Nordicity Group Ltd.
Le Groupe Nordicité ltée

Profile of the Sound Recording Industry in Canada

Nordicity Group Ltd.

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About Nordicity Group Ltd.

Nordicity Group Ltd. (NGL) (www.nglglobal.com) is the rebirth of a successful strategy and policy consulting firm that merged in 1998 with Coopers and Lybrand. NGL started operations in 1981. Prior to its acquisition by Coopers and Lybrand (and subsequent merger with PricewaterhouseCoopers), NGL was one of Canada's leading business and policy consulting firms in the entertainment and media domain.

In 2002, NGL re-launched its operations as one of Canada's pre-eminent communications and media business consulting firms. NGL's principals bring considerable experience from PricewaterhouseCoopers with new skills, talent, and relationships, and now offer a greater range of solutions for enterprise transformation.

The new NGL helps organizations transform their business through sound strategic decisions, shrewd investments and resource commitments, and effective changes in processes. NGL also works with the public sector to assess the economic and business impacts of business conditions and policy or regulatory developments.

The new NGL has offices in Toronto and Ottawa, with associates in other Canadian cities. We also offer global delivery of our expertise through affiliations with international professional services firms.

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1 Executive Summary

The Canadian, and indeed the global, sound recording industry faces a paradox: while the demand for music remains strong, industry viability is threatened by systemic weaknesses in the traditional business model.

Music is an integral part of almost all cultures, and this is reflected throughout the entertainment industries such as live theatre, film, radio, television and, most recently, electronic games. Demand for sound recording product continues to expand, especially in the younger demographics, but rampant piracy is on the rise as well. Players will have to find new ways to capture and lever this demand in order to ensure the long-term viability of the industry and of individual sound recording labels.

This summary presents the objectives of the study, the main aspects of our approach, our key findings and recommendations, and an overview of industry trends.

1.1 Objectives

Endorsed by the Department of Canadian Heritage (PCH) and the principal sound recording industry associations, Telefilm Canada (Telefilm) commissioned Nordicity Group Ltd. (NGL) to produce a broad industry profile that would enhance understanding of the structure of the sound recording industry in Canada and furnish detailed statistical information on the financial health of Canadian sound recording companies and their domestic and international recording sales.

Ultimately, the results of the study are intended to:

- assist in establishing a baseline financial profile of the sound recording sector and in identifying weaknesses in financial definitions and industry databases
- provide quantifiable information for use in assessing the effectiveness of policy objectives and in administering and evaluating the impact of industry-related programs
- provide insight as to the future repositioning of companies

1.2 Approach

The study involved a representative sample of the 400 or so sound recording companies operating in Canada: 37 Canadian independents and three of the five foreign-owned majors.

The principal lines of inquiry were production activity, employment profiles and financial performance. The primary focus period was 2001 and 2002, the last years for which full financial data was available.

Much of the primary data was collected by means of a survey. The survey tools included a questionnaire designed to gather quantitative information (see Appendix A) and executive interviews conducted in person and by telephone. The interviews served to gather insight on numerous qualitative issues. The respondents were assured complete confidentiality and anonymity (i.e. that individual data sets would be consolidated for publication).

A review of the findings of the principal reports produced on the Canadian industry over the last decade provided background on historic developments, an overview of the opinions of key players and valuable insight into many of the issues facing the sound recording industry in Canada today. These reports are listed in Appendix E along with other publications and points of reference upon which we drew, many of them addressing the global industry.

The questionnaire responses were recorded in an online survey software package in order to standardize and centralize the data in a single integrated database. The results were then exported to Microsoft Excel for analysis.

For the purposes of analysis, the companies were categorized by geographic location and size. Quebec companies are thus those based in the province, irrespective of whether their sound recordings are produced for the French-language or the English-language market. The same holds true for firms based in the rest of Canada – in this case, Ontario, British Columbia and the Prairie provinces. For convenience, the terms English Canada and Rest of Canada (ROC) are used interchangeably.

Large companies are defined as having net revenues of $1 million or more and small companies as having net revenues of less than $1 million.

The financial ratios reported in this study reflect only the 37 independents (data supplied by the participating majors has been excluded except as noted in the revenue per employee ratio).

Data sets were sourced from Statistics Canada to estimate the overall economic contribution of the sound recording industry.

Data concerning the retail sale of sound recordings was sourced from Nielsen SoundScan.

1.3 Limitations

It should be noted that the validity of the financial results and ratio analysis in this report is constrained by various potential sources of error. Most important is the difference in accounting methods used by the companies surveyed, which often did not comply with GAAP standards. Other major issues were the varying treatment of government program funding and the way COGS (cost of goods sold), inventory and capitalized costs were calculated.

In our consultation with government agencies and associations, these same constraints were cited as a key issue in evaluating company performance.

Most of the companies surveyed refused to provide their written financial statements, offering to share only some of the financial data required for this analysis (e.g. revenue data without corresponding data on assets). This resulted in an incomplete picture of corporate financial situations and limited our ability to fully analyze financial ratios and other calculations.

The study was unable to compare the financial performance of beneficiaries and non-beneficiaries of the Music Entrepreneur Program (MEP) because the beneficiary companies reflect MEP support only as of their 2003 financial statements, which were not available until after the data capture was completed.

1.4 Key Findings

Revenue Breakdowns

In order to compare the revenue profile of the surveyed companies by corporate location (Quebec vs. Rest of Canada) and by size (small vs. large), we broke down the revenues by target linguistic/ethnic market, music category, business activity, geographical market and origin of releases. This is a summary of our key findings:

- Overall, across Canada, both the small and large companies surveyed derive their sound recording revenues from three main activities: music publishing, the production, release, promotion and distribution of recordings from masters, and the distribution of recordings.

- Non-sound recording activities (live event management, production of DVDs, etc.) account for 37% of revenues for the small companies, compared with only 6% for the large companies.

- The Quebec companies surveyed generate revenue primarily through two business activities: music publishing (40% of revenues) and the production, release, promotion and distribution of recordings from masters (39%). However, non-sound-recording activities account for 21%. This is significantly higher than among the companies surveyed in rest of Canada, where non-traditional sources account for just 1% of revenues. This may suggest that the Quebec firms are further advanced in adapting to new sound recording market realities.

- The companies surveyed in English Canada have a more diversified portfolio, although nearly half their revenues come from the production, release, promotion and distribution of recordings from masters. Recording distribution accounts for 28%, followed by artist management and music publishing, respectively 11% and 10%.

- The large independent companies surveyed derive 24% of their revenues from the French-language market, which compares with 56% for small companies.

- The Quebec companies surveyed earn the greatest share (46%) of their revenues from the pop vocal genre, while the predominant genre among the companies in the rest of Canada is rock (30% share).

Employment Data

Our analysis of Statistics Canada data shows that, despite weak financial performance, the sound recording industry steadily increased its employment base between 1997 and 2003. This translated into an average annual growth rate of 3.6%, well ahead of the overall economy (2.3%).

This growth trend appears to reflect cultural values – the continuing attraction of the sound recording industry for a youth-oriented culture – rather than a calculation of lucrative or even viable career paths. In many cases, particularly in Quebec, full-time employees in the companies surveyed have been replaced by part-time contract workers or by freelancers on a project-by-project basis.

While the large majority of the companies surveyed have a local workforce, the activities that generate the most revenue do not necessarily employ the most workers.

In Quebec, the business model has shifted from traditional sound recording towards non-sound-recording activities. Music publishing activities continue to employ the largest workforce share (36%), followed by non-sound-recording activities.

For the companies surveyed in the rest of Canada, the production, release, promotion and distribution of recordings from masters employs more than half the workforce.

Financial Ratio Analysis

Overall, the financial ratio results for the larger independents in the sound recording sector indicate weak financial performance in comparison to firms in other cultural industries and firms in the economy in general.

Fundamental weaknesses in the Canadian and global sound recording industries include a significant decline in revenues for players throughout the traditional bricks-and-mortar value chain, a downturn for many long-established independent and major labels, corresponding layoffs and bankruptcies in the production industry, fewer specialized sound recording retailers and fewer albums by new artists available on store shelves.

The 70 larger independent Canadian labels and the five multinational majors operating in Canada are estimated to account for 98% of total industry revenues. This study focused on the financial ratios of 37 of the larger independents, which generated net revenues of approximately $80 million in 2002. Three of the five foreign-owned majors provided data relevant to the revenue per employee ratio.

The following table, which is drawn from section 7.3, summarizes the financial results of the companies surveyed.

Table 1: Overview of 2001 and 2002 Financial Performance of Companies Surveyed

	2001		2002		2001		2002	
	Quebec	**Rest of Canada**	**Quebec**	**Rest of Canada**	**Small**	**Large**	**Small**	**Large**
Gross margin %	0.54	0.75	0.61	0.80	0.33	0.70	0.64	0.75
EBITDA margin	8.6%	4.5%	6.2%	-1.2%	-7.3%	7.5%	2.9%	1.5%
Current ratio	1.25	0.91	1.24	1.06	1.25	1.03	1.21	1.13
Debt ratio	0.84	0.74	0.85	0.81	0.48	0.86	0.78	0.84
Revenue per employee	113,862	204,750 505,828*	119,119	262,575 496,963*	39,881	211,785 475,851*	69,277	239,008 460,139*

Source: NGL tabulations and analysis
* Including the three participating majors.

- Gross margin percentage: While gross margins improved in all categories over the 2001 and 2002 period, the ratios continue to be very low among Quebec companies and among smaller companies overall.

- EBITDA: Overall, the EBITDA margins of the surveyed companies are significantly lower than the thresholds required to attract outside investment.

- Current ratio: Overall, the current ratios are very low and fragile.

- Debt ratio: Overall, the debt ratios are generally high and growing.

- Revenue per employee: Overall, productivity as expressed by revenue per employee in the sound recording industry is quite low. This reflects the project-by-project basis of much of the industry and the lack of corporate memory and back-office systems that would allow for productivity gains. Revenue per employee is higher among the firms surveyed in English Canada than among the Quebec firms and significantly higher among the larger firms.

Further analysis of the financial ratios using the quartile method indicates that the smaller independent companies (less than $1M in net revenues) surveyed have a larger distribution of values around the median for the financial ratios measured than the larger independents – except in the case of revenue per employee where large companies have a wider interval. A complete quartile and frequency analysis is presented in section 7.3.3.

1.5 Key Recommendations

These are our primary recommendations concerning financial ratio analysis and database enhancement. The full list of recommendations appears in section 8.

Recommendation: Require sound recording companies that benefit from public programs to provide financial data based on a standard accounting treatment of key activities and corresponding line items (loans, grants, administrative costs, royalties, etc.). Standard accounting treatment would allow for comparison of financial data among firms for any given year and for the measurement of industry performance and the impact of policy and programs over time.

Recommendation: Create a financial portrait of the overall industry through an ongoing study of the five ratios – gross margin percentage, EBITDA margin, current ratio, debt ratio and revenue per employee – combined with other data sources (assuming that the level of information provided in this study can be maintained with the continued cooperation of industry members and associations: CRIA, CIRPA and ADISQ).

Recommendation: Develop benchmark indicators from other cultural industries and the overall economy in order to be able to readily compare the performance of the sound recording industry with other sectors.

Recommendation: Where appropriate, develop ratios and benchmarks specific to individual categories: English Canada, Quebec, large firms, small firms. For example, in the case of the "revenue per employee" productivity indicator, a separate ratio for firms with a majority of contract workers, as is the case in Quebec, should be developed with the appropriate benchmarks.

Recommendation: Agencies involved in developing and administering support programs[1] and industry associations should make a joint effort to enhance the reliability and availability of financial data within the industry, as has been successfully undertaken in other cultural or entertainment industry sectors.

Recommendation: The various agencies and associations involved in the sound recording industry should also promote the availability of audited data among larger firms and make this a prerequisite for program eligibility.

Recommendation: Maintain project funding targeting sound recording start-ups and smaller firms ("mom & pops," partnerships, etc). This funding would not require detailed firm-level financial data in recognition of the contribution of smaller companies to industry vitality, their prevalence in the industry and fact that they generally lack the resources and corporate organization necessary to produce financial data.

Recommendation: The financial data sets required for the five ratios used in this study should be updated on an annual basis

Recommendation: A decision on the development of supplementary financial data sets, such as those required for the three additional financial risk models, should be made following determination of needs and priorities in consultation with key industry stakeholders.

1.6 Industry Trends

There was general agreement among the players consulted that the sound recording industry's poor financial performance is due not only to online music piracy but to larger societal changes that include consumer attitudes and misconceptions, especially among the younger demographics, regarding the role of the labels (perception of overpricing and music as an inexpensive, ubiquitous product), intellectual property (belief that file sharing promotes the artist and label brand) and how music is consumed.

From a public policy perspective, there are strong arguments for investment in Canada's sound recording industry: music is integral to all cultural and entertainment industries; there are significant sound recording activities in all regions; production and evolving distribution (including the Internet) have relatively low capital requirements; and investments have a high multiplier effect relative to other sectors. Consequently, this industry has benefited from substantial public funding from both federal and provincial agencies and private corporations. In the view of many industry experts, public funding has been essential to the development and, more recently, survival of the industry under the current business model. While the long-term viability of the industry depends on the competitive advantage and business savvy of its players, it would appear that some form of funding will be required under any new model if Canada is to have a significant presence in the global sound recording industry.

There was no single business model for success among the labels surveyed, and even the strongest firms had relatively modest financial results. However, a number of these firms have

[1] This would include the federal and provincial agencies directly responsible for setting policy and designing and administering the programs as well as Revenue Canada and Revenue Québec.

developed innovative approaches to diversifying revenue streams (e.g. sharing in artist-generated revenues, production of DVDs, etc.) and/or target niche markets such as ethnic and older consumers (compilations, retro pop, smooth jazz). Some firms also indicated that they had developed strategic alliances upstream (with the majors in the development of artists) or downstream (with major retailers in terms of time to market, minimal inventory, pricing flexibility, avoidance of returns, joint promotion) in the value chain.

Among the interviewees, there was consensus that the industry would be transformed by digital retailing. While some thought that this transformation might occur within three years, others felt it might take as much as 10 years for electronic sales to displace traditional sales channels. Independent labels will have a window of opportunity to capture market share in new digital retailing, but there is no guarantee that they will be significant players in the new industry value chain as there will be intense rivalry among players and alliances for control over the consumer relationship and purse.

Among the potential key elements suggested for new sound recording business models were the following:

- Integrated video/sound (DVD) product with specialty niches for sound (CD, tape, vinyl) products

- Micro payments for downloading individual song selections and copyright revenues from new media (electronic games, Internet radio, etc.) would become a significant industry revenue but not necessarily displace traditional retail channels as the dominant stream.

- Artists and labels would develop more effective models in order to:

  - Give labels a share of artist-generated revenues (direct sales via the Web, at concerts and non-sound recording activities)
  - Develop a new hybrid business model that would allow the labels to exploit both digital and traditional sales channels
  - Lever branding opportunities on the Web into electronic and traditional retail sales
  - Respond to new commercial merchandising, pricing and inventory management standards required by retailers

While a significant portion of newer artists will likely continue to bypass the industry value chain by marketing directly to their fans via concert venues and the Web, players did not consider this an immediate threat because of the lack of professional sound quality and commercial promotion ability. However, it was agreed that piracy and bypass will grow and negatively affect viability in the foreseeable future. This will impact the industry's ability to commercially develop the same number and diversity of Canadian artists as in the past.

2 Introduction

2.1 Context

The sound recording industry in Canada has undergone more change and turmoil over the last few years than in the previous eight decades and, as a result, the viability of key players in the traditional business plan and industry value chain is in doubt.

In September 2003, Telefilm Canada, endorsed by the Department of Canadian Heritage (PCH) and the principal industry associations, commissioned Nordicity Group Ltd. (NGL) to conduct a review of the Canadian sound recording industry. The resulting profile is designed for use by government agencies and associations in developing long-term strategies to improve industry viability and in establishing and evaluating industry programs.

Previous studies of the sound recording industry have been hampered by the limited availability of up-to-date, comprehensive data. Historically, Statistics Canada has provided the most complete data, but it surveys only every three years and the turnaround for publication is typically two years. Moreover, there is some question as to the comprehensiveness and representativeness of the data captured and the methodologies used to analyze the data sets.

2.2 Methodology

This section provides an overview of the methodology used to gather data on the Canadian sound recording industry from primary and secondary sources.

Target Population

The survey targeted a representative sample[2] of sound recording companies[3] in the Canadian music industry.

According to the Canadian Recording Industry Association (CRIA) and Statistics Canada, Canada's sound recording industry comprises more than 400 companies – Canadian-owned independents for the most part and a handful of multinational majors. However, there is considerable churn as firms enter and exit and as a result of buy-outs and consolidation. In some cases, corporate vehicles are set up for specific recording projects or series of recordings. The last few years have witnessed an even higher-than-usual degree of churn as a number of companies have failed due to the marginal overall viability of the sound recording industry.

In consultation with industry experts and associations, 86 companies were identified as potentially appropriate for the purposes of this survey. After determining that 13 of these firms were no longer in operation or had merged with another firm, we approached the remaining 73

[2] The objective was to profile a representative sample, not to compile a comprehensive industry portrait. However, throughout the entertainment and cultural industries, it is difficult to capture a sample large enough to be statistically representative. That fact and corporate variants – market, genre, size, etc. – make the combined use of primary and secondary data more productive than a strictly statistical approach to analyzing the sound recording industry.

[3] As our aim was to capture the sound recording portion of the Canadian music industry (as opposed to aspects such as artist management), we used the well-established Statistics Canada definition of sound recording activities, which appears in section 4.2.

to solicit their participation. Ultimately, we were able to capture significant and comparable data sets on 40, resulting in an overall participation rate of 55% (see summary table below).

In large measure, the high participation rate achieved is owed to the endorsement of the music industry associations and their active encouragement of members. The participation rate varied by region; for example, 20 of the 33 potential Quebec-based companies participated, for a rate of 61%, as compared with just 3 of 13 based in the West, for a rate of 23%.

Table 2. Survey Participation by Region

Target Firm Category	Quebec	Ontario	West	Total
Main list	**35**	**35**	**16**	**86**
Companies closed/merged	**2**	**8**	**3**	**13**
Potential list	**33**	**27**	**13**	**73**
Refused / Could not be reached	**13**	**10**	**10**	**33**
Participating	**20**	**17**	**3**	**40**
% Participation	**61%**	**63%**	**23%**	**55%**

While the participation rate is relatively robust for this type of survey,[4] many companies could not be contacted or refused to participate. Some had exited the industry and others indicated that their financial records were not well organized or up to accounting standards.[5] Some of the principals indicated that they did not want to participate in a government agency-sponsored research project on the sound recording industry.

The participation rate varied for a number of reasons, including the influence of industry associations. For example, a relatively large number of the companies solicited in English Canada did not participate because they did not belong to the Canadian Independent Record Production Association (CIRPA) and thus were not urged to do so.

The study focused on the financial ratios of 37 of the larger independents, which together reported approximately $80 million in net revenues in 2002.[6] In addition, three of the major record companies (majors) agreed to provide selected information.[7]

The participants were categorized by corporate location (Quebec vs. Rest of Canada) and by size based on revenues (small vs. large). For the purposes of analysis, the financial data that they provided was broken down by target linguistic/ethnic market, music category, business activity, geographical market and origin of releases.

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[4] Surveys that require detailed preparation of data sets by respondents generally have a low participation rate.

[5] Accounting standards in the sound recording industry, as in the entertainment/cultural industries and SMEs in general, make it very difficult to capture standardized financial data. Many firms do not have in-house accountants; some use bookkeepers or internal personnel as a substitute for external or internal accountants.

[6] The study focused primarily on 2001 and 2002, the last years for which full financial data were available.

[7] The financial ratios reported in this study reflect only the 37 independents (data supplied by the participating majors was excluded except as noted in the revenue per employee ratio). At the time the study was completed, three majors had provided employment data and two, revenue data. The Canadian Recording Industry Association (CRIA) has since undertaken to secure the participation of all five majors.

Primary Research – Quantitative Data

The participating sound recording firms (labels) were surveyed by means of a questionnaire (see Appendix A) for up-to-date information on their production activity, employment profiles and financial performance. The survey involved in-person and telephone consultation.

The interviewers captured the survey questionnaire responses electronically, using an online survey software package to standardize and centralize the collected data in a single integrated database. The results were then exported to Microsoft Excel for data analysis.

Primary Research – Qualitative Data

Executive interviews designed to elicit qualitative information were conducted as well. All of the firms that agreed to provide production, human resource and financial data also provided a qualitative assessment of key industry trends and issues.

The interviews focused on four key themes:

- Key industry challenges and trends (e.g. threats to viability from piracy)
- Potential or likely business models that will emerge in the industry in the next 36 months
- Likely business model parameters applied to the individual firm interviewed
- Role of government agencies in assisting the industry in the transition period and on a permanent basis

These themes were used as a starting point to guide input. The interviewees spontaneously introduced a number of other issues, such as the efficiency of government programs and the role of majors in the Canadian industry.

The interview and reporting processes were conducted according to best national and international market research practices,[8] which guarantee respondents complete confidentiality and anonymity (i.e. individual company data sets are consolidated for publication).

Secondary Research – Review of Literature and Reports

A considerable body of literature has been published on Canada's sound recording industry and cultural industries in general. For this study, we reviewed the findings of the principal reports produced on the sound recording industry over the last decade to gain a better understanding of key developments and key player viewpoints. These reports provided valuable insight into many of the issues facing the Canadian industry today. They are listed in Appendix E along with other reports, publications and points of reference upon which we drew, many of them addressing the global industry.

To estimate the sound recording industry's overall contribution to the Canadian economy, data sets were sourced from Statistics Canada.

Data concerning the retail sale of sound recordings was sourced from Nielsen SoundScan.

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[8] International and Canadian marketing research societies such as PMRS (Professional Marketing Research Society) require anonymity for participants and non-participants alike, meaning that data and comments are kept in trust by the market research firm and not shared with the end client, except if the researcher requests permission to release individual corporate data and the participant provides informed consent.

2.3 Organization of the Report

In this report, we first present an executive summary with our approach, limitations and key findings. This is followed by the introduction, which provides the context and methodological overview.

In section 3, we look at the key characteristics and current trends of the global sound recording industry. Sections 4 and 5 are devoted to the Canadian sound recording industry, providing a detailed analysis of the industry's characteristics and issues and setting out the challenges it faces.

This is followed in section 6 by an analysis of the economic contribution of the sound recording industry in the Canadian economy.

In section 7, we present the results of a survey of Canadian sound recording firms with analysis of data on revenues, financial ratios and employment. This is followed by our recommendations for financial ratio analysis and databases in section 8.

We complete the report with a review of the issues confronting the sound recording industry and a presentation of suggested elements of a new industry business model based on our interviews with the sound recording firms.

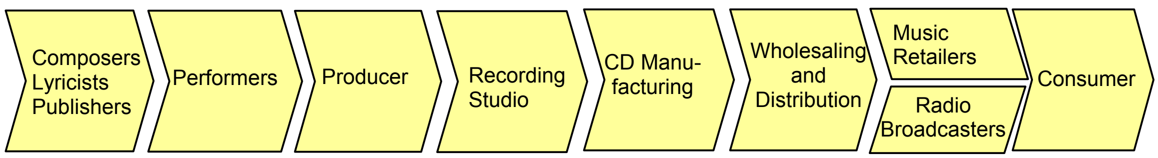
3 Snapshot of the Global Sound Recording Industry

3.1 Sound Recording Industry Value Chain

The traditional sound recording industry value chain is comprised of multiple players that work together from the creation of a musical work to the sale of the work to consumers.

The following figure identifies the main elements of the traditional music industry value chain.

Figure 1. Sound Recording Industry Value Chain



Players in the Sound Recording Industry Value chain

In the traditional sound recording industry model, the key players have distinct roles and individual corporate economic interests as well as incentives to cooperate with each other:

- Composers and lyricists/authors create the content – music and words, respectively – that is the creative basis of the sound recording industry. This creative process is often undertaken in association with or directly by performing artists.

