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The 'R' Words: Recession and Royalties

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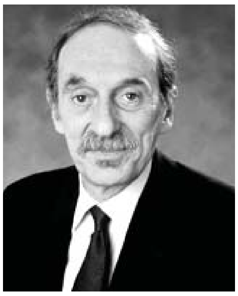
The author is particularly grateful to George Magnus, Senior Economic Adviser, UBS Investment Bank, for his perspectives and insights. George has published extensively on the credit crunch for UBS clients as well as the Financial Times.



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The 'R' word 'recession' is being used with increasing frequency these days, so much so that there's a legitimate danger that the media could talk the economy into entering one. But what actually is a recession, what effects will it have on the UK economy and then what impact will be felt by the various sectors of the music industry? Here, Will Page works through the two 'R' words - recession and royalties - to help the music industry understand who wins and who loses, when an economy contracts for two quarters or more.

Defining the definition of a recession

Let's start by clarifying 'recession'. The official definition reads: *"A recession is a significant decline in activity spread across the economy, lasting more than a few months, visible in industrial production, employment, real income and wholesale-retail trade. A recession influences the economy broadly and is not confined to one sector."* There is a world of difference between a dislocation - confined to only one or two parts of the economy, such as housing and finance - and a generalised economic decline. For businesses and workers, a slowdown is a period of weak growth, modest job losses and disappointing profits; a recession is negative growth, marked by mass unemployment and widespread bankruptcies.

The state we are currently in

Recessions can be driven by either demand or supply-side events. To whistle-stop our way through centuries of economic theory, a 'demand-side' recession occurs when the demand for goods and services falls and the economy then contracts causing prices to fall. Importantly, these falling prices can regenerate demand, allowing the economy to grow again. 'Supply-side' recessions are trickier. As prices for essential commodities like oil rise, the economy is forced into a contraction (negative growth) whilst experiencing inflation (rising prices). This combination of forces - termed 'stagflation' - can be doubly problematic as there's no obvious self-correcting mechanism in place. The economic contraction in the late-70s and early 80s, matched with rising oil prices, is often offered as an example of stagflation, but is this the state we are currently in?

The author thinks not - at least, not in isolation. Whilst oil prices have been consistently high - currently trading at around $100-per-barrel - there is a legitimate debate about whether this spike is being driven by demand (the increasing presence of China in the world economy) or supply (OPEC switching off the taps). One can neatly summarise that debate by referring to the box below, OPEC's net revenues for the first half of 2008 almost equals its entire revenues for 2007! This reflects a historical and cyclical trend in how global wealth (and then inflation) shifts across markets, beginning with the goods market (oil in the 70s and early 80s), then into services (finance in the late 80s and early 90s) and ends up contained in assets (property from the late 90s to present) - and, once this course has been ridden, inflation returns to the goods market - hence back to oil and the OPEC cartel, again!

OPEC net oil exporting revenues	
$671bn	Jan - Dec 2007
$645bn	Jan - Jun 2008

Source: EIA

But we can look beyond the commodities market, and focus instead on balance sheets for both firms and individuals. George Magnus, Senior Economist at UBS Investment Bank who is credited with pioneering this view, believes that looking at balance sheets can help us tease out a more plausible story regarding the state we're currently in.

Balance sheets are important because the perception of a stagflation-type scenario causes 'independent' central banks to focus on curbing inflation as opposed to tackling increasing unemployment or slowing economic growth. This stance is being reflected in the expectations of the US Federal Reserve, UK Bank of England and most recently the European Central Bank. To understand the economic downturn and the growing risk of policy error, we have to acknowledge the influence of deleveraging - where money is sucked out of economic activity and pumped into paying off debt.

Normal business cycles are self-correcting. Deleveraging cycles are self-reinforcing, because the destruction of debts and assets feed on one another until excess leverage has been eliminated. The current deleveraging is unleashing two major deflationary forces. Firstly, the recapitalisation of banks and the restructuring of their balance sheets. Secondly, the long overdue correction of household balance sheets where personal debt levels have risen rapidly, especially in the US and UK. If we do not see the full effects of deleveraging immediately in economic data, it is probably because economic decisions made by banks and households take much longer to affect the economy than in the case of businesses, which have to make production and employment decisions quickly. This deleveraging downturn, therefore, will last a long time, perhaps until 2010.

