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Should societies pursue equity?

When LastFM was sold to CBS for $260 million in June 2007, rights holders naturally wondered what portion of that sale price emerged from the catalogues of musical recordings that provided a platform for the play lists. Dotcom history is littered with high-profile examples of start up firms generating value through both traditional and controversial uses of musical copyrights. These uses prove most challenging when tangible value is created, through earned revenue or acquisitions, while compensation for the uses of music was never paid, or many cases, never negotiated. If society members are to consider if there were 'another way', an intuitive response might be to ask if Societies could and should pursue equity relationships with nascent firms. Here, Will Page teams up with David Touve, to work through what that question would entail.

Traditional broadcasting is well suited to collective licensing. A relatively small number of incumbent players, with mature business models, use music in ways that are not only, quite arguably, profitable, but also widely understood. The online market for music, on the other hand, poses difficult questions for music licensing. A large number of players, many fledgling, operate with unpredictable strategies, dealing with music in ways that can even seem at odds with copyright.

Nascent firms in this market face a trade-off between popularity and legality; those uses of music that go beyond traditional understanding as "legal" are often those uses most attractive to consumers. A certain spiral of rational expectations has emerged, leading firms to pursue popularity first and deal with legal issues second (think of MySpace). Pursuing the legal route first appears to hinder popularity (think of the troubled Yahoo! music). Any factor that hinders popularity, hinders growth for the nascent firm. Growth rates however, are the source of value for these start-up projects, providing the substance for network effects and the advantage of snowball-like growth provides.

Moreover, the goal of the start up entity building a business by exploiting musical copyrights is not only to develop a sustainable business model, but also to take advantage of any opportunities to sell the business to a larger media firm, for a significant return on investment.

The purpose of this white paper is to instigate a wider discussion that could result in a flexible, more easily executable music licence to be offered by music rights societies to nascent firms for the uses these start-up firms make of musical compositions and recordings. The discussion herein will also include an assessment of the opportunities and concerns related to the execution of such a "start-up licence."

Context

Start-up firms present an undeniable headache for music rights entities. At incorporation, emerging firms tend to lack the financial resources, both in terms of cash holdings and cash revenues, to pay otherwise standard fees for music rights. Furthermore, emerging firms are not stable entities, in terms of their chances for success and the nature of their business models. Finally, nascent firms tend to operate at, or far beyond the edge of the envelope that is offering music to the general public according to previously understood, acceptable and agreed upon terms for a licence. It is the risk inherent to these edge-of-the-envelope ideas that setup the capacity for greater-than-average rewards.

Conversely, music rights entities present an undeniable headache for start-up firms. Nascent firms often lack the internal human resources, whether in terms of work experience or sheer count of heads, to navigate the complicated and differing legal environment for licensing music around the world. Additionally, taking a new and innovative product to market, in as little time as possible and in a form that will be most compelling for the end user, requires that the nascent firm be extremely adept and adaptable. Rigid contracts, written to address a very specific use of music, prevent the nascent firm from quickly shifting course according to new information. Finally, fitting the opportunities for a new media product within the terms for previously established music licences erodes the comparative advantage that innovation itself offers to a start-up firm.

About David Touve
David Touve is presently a PhD student at Venderbilt University, within the Owen Graduate School of Management. He previously founded, or held management positions within, a series of startups acquired by the likes of Lycos, Sony and AOL. He learned about music rights the hard way, experimenting with subscription-based and ad-revenue supported music services back when the web was still considered a 1.0 version.

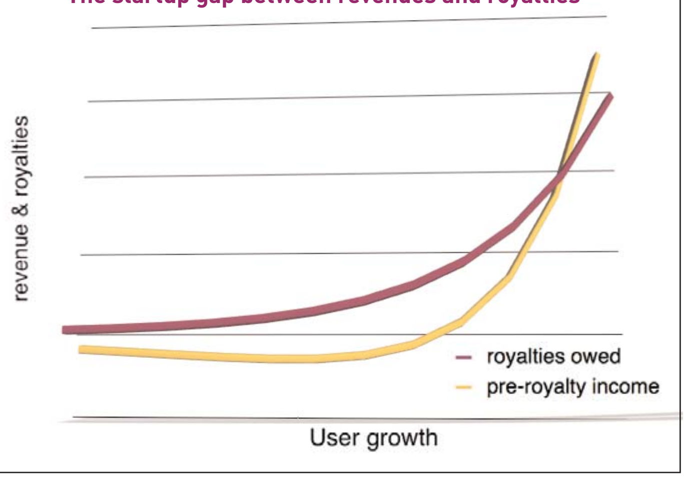
Most importantly, both rights societies and start-up firms have a shared benefit in fuelling ongoing innovation through a flexible and easily executable licence for music use. Innovation is the primary means through which both the creative rights and technology industries come to understand and benefit from the steadily evolving nature of consumer demand. Moreover, rights societies and start-up firms share a common danger in getting caught up in legal complexities. Although, over the longer term, this may be necessary to create certainty, in the more-immediate term this could result in stifling innovation.

