Open Innovation in the Music Industry

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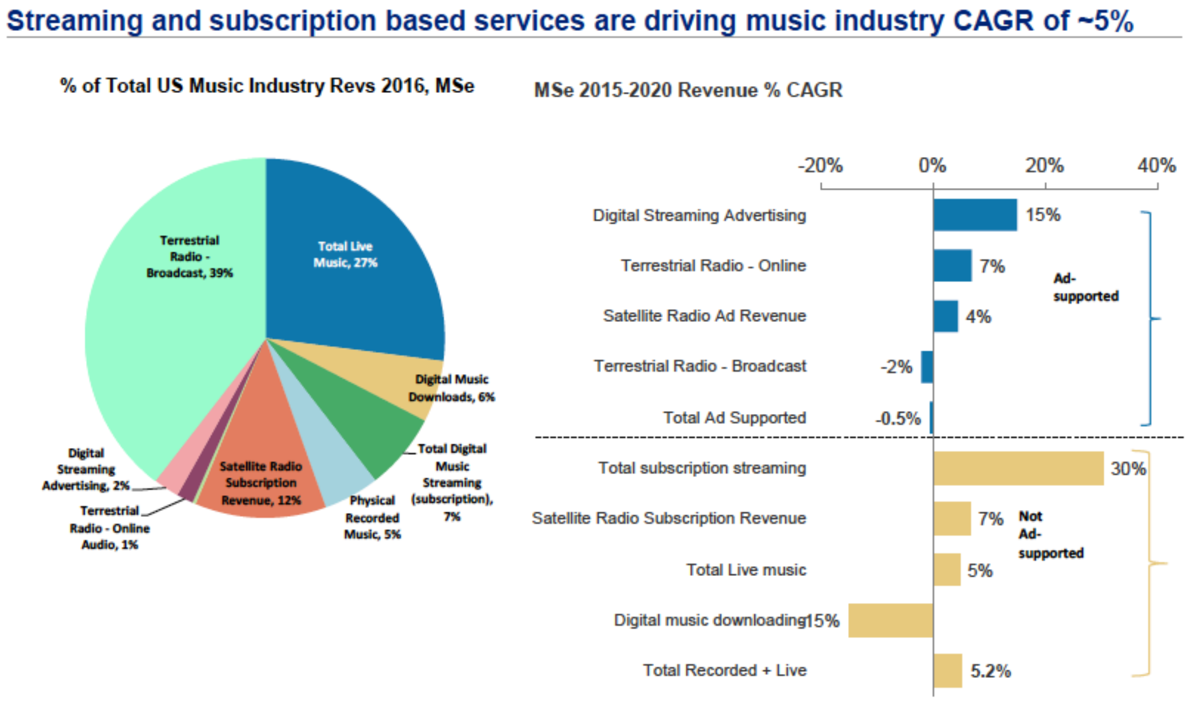
Introduction

To evaluate the opportunity of open innovation on the music industry, we need to address each of the major segments of this industry. As shown in Fig.1, the US music industry is composed of 3 major segments: live music (27%), recorded music (incl. streaming, 20%), and terrestrial radio and satellite radio (52%).

Figure 1. The US Music Industry, by segment (Source: Morgan Stanley)



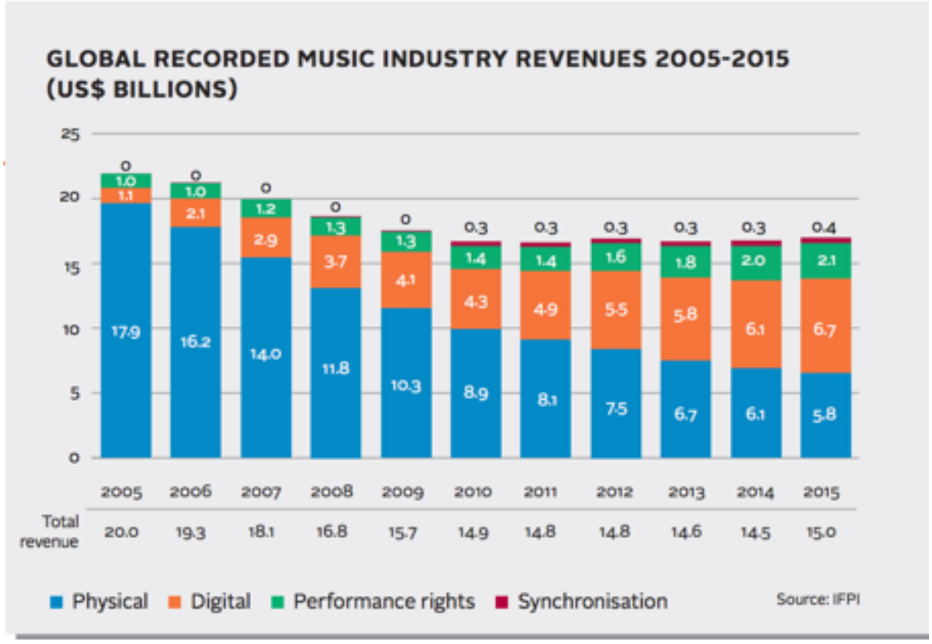
Sources: Morgan Stanley Research, Company data, PwC, RIAA, RAB, RIAA

In terms of growth, the subscription revenue models, live music and the new advertising based platforms (digital, online and satellite) will drive the US Music industry forward at a CAGR of ~5% from 2015 to 2020.