- Producers enhance the quality of the creative work through an understanding of the creative process. Producers assemble the creative team of authors, composers, performing artists and sound/video recording engineers in order to capture, enhance and edit the creative content into electronic format. This recording process is typically undertaken using in-house and third-party recording facilities.

- Record companies, or labels, manage and promote the performing artists, wholly or partially own the sound recording distribution rights and sometimes own the facilities to manufacture the CDs or DVDs. They may also manage the product fulfillment process. Traditionally, labels (in particular the majors) have dominated the industry value chain owing to their vertical integration of key stages in the production and distribution processes.

- Distributors and wholesalers deliver music to retailers. Retailers provide shelf space, customer support, in-store marketing, transaction services and promotions. Consumers are the most important players and their behaviour has tremendous impact on the structure of and changes in the value chain.

Interrelationships among Players in the Industry Value chain

The key players in this traditional industry model have been around since the 1920s. While advances in technology, such as the switch from vinyl to tape to CDs, and the emergence of dominant multinational labels (majors) have modified the relationships among the players, the structure, process flows and viability of the industry have been relatively stable up until the last few years.

The recording labels generally assemble the creative teams – authors, composers, performing artists – and the technical production teams on a project-by-project basis. The labels ensure production of the recording and promotion of the product. In Canada, most labels, including the majors, outsource the physical production and fulfillment functions to specialized firms.

3.2 Value of the Sound Recording Industry and Global Trends

World sales of recorded music fell by 7.6% in value in 2003, the year-on-year decline slowed by a stronger second half in the US market, combined with resilient sales in the UK.[9]

The fourth consecutive year of falling music sales is attributed to the combined effects of digital and physical piracy and competition from other entertainment products.

The decline affected virtually all major markets, with Western Europe showing particularly sharp drops compared to recent years. Sales in Germany were down 19% in 2003 and down by more than 30% in value since 1999. Denmark, France, Sweden, Belgium, Greece, Ireland, Portugal and Switzerland also experienced double digit declines. Year on year, the industry has suffered global losses of 20% over the three years since 2000.

Internet piracy remains a very significant factor in the decline in world music sales. Research by IFPI and numerous independent third parties overwhelmingly proves that unauthorised file-sharing translates directly into lost legitimate music retail sales.

Positive signs include more robust album sales in the U.S. – thanks partly to a strong end-of-year release schedule – and a global rise in music DVD sales. DVD music video now accounts for 5.7% of global retail revenue compared to 3.1% in 2002. These factors helped restrict a global downturn in CD sales, which at the six-month point had been down 10.9% in value.

The recording industry is meanwhile making significant progress in creating an online music business. U.S.-based services achieved download volumes of 19.2 million in the second half of 2003. In Europe, around 30 legitimate services offered upwards of 300,000 tracks for download in 2003. Legitimate online music services also operate in Canada, Australia, Latin America and Asia Pacific.

Online sales of physical CDs also continued an upward trend, with an increase in the U.S. from 3.4% to 5% in volume and in the U.K. up from 5.6% to 6.6% of total units.

The global music market was worth $US32 billion with total unit sales (including music video) of 2.7 billion. Music on audio formats fell 9.9% in value. A small portion of this loss was compensated by an encouraging increase of 46.6% in music video sales. Sales of CD albums around the world dropped by 9.1% in value, while sales of singles fell by 18.7%.

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[9] The following global overview is excerpted from http://www.ifpi.org/site-content/statistics/worldsales.html (press release, April 7, 2004) with the permission of IFPI (International Federation of the Phonographic Industry).

Among the world's top 10 major music markets, the U.S. and the U.K. rank first and third respectively accounting for 37% and 10% of world sales. Germany has dropped from fourth largest market and now ranks fifth in the global music rankings. For the first time there is no Latin American market among the top 10, with sales in both Mexico and Brazil sharply hit by economic downturn and rampant CD piracy in recent years.

Of the world's top ten markets, only two saw growth: Australia was up 5.9% in value with the U.K. up marginally by 0.1%.

Online Sales and Indicators

The sale of sound recordings via the Web appears to have significant commercial potential. While estimates vary, Forrester Research projects that by 2008, one third of music sales in the U.S. and nearly 20% in Europe will come in the form of downloads and streaming music over the Internet.[10]

Apple's iTunes announced that it had reached the 50-million-download mark in March 2004. Puretracks was launched in Canada in October 2003 and by February 2004 had sold 1 million downloads. In Europe, OD2 – powering many of the now 50-plus European portals for music downloads – announced in April that it had sold more than 1 million downloads through its retail partners during the first quarter of 2004.

3.3 Copyright

Copyright[11] is the principal means by which music companies protect their economic assets, which is to say, their investments in artistic talent. Through contractual arrangements, the labels acquire exclusive rights to the artistic output of sound recording artists from which they then generate revenues.

In the traditional industry value chain, copyright was relatively easy to enforce, since the labels closely controlled movement of product from the CD/tape/vinyl pressing plants to the retail outlets. And since the retail outlets are controlled by chains with economic interests allied to those of the labels, incidents of copyright infringement – shipments of physical product like illegal CDs from the Far East, for example – were troublesome but not unmanageable. Today, however, in the new electronic world, no physical product is shipped and consumers can access sound recordings directly via the Web.

[10] Source: http://news.bbc.co.uk/1/hi/technology/3532891.stm

[11] The scope of this study did not include a full discussion of sound recording copyright issues. Recent reports that focus on these issues include *The Changing Face of Music Delivery: The Effects of Digital Technologies on the Music Industry*, Department of Canadian Heritage, 2004.

4 Characteristics of the Sound Recording Industry in Canada

4.1 Sound Recording: A Canadian Cultural Success Story

The sound recording industry has been a major success story among the Canadian cultural and entertainment[12] industries. Music is omnipresent in these industries and there is significant sound recording activity in all regions of Canada. The music industry has been a key player in the development of regional cultural identities, and Canadian authors, composers and performers are hailed as “best in class”[13] by international audiences and critics.

While Canada’s sound recording industry is dominated by multinational majors, a dynamic independent sector comprised of several hundred companies (labels) fosters creative talent across the country – from Newfoundland’s Great Big Sea to Quebec’s Laurence Jalbert.

4.2 Industry Overview

Music is the Industry’s Product

Sound recordings are the product at the end of the sound recording industry value chain. The variety of musical genres appealing to different affinity groups and constantly evolving with consumer trends is almost infinite, but in terms of today’s Canadian market they can be grouped into 17 principal categories:[14]

- Instrumental
- Country
- Urban/Rap
- Pop vocal
- Rock
- Jazz
- Children’s
- Classical
- Alternative
- Dance/Electronica
- R&B/Soul
- Aboriginal
- Folk/Roots/Traditional
- Blues
- Christian/Gospel
- World
- Comedy/Spoken Word

[12] In most countries, the various live and electronic media – theatre, television, film, sound recording, publishing, multimedia – are recognized for their contribution to regional and national cultural identity as well as for their commercial value, hence the designation “cultural industries,” rather than “entertainment industries.”

[13] Canadians have won numerous Grammys and other international awards.

[14] These genre categories were prepared in consultation with industry associations and experts.

It should be noted that the interviewees often categorized their particular genres differently.

For 80 years following the foundation of the modern sound recording industry, sound recording product was associated with the physical shipment of product. Today, it is increasingly associated with the electronic transfer of data files for downloading specific tunes or listening to subscriber services.

Sound Recording is Part of Wider Music and Entertainment Activities

This study is based on traditional sound recording industry definitions. However, we recognize that sound recording is part of the wider music and entertainment business and, as such, will be fundamentally impacted by issues confronting the other sectors.

In Canada, the traditional sound recording industry comprises specific commercial activities:[15]

- Production, release, promotion and distribution of recordings from masters
- Music publishing
- Distribution of recordings
- Production of master recordings (production company)
- Manufacture of duplicate recordings
- Recording studio operations
- Artist management
- Other sound recording activities

The sale of sound recordings via the Web (micro payments, subscription music services, etc.) should be included in this definition, but the lack of reliable data on music e-commerce limits the ability of agencies and associations to capture a true picture of its relative importance in the overall sound recording commercial activity.

In comparison with other Canadian cultural industries, the recording industry has ranked well in the global market place.[16] In 2000, sound recording product exports of $543 million were exceeded only by the publishing industry ($791M) and were well ahead of the high-profile film industry ($151M). When cultural products and services are combined, the music industry still ranks second ($709M) after the film industry ($1.08B).

In addition to sound recording, the music industry's revenue streams include live performance, artist revenues from advertising, product promotion, etc. Sound recording has long been an integral part of other entertainment industries, but digital media are now blurring the boundaries

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[15] This definition of activities has been used by Statistics Canada, the Department of Canadian Heritage, Telefilm Canada, provincial government agencies such as OMDC and SODEC, industry associations and firms as a reference to follow trends, design programs, evaluate performance and in longer-term strategic planning.

[16] For 2000, exports of Canadian cultural goods were valued at $2.88 billion, up $1.117 billion, or 69%, from 1996: Books and Printing $791M / Recordings $543M / Advertising Material $466M / Pictorial Material $439M / Newspapers and Periodicals $246M / Film $151M / Visual Arts $145M / Other Goods $98M.

For 2000, exports of Canadian cultural services were estimated at $2.12 billion, up $484 million, or 30%, from 1996: Film Services $929M / Foreign Tourist Spending on Culture $570M / Printing Services $325M / Music Industry $166M / Broadcasting $77M / Performing Arts $50M / Advertising Agencies $3.4M.
Source: *Canada's Cultural Exports*, Department of Canadian Heritage, 2003.

between one sector and the next. For example, record labels are moving rapidly towards DVD albums, an integrated sound/video product.

According to SoundScan recording sales data for 2003, the Canadian sound recording industry generates about $1 billion in annual sales, calculated at retail value.

4.3 Corporate Structure and Performance

Record labels constitute the heart of the industry value chain described in section 3.1. In Canada, the sound recording industry comprises some 400 labels, a few of them large multinationals, or majors, and the balance Canadian independents, or indies. The indies include approximately 70 larger firms and about 330 very small firms.

4.3.1 *Overall Viability of Canadian Labels*

The Canadian sound recording industry has always been cyclical, with financial performance varying year to year with global and national consumer trends and the popularity of specific artists. Over the 2001-2003 period, sales declined by 21.3%, from 59.8 million units to 47 million units. This decline was greater than those in the U.S. (17.6%) and the global market (20.6%) over the same period.[17]

Worldwide music sales, which according to some estimates had reached US$35.5 billion in 2001, slumped to US$28.2 billion by 2003.[18] The U.S. is the largest export market for Canadian sound recording products and services and, as such, is crucial to the Canadian industry. Thus, while the U.S. erosion in sales was slightly less pronounced than that in Canada, the decline had a very negative impact on the financial performance of a number of Canadian labels.

Prior to globalization, smaller domestic labels were able to find modestly profitable niches. Today, the industry's profitability appears to be decreasing rapidly.

While individual firms have performed well, the overall commercial viability of the Canadian content component of the sound recording industry would be doubtful without support programs.

4.3.2 *Major Label Dominance in Canada and Worldwide*

As they do around the globe, the major record labels, the so-called Big Five (BMG, Sony, Warner, EMI and Universal), dominate the Canadian – especially English-Canadian – sound recording industry in terms of both domestic and foreign recording sales and units shipped.[19]

SoundScan data attributes 82% of all recording sales in Canada in 2003 to the majors:

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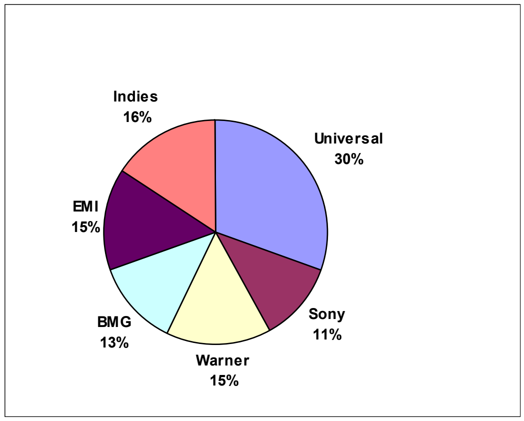
[17] Sources: World sales IFPI. U.S. sales RIAA and Sony Music International, New York. Canadian sales SoundScan.

[18] Estimates for the global industry vary. For example, IFPI puts global and Canadian sales at US$32 billion and US$946 million respectively.

[19] CRIA, the Canadian Recording Industry Association, represents the interests of the majors and the larger Canadian independents. It has Class A members, whose principal business is the producing, manufacturing and/or exclusive marketing of sound recordings, and Class B members, whose principal business is the producing of sound recordings (including phonograph recording studios).

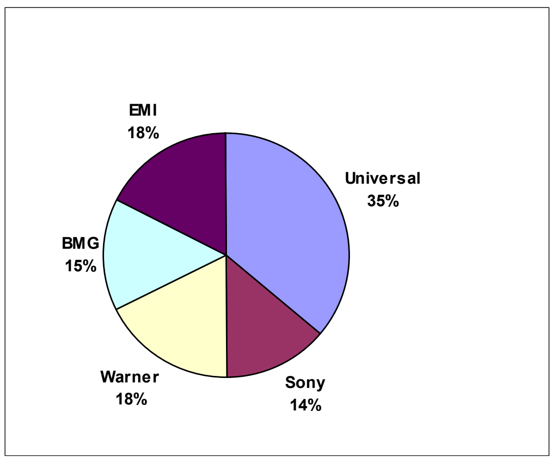
Figure 2. Market Shares of Majors and Indies in Percentages – 2003



Source: SoundScan data

Within the market share captured by the majors, Universal ranks first with 35%.

Figure 3. Market Shares of Majors in Percentages – 2003



Source: SoundScan data

The majors' dominance of the Canadian market is based on several key factors:

- Substantial marketing budgets and international marketing machines often based on corporate media assets that serve to establish awareness and build consumer preference for specific artists in the mass media
- A vast stable of A-list artists and artists in development and the associated rights
- Control of the industry value chain, from artist management through distribution/ fulfillment, and alliances with key retail chains[20]
- A close working relationship with the larger Canadian independents for the identification and promotion of new artists
- Canadian mass-market consumer preference for international artists over national artists

[20] The Big Five have invested heavily in Canada's distribution infrastructure to support the manufacture, distribution and retailing of music

Historically, the Big Five have controlled most of the worldwide music supply chain. But the past decade's wave of media mergers and cross-ownership deals has hit the music industry, resulting in a complex web of business relationships that now defines its powers that be. The new emerging consolidation will most likely create three major music giants and, consequently, a massive opportunity for cost cutting, cross-promotion and the selling of talent and products among the subsidiaries of each powerful parent company.

With the steady decline in industry profits over the last few years, the majors have opted for consolidation in order to cut back overhead and improve revenue generation. Thus Vivendi acquired Universal. The trade press reports that Sony, Warner and BMG are in merger talks, and there are potential mergers among other industry players.

But consolidation is not a panacea. The revenue streams that accrue to those who hold music copyright are threatened by the growth of online music piracy. Advertising and promotion budgets are shrinking, and it is increasingly difficult to amortize marketing and promotion costs.[21] And manufacturing and distribution costs have not decreased.

As the Big Five consolidate, the likely result will be fewer recording artists signed and promoted and fewer releases of new recordings, with the top-selling albums continuing to cover the cost of releasing the rest. In the longer term, however, the majors' reluctance to develop innovative and diverse music product will provide opportunities for independents to capture a portion of the existing business. For example, in the classical music genre, the majors have cut back drastically on symphony orchestra recordings.

Distribution will be affected as well. By tradition, the majors sell sound recordings directly to large retailers or through large intermediaries to local retailers, but they no doubt will have to consider alternative distribution models, including over the Web, which would restructure the current music distribution value chain.

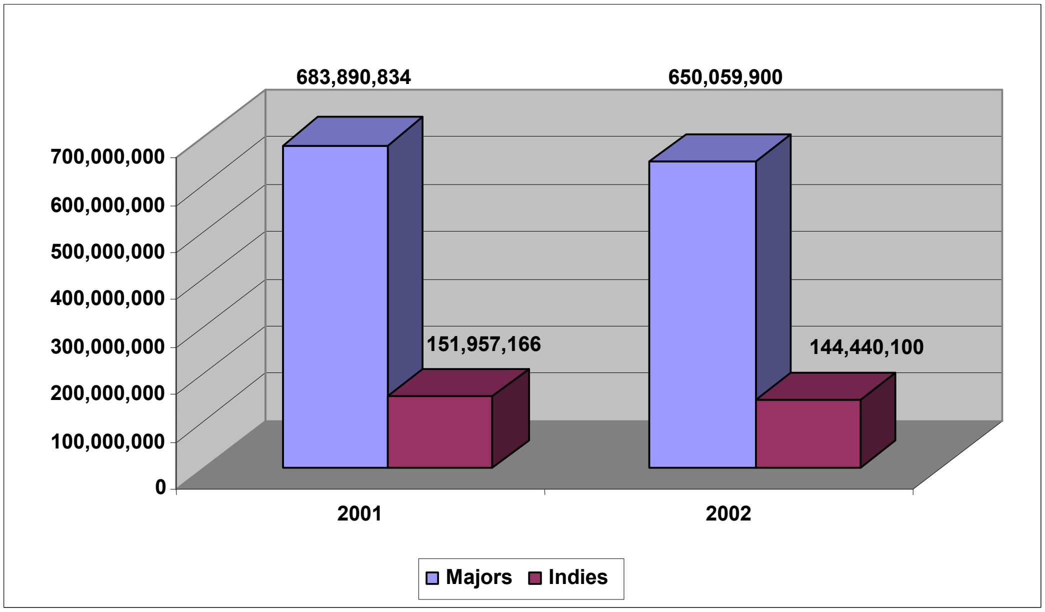
The rationale and role of the indies will not change substantively in the Canadian music business regardless of whether the majors of the music world merge into three or four global behemoths. Canadian independents have always been closer to the local and regional music scenes, allowing them to identify new talent earlier and at a much lower cost than the majors. But once the best new talent has been groomed and is ready to attack the global (read U.S. and other) markets, the indies need to access a whole different level of marketing and promotion resources and knowledge. In all likelihood, these services will continue to be provided by the majors, although it is not yet clear who will bear the costs.

However, for the vast majority of talent signed, the indies have the natural advantages of flexibility, market knowledge and cost efficiencies needed to sustain a career. (Many bands perform as well as those in the global music scene but prefer to focus on a regional fan base.) Thus, in the domestic sound recording market, they will continue to play an important and sometimes dominant role.

[21] Interview with CRIA member

In dollar terms, the five majors generated close to $650 million of the total $800 million industry sales in 2002, compared with $684 million of the total $835 million in 2001.

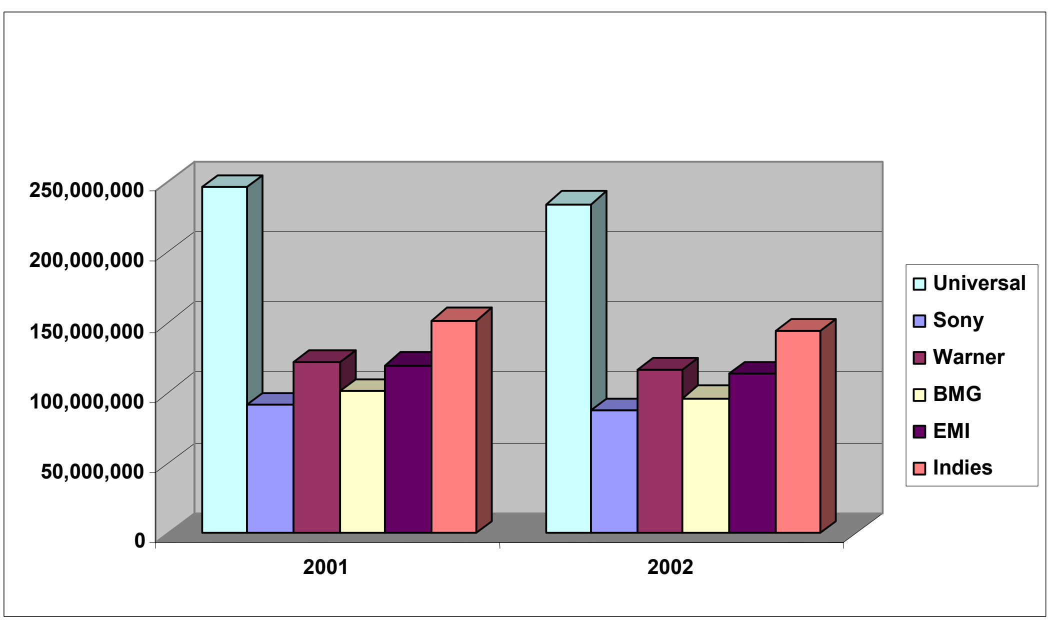
Figure 4. Market Shares of Majors and Indies in Dollars – 2001 and 2002



Source: SoundScan data

Universal was responsible for approximately $240 million of the majors' total sales.

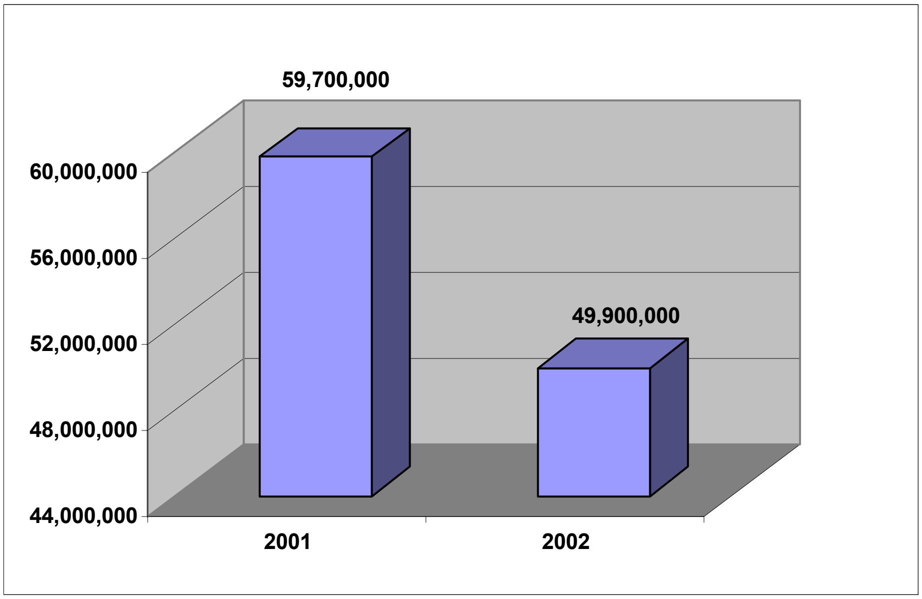
Figure 5. Market Shares of Majors in Dollars – 2001 and 2002



Source: SoundScan data

SoundScan data shows that, like the dollar value of sales, the number of units shipped in the Canadian sound recording industry declined between 2001 and 2002.