Mind the growth gap

There is a clear tendency in the technology and media industries, in the case of start up firms, to reward user growth over revenue, particularly when the endgame is acquisition. The emphasis upon success as measured by audience characteristics, places nearly every growing firm in a quite uncomfortable growth gap.

Undoubtedly, a number of nascent firms reach a growth stage at which the minimum royalty obligations brought on by their usage of music exceeds not only the minimum collection that would be possible as a percentage of revenue, but also the firm's ability to pay any royalties at all. [Note: the recent controversy and subsequent blocking of Pandora around the world offers an apt example]. Furthermore, those uses of music that tend to result in a real expansion in the market for music often involve business models and applications that make copyright owners uncomfortable. As such, the growth gap proves a challenge for all parties involved (See Chart).

The startup gap between revenues and royalties



Equitable dealings

In order to match the interests of rights societies with those of firms offering innovative music services, we propose a set of possible facets for licence terms that rights society members should critically consider. Some of these suggestions will undoubtedly be controversial. However, many are being put to use by owners of rights in recorded music.

The objective here is to find some compromise for the risk that would emerge from offering licensing terms contingent upon revenue growth, and "ability to pay," not estimates of the apparent value of the use at launch, or the cost of uses according to a more fixed method in any period.

The value of any innovative service brought to market by nascent firms is not fully understood until after the innovations are brought to market. Furthermore, a start-up's valuation often scales with its growth in number of users, while its ability to pay royalties may not scale as quickly. Finally, technology firms often face tradeoffs in terms of pursuing user growth or "monetising" this growth. Years after its acquisition of YouTube, Google has still admitted to a bit of a struggle in search of the most effective revenue model for one of the most popular video destinations on the internet.

A good proportion of liquidation events occur by way of equity transactions - firms buying other firms using only stock as currency in the acquisition. In this situation, the ability for rights societies to collect royalties, and perhaps be rewarded for their contribution, depends upon the capacity for licence agreements to be structured to match the currency of the transaction.

Equity

Rights societies could consider accepting the currency with which start-up firms generally operate - equity. Furthermore, a method for exchanging this equity for licence terms should be standardised if at all possible.

It would be ideal to adjust the percentage of equity preferred to the imagined financial prospects of individual firms. However, rights societies must accept that predicting the eventual value of start-up firms, at moments close to their birth, is neither an exercise with which societies are well versed, nor a calculation even those with experience can do with great reliability. Any standardisation of equity could be based upon the series of funding round and valuation levels.

While it might also be desirable for rights societies to hold voting shares, this desire should be considered in ways that recognise the delicate balance between copyright and innovation. Essentially, the value of the licence to the rights society, even under controversial uses, scales with the value of the start-up firm. Wilfully holding back innovation can easily result in holding up not only the value of the start-up and therefore the value of equity held by the society on behalf of its members, but also a clear view into what a longer-term licence would look like given the opportunity.

A consistent constraint placed on this exchange of equity could be that employees of the society may not take shares personally, without also making a personal, non-discounted, financial investment in the firm. Conversely, in exchange for an equity licence, start-ups would be required to compile use data similar to those data gathered by other music rights licensees. The value of equity therefore, once earned through sale, could be distributed to members according to the use of their recordings and works, although this will inevitably raise other practical issues. Finally, there is a moral hazard issue here, in that the start-up could be sold into a corporate structure that makes it impossible for the society to liquidate its equity stake.

Convertible Instruments

Given a nascent firm's royalty obligations often exceed its ability to pay, rights societies could structure the terms for equity transaction by way of convertible debt. In this way, the equity transaction might be aligned with the ongoing use of music, rather than according to opaque metrics, or as compensation for showing up to the party without a lawsuit.

Given the uncertain context within which start-up firms operate, assigning an interest rate appropriate to the risk can be difficult, if not impossible. Furthermore, with stock being the currency through which start-ups often experience liquidity events, debt obligations might only be deferred further into the future.

In response, rights societies could structure debt with convertible solutions - whether through warrants, or beneficial conversion. Accrued royalties take on consideration as debt issued by the start-up to the rights society, with this debt being convertible (at the option of the society) to an agreed upon number of shares at an agreed upon price.

Example: Start-up X owes the rights society £50,000. At the next funding event, during which only £250,000 were raised, the society agrees to accept £25,000 towards the payment of royalties owed and £25,000 in the form of convertible debt with a conversion ratio of 1 to 1.25. The share price at the funding was £1. The rights society would have received some portion of royalties owed in cash, while now holding £25,000 of debt to be paid back at some assigned interest rate, with the right to convert that debt to 31,250 shares in the event of an acquisition or public offering.

