than they did before they downloaded. Only 2% of people said they bought more music after downloading.

Jupiter Research – U.S. (2003): 33% of people who shared music files decreased spending on music after sharing files. Only 16% had increased spending on music after sharing files.

Edison Media Research – U.S. (2003): For heavy downloaders (more than 100 files), the number of CDs they bought dropped 61%.

So illegal downloaders do not spend more on music. Let's look further into the music download segment.

### **Online Music Industry**

Although record companies hate to admit it, the boom in illegal music downloads during the 'Napster' era helped evolve the record industry. It shook record companies out of their complacency.

First, a whole new market was opening up. There were other ways of getting music besides the compilations that record companies produced. We were not restricted to either single artists/bands or the latest 'Summer Sizzlin' Hits' of random tracks which record companies put out.

Second, consumers would not willingly pay for overpriced pressed CDs forever.

Third, record companies could not put up the same arguments about the costs of distribution etc. to justify the high prices charged for records.

Faced with the growing threat of illegal online downloads, and rapidly losing the public relations war as to why sites like Napster should be banned, record companies had to come up with their own online strategies. Merely banning Napster did not make the problem go away.

We are not here advocates of an illegal music industry. We are simply pointing to the fact that it was largely the underground download community that shock record companies out of their complacency to deliver a better outcome for music consumers. Music downloads, whether legal or illegal, was a natural evolution in access to music.

What is the future of the music record industry?

We believe two things will occur:

1. An increase in legitimate online music purchase (at the expense of traditional pressed CDs).
2. A decrease in piracy in terms of burning CD-Rs. (Pressed illegal CDs are not a great problem in our kind of markets.)

Here's why we think so.

### **An increase in legitimate online music purchase**

Purchasing download rights online is on the increase.

Once again, the evidence is in bits and pieces but is growing:

U.S.: Downloaded singles outsold physical singles by three to one in 2003.  
Number of Americans who paid for downloads doubled from 8% to 16% from 2002-3.

Europe: Registered users for legal download sites increased from 380,000 to 450,000 from End Q3 to End Q4 2003.  
Tracks downloaded monthly increased from 220,000 to 300,000 in the same period.

At the moment, market penetration is still small because awareness of consumer download sites is still poor, especially in Europe. But significant companies are investing heavily in the online industry: HP, Microsoft and Amazon in the U.S.; Coca-Cola, iTunes and Napster 2.0 in Europe; and BigPond in Australia.

There is no doubt that an efficient download music industry is a plus for consumers: music will be cheaper, choice of compilations will be far superior and we can download anytime. It is what the Internet was made for.

However, before online music sales overtakes pressed CDs, several things have to happen:

1. Household broadband penetration has to increase.

Consumers are not going to wait half an hour to download one track on dial-up connections. In developed countries like Taiwan and South Korea, household broadband penetration is 50% and 80% respectively. However, in countries such as U.K., and U.S., the figure is closer to 15% and 25% respectively. This needs to increase and will.

2. Profitable online business models for the music industry must be hammered out.

For example, aspects such as rights clearance and re-negotiations between all interested parties (e.g., record companies, music publishers, licence holders in different territories and countries) must be worked out.

3. Enabling technologies must be ready.

Hundreds of thousands of tracks must be digitalized – a massive task. Secure payment systems across national boundaries and virus free environments must be guaranteed.

### **A decrease in piracy in terms of illegally burning CD-Rs**

Consumers in our developed markets illegally burn CD-Rs for several reasons.

First, and most obvious, we're getting something free. That is the ultimate incentive. Is the legal record market then doomed? We do not think so. We all want something for nothing in all kinds of industries but measures are put in place to stop that from occurring. After a slow start, the music industry is starting to get its act together.

1. Public awareness of the problem.

Remarkably, a large proportion of music consumers a few years ago did not realize that downloading music from certain sites were actually illegal. Only one in five people five years ago realized the activity was illegal. Now it's about four in five.

## 2. Greater willingness to abide by the law.

When illegal download sites first sprung up, consumers were not just lured by free music. Surveys revealed a definite intent to defy record companies who were perceived as greedy, exploitative and monopolistic. Legal or illegal, it was cool to use to Napster.

The perception now is changing. In surveys conducted in the U.S. and U.K., almost two thirds of music consumers now believe that piracy is harming the industry and legal action is appropriate.

Moreover, as record industries are forced to buy into the online distribution model, there is now a legitimate alternative to illegal downloading.

## 3. Technological protection of copyrighted music.

A combination of pre-release and post-release technological security has been bulked up by record companies to prevent unauthorised access to music digitally. This is far from perfect but significant money is being spent on these types of technology.

## 4. Cooperation with ISPs

The number of music files removed from the Internet and infringing sites due to action by ISPs is increasing rapidly. Files taken down has jumped from 700 million in 2001 to 1.6 billion in 2003. Similarly, websites taken down for illegal distribution of music have increased from 28,000 in 2001 to 41,000 in 2003.

## 5. More effective laws and greater prosecution of large operations that illegally distribute music.

Western European countries as well as Taiwan and South Korea are now following the lead of the U.S. in aggressively pursuing illegal activity.

There is one final point worth noting. This analysis only applies to developed markets like Australia, Western Europe, U.S. and a handful of countries in Asia. Music piracy in the form of pressed CDs and cassettes will continue more or less unabated for the foreseeable future in the less developed world due to a lack of enforcement mechanisms.