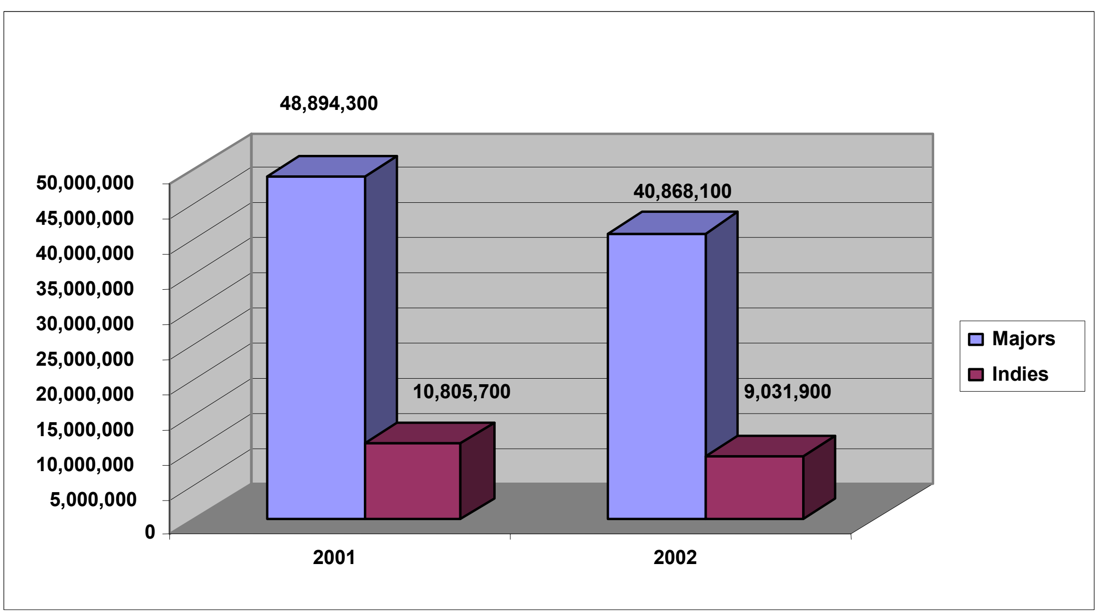
Figure 6. Total Units Scanned – 2001 and 2002



Source: SoundScan data

The data also shows that shipments by the majors fell faster than those by independents.

Figure 7. Market Shares of Majors and Indies in Units – 2001 and 2002



Source: SoundScan data

Over 80% of all sound recording product sold in Canada originates outside the country, principally in the U.S. This is a result of the overwhelming presence of American artists on the Canadian charts, where they commonly hold more than half of the top 100 positions. In contrast, Canadian artists hold few positions in the U.S. and generally only about 10 to 15 of the top 100 on market charts in Canada.

The majors control almost all foreign product through copyright and distribution agreements. They also dominate in the domestic industry in terms of managing, promoting and distributing A-list artists, with Universal far outstripping its fellow majors as well as the Canadian indies.

But while the majors lead in overall sales in both English and French Canada, their dominance is much less pronounced in the Quebec market, where domestic labels have signed the majority of Canadian A-list artists[22] and regularly dominate the top 10. The success of the Quebec labels with the music-buying public is based on the linguistic and cultural specificity of the product. Furthermore, Quebec artists tend to prefer to deal with local labels, not just for cultural reasons but because they can generate revenues from converged media activities in local markets (concerts, radio, television, print, etc.). The Quebec star system is an efficient, integrated multimedia industry that ensures the development of homegrown artists.

In comparison, the fans in English Canada are far more devoted to foreign (i.e. American) music and the artists have significantly fewer converged media opportunities.

4.3.3 *Major Labels and Cross-media Synergies*

The traditional model in the sound recording industry has been for a handful of large multinational majors and an abundance of smaller independents. The majors, in addition to having vertically integrated production-through-distribution record operations, are owned by media companies with interests in the wider music industry and entertainment industries, including event management, radio and television broadcasting, film production, cable and satellite distribution services and print and publishing. Sony, Warner and Universal all own film production studios and television networks in the U.S. as well as a multiplicity of other media interests. In Canada, there is only one domestically owned multimedia giant with recording operations: Quebecor, which has actively expanded its cross-media holdings and uses them to develop its stable of artists.

Control of multiple media platforms provides their owners with important synergies and competitive advantages for promoting sound recording products that are not available to small independent labels. In a number of interviews, respondents indicated that the large media groups have the ability to modify listening and consumption habits through cross-promotion involving old and new media vehicles.[23]

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[22] Among the Quebec-based labels with A-list artists are Audiogram, Guy Cloutier Communications, Aquarius, Disques Tox, Disques GSI Musique, Disques Justin Time, OCTANT Musique, Diffusion YFB, Disques Passporte. Source: ADISQ, SoundScan and websites of Quebec labels. A few Quebec artists, such as Linda Lemay, have chosen to sign with a major.

[23] For example, it was suggested that a radio broadcaster might influence listeners towards a particular artist because the station is owned by the same company that releases the artist's film and CD and that prints the newspaper that runs the favourable reviews. Or that a music download site could become a broadcasting medium owned and controlled by the same company that owns the cable and the content.

The ability of the media giants to cross-promote the brand image of the recording artist across its media platforms gives them a competitive edge, especially in a cluttered media market place where even the best artists can disappear after a single album.

As mentioned above, the only Canadian-owned firm that vertically integrates sound recording and various media industry operations to a degree similar to that of the majors is Quebecor. Quebecor controls key components of the music industry through its subsidiary firms Archambault Musique (retail chain), Select (distribution), Vidéotron (cable and ISP), Musicor[24] (label) and Star Académie (live event management).[25]

4.3.4 *Key Role of Indies*

According to SoundScan data, some 400 Canadian independents capture approximately 18% of industry sales.[26] However, SoundScan data has its problems. For example, some Canadian artists signed to Canadian labels but distributed by majors are attributed to the majors' share due to coding errors. On the other hand, all independent distributors and labels, foreign owned and/or controlled as well as Canadian, are lumped together in the independent category. Thus, the 18% market share for Canadian labels is undoubtedly overstated.

In any case, the importance of the Canadian indies to the Canadian music industry far outweighs their market share, since their sales stem largely from the release of homegrown albums.

Of these 400 or so firms, about 70 account for 90% of the overall 18% market share. In other words, 70-plus firms generate 16.2% of total Canadian industry sales, while 330-plus micro labels account for just 1.8%. And of the 70, about a dozen generate 80% of the 16.2% (12% of total sales).

Even among the 70 larger independents, most are small and medium-sized enterprises (SMEs) with less than a half dozen employees and many or most operations undertaken by part-time contract workers and/or freelancers.

Like the majors, Canadian indies have become more risk-adverse in the signing and promotion of new artists. This leaves few opportunities for emerging and lesser-known talent – essentially promotion in concert venues and via the Web.

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[24] Musicor is a still a relatively small label – only two artists at time of writing – but it is in the process of expanding.

[25] Quebecor's positioning in the communications industry is unique. Quebecor World, the largest commercial printer in the world, serves an immense customer base in North America, Europe and Latin America with a wide array of products. It prints magazines, catalogues, advertising inserts, books and directories, and offers digital, premedia and logistical services. Quebecor Media has operations in cable television and Internet access (Vidéotron), broadcasting (TVA), newspapers (Sun Media Corporation), magazines (Les Publications TVA), book publishing, Internet portals (Netgraphe), Web integration (Nurun), the distribution and retail of music and videos (Groupe Archambault and Le SuperClub Vidéotron) and business telecommunications (Vidéotron Télécom).

[26] Source: SoundScan data for Q4 2003 and Q1 2004. Estimates for Canadian independents overall and especially for the split between larger and micro labels are approximate due to non-reporting by the micros, corporate turnover and the near-total lack of data from Web-based independents.

The independent labels, which are closer to the music scene in various markets and genres than the majors, are responsible for launching the careers of most new commercial artists.[27] New artists typically sign with smaller indies, but as their careers progress some switch to the majors in order to access their promotional budgets and distribution networks. In some cases, the independents lose the future recording rights to their most promising artists and become unwilling de facto “farm teams” for the majors.

Most of the larger Canadian independents in English Canada have developed some form of working relationship or strategic alliance with the majors in order to develop new talent for the mass and/or international markets in the most efficient manner possible.

Universal and MapleCore have developed a unique model based on equity investment. In 2002, Universal Music made an undisclosed equity investment in the two-year-old MapleCore Inc., which operates MapleMusic Recordings, distributed by Universal. To date, Maple has released recordings by Sam Roberts, Pilate, Headstones, the Skydiggers, the Dears and many other new Canadian artists.

Few other major-indie relationships include an equity component and focus instead on risk sharing. In arrangements of this type, the Canadian independent assumes the cost of developing and promoting new Canadian artists.

In English Canada, the majors play an essential role for indies in marketing, promoting and distributing sound recording product. These are some of the distribution arrangements:

- EMI – Nettwerk Productions, Marquis, Aquarius and Popular
- Universal – Alert Music, True North, MapleMusic Recordings, Somerset Entertainment, 604, Radioland and CBC Records
- Warner Music Canada – Linus Entertainment, Stony Plain and The Children’s Group

Under the EMI-Marquis arrangement, for example, Marquis, an independent classical and jazz label, is distributed by EMI Music Canada. Patricia O’Callaghan is one of several artists that Marquis is promoting and distributing with the help of EMI.

In Quebec, distribution is either handled directly by the indies or outsourced to distributors, the largest of which are Distribution Select, owned by Groupe Archambault,[28] and DEP Distribution.

4.3.5 *Role of Micro Labels*

The 330 or so micro labels are often sole-owner firms or partnerships that work on a single recording project at a time. Micro labels have shown their ability to identify and develop new artists and even to manage established artists over their full careers.

These small firms have to overcome significant hurdles before they can play a major role in the Canadian music industry. First and foremost is the lack of financial resources, which leads to

[27] Industry experts hold that at least 80% of Canadian performing artists are never signed by any label, independent or major.

[28] Groupe Archambault also owns the largest retail chain for books, CDs, videos, DVDs, magazines, newspapers, musical instruments and sheet music in Eastern Canada.

constant turnover and churn and hinders production and promotion.[29] In the case of the now successful micro label Teenage USA, for instance, the principals originally had to hold day jobs to fund artist development.

A micro may be created around a single artist as a “vanity label,” or formed to facilitate access to public and private funding. In some cases, it is the personal corporation of an artist or band, run by their manager. In others, former artists wanting to stay in the industry once their own careers have faded have set up companies that include recording studios and artist management operations

Micro labels typically contract for the provision of most services in the production chain, and management and technical talent often flow from one to another, depending on which projects have the go-ahead.

Few micro labels have developed a structured corporate organization with back-office accounting, marketing and production specializations that generate efficiencies in the production process. A number of owners have deliberately chosen not to fully ramp up operations out of a desire to better control the quality of their recordings, net better “money in pocket” to the owners/principals and avoid the distractions of a corporate setting.[30] The operations are usually funded on a project-by-project basis with internal resources, rather than with third-party backing.[30] Despite their modest size and lack of corporate structure, these firms often display a surprising degree of longevity and financial stability.

The focus of this study is the larger Canadian independent labels, which generate the bulk of revenues for Canadian artists.

4.3.6 *Quebec Sound Recording Industry*

Quebec’s sound recording industry, wider music scene and consumer preferences are notable for distinct differences (*spécificité*) that set them apart in the Canadian market.

The Quebec market is very small, just seven million consumers, but these consumers have a marked preference for homegrown artists. Adjusting for market size, Quebec has more commercially sound independent labels than the rest of Canada. While the majors are still dominant in the Quebec market, independent labels account for a significantly higher proportion of total releases, estimated at 25-30%. Quebec-based indies release almost all (90-95%) sound recordings by Quebec artists. New labels such as Indica have been launched as joint ventures and have benefited from local market circumstances that include intense competition among radio stations for audiences and advertisers.

The Quebec sound recording and larger media industry is dominated by a handful of firms, chief among them Quebecor. This media group has its own label (Musicor), radio and television

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[29] Although a demo can be done inexpensively in a home studio, the result is noticeably inferior to a professional studio production and thus must be targeted to niche audiences. To reach significant market niches entails re-editing, marketing, promotion and distribution costs that are generally beyond the reach of most micro labels.

[30] *Profile of Small and Medium-sized Enterprises in the Canadian Cultural Industries*, Department of Canadian Heritage, 2003.

stations (TVA), live event management (Star Académie), print and publishing operations (Quebecor Media) and a major specialized music retail chain (Archambault).

Quebec-based indie labels are not dependent on the majors for promotion, marketing or distribution as are the larger indies in English Canada.

Among the larger indies surveyed, the study found differences between the financial situation of those in Quebec and that of those elsewhere in Canada. In Quebec, a greater proportion of revenues came from assistance programs such as Musicaction and FACTOR, and the cost base was higher.[31] One possible reason for higher costs is that the sound recording industry is more unionized in Quebec. To help control COGS (cost of goods sold), Quebec firms use relatively more freelancers than those based in English Canada.[32] The costs of marketing and promoting an album are typically scaled to the size of the market.

While the Quebec market is not subject to the same degree of competition from foreign labels as the English-Canadian markets, competition for retail space is still fierce. Distributors' margins have been squeezed and even the biggest labels have had to woo buyers for the larger retail chains for shelf space. Quebec has higher retail sales per capita owing to its version of the star system (magazines, TV appearances, newspapers, televised awards shows, etc).

As in other markets, the Quebec industry is focused on the music of mass-market pop icons. Thanks to the local star system and synergies among the various media industry components, recording artists enjoy more brand leverage opportunities than their counterparts in English Canada. Support through a network of live venues, television, radio and publishing is much more comprehensive in Quebec and allows artists to establish their careers more quickly than in the rest of the country. Both the artists and independent media companies are able to generate multiple revenue streams, resulting in higher revenues per capita for domestic artists.

On the other hand, the Quebec market is very small and Quebec-based artists are inevitably required to work in associated entertainment industries: radio, television and print media. This often leads to overexposure in the mass media.

4.4 Promotion and Retailing of Sound Recordings

While retailing is not the focus of this report, an understanding of retailing activities and how they relate back to the labels is essential to understanding the sound recording industry.

4.4.1 *Marketing Machines and Industry Clutter*

Independent labels face a number of challenges in reaching the customer: competing with the majors' marketing budgets and access to mass media promotion, dependence on majors for access to retail channels, overall clutter of new product in the industry and retailers' stringent commercial standards.

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[31] For example, in 2001, for similar average revenue of about $2 million, the Quebec companies surveyed had an average COGS of $860,000, compared to only $328,000 for the companies surveyed in other provinces.

[32] See figures 57 and 58, p. 90.

One industry member indicated that the generally accepted figure of 30% for the decline in retail sales has masked a much greater decline – 50 to 60% – among independent labels, even those distributed by a major.[33] This points up their vulnerability in the shifting value chain.

Retail sales are driven by hits on commercial radio. According to a Quebec-based player, "It's easy to find the top 100 in stores but hard to find individual recordings by other artists."

Growing competition is making it more and more difficult for labels to gain and maintain access to shelf space for their artists' recordings. The retailers are driven by sales volume metrics, and recordings that fail to perform are replaced by others with sales potential.

The cost of marketing and promotion has increased dramatically. Labels must pay for retail shelf space as well as promotional space at end of row and in store windows. There are about 2,000-3,000 new releases per month in North America. Even in a "protected" regional/linguistic market such as Quebec, 200 to 250 new albums are released each month. The Internet has reopened the door for small labels and artistic groups wanting to target niche and regional audiences.[34] However, the production quality of many of the albums and musical selections offered is not equivalent to that found in the traditional retail channels.

The retail prices of new release CDs in Canada and the U.S. range from $9.99 to $24.99, with a median tending towards the lower end. These levels are significantly lower than those in Europe, where albums are commonly priced in the $25-30 range.

Success in the mass-market merchandising of sound recording product depends on quick response to sales trends. As they have done decades, the majors and associated independent labels ship once a week to stores for purposes of cost efficiency, with a possible top-up order on Fridays if needed. Distribution is adjusted according to the retailer's sales cycle. For example, HMV's inventory management and delivery cycle is different from that of Wal-Mart. Distributors have become very nimble and cost-efficient in responding to retail demand by tailoring on-demand production runs at pressing plants and ensuring rapid delivery of product to stores via specialized delivery firms. However, mass marketing can quickly result in the overexposure of artists or the hasty release of recordings. In some cases, distributors have accused smaller labels of not being flexible in allowing pricing adjustments (discounting).

The generalized pressure to focus on merchandising and respond to trends has created opportunities for some firms, especially smaller boutique labels, to concentrate on the development of talent and production quality with one or two artists. Some boutique labels have been able to develop loyal fans in the smaller niche genres.

4.4.2 *Big-Box Stores*

The most important development in the retailing of sound recording product has been the emergence of big-box or "category buster" stores like Wal-Mart and Costco and the introduction of music CDs and DVDs at outlets such as Future Shop. Mass-market retailers now account for approximately 40% of the Quebec and English-Canadian markets.

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[33] Source: Interview with a larger independent label based in English Canada.

[34] Industry experts estimate that some 33,000 compilations (albums, clips, etc.) are released in the U.S. over the Web each year.

These stores carry a limited number of albums but sell at a significant discount to the traditional $19.99-$24.99 price points found in specialty music stores. Their pricing is based on a loss-leader strategy and the ability to generate additional sales in other departments. Furthermore, they have the clout to secure exclusivity deals that have proven controversial.[35]

Big-box stores typically focus on major international pop artists with well-launched careers (e.g. Britney Spears) and on compilations of well-known tunes (e.g. *Elvis Presley's Greatest Hits*).

Price discounting among the bigger retailers has resulted in significant cuts to sound recording retail prices.[36] While discounting has been around since the 1960s, retailers have pushed more marketing and promotion costs onto the distributors, which, in turn, pass them on to the labels. These new competitive pressures have jeopardized the viability of traditional specialty music retailers and that of many labels. A number of specialty retailers, such as Sam the Record Man, have gone out of business or have been forced to drastically change their merchandising practices. Specialty stores now ask the labels to co-promote their artists with in-store merchandising and events and/or to pay for shelf space. This has driven up the cost of promoting new artists and albums. Many labels have turned to niche markets and ancillary retail opportunities.

Overall, there has been a significant loss of diversity of music genres and variety of recordings by Canadian and international artists available through traditional bricks-and-mortar retailers. Some consumers appear to have reacted negatively to the lack of selection and lowering of quality by curtailing their purchases from such retailers, but most appear to be willing to trade off selection and quality for price reductions.

4.4.3 *Online Sales*

A number of players – music producers, artists and labels – are using the Web to reach the consumer directly. Web sales range from a simple telephone contact number for taking orders to e-commerce enabled sites such as Apple's iTunes and the Canadian Puretracks, where consumers can download single tunes or albums based on a fee for service. In many cases, distribution deals prohibit direct online sales by the labels. Where distribution deals allow Web purchasing, artists often use third-party firms that specialize in online sales and have the capability to ensure secure payment channels.

Music producers and labels are tempted to bypass distributors and retail chains and set up their own distribution via the Web in order to cut costs and access additional revenue streams.

Some artists have experimented with direct sales to consumers via the Web. Alternative sales channels are particularly attractive to newer artists and to consumers seeking something more than the selection found in traditional retailing, but each of these channels has its drawbacks.

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[35] One such deal that gave Best Buy and Future Shop an exclusive window for a Rolling Stones release prompted a number of retail chains in Canada and the U.S. to pull Rolling Stones music and merchandise from their stores. The growing trend towards exclusive deals among music acts and retailers seeking an edge in a dog-eat-dog marketplace is not without its downside.

[36] One Quebec-based independent estimated that sound recording retail prices had declined by approximately a third with the arrival of larger retailers in the distribution chain.

In theory, the Web could be a repository for an almost infinite diversity of music genres and artists as well as a commercial vehicle for reaching niche audiences on a global scale. A number of groups have established their careers through Web-based "buzz." However, the promise of commercial online distribution appears to have outstripped its ability to deliver. There was consensus among the players consulted that retail sales are enhanced by the larger distributors' marketing budgets and commercial intelligence.

To date, online sales appear to have had only a marginal effect on the retailing of international and Canadian sound recording products.[37] As indicated previously, the lack of reliable data on the music sales portion of e-commerce makes it difficult to evaluate the true importance of the Web in total retail sound recording sales.

4.4.4 *Direct Sales by Artists*

In addition to setting up their own websites, many artists sell directly to their fans at concerts or even out of the trunks of their cars. Direct sales via the Web have been very profitable for some smaller labels and groups. Although legally entitled to distribution exclusivity, many labels have tolerated and even enabled[38] artists to undertake direct sales. As the volume of such sales is expected to increase, the labels will seek and no doubt obtain a share of the revenues, since the artists are dependent on them for the release of product.

Many newer artists have recorded their own albums or selections and posted them directly on the Web. But these offerings have had little impact on the commercial market, since home-studio recordings cannot match the quality of those done in a professional studio. Independent artists undertaking online sales face hurdles: even with advanced search engines, it is not easy to seek out and promote a product to target audiences, and setting up and maintaining a website and direct payment arrangements for downloaded songs or albums entails substantial cost and effort. Furthermore, some consumers are wary of e-commerce because of the threat of spam and viruses.

4.5 Support Programs

Culture is often described as the heart of a nation. It has long been recognized that investment in the cultural industries is primarily a social and cultural, rather than an economic or financial, decision, since the key benefits are enhanced social cohesion, a sense of connectedness and nation building. However, where funding is concerned, a rigorous methodological framework is useful to ensuring equitable allocation among cultural industry sectors, evaluating the return on investments in each sector, evaluating the efficiency of programs and measuring their impact on individual firms, and ensuring the proper use of public funds.

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[37] Based on our interviews with industry experts, we estimate that online transactions account for less than 2% of total sound recording product sales (CDs, DVDs, tapes, vinyl, electronic downloads). Further accuracy is difficult, as online sales are not reliably reported within overall e-commerce activity. Estimates vary widely. A FAD Research report for the Department of Canadian Heritage, *The Changing Face of Music Delivery*, estimates that downloads constitute only .25 of 1% of CD sales in Canada.

[38] One label indicated that it supplied artists under contract with CDs to sell below retail cost at concerts or elsewhere, provided these sales did not conflict with traditional retail channels.

From a cultural perspective, assisting independent labels and artistic groups in the production and distribution of recordings ensures greater diversity and the reflection of local culture. Without ongoing financial assistance to independent labels, music risks becoming a commodity largely disassociated from its cultural component, even in regional markets with distinct musical and cultural expressions such as Quebec and the Atlantic provinces.

The Canadian sound recording industry has benefited from substantial public funding over the last decade, and a variety of support programs have been established.

Federal and provincial agencies and private corporations fund a number of direct and indirect financial aid programs for the sound recording industry. In some cases, industry associations participate in the administration of funds through specially created independent organizations. As well, some associations and larger firms offer direct financial support for music creators and/or producers.

In the view of many industry experts, this public and private funding has been essential to the development and, more recently, survival of the industry under the current business model. There was consensus among the industry members interviewed[39] that the role of government will become increasingly important in supporting domestic content development, domestic artists and the international promotion of Canadian music acts.

Opinions differ as to the appropriate role of government in safeguarding and promoting the sound recording industry. Some firms were critical of the selection criteria and project evaluation methods of some government programs, and of the fact that funding typically goes to well-established independents rather than to support new innovative companies. However, most agreed that funding is necessary for indies to survive. Government should not micromanage the existing funds and programs but, instead, should help indies build the infrastructure and financing mechanisms needed to assist/enable independent sector survival in digital transition.

By and large, the interviewees agreed on the need for rigorous selection and eligibility criteria such as a sound business plan, a distribution agreement and expertise in production and marketing. However, some felt that the larger companies are favoured by the assistance programs because they have the financial and professional resources to deal with the bureaucracy ("better able to fill out the paperwork") and the cash flow necessary to tide them over during long turnaround times for acceptance decisions. One player observed that the selection criteria and target groups tend to repeat from program to program, making it relatively easy for beneficiaries of one program to access others.

While the long-term viability of the industry depends on the competitive edge and business savvy of its players, it would appear that some form of funding will be required under any new model if Canada is to have a significant presence in the global sound recording industry. There was no consensus on the long-term role of funding programs in industry development. One point of view was that funding programs should be seen as a means to assist firms in adjusting to changes in markets or technologies, thus as complementary, not core, to industry development. Other players view funding as fundamental to the industry's continuing viability

[39] CRIA, CIRPA and ADISQ members generally supported public programs.

given the fragmented nature of the small domestic market and the spillover of the U.S. market into Canada.