Exposure to an economic downturn

A deleveraging cycle results in less spending and more saving (or paying off debt) by both households and firms, leaving less money around. But what does this scenario mean to the music business? One frequently touted (but historically flawed) argument runs like this: less money presumably means less demand for expensive concert tickets, and relatively more demand for CDs (buying two CDs instead of one is cheaper than one £50 ticket yet provides you with more music). This allows us to consider which parts of the music industry would be net benefactors of a deleveraging cycle. Put another way, who does well during a downturn?

The contrast between concerts and CDs provokes a timely reminder that the music industry does not revolve solely around the high street record store and local music venue, but crosses a wide number of revenue streams which can be divided into *business-to-business* and *business-to-consumer*. The table below attempts to lay out how much money is tied up in both, and adjust for double counting. Based on this assessment there is currently around £3.2 billion directly tied up in the UK music industry; eighty percent of which is considered business-to-consumer. [Note: This example should not be treated as conclusive, so please consider the footnotes.] Whilst this B2C market might be considered 'the front line' in terms of exposure to a recession, this analysis will show how much of the more insulated B2B revenues find themselves at risk as well.

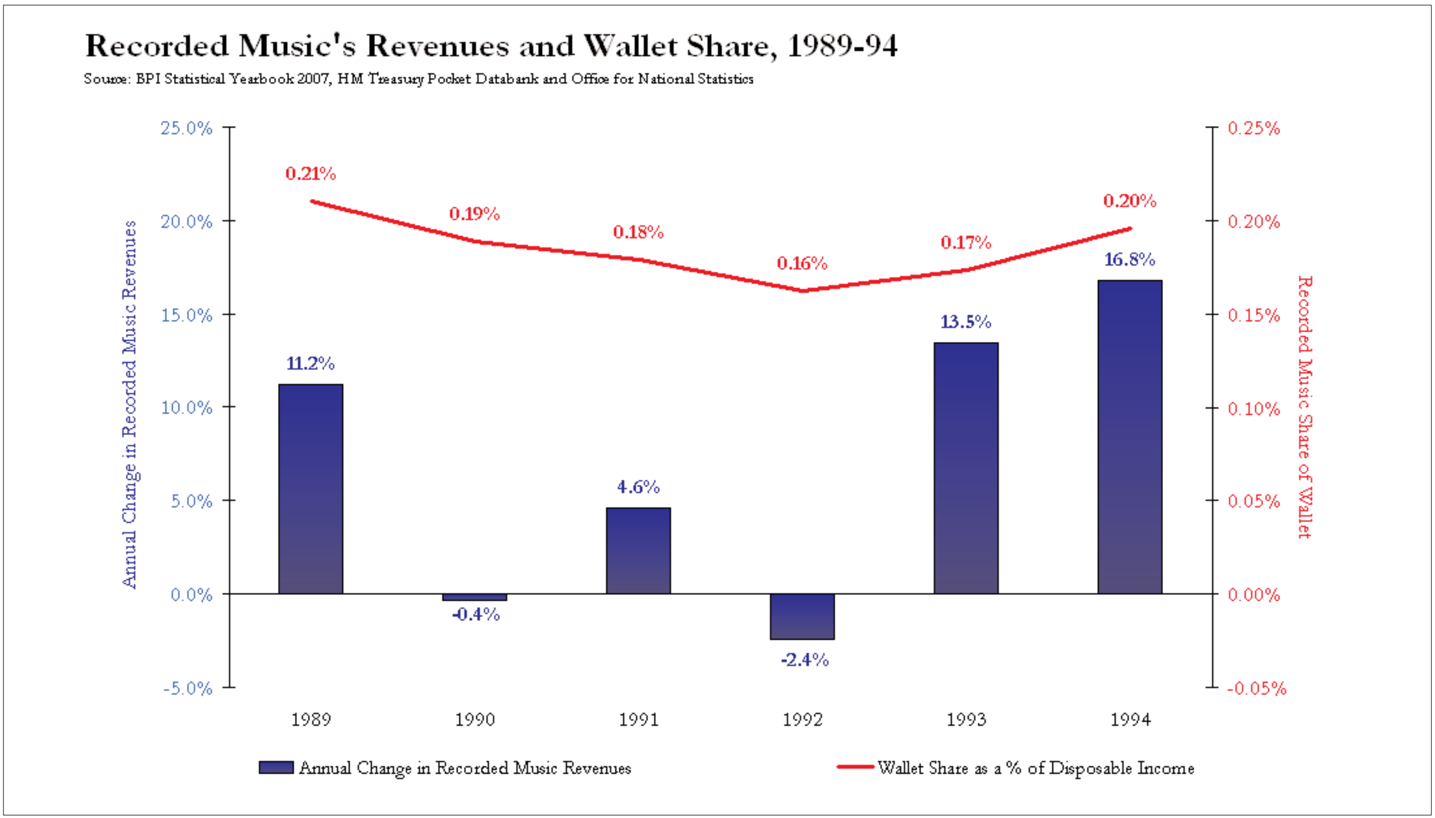
Adding up the estimated value of the music industry in 2007 (£million)