Advisory

Rights societies could offer, and perhaps at times require, an advisory board role to the nascent, licensed firm. While advisory boards are subordinate to the board of directors, these roles would offer rights societies the opportunity to share both the experience and concerns of the membership with start-up firms at a level not previously available. It is in the opinion of the authors that a long-standing solution to the dilemma of licensing nascent and controversial uses will only occur by way of persistent, perhaps heated dialogue between the developers of new services, the investors in those services, and the owners of the underlying rights involved. Each party has a stake in the success of innovative opportunities.

Case Studies

Recent events highlight the extent to which the owners of recording rights have negotiated for equity holdings in start-up firms. The Financial Times recently reported on the exchange of an equity stake in the start-up firm Imeem for the rights to stream musical recordings and audiovisual works from the Universal Music Group[1]. Immediately prior to its sale to Google, YouTube negotiated a series of equity transactions with three of the four major labels[2].

Not surprisingly, the exchange of equity is no guarantee of success. MusicBank, a music service started in 1999, acquired licences from all four major labels and issued shares to at least one of these labels - Universal Music. In April of 2001 however, the firm folded in the context of the Dot Com crumble[3].

These equity transactions however, are not without their controversies. EMI sold shares it held in Musicmaker upon the public offering of the online music firm. Shareholders subsequently launched a lawsuit claiming the both Musicmaker and EMI were not completely forthcoming as to the real nature of the rights involved in the transaction[4].

Further controversies emerge when equity is negotiated as an exchange for the assumed value of holding a licence itself, regardless of future revenues attributed to that licence. Some start-ups consider this the equity "just for showing up to the party." Labels have long recognised that a licence from a major is valuable, not necessarily in terms of the content which the label is able to bring, but instead the overall value to the company in securing deals - particularly with all four majors. There have been a number of examples of small companies securing label deals, only to be bought by another company keen to acquire those licences. US firm Wurld Media secured all four majors a couple of years ago for it's licensed P2P service, only to then sell the business for USD $5m - more than it probably would have earned from the sale of music. Finally there's the Zune deal which Universal struck with Microsoft, whereby the label takes USD $1 from the sale of every Zune. How shall, or will this type of equity be distributed to performing artists, composers and lyricists?

Concerns and Counterfactuals

As with any radical proposal, it's important to conclude with some deeper questions given the structure of the current market. For instance, what criteria would a collective licensing entity impose for an equity 'option' to be considered, and might this criterion be akin to the State attempting to 'pick winners' and crowd out more productive market activity, or music usage that would of otherwise have taken place? In addition, is there a risk of 'moral hazard' in that those genuine sustainable business models with a higher chance of success would be less inclined to participate in an equity option, and vice versa? Finally, would collective rights societies be able to design standard, non-discriminatory terms for licensing start-ups through the exchange of shares? If not, the cost of negotiating each deal uniquely might outweigh the imagined benefits.

The ownership of previously issued shares could present rights societies with exposure to "down rounds" (rounds after which the valuation of the start-up sees a decrease, diluting the value of previously held shares). Most founders face a similar situation within the hierarchy of investors and rights, as the firm navigates subsequent funding rounds. Conversely, would these contributions of repertoire, by way of equity, be considered a sort of Founders Stock- a class of shares, a portion of which may be sold to new investors in subsequent rounds of funding?

Furthermore, we have to be aware of the concern that is just how societies would distribute the benefits of equity, once shares have been converted to cash. Furthermore, such a situation might require a set of standardised procedures for the sale of shares, once released for sale in the market.

Questions as contentious as, 'should societies pursue equity,' will inevitably create a knee jerk reaction from the society itself, and that's before you consider whether the start-up would be willing to 'play ball' with such a concept. Such a proposal represents a 'paradigm shift' in collective licensing. But the sharp pain in our shins should not prevent us from considering the present that provides the context for this primer: Torrent traffic continues apace; Apple continues to dominate a market, cross-subsidising the low margins of music retail with the high margins of music anywhere you want it. What we've tried to do here is provide the catalyst for rights holders to consider more critically the source of the value of their creative work within the context of what the music industry has yet to become.

[1] http://www.ft.com/cms/s/0/ff0a7e34-a6c3-11dc-b1f5-0000779fd2ac.html?nclick_check=1
[2] http://www.nytimes.com/2006/10/19/technology/19net.html?
[3] http://www.news.com/2100-1017-255642.html
[4] http://findarticles.com/p/articles/mi_m0EIN/is_2000_March_2/ai_59698630