The continued availability of public funding for the development of the sound recording industry is by no means assured. A number of the programs in question were created in the 1990s.

In the following section, we provide an overview of the various types of funding, mainly those that provide direct or indirect financial assistance to sound recording firms for projects and/or corporate capacity building. Related website addresses can be found in Appendix E.

4.5.1 *Federal Funding*

The Government of Canada renewed its commitment to the sound recording industry in 2001 by developing a new Canadian Sound Recording Policy. The principal tool for implementing this policy is the Canada Music Fund, which has introduced programs designed to deliver on the policy's vision of supporting diversity, capacity and excellence in the sound recording sector at every level, from creators to audience. The Fund comprises the following programs:

- Creators' Assistance Program
- Canadian Musical Diversity Program
- New Musical Works Program
- Music Entrepreneur Program (MEP)
- Support to Sector Associations Program
- Collective Initiatives Program
- Canadian Music Memories Program
- Policy Monitoring Program

At the federal level, the principal programs are FACTOR and Musicaction (for the English-language and French-language markets respectively) and the MEP/PEM program. Independent corporations administer FACTOR and Musicaction with participation on the boards by CIRPA and ADISQ respectively. MEP/PEM is administered directly by Telefilm Canada.

- **FACTOR / Musicaction**

FACTOR, The Foundation to Assist Canadian Talent on Records, and Musicaction are private non-profit foundations set up as a joint initiative of the industry associations, radio broadcasters and the Department of Canadian Heritage. The foundations are mandated to provide financial assistance towards the growth and development of the Canadian independent recording industry, in English and French Canada respectively. The funds administered by the foundations originate from two sources: voluntary contributions from sponsoring radio broadcasters and two components of the Department of Canadian Heritage's newly formed Canada Music Fund Council programs to support the Canadian music industry.

The funds assist Canadian producers in getting their recordings made and their videos created. A small portion of their resources goes to supporting distributors and artist managers. Their principal programs are as follows:[40]

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[40] Source: Interview with FACTOR, Canadian Music Week, March 2004.

FACTOR

- Professional Demo Award
- Independent Loan Program
- FACTOR Loan Program
- Professional Publishers and Songwriters Demo Award Program

Musicaction

- Nouvelles œuvres musicales
  - Production d'un album
  - Commercialisation
  - Démarchage
  - Soutien à l'émergence
- Initiatives collectives

In 2002-2003, FACTOR allocated funding of $9,638,386 in the form of grants and repayable loans, while Musicaction provided $4,561,937.[41]

- **MEP / PEM**

Since October 2001, established Canadian companies actively engaged in developing and promoting Canadian sound recording creators and performers have been able to apply for support to MEP, the Music Entrepreneur Program (Programme des entrepreneurs de la musique).

Created with a budget of approximately $23 million, the program marks an important shift in the nature of support provided to the Canadian recording sector, from a traditional focus on project assistance to one geared to building corporate capacity.

MEP has provided funding in two phases, the first for development of multi-year business plans and the second for implementation of business plans. In 2002, 26 companies qualified for a total of $1 million in Phase I support. In 2003, 13 companies qualified for $17.8 million in Phase 2 support.

An evaluation of this program will be conducted for the Department of Canadian Heritage once Phase 2 is completed and the results become measurable.

- **DFAIT and PCH**

The Department of Foreign Affairs and International Trade and the Department of Canadian Heritage fund a number of export-related activities for sound recording companies and artists, including travel and exhibition at trade fairs, conventions, etc.

4.5.2 *Provincial Funding*

Several of the larger provinces – Quebec, Ontario and BC – have direct and indirect financial programs for sound recording firms.

- **Quebec**

Quebec appears to have one of the more comprehensive approaches to supporting the sound recording industry. SODEC, the principal administrator of the province's initiatives, is an agency of the Ministère de la Culture et des Communications.

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[41] Source: FACTOR and Musicaction. In 2000-2001, FACTOR provided $6,560,788 in grants and reimbursable loans to 834 companies, while Musicaction allocated $5,926,036 to 572 firms and artists.

- SODEC programs: Quebec sound recording and live event[42] companies can apply for grants, reimbursable loans and favourable loan financing terms. In addition, the Sodexport program funds export-related activities and promotes international cultural influence.

  In 2002-2003, SODEC allocated $12.25 million to some 275 firms: $10.6 million via general programs, $0.86 million via Sodexport and $0.75 million via funding programs. In 2001-2002, it allocated $8.92 million to some 250 firms: $7.64 million via general programs, $0.63 million via Sodexport and $0.66 million via funding programs.

- Quebec Tax Credits: Quebec-based firms in the cultural industries, including sound recording and live event producers, can benefit from provincial tax credits. The program is administered by SODEC in conjunction with the Ministry of Finance.

  For 2002-2003 and 2001-2002, sound recording companies were granted tax credits of $978,007 and $677,839, respectively. For the same years, tax credits totalling $6,490,845 and $2,439,036 were granted to live event production firms.

➢ **Ontario**

The principal support programs for the sound recording industry are funded and managed by the Ontario Media Development Corporation (OMDC) as part of an overall program targeting the cultural industries.[43] Firms can apply to the following programs:

- Ontario Sound Recording Tax Credit (OSRTC): a refundable tax credit based on eligible production and marketing costs incurred with respect to an eligible Canadian sound recording

- Business Innovation Group: focusing on programs and services designed to build capacity, encourage strategic partnerships and develop skills in all of the sectors

➢ **British Columbia**

The Music Industry Travel Program is the principal provincial support program for the sound recording industry in British Columbia. It provides assistance to recording artists and their business representatives to participate in performance, touring or showcasing initiatives, or to business representatives attending industry events implemented in conjunction with the release of a recorded sound product.

The Pacific Music Industry Association administers this program with financial support from the Ministry of Small Business and Economic Development.

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[42] Such as music concerts and variety shows.

[43] The Ontario Media Development Corporation (OMDC), an agency of the Ontario Ministry of Culture, plays an important role in book publishing, music, interactive digital media, film, magazine publishing, and television industries. The focus is to build the capacity and competitiveness of Ontario's cultural media industry, individually and across the sectors, and to provide opportunities that encourage business alliances across the cultural industries.

4.5.3 *Association-based Funding*

A number of national and province-based music industry associations administer financial assistance for music creators and producers. Sources of funding are usually private broadcasters or media companies, and the amount of financial assistance depends on the music genre and the geographical location.

- Radio Starmaker Fund / Fonds Radio Star is a program for Canadian artists with a track record in their current career. The Fund was created in the fall of 2000 on the initiative of the Canadian Association of Broadcasters (CAB) and approved by the CRTC. It is a private fund that has as its stated purpose to "make a substantial and discernable difference to the careers of Canadian artists" by providing substantial incremental investment where the artist has established a proven track record and the label is making a significant investment in the artist's future career.

- VideoFACT was created in 1984 by MuchMusic Network to fund Canadian music videos by means of non-recoupable grants covering up to 50% of the production budget to a maximum of $20,000. It accepts applications from record companies, record producers, video directors, producers and artists – in short, anyone involved in a music video production. While most videos are produced to promote a sound recording, this is not a requirement for VideoFACT, which supports all forms of music videos in both English and French.

- PromoFACT was set up in 1998 by MuchMoreMusic to provide production funding of up to 50% of the budget, to a maximum of $3,500, for electronic press kits and website programs for Canadian independent artists and record labels.

- MaxFACT was established in 1997 by MusiMax to provide grants of up to 50% of the cost, to a maximum of $20,000, for the production of French-language music video clips.

5 Challenges Facing the Sound Recording Industry in Canada

Here we analyze the key issues confronting sound recording companies operating in Canada.

To identify these issues, the study team surveyed 40 key industry players, both Canadian independents and multinational labels, in the English- and French-language markets.[44] We also reviewed previous studies of the Canadian and global recording industries (see Appendix E).

5.1 Fragmentation within the Entertainment Industry

The sound recording industry, one of the oldest of the entertainment industries, has always had to compete for the consumer's time and purse: initially with film and print media, then, in succession, with radio, television, electronic games and various forms of entertainment delivered over fixed and mobile devices. Today's commercial entertainment market is extremely fragmented, making it difficult for sound recording labels to identify, reach and capture the attention of consumers in the target markets and, ultimately, to motivate them to purchase the sound recording product.

The business plans of the larger independents and the majors are constructed on the capture of significant market share by popular artists, as there is a large component of fixed costs in the recording, pressing and promotion process. The profit margins therefore depend on the volume of sales. With the globalization of the sound recording market, the competition to supply product to retailers and over the Web has risen dramatically, resulting in industry clutter. And with the rise of big-box stores, retail prices have fallen significantly, as have the number and diversity of sound recordings offered on store shelves.

5.2 Increased Marketing and Promotion Costs

As indicated previously, the majors play an important role in the selection of new artists and groups for commercial promotion through their agreements with the larger independents or their own stable of artists.

The potential for new Canadian artists to be signed by a label with substantial marketing and promotion budgets has dwindled as the costs of marketing and promotion have escalated. According to an independent operating in English Canada, marketing and promotion costs are currently rising by about 25% a year. Whereas previously the labels could afford to nurture the development of artists over a number of albums, there is increasing pressure to produce hit albums immediately or risk being replaced by other acts. Both the majors and the larger independents must now decide within weeks of an album's release whether they will continue to support the artist.

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[44] These firms also provided financial, shipment and employment information for the survey component of this study.

5.3 Flight of Canadian Talent to the United States

The U.S. market, by its size and diversity of talent, invariably sets the trends in the global, and particularly the Canadian, sound recording industry. Canadian consumers have always been very aware of U.S. artists through the influence of American mass media, and many Canadian artists have been attracted by the commercial rewards of the much larger U.S. market.

A key issue expressed by many top executives and industry leaders is the flight of Canadian talent to America and Europe. This relocation of talent stems from the artists' ability to gain exposure for their career in larger markets, which leads to other benefits such as lower taxes, privacy, choice of ideal location to live, etc.[45]

Within the major labels, the Canadian corporate divisions sometimes compete with their U.S. counterparts for management rights to Canadian A-list artists. On occasion, these subsidiaries complain[46] of the U.S. divisions "raiding" Canadian artists who, after initially signing with a Canadian independent, switch to a U.S. division in anticipation of greater financial backing and better positioning with American broadcasters, magazine publishers and concert circuit owners. The agents and lawyers of Canadian A-list artists often take a short-term, revenue-maximizing view.

In order to ensure an album's commercial success, a multimedia (print, broadcasting, etc.) marketing campaign must be developed and implemented. In general, these campaigns focus first on the major American and European markets. In the Canadian industry, the estimated cost, when undertaken by a major, is on the order of $950,000 per album. U.S. labels have higher promotion budgets but a short-term perspective: if the artist does not continually produce hits, he/she is dropped in favour of the next hottest thing.

Furthermore, in the U.S., rights are paid per song, so there is an incentive to include fewer songs on each album. In the rest of the world, rights are paid as a percentage of revenue, so, while more songs are included, the per-song rights value is lower.

5.4 Piracy

The music industry has often been in the forefront of technological, consumer and business trends. Music is the oldest and most widely distributed form of entertainment and cultural content. It is popular in almost every culture, and, beyond the sound recording sector, it is a key component in the radio, television, film and gaming industries.

In the traditional sound recording industry model, the value chain was dominated by the major record labels, which controlled the entire process,– from selection of performing artists to promotion, through rights management, manufacturing and distribution deals with wholesalers and retailers. Today, the viability of this traditional value chain is threatened by new digital technology, consumer habits and changes in the distribution chain. Principal among the challenges facing the industry is the now-entrenched habit of the core sound recording

[45] For example, Shania Twain's decision to live in Switzerland. Or Joni Mitchell fleeing to Paris to escape "the star-making machinery behind the popular song" (see www.socan.ca/jsp/en/news_events/feature_stories/Canucks.jsp).

[46] Interview with a major

demographic (12 -34) – long the most intensive consumers – to illegally access and download music and music videos.

This piracy activity has been enabled by changes in consumer attitudes and new technology.

"While there is a consensus in the industry that piracy is a major cause for industry losses, there are some academic and individual sound recording industry players who disagree that it is a substantial problem. A recent study by academics found no significant link between file sharing and falling record sales and, in certain cases, found evidence that file sharing might actually increase sales of hit albums."[47]

Some industry players indicated that there has always been a certain degree of illegal copying since the early days of vinyl and that illegal downloading is less a fundamental problem than the inability of the music industry to produce a quality product and to understand and respond to customer needs and budgets.[48] Labels targeting the youth audience with popular music genres were more concerned about niche genres.

5.4.1 *Consumer Attitudes*

Consumer research has revealed a widespread view in the key music-consuming demographic (12-34) that music should be free, or nearly free, based on common attitudes and perceptions:

- Labels have outrageous profit margins and overcharge for their product.
- Labels oblige consumers to purchase songs they do not want or that are of poor quality ("fillers") by selling the album in order to get the desired single songs.
- Music is ubiquitous in daily life (radio, TV, film, on the Web) and is offered at no or low cost by many retailers and commercial organizations,[49] thus the prices charged by labels and retailers are outrageous.
- Music CDs are relatively poor value for money in comparison with DVDs, which combine sound and video and require more sophisticated production techniques. In fact, consumers in general complain that the quality of music and value for money on these albums has become uneven in the rush to get to market.[50] The counter viewpoint is that the problem of uneven quality and value for money has existed for as long as there have been albums, whether on vinyl, tape, CDs or DVDs.

These attitudes and perceptions about the role of labels in the industry value chain are fairly prevalent, even among some members of the industry.[51]

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[47] F. Oberholzer-Gee and K. Strumpf quoted by CanWest-Global News, April 4, 2004 (see Oberholzer, Appendix E).

[48] Interviews with ADISQ and CIRPA members

[49] For example, fast food restaurants in the U.S. have begun to sell albums by major artists affixed to drink cup lids for a small surcharge (a couple of dollars) on the price of a meal.

[50] Canadian Music Week conference, March 2004. Session with majors.

[51] For example, participants – mainly younger artists – at the March 2004 Canadian Music Week conference, raised a number of these issues, including the bundling of hit songs on albums, label profit margins and the relative pricing of CDs and DVDs, and questioned the majors' dominance and profit margins.

While the industry has responded with a variety of measures, including legal prosecution of individuals, consumer education on the impact of piracy, and technological digital watermark solutions, it is clear that piracy now accounts for a significant portion of music consumption.

Among the key challenges to the viability of the traditional model are substantial increases in the cost of promoting artists in a cluttered media universe and the emergence of big-box retailers. As well, more and more artists are marketing directly to their fans.

Overall, the study data and interviews indicate that the key players in the Canadian and international music industries have not yet developed effective strategies to ensure viability under the current industry model, or developed the core components of a new industry model. As a result, the viability of the sound recording industry – large and small companies as well as artist career development – is in jeopardy. Section 9 reports the views and outlooks of the key players interviewed for this study.

5.4.2 *Changes in Technology*

The modern music industry was created some 80 years ago with the development of vinyl records and AM radio. These technology platforms enabled the widespread availability of affordable music product. FM stations and, more recently, digital audio broadcasting (DAB) and Internet radio have layered over existing AM stations. Vinyl was displaced in succession by tapes, CDs and DVDs.

While these previous technological developments were evolutionary in nature for the sound recording industry, the convergence of data and content and the arrival of broadband access have changed the way consumers access and utilize music.

A growing percentage of music distribution has moved from the corporate sales channels to individual selection. The Web offers consumers the upper hand: a wide selection of sound recordings at very low or no price with very little effort. The evolution of Web-based technologies – high speed, broadband and wireless access, search engines, sophisticated peer-to-peer software, mobile players, music upload sites, devices with integrated CD burners, etc. – has greatly facilitated consumer access to music, made piracy on a mass scale feasible and contributed to the financial crisis of sound recording firms and artists.[52] The music offering has increased dramatically with the Web, However, not all music on the Web is of professional quality, as production may have been rushed or pirated (e.g. demo tapes from studios or concert recordings offered instead of final edited cuts).

MP3 technology, in particular, has played a key and radical role in changing the music industry and is now the standard among online music fans, who can easily transform, or “rip,” compact discs into MP3 files, save the files on their own computer and make them publicly available.

With the emergence of broadband, transferring digital files requires only an Internet service provider (ISP) at minimal expense. Technological changes have increasingly heightened competition for the major labels and produced a new player in the value chain, namely, the ISP,

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[52] According to some players, another factor contributing to the intensified use of sound recordings by consumers was the sudden decrease in price of blank CDs, which coincided with the arrival of new technologies.

which directly capitalizes on the content provided by music and other media industries. The distribution of music over the Internet requires only a single master copy, whereas traditional distribution requires the delivery of multiple physical items (CDs, audio cassettes, etc.).

The demand for music has not decreased, but revenues previously captured by labels and other sound industry players are being hijacked by new players such as ISPs and music pirates that ignore copyright. On the other hand, some labels are hedging their bets by working with the ISPs – posting demo cuts, etc. – while at the same time denouncing illegal music use. Others are targeting niche markets, which are less susceptible to piracy either because they are little known or because the fans want higher production values than those available over pirate websites or are willing to pay retail prices.

Many newer artists, producers and smaller labels view the Internet as an instrument for gaining awareness in broader affinity markets, building audiences for live events and getting their product to market cheaply by by-passing the traditional distribution and retail gatekeepers. They contend that consumers do not get their money's worth in albums sold by the labels, that the big players "rip off" buyers by bundling very good tunes with "B side" tracks and overcharging. Consequently, they feel that consumers are justified in finding cost-efficient ways of accessing the specific sound recordings they want.

Some experts believe that physical products – CDs, DVDs – will disappear from the mass market over the next decade, since consumers are more interested in the music than the container. Portable players (MP3 and other) that can download directly from the Web offer all the features desired by consumers: speed, flexibility, minimalism, elegance and the ability to store thousands of tunes and organize and select them instantaneously.

It is expected that a specialty niche market for physical product will continue to subsist among consumers who either are not technically savvy or want the physical product as a souvenir of a particular artist or concert event. The sound recording industry has an economic interest in ensuring that some form of physical product continues to exist in the market place.

5.4.3 *Impact of Technology Changes on the Industry Value Chain*

When music is stored and sold as a computer file, disintermediation (removing the middleman) occurs, cutting labels, wholesalers and retailers out of the business process. This has had a major impact on the conventional distribution channels in recent years, doing particular harm to the Big Five (BMG, Sony, Warner, EMI and Universal), which have traditionally controlled over 80% of the Canadian industry as distributors of music to retail stores.

Economies of scale in the distribution of physical music products have always placed smaller, independent music labels at a disadvantage. Today, the Internet has the potential to reduce the majors' market domination in the area of emerging distribution. By delivering music over the Internet, independent record companies, which are able to generate significant online traffic, could achieve revenue growth and profitability. Digital downloading technology gives sound recording firms control over the distribution of their artists' works and thus the potential to create new sources of revenue for the industry. That being said, many digital distribution companies have yet to prove their business plans viable over the long term.

5.4.4 *Industry Response to Piracy and Other Threats to Viability*

Record labels have responded to threats to long-term viability in a variety of ways, the most immediate being cost-cutting and revenue-stabilization measures. Many have cut back staffing, limited the number of artists signed, reduced promotion expenditures and undertaken merger talks with a view to sharing common costs.

On the revenue side of the balance sheet, copyright enforcement is a major concern for the recording industry around the globe.

The U.S. has been particularly aggressive in combating sound recording piracy through the courts, as it is seen as the precedent for potential piracy in other entertainment industries (film, games, broadcasting) that collectively constitute one of the country's major export earners. Closely backed by the courts, the Recording Industry Association of America (RIAA) has pursued uploaders and downloaders so vigorously that there has been negative backlash in the media for going after "kids and grandmas."

With the recent decision by Canada's Federal Court to deny legal action against ISPs that would have forced them to divulge customer records to identify suspected cases of illegal downloading, Canada has, in the short term at least, diverged from the U.S. strategy of targeting downloading as well as uploading.

Given the practical difficulties involved in pursuing uploaders – most operators are sophisticated enough to use servers in foreign jurisdictions where copyright enforcement is a doubtful proposition – file-swapping forms of piracy will continue to be a significant, if not the dominant, mode of access to sound recordings for the crucial 12-34 demographic. Thus, changes in copyright legislation will be required if Canada is to effectively enforce copyright.

It bears noting that the sound recording industry appears to be divided on the piracy issue. Young performing artists, especially those not under contract with a label, appear to favour the open distribution of music via the Web. They contend that file sharing is a means to build their reputation among target audiences and believe that a portion of the sharers will purchase their sound recordings over the Web or in traditional retail once they have become fans.

5.5 Financing, including Support Programs

5.5.1 *Limited Access to Capital*

Limited access to capital is the major roadblock to growth in sound recording companies.

Since third-party financial institutions generally consider sound recording activities too risky, most firms derive funds for projects and growth either from internal sources or from government support programs. Contrary to what it has been done for the film production industry, Canadian governments have not fostered development loan portfolios for sound recording firms based on direct equity investment and tax credit regimes.

As internal corporate funds are typically limited and vary from project to project, firms are forced to restrict staffing and concentrate on only a few projects and music genres with the greatest sales potential. Many companies are in financial survival mode. Others that were previously profitable and leaders in their fields have gone bankrupt over the last few years and more closures are expected.

In Quebec, some players anticipate that there will be only ten independents left five years from now.[53] This will result in further concentration in an industry that is already highly concentrated: currently, 20% of the firms do 80% of the business.

5.5.2 *Direct and Indirect Financial Support Programs*

By and large, the industry players surveyed recognized the need for government support programs in the sound recording industry to promote diverse voices and genres and new talent, even among larger independents and majors that focus on commercial hits. In the case of the smaller labels, many projects cannot be realized without financial support, and the need for assistance outstrips available funding.

The interviewees had many suggestions for improving and creating programs, but their first concern was to conserve existing program levels. A number of them suggested that the industry associations become more actively involved in designing programs and, especially, in setting the parameters for candidate selection. There was general agreement that the selection processes are too long, that the admission criteria attract too many candidates and that the selection parameters are not flexible enough. While some players wanted the programs to shift from project to corporate financing, this was not a unanimous position.[53]

Another minority opinion saw grants as an obstacle to developing a viable industry, suggesting that they can create inequities among companies (beneficiaries vs. non-beneficiaries) and make players risk-adverse and less nimble in responding to opportunities even though the objective is to enable them to take calculated risks.

These are some of the suggestions for changes to the criteria or focus of the programs:

- Have support programs subsidize salaries for key production positions (artistic directors, authors, composers, etc.).[53]
- Add a distribution support program for independents to foster real competition for the major distributors[54] and ensure access to sales channels for Canadian labels.
- Enable third-party financing – loan portfolios – for companies with a good track record.
- Create a small budget, forgivable loan program for emerging sound recording firms.

Some recommendations spoke <u>against</u> creating a particular program, such as one based on long-term credit.

In regard to selection parameters, it was suggested that a firm's track record and portion of revenues from foreign sales be taken into account, and that a program specifically targeting the development of foreign sales be created because the "future of the domestic industry is in the global market" and foreign revenues would allow domestic firms to reinvest in artistic talent.[53]

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[53] Interview with ADISQ member

[54] The largest independent distributor of music and videos in Canada is Quebec-based Distribution Select (formerly Communications Select, Musicor and Musicor Vidéo), a division of Groupe Archambault.

In short, to address the key financial issues facing the Canadian industry, players recommended that stakeholders and policy makers develop direct and indirect support programs that will:

- Encourage moderate risk taking by sound recording firms
- Develop access to third-party financing mechanisms for sound recording firms
- Promote true competition among players in the industry value chain without unduly favouring the beneficiaries of support programs
- Encourage the development of export markets
- Encourage the hiring of key talent and the development of new Canadian artists
- Create attractive tax incentives and alternative compensation mechanisms to keep Canadian talent in Canada

5.6 Labour and Employment Issues

5.6.1 *Job Growth Replaced by Layoffs and Loss of Corporate Memory*

Canada's sound recording industry managed to increase its employment base by 23% between 1997 and 2003, from 2,121 to 2,618 persons.