The evolution of the global recorded music industry (by IFPI, The International Federation of Phonographic) in Figure 2 highlights the disruptive changes that occurred in this industry segment. Total industry revenues have declined by 25% from 2005 till 2015, driven by a sharp decline in physical recorded music revenues by more than two thirds. Digital revenues have steadily increased, mainly driven by streaming revenues, and have surpassed physical revenues in 2015 (6,7 billion $ vs 5,8 billion $). The growth of digital revenues (and to a lesser extent performance rights) have since 2010 compensated the decline in physical recorded music. As a result, total industry revenues for recorded music have grown again as of 2010.

In terms of industry structure, the big 3 record labels (Universal Music Group, Sony Music and Warner Music) hold a 63% market share, with independents increasing their share to 37%.

Figure 2. The global recorded music industry (Source: IFPI)



Source: IFPI, Global Music Report 2016

The second industry segment, live music, is thriving. Despite the abundance of platforms and high definition television, consumer demand for live music experience at concerts keeps growing. The largest concert operator, Live Nation, just announced that 2016 revenues grew by 15%.

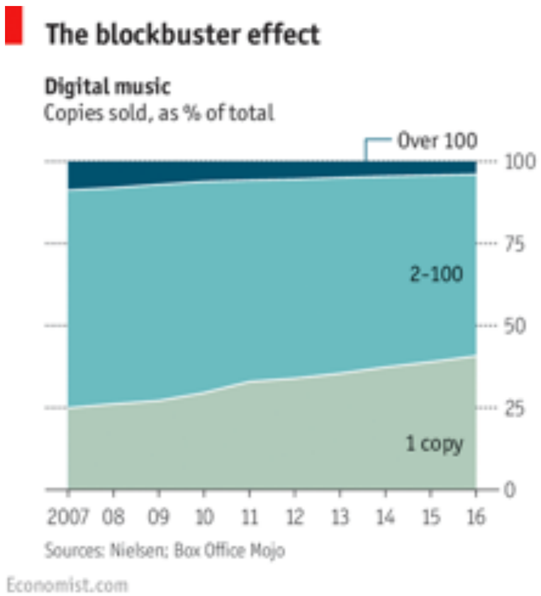
In the third industry segment, radio, the classical terrestrial broadcast industry, which relies on advertising, will gradually decline, whereas online and satellite radio will grow by single digits.

Open Innovation in the Music Industry

In his book on Open Services Innovation (Chesbrough, 2011) Henry Chesbrough illustrates the opportunities for open innovation in the music industry. He elaborates the potential of co-creation as an alternative vision for music production and distribution. Artistshare, the first crowdsourcing platform, is highlighted as a new kind of patronage company to link fans with their favorite artists. Tastemakers such as Popcuts are described as examples of co-creation in the promotion of music. He describes a new digital age music model as an alternative model to the traditional record company business model. He concludes that "...the business models that will succeed in the future music business will be those that help artists connect to their audiences, empower audiences to find artists they enjoy, capitalize on the enthusiasm of fans for certain artists, and spark co-creation between both groups". (Chesbrough, 2011)

Fast forwarding to 2017, we notice that the promises of the new digital model and the new players have not completely been realized. On the one hand, Artistshare has evolved into a record label and has won 10 Grammy awards for its artists since 2005.
Popcuts on the other hand has closed its doors in 2012. "We set out with a grand vision: repair the broken economics of the music industry," wrote the retailer's co-founders, Kevin Lim, Hannes Hess and Yiming Liu, in a notice today on their web site that was also e-mailed and tweeted to customers. "We had high hopes for this new model to change the way music is sold in the digital age, but we weren't able to realize this promise. One reason is that margins on 99-cent downloads are small, and they're even smaller when you're allotting part of it to fund rewards for previous buyers. So it's inherently difficult to turn a music download store into a profitable business." Popcuts' founders further stated that they "probably could have been much more aggressive in convincing music labels and distributors to sign up for our idea." (Internet retailer, 2012)