BPI retail value of record music industry		£1,392
Estimated value of the live music industry (1)		£1,078
Business-to-Consumer Total		**£2,470**
MCPS-PRS Alliance gross collections	*£562*	
Adjustments-for-double-counting mechanicals (2)	*-£92*	
Adjustments-for-double counting live revenues (2)	*-£17*	
		£453
PPL gross collections	*£115*	
Adjustments-for-double-counting record co's(3)	*-£57*	
		£58
BPI record company licensing revenues		£122
Non-society publisher revenues(4)		£80
Business-to-Business Total		**£713**
Aggregated total B2B and B2C Value		**£3,183**

(1) This is made up of Mintel estimate for the primary live music sector of £743m, a Tixdaq estimate of the secondary ticketing sector of £144 and a combined TixDaq/PRS estimate of the merchandise, food and beverage sector of £191m. Depending on the commercial arrangement, the 'music industry' is able to extract revenues from all three revenue streams.
(2) Double counting takes place when the Alliance collects revenues that have already appeared in either the BPI Statistical Yearbook (mechanical revenues) or the Live Music Sector estimates (LP Tariff). The focus here is on Gross Collections, as opposed to Net Revenue Distributed, as the context is about market exposure.
(3) Double counting takes place in that 50% of revenues collected by PPL are then passed on to the record company, which then carried into BPI record company licensing revenues, which total £122 million.
(4) Source: BPI Press Release, (30th June 2008) 'New business models boost income for British record labels: licensing and multiple rights deals net £122m in 2007'
(5) This estimate represents mainly 'synch revenues' which the publisher collects directly, as opposed to through the society, and is derived from Enders Analysis - with reference to their report *'Recorded Music and Music Publishing'* published April 2008 and uplifted to account for 'other' revenue streams (e.g.. print, stage) which have been derived from the author's exposure to publisher accounts.