However, there are indications that the industry has fundamentally downsized its labour force over the past year, with a corresponding loss to its corporate knowledge base. With labels concentrating on fewer, more successful artists, some independents and majors reported that they had already reduced their staffing levels by 25% and were preparing for further cutbacks. In many cases, full-time employees have been replaced by part-time contract workers or by freelancers on a project-by-project basis.

This appears to be the case chiefly in Quebec, where most of the employment is part-time and freelance.[55] Freelancers are typically managed by a full-time manager and used on a project-by-project basis. In the companies surveyed in the rest of Canada, we found a significantly higher proportion of full-time employees.

In the larger music industry, musicians have been hard hit by the digitization of music and the use of synthesizers in live and recorded performances. Other trades throughout the value chain have been affected as well (live event and concert technicians, publicists, etc.).

5.6.2 *Need to Prepare the Next Generation of Talent and Management*

The baby boomers who make up the demographic cohort that currently dominates the industry are expected to retire en masse over the next decade, and this will entail an equivalent loss of corporate memory and experience. But with low profitability, labels lack the resources to train replacements. With the advent of new digital production techniques, firms will need both academic and on-the-job training for their staff and freelancers in order to remain competitive.

For recent graduates and others wanting to make a career in the sound recording business, the elimination of permanent positions and layoffs have made it much more difficult to gain entry.

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[55] Interviews with ADISQ members

This study found that the availability and turnover/retention of skilled labour are not major problems in the sound recording industry owing to layoffs and industry norms whereby staff are willing to work long hours for little remuneration. This finding corresponds with those of previous studies.[56]

If there are critical skills shortages, it is for experienced professionals and managers who have good overall business skills in marketing, finance and production and an understanding of back-office systems such as legal, accounting, etc. The skills of these experienced professionals are mobile outside the industry, where they can earn significantly higher wages than those offered in sound recording.

In the opinion of one Quebec-based player, academic institutions' curricula are not adequately adapted to the needs of the sound recording industry, in that they do not teach the flair and savoir-faire necessary for success. Executives and others interviewed for this study suggested that those who enter the music industry do so largely because of their passion for music and stay despite long hours, high risk of failure and low pay.

There is an increasing need to provide creative talent in the industry with opportunity to develop, as opposed to the temptation to capture early commercial success. This is the case particularly for authors and composers, who, amidst a surplus of singers/artists, are often forgotten despite being the keystone of the creative process and of the ability to compete globally.

It should be noted that there are significant differences in salary levels between the small labels (SMEs) and the larger independents, which are organized on a formal corporate basis.

[56] *Profile of Small and Medium-sized Enterprises in the Canadian Cultural Industries*, Department of Canadian Heritage, 2003.

6 Economic Contribution of the Sound Recording Industry in Canada

In this section we measure the overall economic contribution of the sound recording industry in Canada.

This contribution is measured in terms of real Gross Domestic Product (real GDP) and total employment. It is also expressed in terms of total economic impact, which includes any downstream impacts in other industries that result from economic activity in the sound recording industry. The latter is based on GDP and employment multipliers derived from Statistics Canada's input-output model of the Canadian economy.

GDP measures the dollar value added of an industry after the value of inputs (except labour) to the industry is deducted from the value of the particular industry's total output. Real GDP adjusts the dollar value of GDP to account for inflation and thus changes in purchasing power. In comparison to revenue, GDP is a better measure of an industry's contribution to the overall economy because it eliminates any double counting inherent to the value of revenues, which include the cost of inputs acquired from other industries.

All of the real GDP amounts in this report are in constant 1997 dollars.

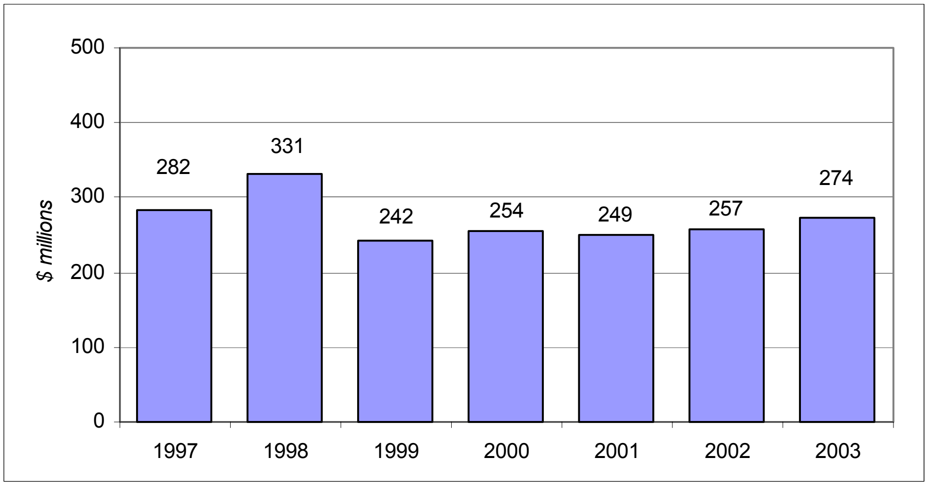
The employment data used in this analysis is derived from Statistics Canada's *Survey of Payroll, Employment and Hours* (SEPH). The SEPH is based on data from Statistics Canada's *Business Payroll Survey* results and the payroll deductions administrative data received from Canada Customs and Revenue Agency.

In this section, the terms "sound recording industry" and "sound recording industries" are used interchangeably. The North American Industry Classification System (NAICS) defines the "sound recording industries" as including record production, integrated record production and distribution, music publishers and sound recording studios.

6.1 Real GDP

In 2003, the sound recording industry contributed $274 million to real GDP. This is well below the peak contribution of $331 million for the 1997-2003 period attained in 1998, which was followed by a sharp drop in 1999.

Figure 8. Sound Recording Industry Contribution to Real GDP – 1997 to 2003

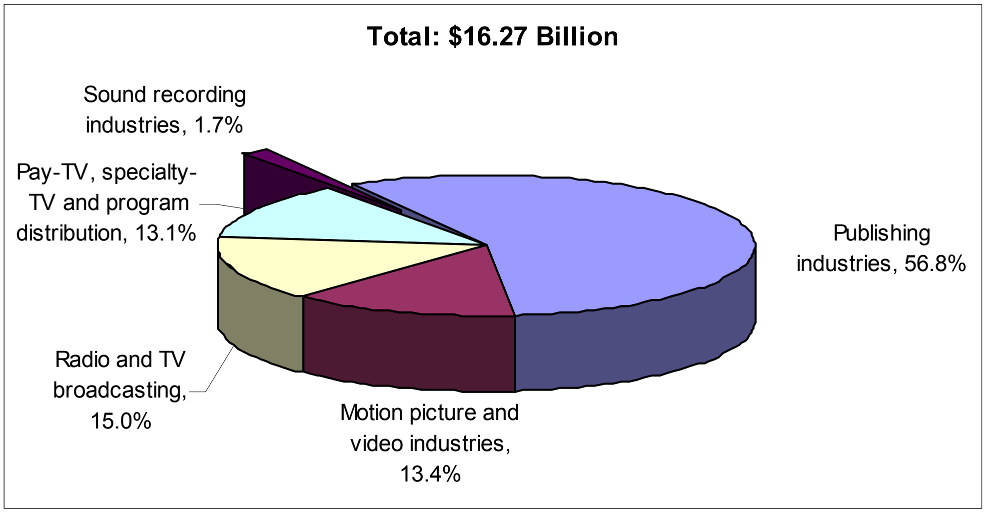


Source: Statistics Canada, CANSIM Table 319-0017.

In terms of the overall Canadian economy, the sound recording industry's contribution to real GDP is extremely small. In 2003, the industry's contribution of $274 million was equal to 0.0025% of the nearly $1.1 trillion in economy-wide real GDP.

Similarly, the sound recording industry accounts for a small portion of the cultural industries' contribution to real GDP (the cultural industries being defined as the sound recording industries, publishing industries, motion picture and video industries, radio and TV broadcasting industry, and pay-TV, specialty-TV and program distribution industry). In 2003, the cultural industries' contribution to real GDP totalled $16.27 billion. Of this amount, the sound recording industry contributed only 1.7%, or $274 million (see following figure).

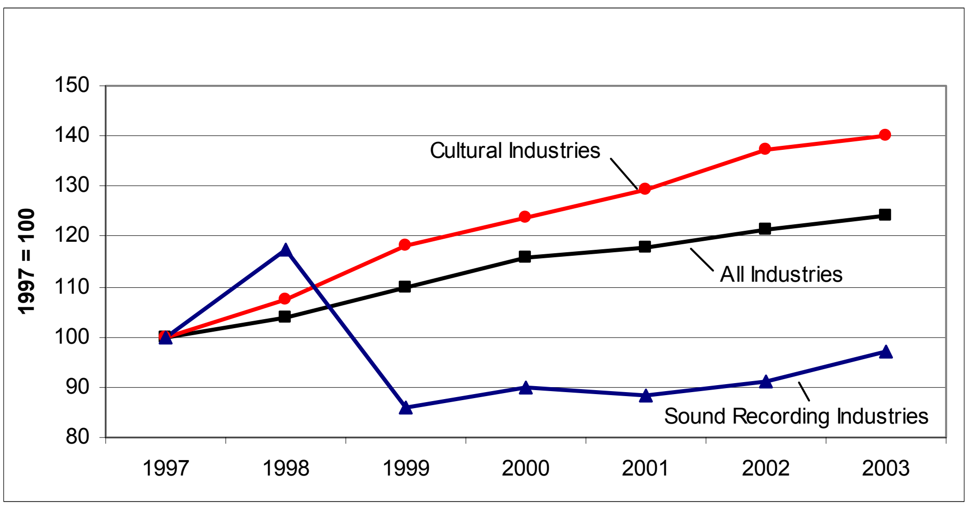
Figure 9. Cultural Industries Contribution to Real GDP – 2003



Source: Statistics Canada, CANSIM Table 319-0017

Since 1997, the sound recording industry's contribution to real GDP growth has trailed that of the cultural industries as well as that of all industries (aggregate basis). In 2003, the sound recording industry's contribution to real GDP was actually 3% below its 1997 level. During the 1997-2003 period, the cultural industries' contribution to real GDP rose by 40%. On an aggregate basis across all industries, real GDP was up by 24%.

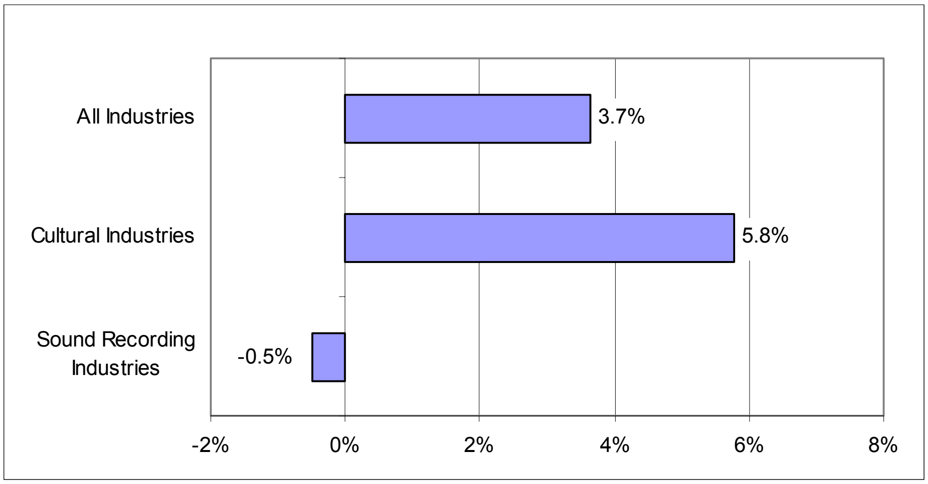
Figure 10. Comparative Contribution to Real GDP Growth – 1997 to 2003



Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 319-0017

Much of the decline in the sound recording industry's contribution to real GDP can be traced back to a sharp drop in 1999. Between 1999 and 2002, this contribution was somewhat weak. In 2003, the industry experienced a strong recovery and its contribution to real GDP grew by 6.6%. Between 1997 and 2003, the sound recording industry's contribution to real GDP grew by an annual average rate of 0.5%. By comparison, real GDP across all industries grew at an average rate of 3.7% and the overall cultural industry contribution to real GDP grew by 5.8%.

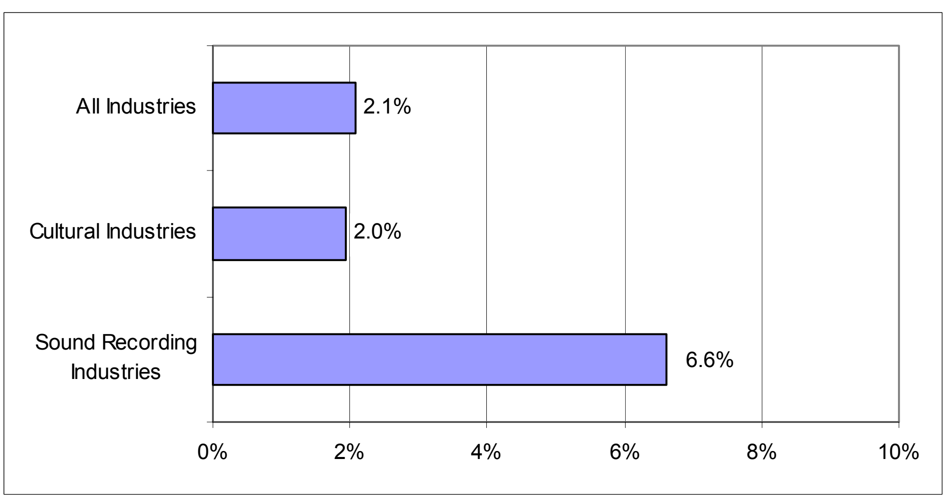
Figure 11. Comparative Contribution to Average Annual Real GDP Growth – 1997 to 2003



Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 319-0017.

Despite the sound recording industry's weak performance in terms of contribution to real GDP growth during the late 1990s and early 2000s, its contribution grew by 6.6% in 2003. This strong performance outstripped growth in the overall economy and the contribution of the cultural industries.

Figure 12. Comparative Contribution to Real GDP Growth – 2003

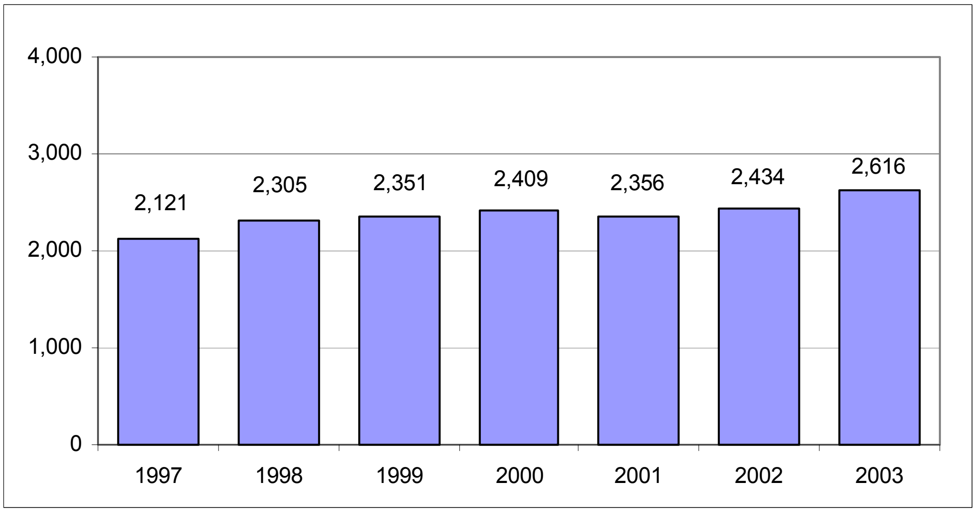


Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 319-0017.

6.2 Employment

Even though Canada's sound recording industry showed relatively weak performance in terms of contribution to real GDP between 1997 and 2003, it managed to increase its employment base. During this period, total employment in the sound recording industry grew by 23%, from 2,121 to 2,618 persons.

Figure 13. Sound Recording Industry Employment – 1997 to 2003



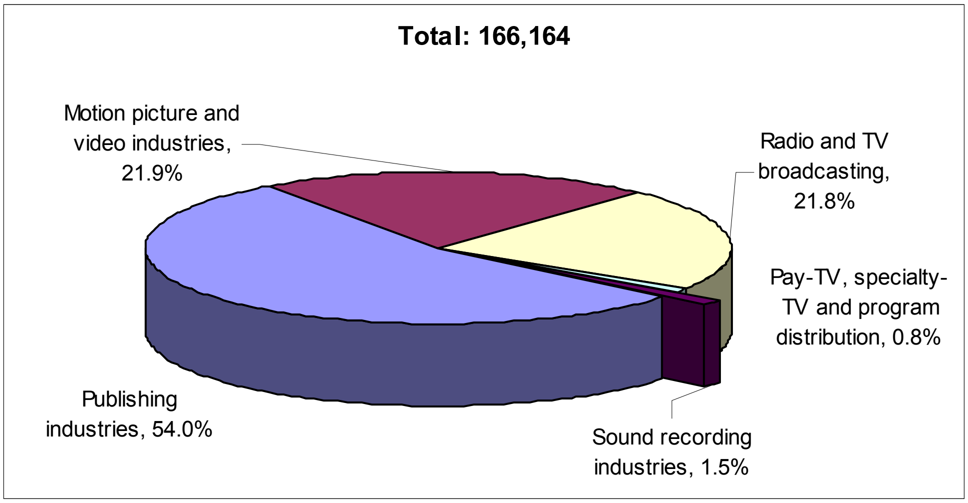
Source: Statistics Canada, CANSIM Table 281-0024 (Survey of Employment, Payroll and Hours).

In 2003, the sound recording industry employed 0.019% of the total Canadian workforce of over 13.3 million persons.[57]

[57] Estimate based on SEPH data. An estimate based on Statistics Canada's Labour Force Survey data will differ.

In 2002, the sound recording industry accounted for 1.5% of the 166,164 jobs in the cultural industries.

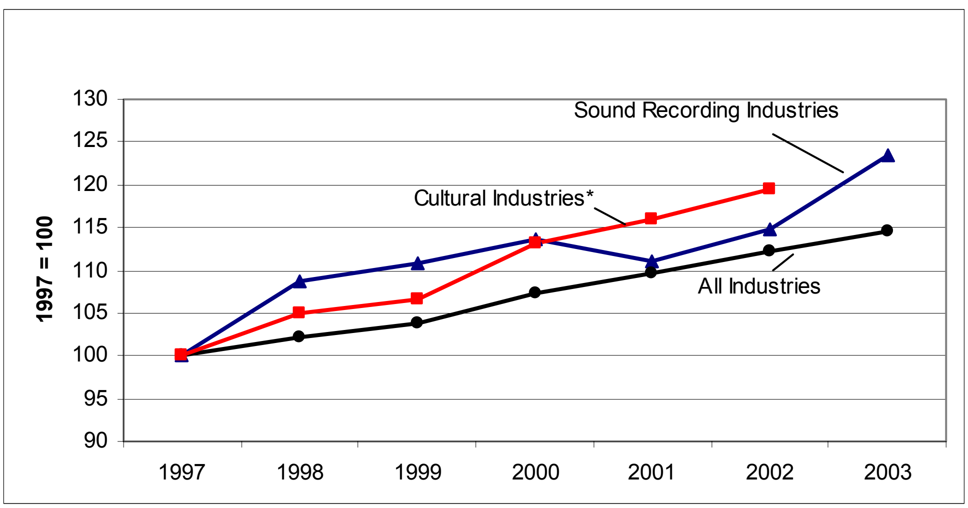
Figure 14. Cultural Industries Employment – 2002*



Source: Statistics Canada, CANSIM Table 281-0024 (Survey of Employment, Payroll and Hours)
* Due to a lack of data for 2003, these calculations are based on data for 2002.

Over the last several years, total employment in the sound recording industry has grown at a faster pace than the overall economy. Employment across the Canadian economy grew by just under 15% during 1997-2003, while employment in the sound recording sector grew by 23%.

Figure 15. Comparative Employment Growth – 1997 to 2003*

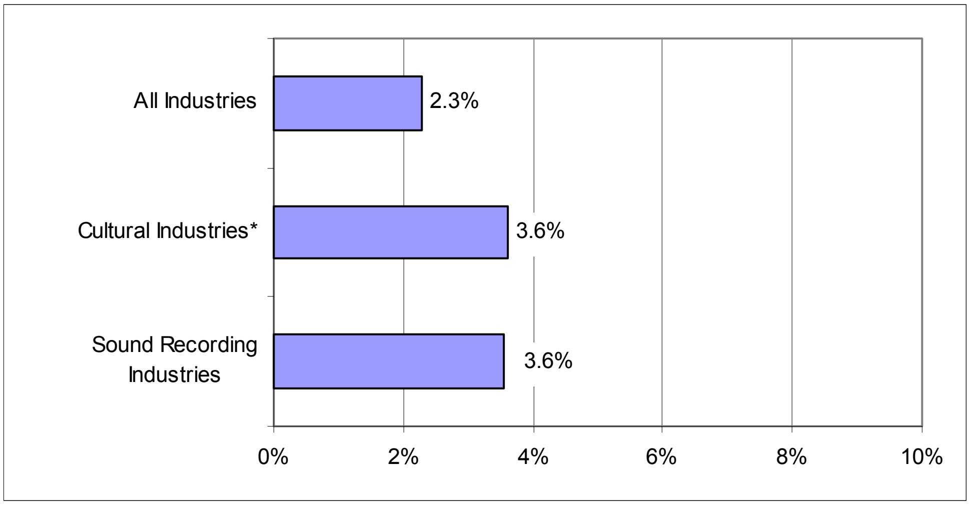


Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 281-0024
* The data required to calculate total employment in the cultural industries in 2003 was not available.

Growth in employment in the cultural industries outpaced that of the sound recording industry during 1997-2002. In the absence of data for 2003, we cannot say whether it continued to outpace the sound recording industry in that year.

The sound recording industry's steadily rising employment translated into an average annual growth rate of 3.6% between 1997 and 2003, well ahead of the overall economy (2.3%).

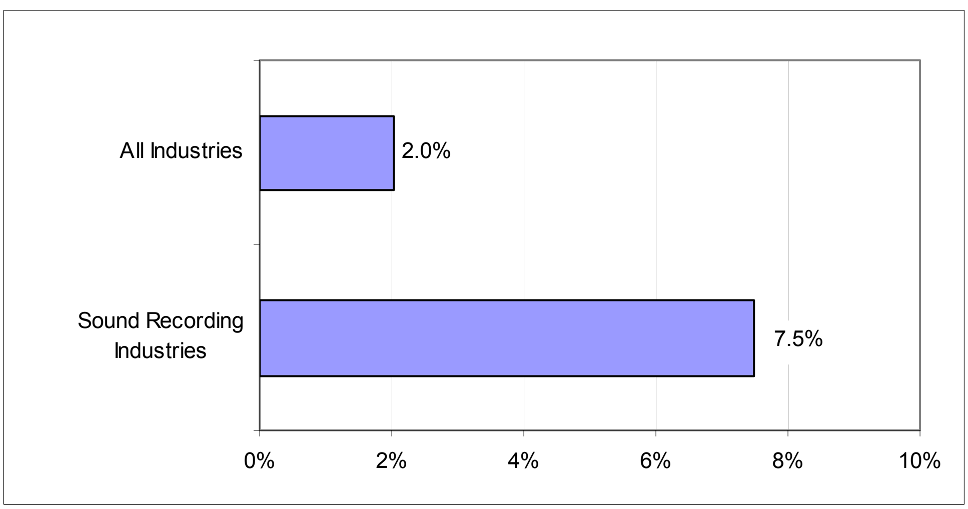
Figure 16. Comparative Average Annual Employment Growth – 1997 to 2003*



Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 281-0024
* Due to a lack of data for 2003, the average annual growth rate for the cultural industries is for 1997-2002.