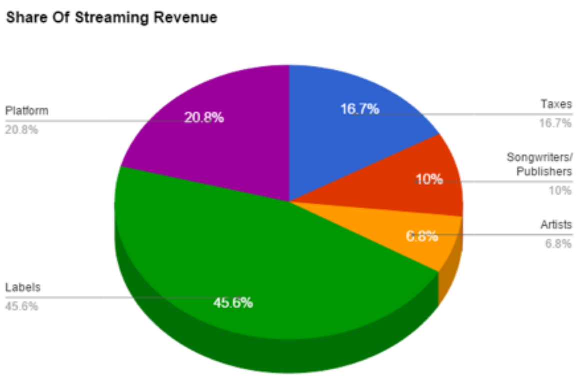
In 2017, the 3 major record companies still dominate the industry, even though independents continue to gain market share. Through lower production costs, the 'long tail' supply of music has substantially increased. However, the money is to be made in the 'head', i.e. in the hits. In a study of digital music purchases, Anita Elberse of Harvard Business School notes that 96% of music tracks sold fewer than 100 copies and 40% (3,5 million songs) were purchased just once (Economist, 2017). This compared to 91% of tracks selling fewer than 100 copies in 2007. A similar trend towards 'hits' has occurred in streaming. According to BuzzAngle Music, in 2016 the top 1.000 songs accounted for 23% of total streams, up from 19% in 2015. (Economist, 2017)

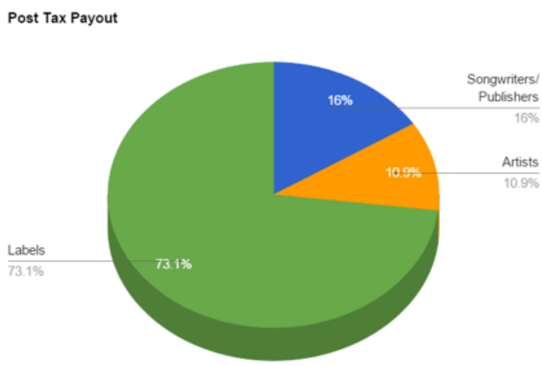


The battle for dominance in the music industry is fought in two domains. The first is the battle for free (or ad-supported) music, where the social platforms such as Facebook and Youtube, aim for the maximum amount of eyeballs or 'ears' to monetize advertising. The second is the battle for premium or subscription content, where platforms such as Spotify in music or Netflix in video offer ad-free content, comfort and personalized recommendations to paying subscribers. Spotify now has 100 million subscribers, of which 40 million paying subscribers.
Today's recommendation algorithms tend to exploit known preferences of consumers more than to encourage exploration of new, unfamiliar content. This makes it more difficult for independent producers to get noticed amidst the abundant choice consumers face.

After the hemorrhage the music industry suffered, the 'incumbents' have adapted reasonably well since 2010. One strategy they adopted was to close 360° contracts with their artists, in which they also received a share of the live concert revenues in return for early marketing investments.
The labels have also concluded profitable contracts with the streaming platforms, which have become the major growth driver for the recorded music industry segment.

Of the almost 2/3 of revenues that streaming platforms such as Spotify and Pandora pay out to content providers, 73% goes to the record labels, 11% to the artists and 16% to the songwriters/publishers.





Source: TechDirt

The Economist concludes that the paradox of the entertainment industry today is that the biggest crowds will increasingly gravitate to just a small number of the most popular hits. Previously, this was explained by scarcity and physical limits on production and distribution. Today, even in a potentially unlimited digital marketplace, social networks, recommendation algorithms and rankings focus people attentions on just a few items in the same way. Technology has given people too many choices, and then instantly relieved them of the need to make them (Economist, 2017).

Opportunities for Open Innovation in today’s music industry

Opportunities remain for players in today’s music industry to leverage open innovation to strengthen their market position.

In the radio segment, a major opportunity for terrestrial broadcasters is the switch to digital terrestrial (DAB) and to online radio, which greatly increases the number of channels, and therefore increased choice and opportunity for better consumer segmentation. In cooperation with festivals, temporary ‘event’ channels can be created for targeted audiences. An inside/out opportunity is the commercialization of ‘playlists’, to non-traditional radio audiences and making them available on other digital platforms.

In the live music segment, opportunities for open innovation abound first for enhancing the experience at the venue or for automation of its operations, in cooperation with third parties. Social wearables are an example specific for live events. Another opportunity is the use of live streaming, or even virtual reality to offer the live experience to international audiences or to re-live the concert again at a later time. A big trend in live music events is the steady proliferation of mobile use and social media. Serving as a "one-stop shop" for every concert necessity, phones can hold tickets, make payments, arrange GPS-specific meet-ups with friends, and more. (NBCnews, 2014)

In recorded music, the challenge for the independents and for new artists is to break through in today’s abundant choice and against the pull of the ‘blockbuster’ artists and major labels. Partnering with platform challengers and promoting recommendation algorithms that strive for exploration of diversity and of new offerings will assist meeting this challenge. An inside out opportunity for the digital platforms is to license the recommendation or machine learning technology for non-related applications or domains.

Across all segments, synergies between major brands can be realized by offering the consumer the 360° experience originating from a major brand.

Conclusion

In conclusion, the breadth and depth of changes to the music industry through open innovation as predicted by Henry Chesbrough have not quite occurred. The industry itself has nevertheless further evolved and is adapting to the new digital reality, whereby the subscription streaming model and live music have become the major growth drivers.
In this new environment, new opportunities for open innovation arise in each of the industry segments.

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