Recessionary 'smoke signals' for the music industry

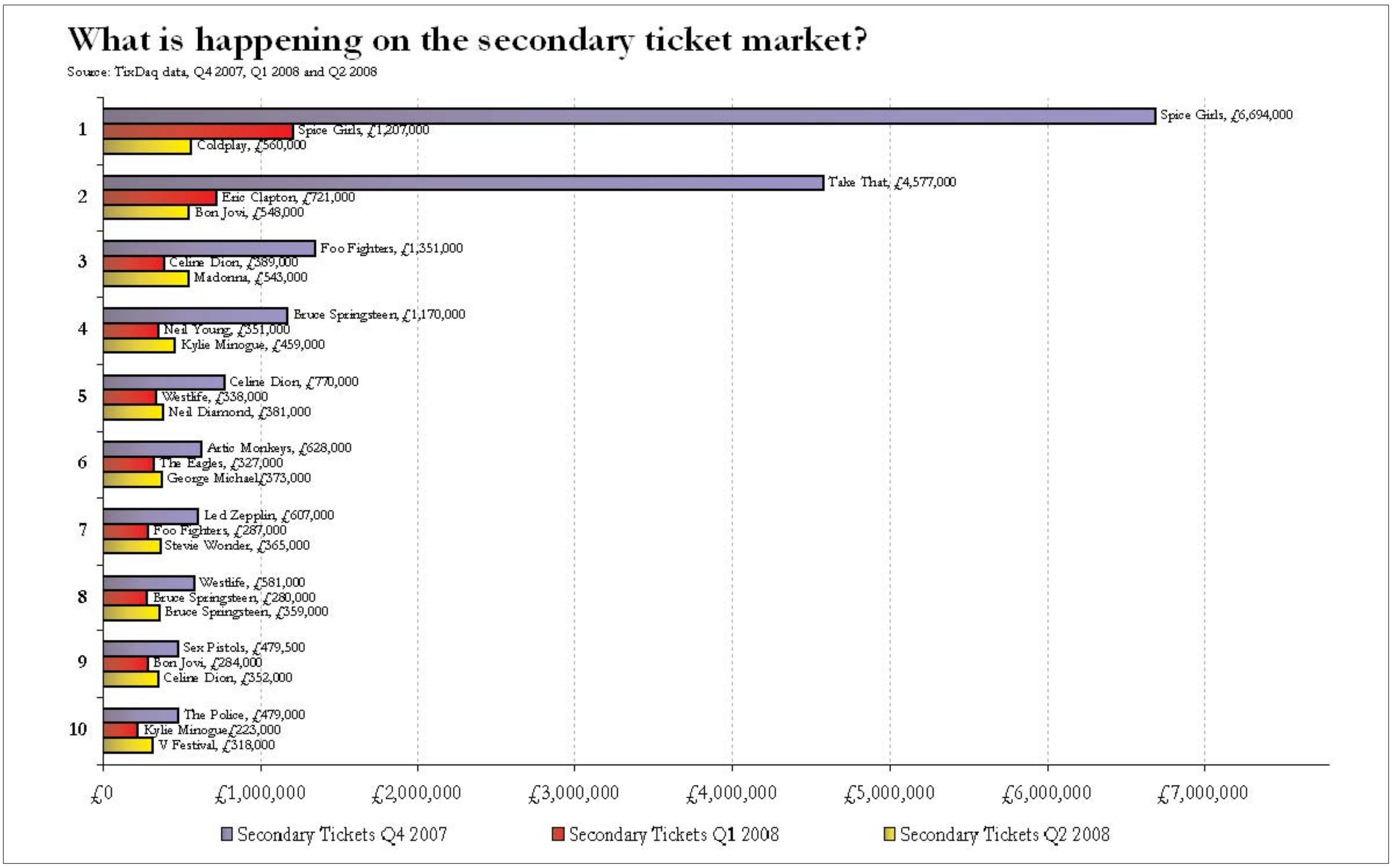
For B2C revenues, it is important not to confine the debate to *'will people buy fewer tickets and therefore a greater number of CDs'*. We need to think about the supply side effects. For example, music plays a much smaller share in (even a music-specific) retailer's portfolio, hence there's less scope for a 'net benefactor' style upswing to kick in, and depending on margins, more chance that the music stock could be eliminated completely. After all, it is easier to sell the consumer something that they can't get already, for free. More interesting, however, is that this 'net benefactor' argument doesn't stand up to historical evidence. The chart below - constructed from the BPI Statistical Yearbook and ONS data - shows the year-on-year percentage change in recorded music revenues (left hand axis), along with the respective share of wallet (right hand axis). What can be observed clearly is that during the 1991-to-93 downturn period, the growth rate of recorded music revenues and its 'share of wallet' both fell sharply.