Data for the cultural industries was not available for 2003, but between 1997 and 2002, employment in this sector grew at an average rate of 3.6%.

Figure 17. Comparative Employment Growth – 2003



Source: NGL tabulations based on data from Statistics Canada, CANSIM Table 281-0024

Growth in the sound recording industry's employment base continued to be strong in 2003; at 7.5%, it again exceeded growth in the overall economy (2.0%).

6.3 Economic Impact Analysis

The economic impact analysis is based on multipliers sourced from Statistics Canada. Statistics Canada does not publish multipliers for the sound recording industry per se. So, to estimate the economic impact of sound recording activity, we used Statistics Canada multipliers for *SIC 961 Motion picture, audio and video production & distribution*. While this industry grouping is not exclusively related to sound recording, the sound recording industry is a subset of it. Therefore, we chose SIC 961 multipliers as the best proxy multipliers for the sound recording industry.

Table 3. Selected Economic Multipliers for SIC 961
Motion Picture, Audio and Video Production & Distribution

Type of Multiplier	Multiplier Value
Total employment multiplier	2.11
GDP multiplier	2.20

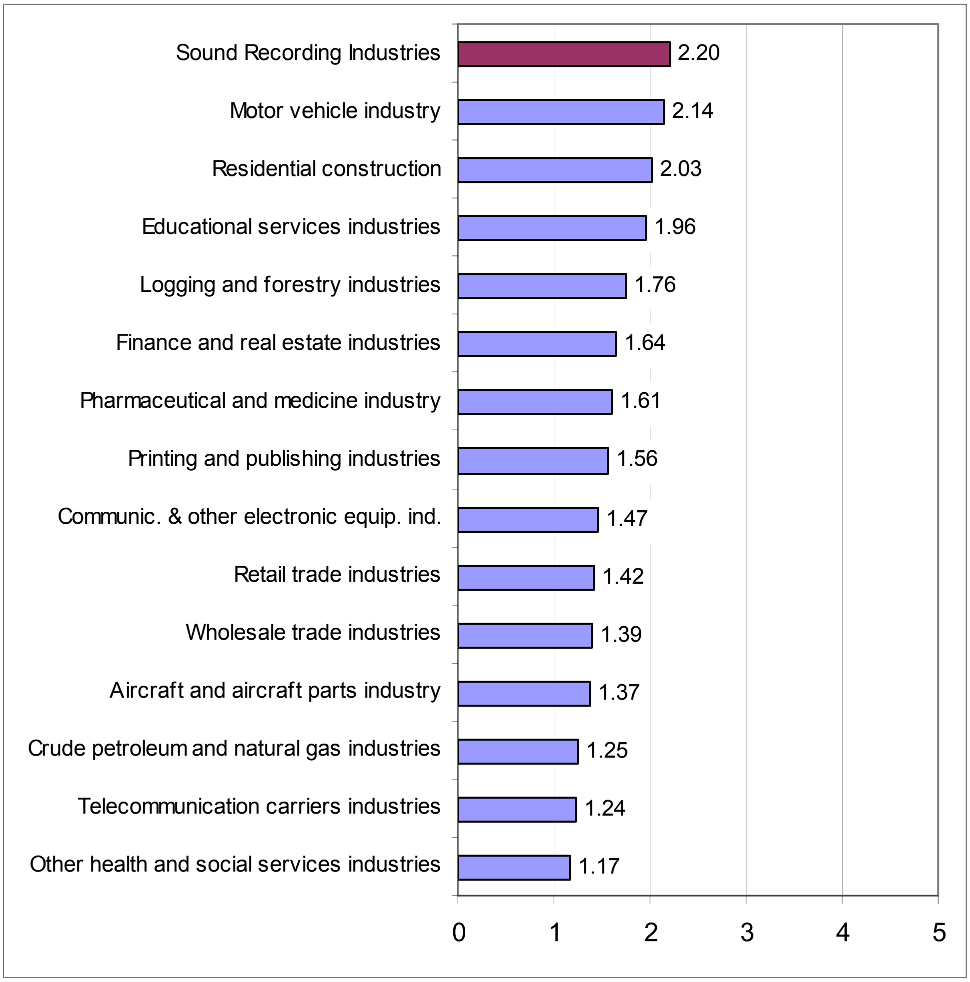
Source: Statistics Canada, Input-Output Division

The Total Employment Multiplier is the total number of jobs created in the Canadian economy as a result of the creation of one job in the sound recording industries.

The GDP Multiplier is the dollar amount of GDP created throughout the Canadian economy as a result of a $1 increase in the sound recording industry's contribution to GDP.

When compared with the GDP multipliers for 13 other leading industries in Canada, the GDP multiplier for the sound recording industry (as represented by motion picture, audio and video production and distribution) ranks first.

Figure 18. GDP Multipliers by Industry

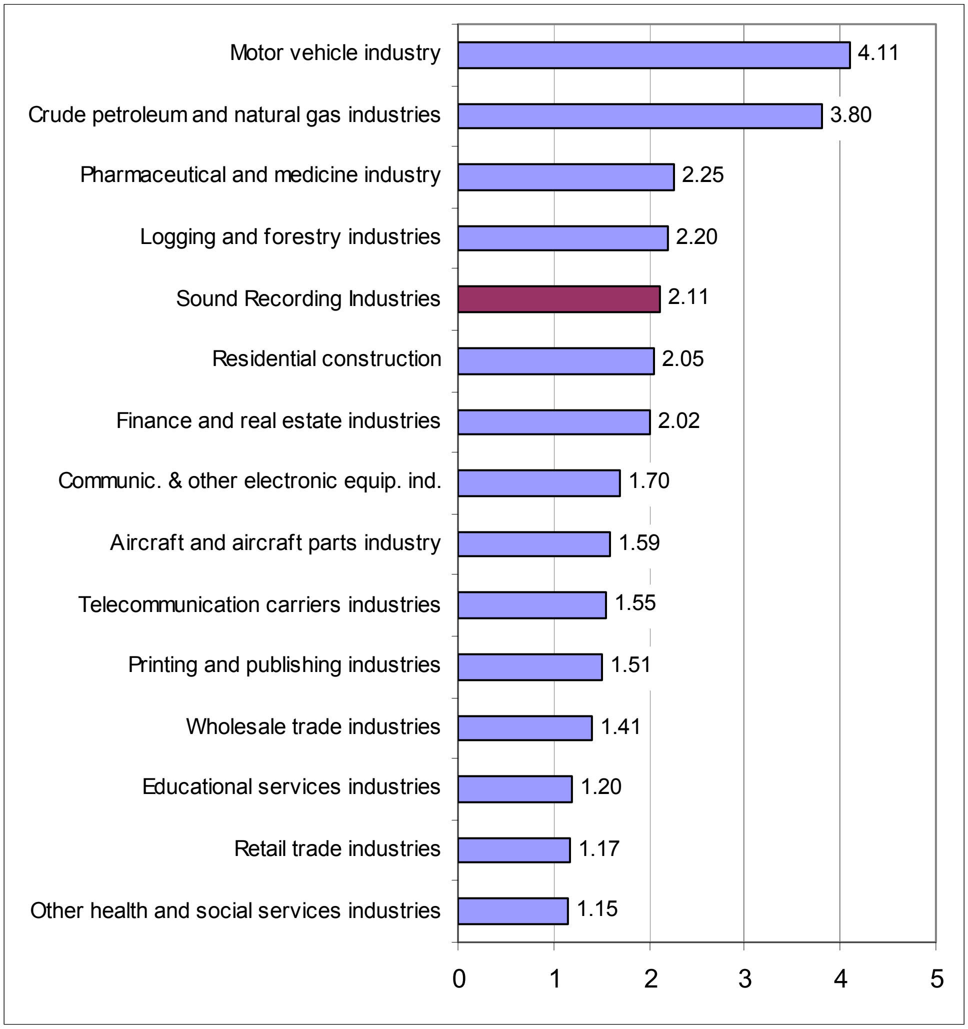


Note: Multipliers based on data from Statistics Canada's 1996 input-output model of the Canadian economy.

Thus, while the size of the sound recording industry is small, the potential economic impact of public and private investment can be significantly greater than in other sectors

When the sound recording industry group (as represented by motion picture, audio and video production and distribution) is compared with the same leading Canadian industries on the basis of its total employment multiplier, it ranks fifth out of 13. For every job created in the sound recording industry, an additional 1.11 jobs are created elsewhere in the Canadian economy. This yields a total of 2.11 jobs in the Canadian economy – a total employment multiplier of 2.11.

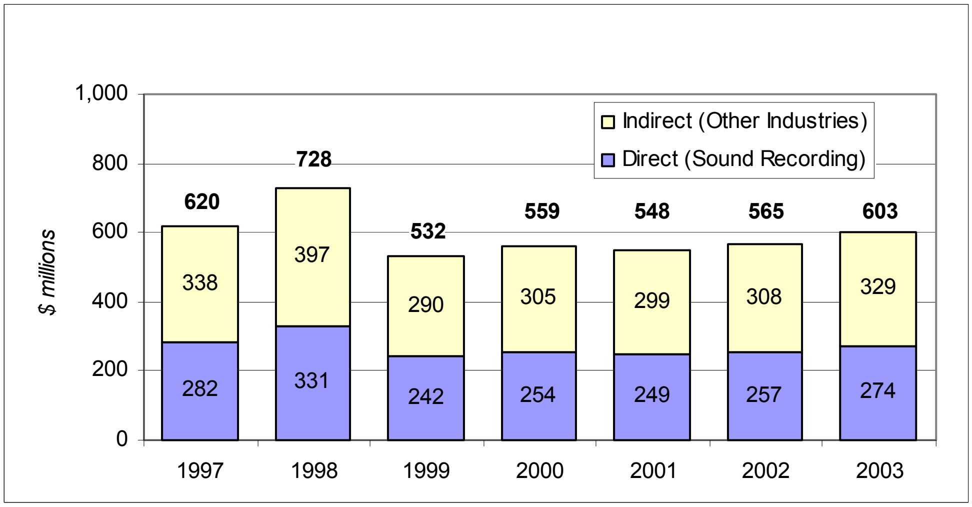
Figure 19. Total Employment Multipliers by Industry



Note: Multipliers based on data from Statistics Canada's 1996 input-output model of the Canadian economy.

Based on the sound recording industry's GDP multiplier, the sound recording industry's contribution of $274 million to real GDP in 2003 resulted in an additional $329 million of real GDP throughout the rest of the Canadian economy.

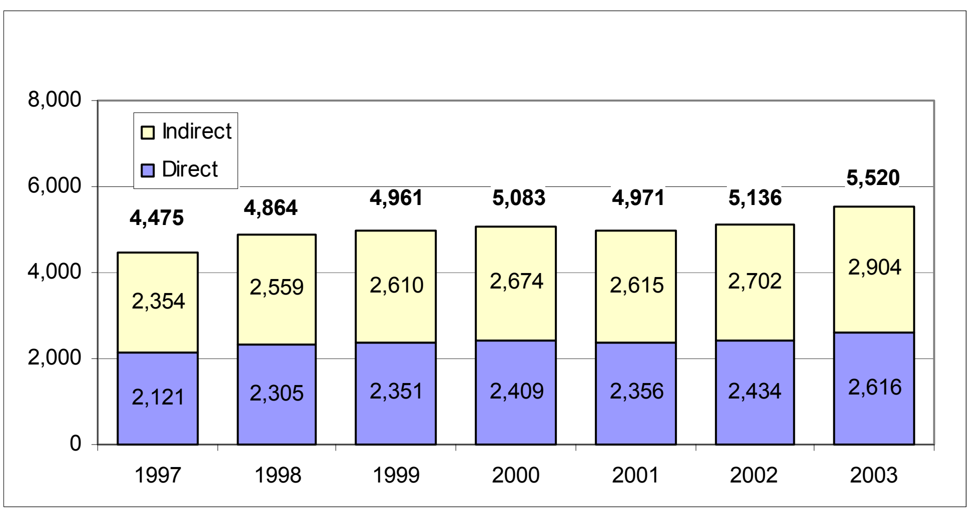
Figure 20. Direct and Indirect Contribution to Real GDP – 1997 to 2003



Source: NGL calculations based on data from Statistics Canada, Input-Output Division and Statistics Canada, CANSIM 379-0017

Based on the sound recording industry's total employment multiplier, the 2,616 jobs created directly in the sound recording industry in 2003 resulted in an additional 2,904 jobs created throughout the rest of the Canadian economy. In total, sound recording industry activity generated 5,520 jobs in Canada in 2003.

Figure 21. Direct and Indirect Job Creation – 1997 to 2003



Source: NGL calculations based on data from Statistics Canada, Input-Output Division and Statistics Canada, CANSIM 281-0024

7 Analysis of Financial and Employment Data on Surveyed Sound Recording Companies

In this section we present an analysis of the data captured on 37 of the larger Canadian-owned independent sound recording companies. The selected information[58] provided by three of the five multinational majors operating in Canada is excluded from this analysis except as noted in relation to the revenue per employee ratio.

The primary focus period of the study was 2001 and 2002, the last years for which full financial data was available.

The study was unable to compare the financial performance of beneficiaries and non-beneficiaries of the Music Entrepreneur Program (MEP) because the beneficiary companies reflect MEP support only as of their 2003 financial statements, which were not available until after the data capture was completed.

7.1 Survey Approach and Methodology

7.1.1 *Companies Surveyed*

The survey targeted a representative sample[59] of the sound recording companies[60] operating in Canada, which, according to CRIA and Statistics Canada, number in excess of 400.

In consultation with industry experts and associations, 86 companies were identified as potentially appropriate for the purposes of this survey. After determining that 13 of these firms were no longer in operation or had merged with another firm, we approached the remaining 73 to solicit their participation. Ultimately, we were able to capture significant and comparable data sets on 40, resulting in an overall participation rate of 55%.

Table 4. Survey Participation by Region

Target Firm Category	Quebec	Ontario	West	Total
Main list	**35**	**35**	**16**	**86**
Companies closed/merged	**2**	**8**	**3**	**13**
Potential list	**33**	**27**	**13**	**73**
Refused / Could not be reached	**13**	**10**	**10**	**33**
Participating	**20**	**17**	**3**	**40**
% Participation	**61%**	**63%**	**23%**	**55%**

[58] At the time this study was completed, three majors had provided employment data and two, revenue data. The Canadian Recording Industry Association (CRIA) has since undertaken to secure the participation of all five majors.

[59] The objective was to profile a representative sample, not to compile a comprehensive industry portrait. However, throughout the entertainment and cultural industries, it is difficult to capture a sample large enough to be statistically representative. That fact and corporate variants – market, genre, size, etc. – make the combined use of primary and secondary data more productive than a strictly statistical approach to analyzing the sound recording industry.

[60] As our aim was to capture the sound recording portion of the Canadian music industry (as opposed to aspects such as artist management), we used the well-established Statistics Canada definition of sound recording activities, which appears in section 4.2.

In large measure, the high participation rate achieved is owed to the endorsement of the music industry associations and their active encouragement of members. The participation rate varied by region; for example, 20 of the 33 potential Quebec-based companies participated, for a rate of 61%, as compared with just 3 of 13 based in the West, for a rate of 23%.

While the participation rate is relatively robust for this type of survey,[61] many companies could not be contacted or refused to participate. Some had exited the industry and others indicated that their financial records were not well organized or up to accounting standards.[62] Some of the principals indicated that they did not want to participate in a government agency-sponsored research project on the sound recording industry.

The participation rate varied for a number of reasons, including the influence of industry associations. For example, a relatively large number of the companies solicited in English Canada did not participate because they did not belong to the Canadian Independent Record Production Association (CIRPA) and thus were not urged to do so.

As the primary objective was to produce a representative profile of the Canadian sound recording industry, we focused our efforts on central Canada, where most of the firms – especially the larger ones – are concentrated. Thus the largest number of participating companies was located in Quebec, followed by Ontario. Only a few firms from BC and the Prairies were captured and no firms from Atlantic Canada participated. This reflects the industry's geographical dispersion. More importantly, the scope of the study – limited time frame and available resources – did not allow detailed data capture across all regions and provinces.

7.1.2 *Tools and Definitions*

The selected firms (labels) were surveyed by means of a questionnaire (see Appendix A) for up-to-date information on their production activity, employment profiles and financial performance. The survey involved in-person and telephone consultation and also included executive interviews.

The interviewers captured the survey questionnaire responses electronically, using an online survey software package to standardize and centralize the collected data in a single integrated database. The results were then exported to Microsoft Excel for data analysis.

The interview and reporting processes were conducted according to best national and international market research practices,[63] which guarantee respondents complete confidentiality and anonymity (i.e. individual company data sets are consolidated for publication).

For the purposes of analysis, the companies were categorized by geographic location and size. Quebec companies are thus those based in the province, irrespective of whether their sound

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[61] Surveys that require detailed preparation of data sets by respondents generally have a low participation rate.

[62] Accounting standards in the sound recording industry, as in the entertainment/cultural industries and SMEs in general, make it very difficult to capture standardized financial data. Many firms do not have in-house accountants; some use bookkeepers or internal personnel as a substitute for external or internal accountants.

[63] International and Canadian marketing research societies require anonymity for participants and non-participants alike, meaning that data and comments are kept in trust by the research firm and shared with the end client only if the participant gives informed consent.

recordings are produced for the French-language or the English-language market. The same holds true for firms based in the rest of Canada – in this case, Ontario, British Columbia and the Prairie provinces. For convenience, the terms English Canada and Rest of Canada (ROC) are used interchangeably.

Large companies are defined as having net revenues of $1 million or more and small companies as having net revenues of less than $1 million.

Table 5. Number of Companies Surveyed, by Region and Size

	Large	Small	Total
Quebec	11	9	20
BC	1	1	2
Ontario	11	6	17
Prairies	0	1	1
Total	23	17	40

Source: NGL tabulations and analysis

In discussing domestic target markets, we refer to English- and French-language markets, although the distinction between French- and English-language markets is artificial in the case of some music genres (e.g. instrumental music).

7.1.3 *Problems Encountered and Possible Sources of Error*

The absence of standard accounting methods and practices among the sound recording firms consulted for this study could affect the validity of some financial results as well as the results of our financial ratio analysis.

In the larger context, the majority of financial statements provided were unaudited[64] and did not comply with GAAP standards, meaning that the companies may have changed their accounting methods and treated revenues and expenses differently from year to year.

Most of the companies surveyed refused to provide written financial statements, offering to share only some of the financial data required for this analysis (e.g. revenue data without corresponding data on assets). This resulted in an incomplete picture of corporate financial situations and limited our ability to fully analyze financial ratios and other calculations.[65]

Specific accounting issues that arose in the course of the study to cause problems and potential sources of error include the following:

- Some firms consider funds received from government programs (Musicaction and FACTOR) as long-term debt, while others treat them as a reduction of expenses or as generated revenue. This has a significant impact on the calculation of key financial ratios: gross margin, EBITDA margin, debt ratio and revenue per employee.

[64] Only two companies provided audited financial statements.

[65] Even when written financial statements are available, it can be difficult to identify key financial information such as breakdown of debt by source and accounting treatment of grants. Source: SODEC, Marc Ménard.

- The companies surveyed have different ways of calculating their cost of goods sold (COGS)
    - Some do not include royalties in COGS.
    - Some include manufacturing and/or marketing costs while others do not.

  This lack of standardized accounting treatment of COGS directly impacts calculation of the gross margin ratio.

- Inventory is variously accounted for under Inventory or Accounts Receivable, which can substantially impact the calculation of the current ratio. When inventory is accounted for as an account receivable it can be valued at five times the acquisition cost. However, the value of the account is subject to re-evaluation in the case of returns from retailers, which can change the corresponding portion of receivables into an account payable.

- Each company has a different way of accounting for production expenses. Some firms capitalize these expenses while others do not. In addition, some companies have changed the treatment of production expenses (capitalize all, part, none) from one year to another in order to inflate or deflate profits. This lack of standardized accounting treatment impacts the calculation of financial ratios, specifically the debt ratio and EBITDA margin.

- The debt ratio as calculated includes forgivable governmental loans. However, most of the companies were unable to identify the portion of debt attributable to government loans. This lack of financial data affects the calculation of the debt ratio.

- For the revenue and employment breakdowns (by activity, by genre, etc.), the companies were unable to provide a breakdown by year under study (2001 and 2002). Instead, they provided an average percentage breakdown that was then used to do the calculations on revenues and employment for 2001 and 2002. For some breakdowns the percentages were on an estimated basis, especially for the small indies, which did not keep track of details in their financial statements. This lack of accounting data directly influences the calculation of revenue per employee and other ratios.

Further discussion of the impact of lack of standardized accounting treatment and/or financial data is provided in the following section in relation to the specific financial ratios.

7.2 Analysis of Revenue Data

This section analyzes the revenue data supplied by the 37 independents in terms of the domestic linguistic/ethnic market targeted, music category, business activity, geographical market and origin of releases. The results are broken down first by corporate location (Quebec vs. Rest of Canada) and then by company size (small vs. large). Further to consultation with industry players, small companies were defined as those with revenues of less than $1 million and large companies as those with revenues equal to or more than $1 million.[66]

[66] If and when the majors provide full financial data, a third category will be added to reflect their much larger size.

7.2.1 *Revenue Breakdown by Corporate Location*

Analysis by Target Linguistic/Ethnic Market

**Figure 22.
Revenues by Target Linguistic/Ethnic Market
– Quebec Companies**

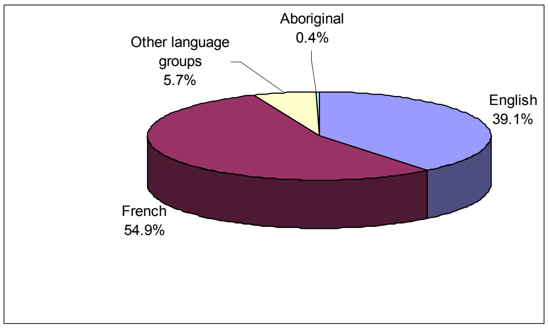
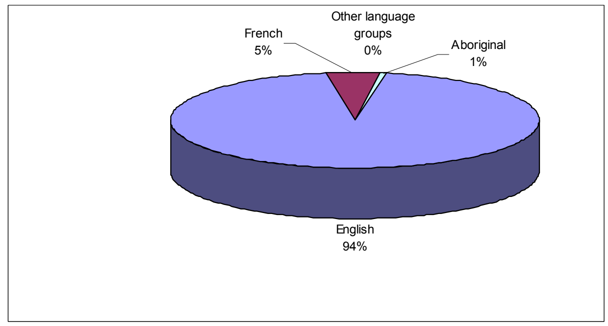


**Figure 23.
Revenues by Target Linguistic/Ethnic Market
– Rest of Canada Companies**



Source: NGL tabulations and analysis

Of the companies surveyed, those in Quebec sourced their revenues from more diverse domestic markets than those in the rest of Canada. This reflects the bilingual nature of the sound recording industry in Quebec.

The Quebec-based firms targeted the English-language market (40%) nearly as much as the French-language market (55%) and other language groups to a much lesser extent (6%).

The firms in the rest of Canada targeted the English-language market either primarily or solely, generating 94% of their revenues there. This focus is largely due to the influence of the much larger U.S. market in determining musical formats and tastes in the rest of Canada.

Analysis by Music Category

The following figures present the results of production activity by music category, or genre. There are significant differences in the popularity of genres between Quebec-based and English Canadian-based sound recording labels.