Whilst one might be tempted to correlate the decline in recorded music revenues with economic downturn, caution is required. There are many factors which could explain the annual change such as major releases, format shifting and pricing policies. Indeed, some positives can be taken from the evidence: (i) albums held up during the period, with singles explaining a large part of the slump, and (ii) the sector bounced back sharply in the years that followed, with recorded music revenues beating 17 percent annual growth and wallet share returned to 0.20 percent peak (see box). Nevertheless, growth in recorded revenues slumped and even contracted, as the economy went through its last cyclical downturn. This evidence casts considerable doubt over the premise that recorded music "does well in a downturn".

Wallet Share Dynamics: Intuitively, if disposable income falls, and people buy the same number of CDs, music's share of wallet increases. If a consumer's income falls by 5% and in response they buy 19 CDs instead of 20 then music's wallet share has stayed constant. Finally, if that same consumer decides to buy 17 CD's following a 5% fall in income then music's wallet share has fallen.

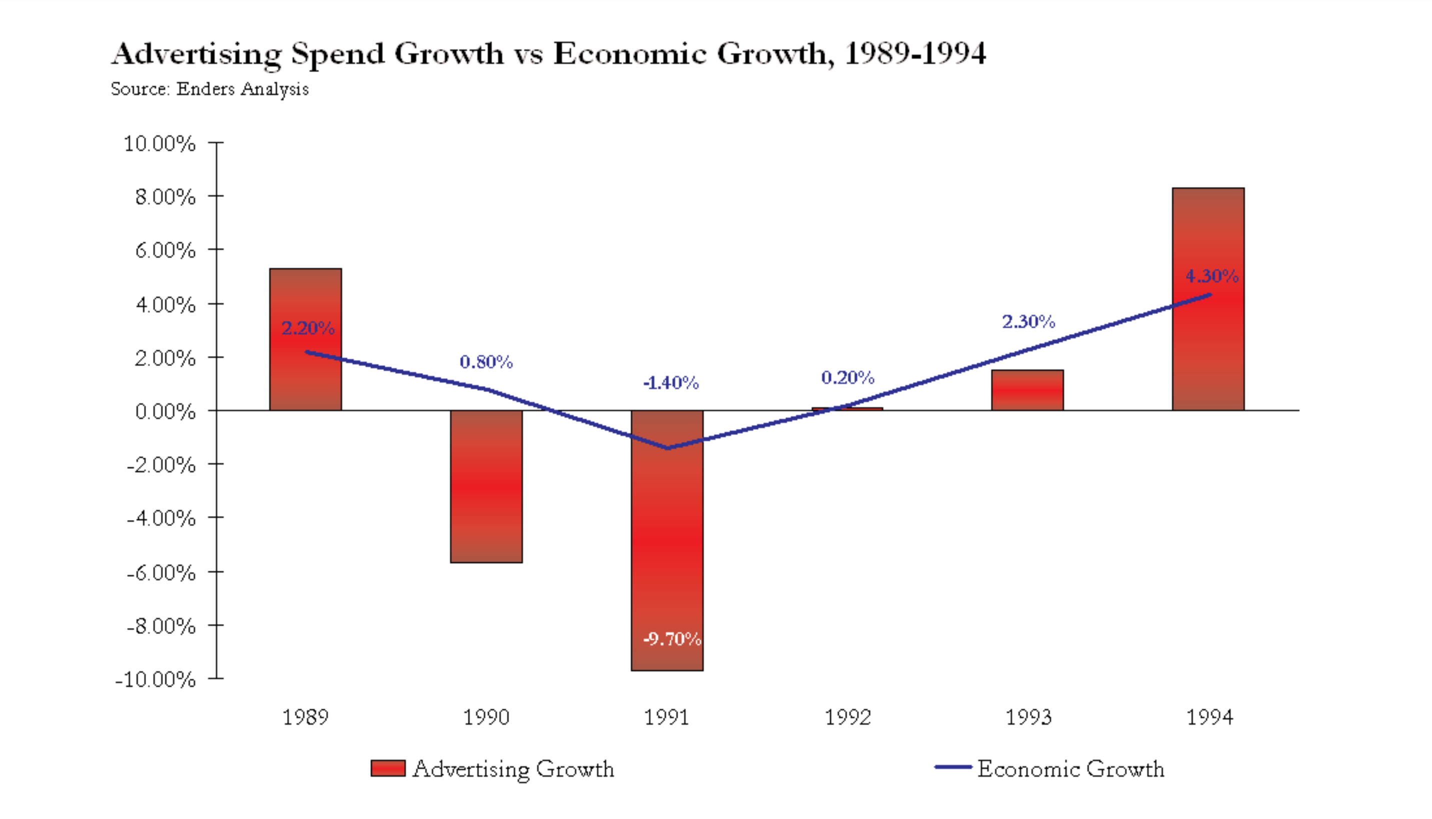
Due to the lack of data available, the effects of an economic downturn on the live music sector are easy to conjecture - people buy less tickets, or at least prefer less expensive tickets - but harder to fully understand. What we can do is consider some smoke signals that exist, and the order in which these signals could appear. The first signal of a downturn biting into the live music sector's revenues is that of the secondary market - brokered tickets and auctions - as this ultra sensitive market rides the waves of upside and downside movements in consumer confidence and demand. The thinking goes like this: if CDs are no longer a luxury good, then concert tickets are, and tickets sold on the secondary platform even more so. Hence, the value exchanged on the secondary platforms is an arguably better barometer. The chart below illustrates the sensitivity of this sector. In the fourth quarter of 2007, the top ten events produced £17.3m in business for the willing seller and the platform, via commission. That number dropped a massive 75% in 2008 Q1, to a relatively meagre £4.4m and declined further in Q2 to £4.25m.



Of course, there are lots of variables which could be distorting this picture: such as the pre-Christmas binge on concerts, and the New Year hangover. Similarly, there could be significant activity in events occurring outside of the top ten, as well as better pricing strategies by the primary sector over time. Nevertheless, the consumer is clearly not spending the same volume of cash on the luxury of a sold-out ticket as previously. Also notable is the volatility of the secondary ticket market, as this allows us to consider a domino theory of what might be next: perhaps merchandise, then food and beverages, then finally the primary ticket itself. Finally, as the live music sector is largely a 'cash' business, it is particularly important to follow fluctuations in the available data here - especially for those bands that have sold out their show and are considering the gamble of adding an additional date!

Feeling the pinch: advertising revenues in a downturn

Advertising spend can offer another smoke signal, with advertising budgets likely to be cut quickly if financial difficulties are anticipated. An example of this shift can be seen in the 1989-1993 downturn, during which total advertising spending fell significantly, with a close to 10% shrinkage in 1991. This decline in available advertising cash might cause further difficulties for those innovators in the advertising-funded music space, as they wrestle with price (licensing costs) set through existing long term contracts with major labels and collecting societies and then downward price pressure (on revenue) from their shorter term contracted advertising clients.

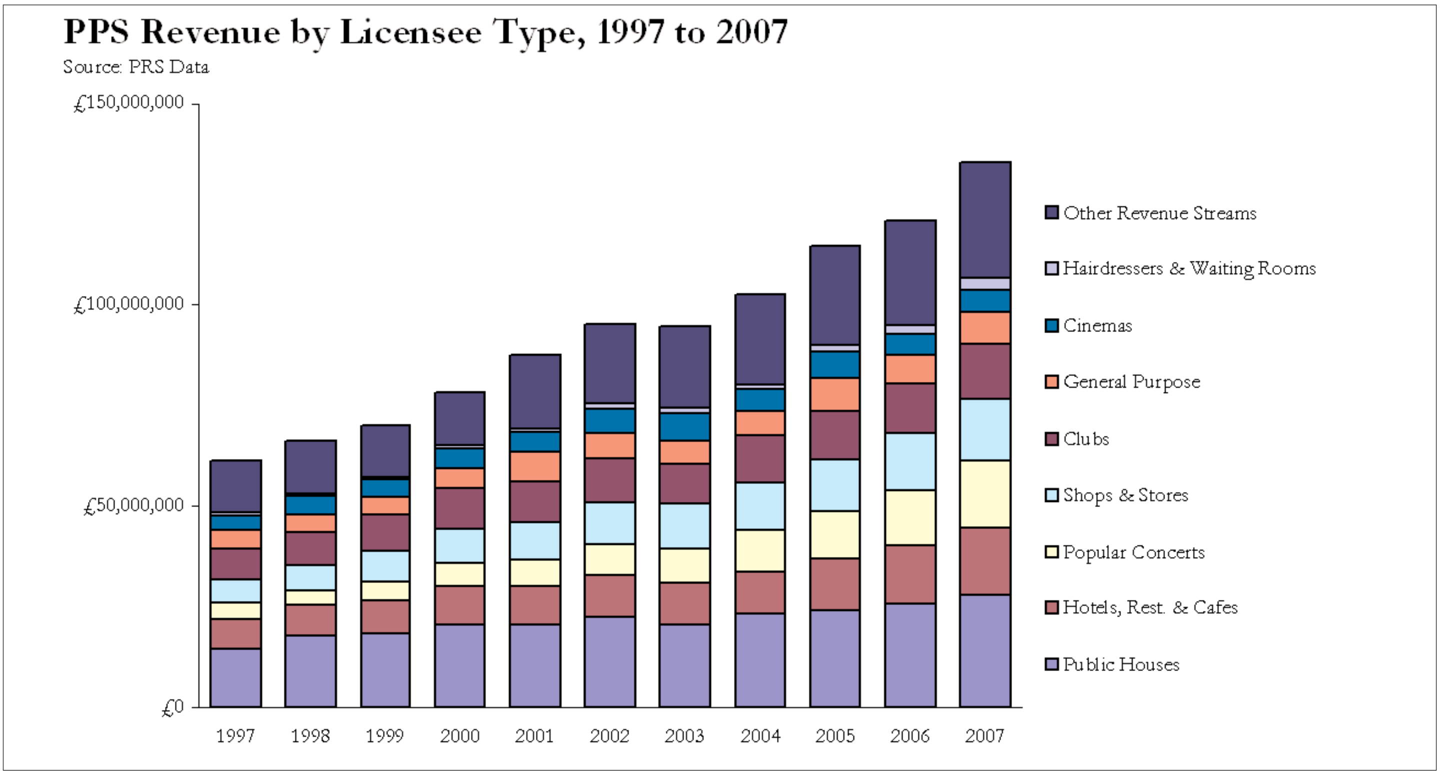


Similarly smoke signals are already emerging in the advertising funded market for music synchronisation rights. Rachel Wood of Woodwork Music, an expert in 'middle tier' synch-licensing negotiations, has noticed that production budgets have been shrinking noticeably for at least the last three years. This is largely due to the dispersion of new media formats leading to the rights user wanting *more* media and territory in their licences for *less* money. While