**Figure 24. Revenues by Music Category
– Quebec Companies**

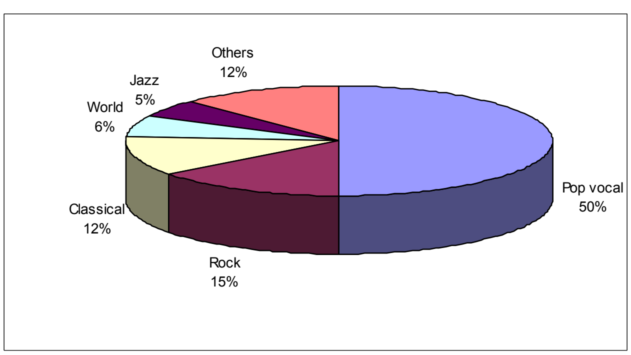
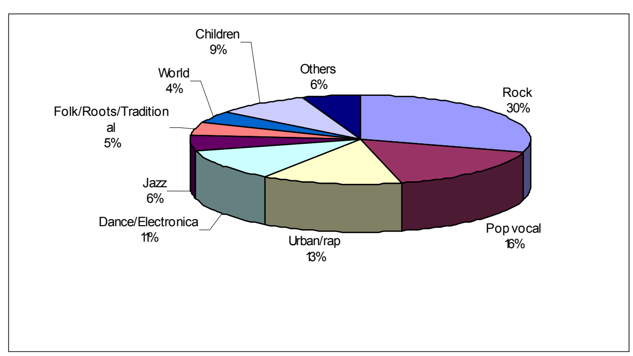


**Figure 25. Revenues by Music Category
– Rest of Canada Companies**



Source: NGL tabulations and analysis

As seen in the figure above, Quebec-based sound recording companies earn most of their revenues (46%) from the pop vocal genre; this is followed by rock (17%), classical (13%), world music (7%) and jazz (5%).

As a percentage of sound recording revenues, the predominant genre for the surveyed companies in the rest of Canada was rock (30%), followed by pop vocal (16%), urban/rap (13%), dance/Electronica (11%), children's (9%) and jazz (6%).

The revenue data by music category is based on a three-year average as the figures per genre vary considerably from year to year.

Analysis by Business Activity

Figure 26. Revenues by Business Activity – Quebec Companies

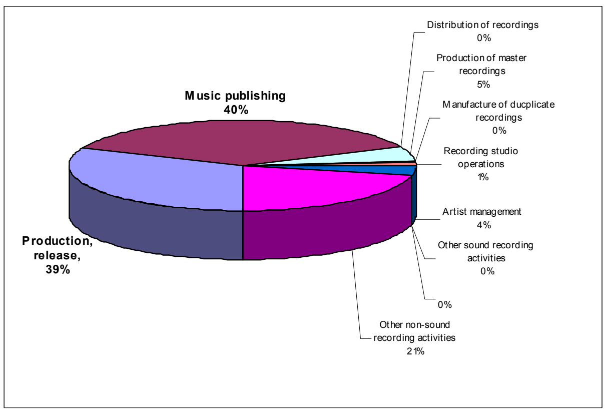
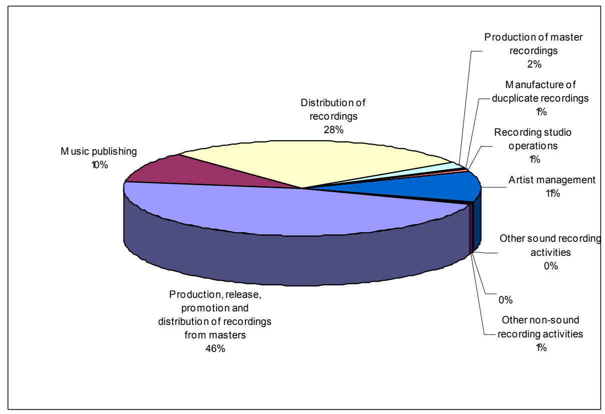


Figure 27. Revenues by Business Activity – Rest of Canada Companies



Source: NGL tabulations and analysis

Music publishing and the production, release, promotion and distribution of recordings from masters are the primary business activities of the surveyed Quebec companies, generating revenue shares of 40% and 39% respectively. However, non-sound-recording activities account for 21%. This is significantly higher than among the companies surveyed in the rest of Canada, where non-traditional sources account for just 1% of revenues. This may suggest that the Quebec firms are further advanced in adapting to new sound recording market realities.

The companies surveyed in English Canada have a more diversified portfolio, although nearly half their revenues come from the production, release, promotion and distribution of recordings from masters. Recording distribution accounts for 28%, followed by artist management and music publishing, respectively 11% and 10%.

It bears noting that most of the companies had difficulty separating the revenues of the two major sound recording subcategories: music publishing and the production, release, promotion and distribution of recordings from masters.

Analysis by Geographical Market

Here we look at the geographical market, or source of revenues. As might be expected, the firms based in English Canada are more export-oriented than their counterparts in Quebec. This is driven principally by the presence of the large U.S. market next door.

Figure 28. Revenues by Geographical Market – Quebec Companies

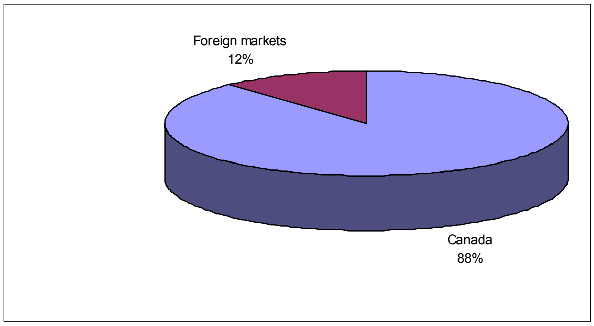
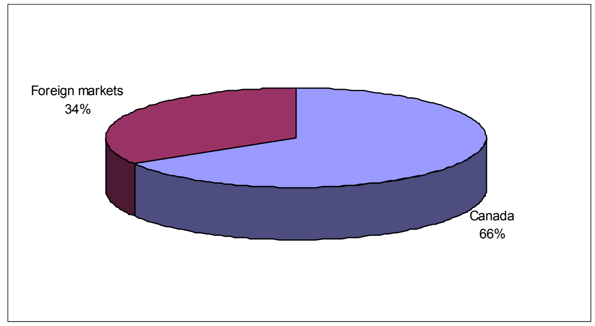


Figure 29. Revenues by Geographical Market – Rest of Canada Companies



Source: NGL tabulations and analysis

Foreign markets accounted for 34% of the revenues reported by the companies based in English Canada, compared with only 12% for the Quebec-based companies.

Analysis by Origin of Releases

In this section, we analyze revenues by country of origin of the recordings released.

Not surprisingly, the companies surveyed in English Canada generate a greater portion of their revenues (30%) from foreign releases than do Quebec companies (12%).

Figure 30. Revenues by Origin of Releases – Quebec Companies

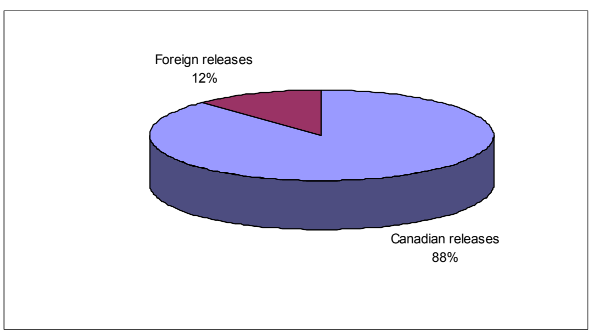
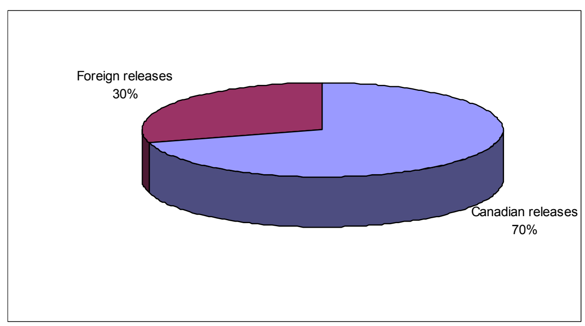


Figure 31. Revenues by Origin of Releases – Rest of Canada Companies



Source: NGL tabulations and analysis

7.2.2 *Revenue Breakdown by Company Size*

Analysis by Target Linguistic/Ethnic Market

Overall, the surveyed companies of all sizes target the domestic English-language market, which generates 73% of revenues for the large firms and 40% for the small firms.

Figure 32.
Revenues by Target Linguistic/Ethnic Market – Small Companies

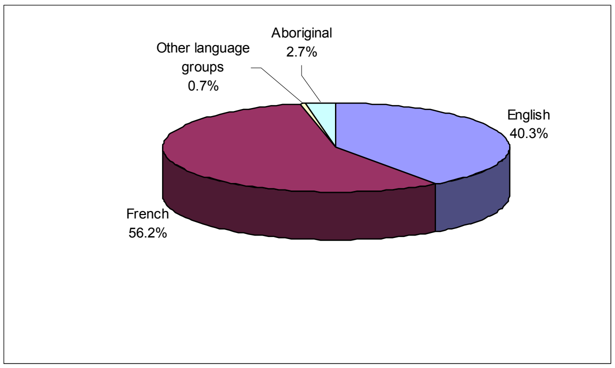
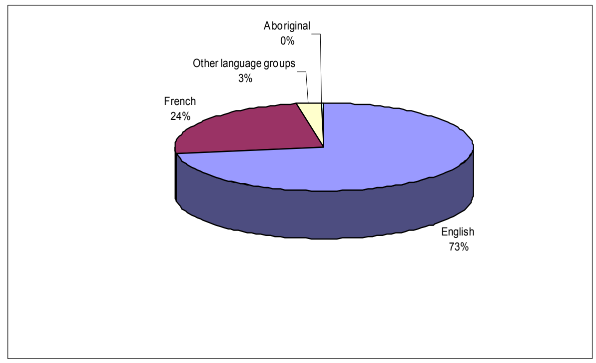


Figure 33.
Revenues by Target Linguistic/Ethnic Market – Large Companies



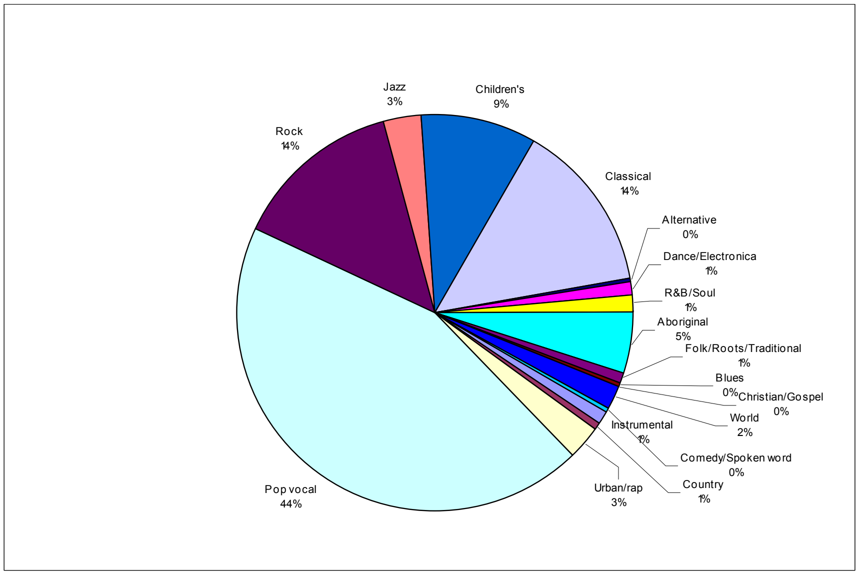
Source: NGL tabulations and analysis

The French-language market accounts for 24% of revenues for the large companies, compared with 56% for the small companies.

The Aboriginal-language market is concentrated in the small company niche, accounting for 2.7% of revenues.

Analysis by Music Category (Genre)

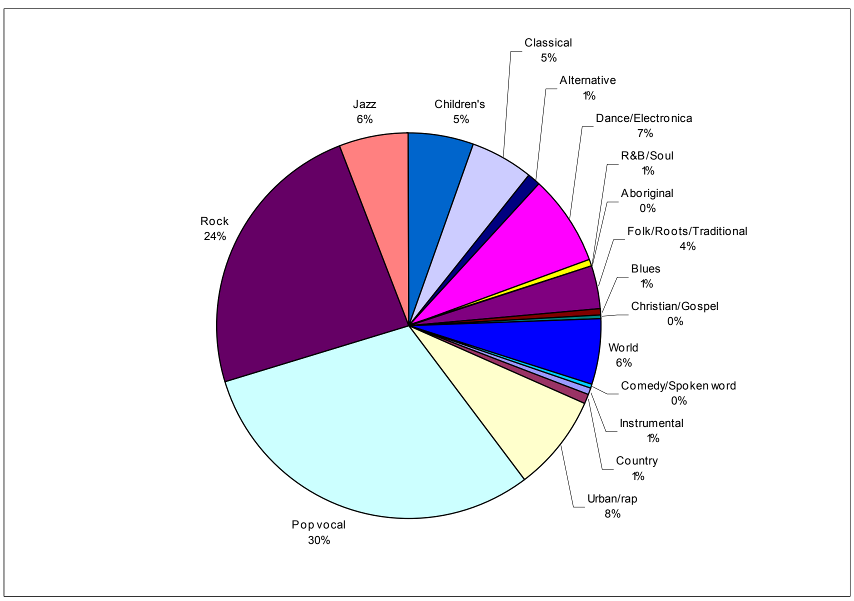
Figure 34. Revenues by Music Category – Small Companies



Source: NGL tabulations and analysis

As can be seen in the figure above, pop vocal generates 44% of revenues for the small companies surveyed, followed by rock, classical, and children's.

Figure 35. Revenues by Music Category – Large Companies



Source: NGL tabulations and analysis

Pop vocal generates 30% of revenues for the large companies surveyed, followed by rock (24%), urban rap (8%), children's and classical (9% each), dance/Electronica (7%) and jazz and world (6% each).

Analysis by Business Activity

Overall, the sound recording revenues of both the small and the large companies surveyed are dominated by three principal activities: music publishing, the production, release, promotion and distribution of recordings from masters, and the distribution of recordings.

The respective shares for small companies are 26%, 16% and 8%, compared with 24%, 43% and 15% for large companies.

For the small companies surveyed, non-sound recording activities generate the largest portion of revenue, 37%, which compares with just 6% for the large companies surveyed.

Figure 36. Revenues by Business Activity – Small Companies

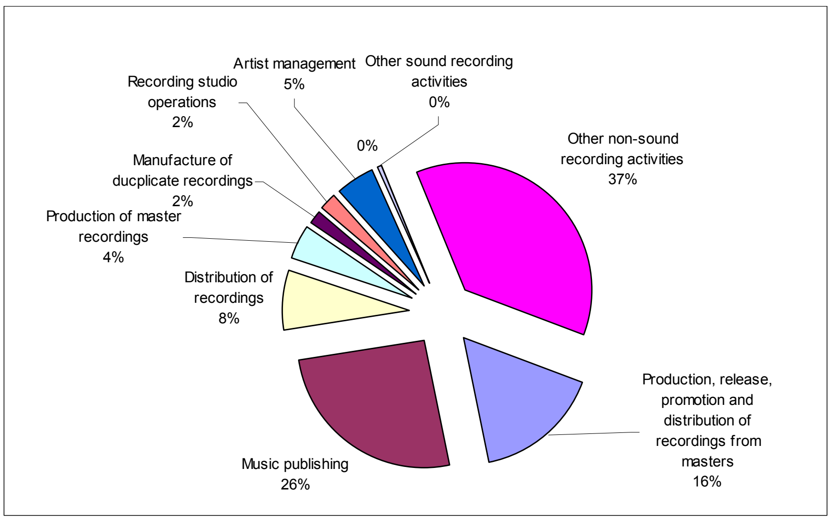
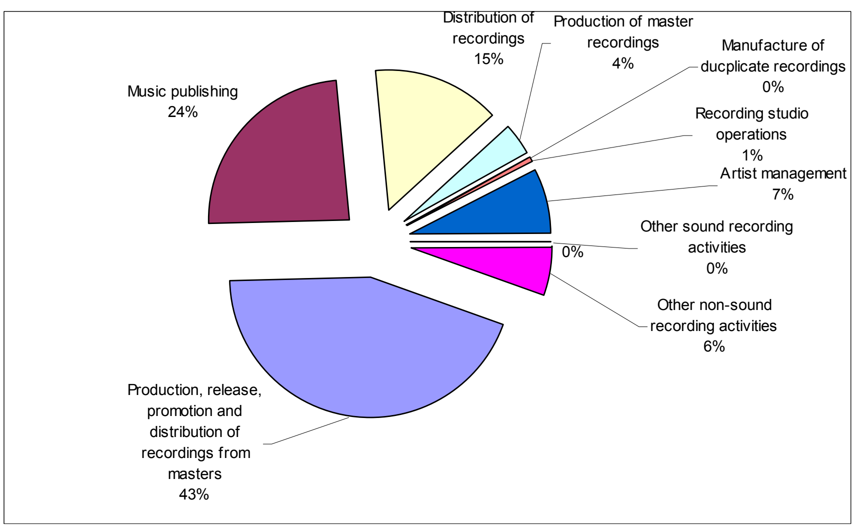


Figure 37. Revenues by Business Activity – Large Companies



Source: NGL tabulations and analysis

Analysis by Geographical Market

Foreign markets generate 17% of sound recording revenues for the small companies surveyed, as compared with 24% for large companies.

Figure 38. Revenues by Geographical Market – Small Companies

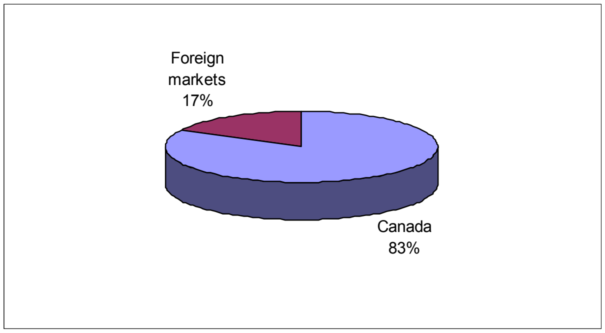
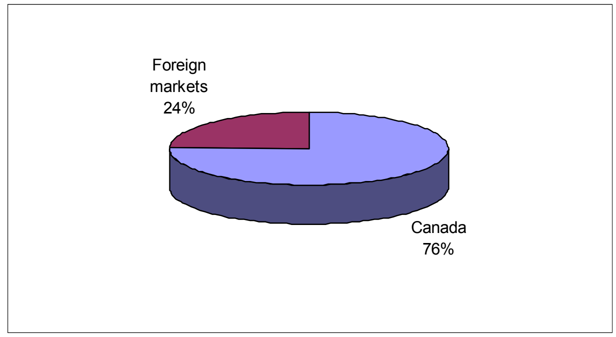


Figure 39. Revenues by Geographical Market – Large Companies



Source: NGL tabulations and analysis

Analysis by Origin of Releases

The large companies surveyed generate a larger share of their revenues with foreign releases than the small companies. Large companies earned 23% of their total revenues from foreign releases, while small companies earned 10%.

Figure 40. Revenues by Origin of Releases – Small Companies

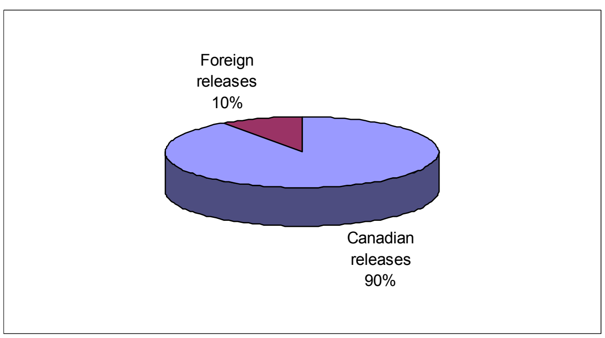
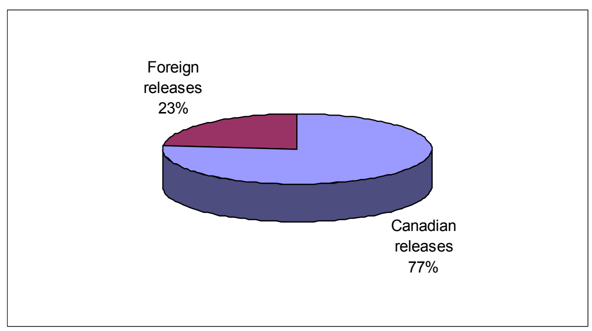


Figure 41. Revenues by Origin of Releases – Large Companies



Source: NGL tabulations and analysis

7.3 Analysis of Financial Ratios

This section analyzes selected key financial ratios for the Canadian sound recording industry in order to evaluate the financial performance of firms in this industry relative to their peers in the sector, to other cultural sectors and to firms in the overall economy.

As indicated in section 4.5, a rigorous financial methodology is useful to ensuring the rational, effective allocation and use of public funds in the cultural sector. In the larger context, accurate and up-to-date financial data and key analytical tools – as summarized by the five ratios used in this study – are essential to assist the industry, including policy makers, funding agencies, associations, lenders and investors, individual firms, in making strategic and management decisions:

- Design and evaluation of assistance programs
- Benchmarking of an individual firm's performance relative to that of its industry peers
- Evaluation of financial performance and risk by third-party financial institutions for lending and investment decisions
- Selection of individual companies and evaluation of results within the context of managing existing programs
- Evaluation of industry performance, identification of problem areas[67] and allocation of funding among competing sectors

In our consultations, industry players indicated that strategic and management decisions by the players and third-party investors and lenders were hampered by the absence of up-to-date, comprehensive financial data on the sound recording industry.

Financial ratio analysis pre-supposes that decisions on funding and other forms of assistance to firms require information on the firm as well as on the individual project. Currently, a number of federal and provincial programs available to sound recording firms offer financial assistance in the form of tax credits, loans and grants. Until recently, financial assistance was generally granted on a project-by-project basis, with the selection of projects based on project-specific indicators such as projections of potential sales (in dollars and units), target markets and music genres, employment impact within the firm and return. In some cases, applicants have had to provide firm-specific information such as revenues as well as non-financial information: track record in the sound recording industry, number of sound recordings produced over the previous years, number of years in existence, etc. However, in general, firms have not been required to provide detailed, audited financial information to qualify for these programs.

Telefilm was among the first agencies to promote the development of comprehensive financial information from individual firms to support allocation and selection decisions. The creation of the Music Entrepreneur Program (MEP), which is aimed at corporate rather than project development, marked a major change in the nature of aid. As a condition of eligibility for MEP funding, companies must provide financial information as part of their business plan.

The following financial ratios provide a summary portrait of four key financial performance indicators – profitability, productivity, indebtedness and liquidity – for the sound recording industry and its various sub-sectors.

- Gross margin percentage: This profitability measure indicates how much revenue a firm is generating over and above its cost for royalties and manufacturing or COGS.

- EBITDA margin: This is another profitability measure, which indicates how much profit firms are generating in terms of net revenues. EBITDA is the classic definition of profitability before interest, taxes, depreciation and amortization expense are considered.

[67] "Problem areas" in the sense of whether public funding can and should be allocated to alleviating or improving the situation or whether the problem is structural or systemic and cannot be fixed by pubic programs or policies.

- Current ratio: This liquidity measure indicates to what extent cash on hand and disposable assets are enough to pay off near-term liabilities.

- Debt ratio: The debt ratio indicates total indebtedness to third parties. It also provides an indication of the corresponding interest expense on the debt and the potential exposure of the company to changes in lending rates. The debt ratio is defined as Total liabilities/ Total assets.[68]

- Revenue per employee ratio: This measure provides an indication of the productivity of the company's workforce.

These ratios are useful for funding agencies in assessing the longer-term profitability and viability prospects of individual firms. In the wider context, they are important for sound recording industry players in developing a common understanding of the industry and its performance and as support for strategic and management decision making.

The selection of these financial ratios was circumscribed by the quality of financial information available in the sound recording industry as well as by the timeframe and resources available for completion of the study.

The following table summarizes the financial results of the companies surveyed.