the credit crunch has yet to make a visible impact on Wood's advertisers' marketing budgets, she accepts that - once it bites - this will further accentuate the shrinking of available funds. Importantly, for rights holders, music's share of the production budget continues to be squeezed and has been long pushed below the 'old' 10 percent yardstick.

Anecdotally, a lot can be picked up from the wider market suggesting we're entering a downturn. In commercial radio, for example, we are already seeing a sudden spike in advertising activity as retailers promote sales - but note this is not January - rather it is an example of the high street competing to 'get in first' during a downturn, before they themselves close down. For those who are well versed in the economic cycles of commercial radio, it's another well known 'smoke signal' that tougher times lie ahead. Hence, from a B2B perspective, the likely transmission mechanism is likely to come from a downturn in the advertising market. For licensing bodies whose income depends on formulas which are drawn from gross revenue of the licensee, a decline in advertising expenditure feeds directly through to a decline in royalties payable.

Another B2B area of exposure is an erosion of the licence base - when companies scale back their operations, or close completely due to bankruptcy. Sticking with commercial radio, what would happen if a large broadcaster cut back its radio station portfolio by 50% due to declining advertising revenue - not only would royalties payable suffer due to the worsening market conditions, but the licensee base would be halved as well. On the high street, the design of licensing schemes is more insulated from market conditions as they are levied upon the premise in a similar way to business rates. However, this scheme is still exposed to the risks of downsizing, or outright closures. Pub chains might pre-empt the effects of a recession, during which consumers go out less often, by closing a fraction of their expansive outlets. A greater number of closures on the high street would lead to lesser levels of public performance revenues.

An important response for the music industry may be to continue its efforts to broadly diversify sources of revenues as **the more broadly distributed the available sources of revenue, the greater chance the industry has to perform no worse than the economy overall.** A single-digit decline in top-line revenues is a less fiscally traumatic experience than the double-digit declines the music industry has seen in the past. New markets exist, yet to be fully tapped for their opportunities. An example of an organisation executing this strategy successfully is illustrated below with the breakdown of the PRS public performance and sales revenues. The key point to learn from their inflation beating performance is 'not to put all your eggs in one basket'. As key revenues such as public houses have maintained consistent but modest growth - but it is the development of new markets that have raised their top line.



Weathering the storm

Habitual spending on music is one encouraging morsel for the music industry. However, habit or not, the consumer's appetite for music is being tested. According to the consultancy, Jupiter Research, music's share of total entertainment spending is falling, as consumers build stronger purchasing relationships with other media products, such as DVDs. Equally important would be the current price increases in essentials (food and fuel), reducing that proportion of household income available for media spending. Monthly billing relationships, such as those for pay TV, mobile and broadband are likely to experience a higher degree of protection. However, discretionary and impulse spending on individual physical media would likely be more vulnerable. Music CDs and downloads fit into this discretionary mix. With the widespread availability of free alternatives (e.g. music channels, radio, file sharing) the consumer can cut back impulse spending without significantly impacting consumption. Music, the product, may face a decreasing share of a shrinking pie.

However, recessions have a Janus-like appearance - the contraction in economic activity often coincides with the circumstances for ongoing economic growth. As the music industry and the broader economy are squeezed, innovation and consolidation form an important part of business strategy, which may well lead to new and/or improved business models going forward. One example of music's resurgence might come from the pubs, which are experiencing weakening demand as people prefer to stay home drinking cheap supermarket booze. In order to compete with this compelling offering, pubs need to offer something compelling of their own, and live music might just be the hook that draws people back into the bars. Indeed as bars try to draw back their back customers from their sofas at home; it might be that they need music - especially live music - more than ever before.

Facing a different type of 'crunch' in the fourth quarter

Back down on the ground, (or in the bars and music venues up and down the country), it's important to separate out evidence of 'cut backs' that were planned prior to the credit crunch from emergence of trends that have taken place since. EMI, under Terra Firma, announced they would slash the roster of non-profitable artists and neuter EMI's 260 strong A&R team - but this has more to do with classic private equity turnaround than a response to a downturn. What might be an example of a reaction to tougher economic times is more exploitation of catalogue and less investment in new artists. Perhaps this can be best symbolised by the issue of tour support, which newly signed acts are often failing to receive, whilst at the same time 'heritage acts' are experiencing an unprecedented boom on the road, and that's even by *their* standards. Could a recession turn this 'heritage boom' to 'bust' but, due to prior cut backs in A&R, leave no new 'inventory' (read awesome new bands) coming through to fill the void?

The impressive, if not daunting, fourth quarter release schedule (and subsequent touring) will tell us a lot, not just about the state of the industry but the impact the economic downturn is having on it. With all major labels holding back many of their 'blockbuster' acts for the Christmas quarter; the jury is out as to whether this high risk strategy will work. Might it be a stroke of genius, for example, by striking a major campaign whilst the market is thin and 'crowding in' additional spending from shoppers who make multiple purchases, once they've been drawn in by the big names? On the other hand, it might prove to be a visit to the 'last chance saloon,' with the risk being that the barrage of big name releases 'crowd out' both the consumer's attention and their wallet, eroding the probability of generating a classic blockbuster hit. With the likes of AC/DC, Tom Jones and Celine Dion all releasing new product in this coming quarter; come the new year we will not only have an insight into longevity of the heritage acts but the willingness of labels and publishers to sustain their investment in new creative talent. What this report has allowed the reader to do is to factor in the likely effects of the economic downturn when making a judgement call on how this uncertain-but-critical period, for the music industry *and* the economy, might play out.