Table 6. Overview of 2001 and 2002 Financial Performance of Companies Surveyed

	2001		2002		2001		2002	
	Quebec	Rest of Canada	Quebec	Rest of Canada	Small	Large	Small	Large
Gross margin %	0.54	0.75	0.61	0.80	0.33	0.70	0.64	0.75
EBITDA margin	8.6%	4.5%	6.2%	-1.2%	-7.3%	7.5%	2.9%	1.5%
Current ratio	1.25	0.91	1.24	1.06	1.25	1.03	1.21	1.13
Debt ratio	0.84	0.74	0.85	0.81	0.48	0.86	0.78	0.84
Revenue per employee	113,862	204,750 505,828*	119,119	262,575 496,963*	39,881	211,785 475,851*	69,277	239,008 460,139*

Source: NGL tabulations and analysis
* Including the three participating majors

The next table presents the results for participating companies by region and size (Quebec vs. Rest of Canada and small vs. large). It reflects only those firms that answered the survey questions related to ratio calculation (e.g. COGS, short term assets, total assets).

68 As it was difficult to obtain a total debt figure from many of the companies surveyed, we used Total liabilities/Total assets for the debt ratio calculation.

Table 7. Number of Companies Reflected in Ratios, by Region and Size

	2001		2002	
	Quebec	Rest of Canada	Small	Large
Gross margin %	16	17	15	17
EBITDA margin	15	15	16	15
Current ratio	14	15	14	14
Debt ratio	15	14	14	14
Revenue per employee	16	19	16	19

Source: NGL tabulations and analysis

It should be noted that the number of companies participating differed from one ratio to another, either because firms did not have the financial data to answer all the questions or because they refused disclosure. Thus, comparisons across financial indicators should be qualified with the relevant number of participants. Also, it should be noted that for our calculation of the above ratios we had to rely on unaudited financial reports in the case of some firms.

7.3.1 *Source, Inter-industry and Economy-wide Comparisons*

Comparison of Financial Results for Surveyed Firms with Other Sound Recording Industry Information Sources

Overall, the financial ratio results indicate weak financial performance by the larger independents within the sound recording sector relative to firms in other cultural industries and firms in the economy in general.[69] The poor financial results coincide with interviews of key players who indicated that their financial performance had weakened over the period and that a number were in financial distress or technical bankruptcy. The poor results also correspond with previous studies and public domain data on the sound recording industry both in Canada[70] and globally.[71]

A further indicator of the industry's degree of instability is the fact that a significant number of companies initially selected were unable to participate in this study due to bankruptcy or takeover by another firm.[72]

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[69] Published financial benchmark data are generally not available for the sound recording industry or cultural industries. However, financial ratios published by the CRTC indicated consistently strong financial performance by broadcasting firms. Source: CRTC Annual Financial Reports. Financial data are also available for publicly traded major Canadian publishing firms.

[70] Statistics Canada Catalogue #61-207. Statistics Canada – financial performance indicators for firms under $25M in the Sound Recording Industry, up to year 2000.

[71] RIAA in the US and other industry associations in Europe, South East Asia, etc. have reported disappointing results for their sound recording industry sectors over the last few years.

[72] Statistics Canada similarly indicates a significant number of "non-respondent" companies in its reports. Of 542 companies targeted, only 331 were eligible (Note: 42 out of scope, 43 out of business, 90 inactive, 36 duplicates). Of the 331 eligible, 241 responded to the survey in whole or in part. Catalogue #61-207 Statistics Canada – financial performance indicators for firms under $25M in the Sound Recording Industry.

We concentrated our analysis on the larger Canadian independent sound recording firms. However, media reports on the five majors indicate that the industry's financial difficulties are not a function of size alone.

Comparison of Sound Recording with Financial Results in Other Cultural Industries

It was difficult to compare the results of our analysis of the sound recording industry with other cultural or entertainment industry sectors, since little published financial data is available in Canada or elsewhere. However, when compared with well-established sectors such as magazine publishing[73] that have no licensing framework barriers to entry and limited assistance programs, the financial results are weak. In comparison to sectors that have both regulatory protection and financial assistance programs – for example for the broadcasting sector where profit levels approach 30%[74] – the results for the sound recording industry appear very weak.

Data sets from Statistics Canada[75] and private financial research firms[76] are either too aggregate or too out-of-date to be used for strategic and managerial decisions by players in the sound recording industry. As well, because these sources use different methodologies, the financial ratios are not necessarily comparable.

In section 8, we provide recommendations for the development of an analytical framework for financial analysis of the sound recording industry based on the Dupont model of long-term corporate profitability.

Comparison of Sound Recording Financial Results with the Overall Economy

Financial experts have developed a significant body of work on the trend line analysis of key financial indicators. There would appear to be a relationship between bankruptcy and weak financial performance as indicated by the financial ratios. One study used six ratios to predict bankruptcy as follows: cash flow / total debt, net income / total assets, total debt / total assets, working capital / total assets, current ratio, no credit interval.[77]

For the purposes of assessing the performance of industry sectors and for government agencies and industry associations developing and evaluating the performance of assistance

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[73] For example, financial data on publicly traded media firms with publishing assets, such as Quebecor, Torstar and Rogers, show much stronger financial results based on standard financial ratios than the sound recording industry.

[74] CRTC Annual Financial Reports for the television broadcasting sector, results for year ending August 31, 2003.

[75] Statistic Canada data for the sound recording industry are typically three years out-of-date by the time they are published. The most recent data available at the time of this study was for the period 1998, 1999, and 2000 (Statistics Canada Catalogue #61-207). Financial performance results for the net profit margin, pre tax profit margin, return on equity and receivables turnover indicators are presented by revenue category (e.g. firms with revenues less than $500K) for firms with revenues of less than $25M. Overall, in the 2000 report, there was a 73% response rate, based on 331 eligible companies.

[76] Dun & Bradstreet of Canada publishes financial ratios for 166 industrial sectors of the Canadian economy. The major deficiencies: sectoral distinction is limited and data is made available with a considerable delay. Robert Morris Associates. Recent financial ratios are based on American firms' financial results. Even where the sectoral definitions are supplied, information has to be used carefully in comparisons of performance with Canadian firms.

[77] "Financial Ratios as Predictors of Failure" in *Journal of Accounting Research*, reprinted in "Credit and Risk Analysis, The Prediction of Bankruptcy" in *The Analysis and Use of Financial Statements*, G. I. White, A. C. Sondhi and D. Fried, John Wiley & Sons, 1994.

programs, it would very useful to be able to identify specific thresholds of financial health and/or distress by industry sector.

Studies have found that firms with very poor financial ratios often end up in technical bankruptcy. While there is a legal connotation to bankruptcy that has to be taken into account, it is revealing that there appear to be financial thresholds that indicate distress, both for individual firms and for groups of firms constituting an industry sector.[78]

In the following sections, we provide results for each of the five key financial indicators, followed by conclusions.

7.3.2 *Analysis by Ratio*

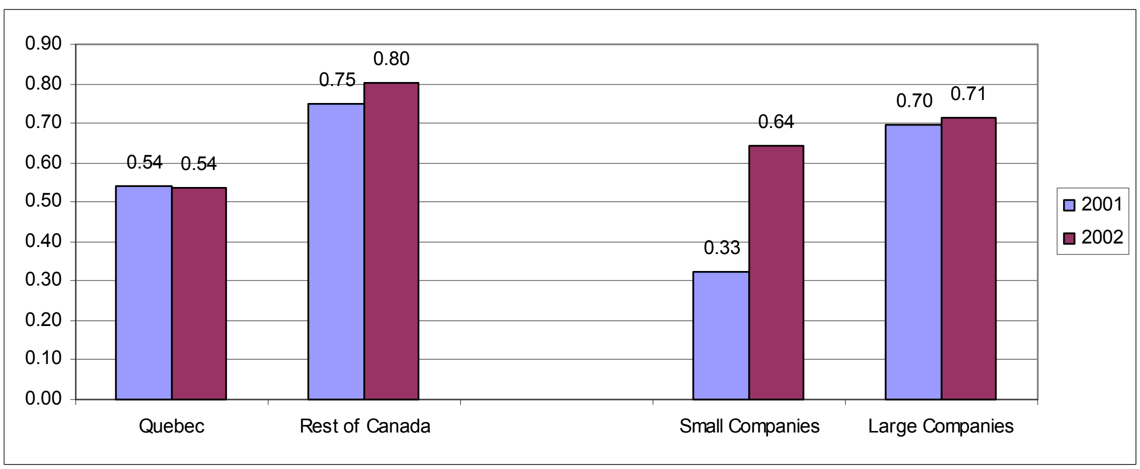
- **Gross Margin Percentage**

The definition for this ratio is as follows:

Gross Margin = (Revenues – COGS) divided by Revenues.

This ratio indicates how much revenue a firm is generating over and above its COGS.

Figure 42. Gross Margin Percentage – 2001 and 2002



Source: NGL tabulations and analysis

While gross margins improved in all categories over the 2001 and 2002 period, the ratios continue to be very low among the Quebec companies and among smaller companies overall.

[78] Ibid. Studies linking weak performance and bankruptcy are limited insofar as the determination of bankruptcy is not only a financial but also a legal decision.

The companies surveyed in English Canada have a significantly higher gross margin than the Quebec companies. Similarly, large companies have significantly better gross margins than small companies.[79]

The validity of the gross margin calculations could be affected for the following reasons:

- Some companies surveyed account for government loans as a reduction of expenses, while others report them as an increase of revenue or as long-term debt.
- Different companies have different ways of calculating their COGS and this has a direct impact on the calculation of the gross margin ratio.
- Some companies do not include royalties in COGS.
- Some companies include Manufacturing and/or Marketing costs while others do not.

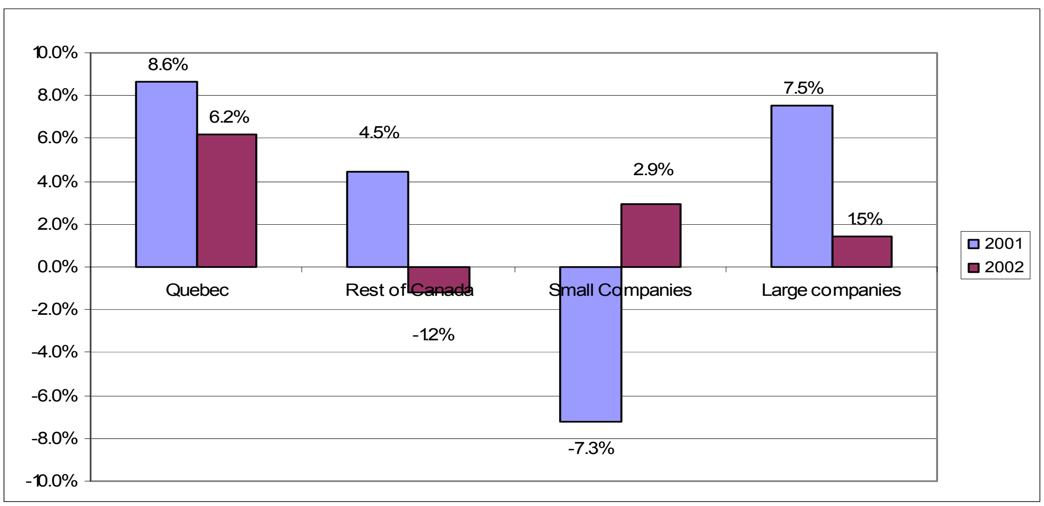
➢ **EBITDA** Margin

The definition for this ratio is as follows:

EBITDA margin = Earnings before interest, taxes, depreciation and amortization / revenues

EBITDA is the classic definition of profitability before interest, taxes, depreciation and amortization expense are considered.

Figure 43. EBITDA Margin – 2001 and 2002



Source: NGL tabulations and analysis

Overall, the EBITDA margins for the companies surveyed – Rest of Canada and Quebec, small and large – are substantially lower than the thresholds required to attract outside investment.[80] The Quebec companies show a relatively stable weighted average EBITDA over the years 2001

[79] Although the differences between Quebec and the rest of Canada and small and large companies are not surprising, according to industry experts, they may be at least in part explained by the use of different and variable accounting methods by sound recording firms.

[80] Generally EBITDAs in the 12-15% range are required to attract outside capital; the levels are higher where there is significant risk, which characterizes the sound recording industry.

and 2002, whereas the overall EBITDA for those in English Canada fell sharply. This is attributable in part to the results reported by one major player.

The EBITDA margin of the Quebec companies is very high compared with that of the companies in the rest of Canada: respectively 8.6% / 4.5% in 2001 and 6.2% /-1.2% in 2002.

The performance of small companies vs. large companies appears to differ significantly. The EBITDA margin for the small companies increased from -7.3% to 2.9% from 2001 to 2002, while for the large companies it decreased from 7.5% to 1.5%.

The validity of the EBITDA margin calculations could be affected for the following reasons:

- Some companies account for government loans as a reduction of expenses, while others report them as an increase of revenue or as long-term debt.
- Each company has a different way of accounting for capital spending. Some firms capitalize expenditures while others do not, and some have elected to capitalize expenditures in one year and not in another in order to inflate or deflate profits.

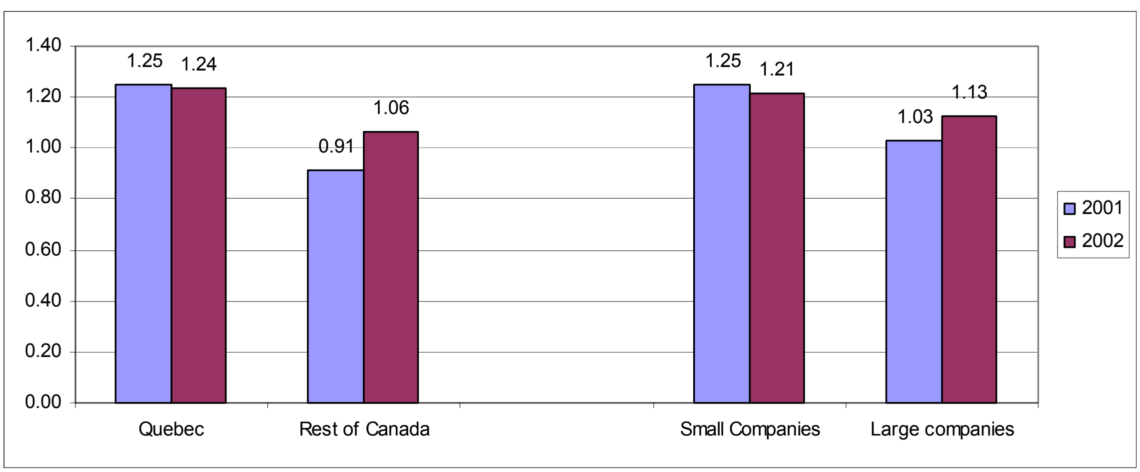
➢ Current Ratio

The definition for this ratio is as follows: Current Assets divided by Current Liabilities

This ratio measures current assets available to cover current liabilities and is a test of near-term solvency. It indicates to what extent cash on hand and disposable assets are enough to pay off near-term liabilities.

The following figure shows current ratios for Quebec vs. English Canada firms and for small vs. large firms for 2001 and 2002:

Figure 44. Current Ratio – 2001 and 2002



Source: NGL tabulations and analysis

In 2001, the current assets of the firms based in English Canada were not sufficient to cover current liabilities; the ratio was actually less than unity and these firms were technically insolvent. Similarly, the current ratio for large companies was marginal.

The Quebec companies show higher current ratios than those for the companies in the rest of Canada (1.24 vs. 1.06 in 2002). Similarly, smaller firms show higher current ratios than those for larger companies. The small companies surveyed have a higher current ratio than the large companies (1.21 vs. 1.13 in 2002). One explanation for this result might be that smaller firms are largely self-financing and have a tighter control on current liabilities than do larger firms.

The validity of the current ratio calculations could be affected by the way companies have accounted for their inventory, in some cases under Inventory and in others under Accounts Receivable. When inventory is accounted for as an account receivable it can be valued at five times the acquisition cost. However, the value of the account is subject to re-evaluation in the case of returns from retailers, which can change the corresponding portion of receivables into an account payable.

- **Debt Ratio**

The definition for this ratio is as follows: Debt Ratio = Total liabilities divided by Total assets

In the calculation of this ratio, we used total liabilities instead of total debt, because some companies were unable to break total debt out of total liabilities.

The debt ratio indicates total indebtedness to third parties. It also provides an indication of the corresponding interest expense on the debt and the potential exposure of the company to changes in lending rates.

Overall, we found that a high proportion of companies surveyed benefited from public support programs, notably FACTOR/Musicaction, and that, as a result, debt sourced to public programs constituted a high proportion of total debt. However, we encountered a number of difficulties in determining whether the debt represented a significant risk for the companies.

First, companies were not always able to differentiate among public programs in identifying their debt.[81] Second, the accounting treatment of the debt incurred varied significantly among companies and the accounting treatment was not verifiable. Third, lending terms vary significantly among the programs. The principal federal programs, FACTOR (English) and Musicaction (French), offer relatively “soft” terms (loans repayable only if a sales threshold is triggered[82] and no interest) in comparison with provincial programs such as SODEC’s loan guarantees, which are configured closer to market conditions: preferential lending rate plus 2% plus performance premium (0-2%). Thus, even if the debt ratio is relatively high, the impact on a firm’s cash flow may still be manageable as interest expense would be modest.

Interest coverage Ratio:

The capitalization ratios examine the capital structure of the firm and thereby indirectly the ability to meet current or additional debt obligations. A more direct measure of the ability to meet interest payment is:

Times interest earned = EBIT/Interest expense.

---

[81] The Quebec firms were relatively better able to distinguish among sources of debt than firms in the rest of Canada.

[82] FACTOR/Musicaction requires firms to repay loans if the threshold of 10,000 copies is exceeded.

This ratio, often referred to as the “interest coverage ratio,” indicates the degree of protection available to creditors by measuring the extent to which earnings available for interest “cover” required interest payments.

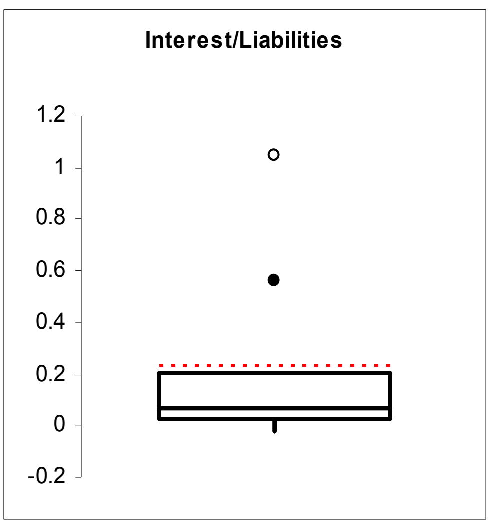
For the Quebec companies surveyed, we were able to calculate the interest coverage ratio.

A rule of thumb is that, if the ratio of interest to EBIT exceeds unity, the firm is capable of paying its interest load. For 2001, the interest coverage ratio for Quebec companies had a weighted average value of 7.72 and a ratio of interest to liabilities of 1.6%, as follows:

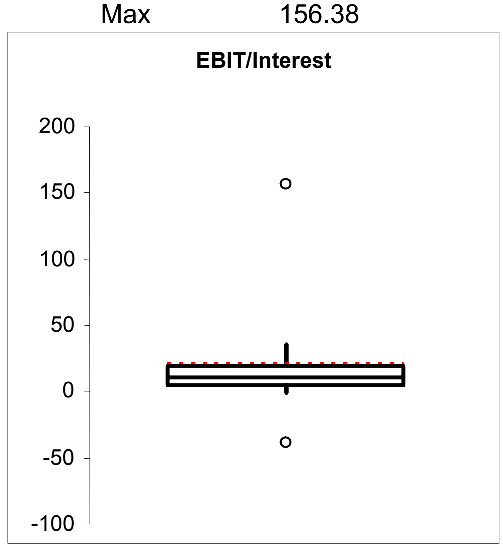
Interest	$	209,801
EBITDA	$	2,617,393
DA	$	996,864
EBIT	$	1,620,529
EBIT/Interest		**7.72**
Interest	$	209,801
Liabilities	$	13,068,169
Interest/Liabilities		**1.6%**

Figure 45. Quartile Analysis of Interest Coverage for Quebec Companies – 2001

Median	5.7%
Min	-0.02
Max	104.9%



Median	8.54
Min	-39.41
Max	156.38



Source: NGL tabulations and analysis

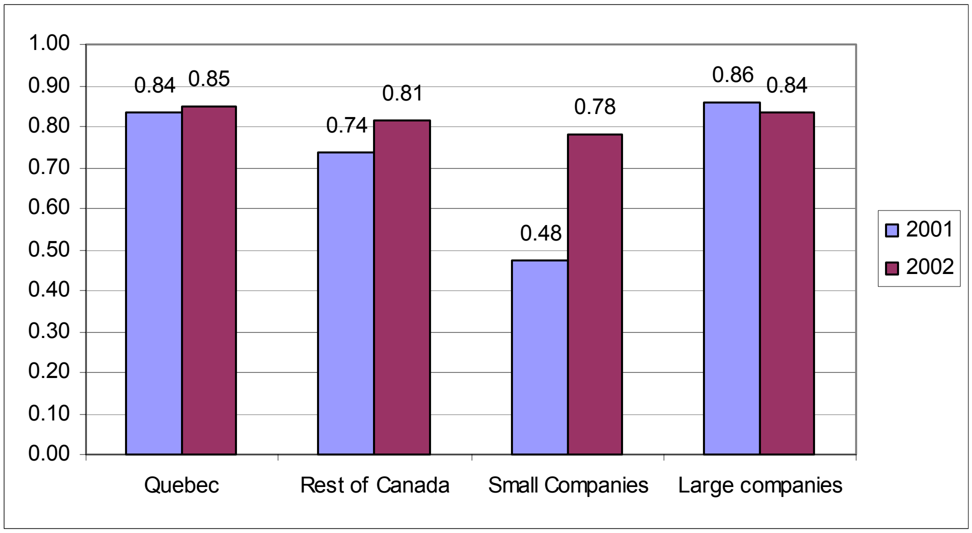
There are two distinct groupings of Quebec-based sound recording companies with respect to the results of the interest/liabilities ratio calculation. For half of the Quebec companies surveyed, the range in values for the interest/liabilities ratio was between -2% and 5.7%; for the other half the range in ratio values was quite dispersed, with a maximum value of 105%.

For the EBIT/Interest ratio, the values were more concentrated: around the median of 8.54.

In light of these ratios, while debt is relatively high for the Quebec companies surveyed, it would appear that the debt load does not threaten their financial stability since a major portion of the debt involves government funding that entails low interest expenses.

The following figure shows the debt ratios for Quebec vs. English Canada and small vs. large firms for 2001 and 2002:

Figure 46. Debt Ratio – 2001 and 2002



Source: NGL tabulations and analysis

Overall, debt ratios are generally high in the sound recording industry. The debt ratio of the Quebec companies surveyed remained relatively stable from 2001 to 2002, while that of the companies in English Canada increased from 0.74 to 0.81.

The small companies surveyed had a lower debt ratio (0.48) in 2001 than the large companies (0.78). While the ratio for small companies increased significantly from 0.48 to 0.78 in 2002, it was still lower than the ratio for large companies. This reflects the fact that small sound recording firms are largely financed from internal sources. The large companies surveyed saw a slight decrease in debt ratio, from 0.86 to 0.84.

The higher debt ratios increases industry exposure to interest rate fluctuations. As interest rates are currently close to historical lows and are expected to rise, it is likely that some firms will face financial difficulties due to interest rate exposure.

The validity of the debt ratio calculations could be affected for the following reasons:

- Some companies account for government loans as a reduction of expenses, while others report them as an increase of revenue or as long-term debt.
- Most of the companies were unable to identify the portion of debt attributable to government loans. The debt ratio as calculated includes forgivable government loans.
- Each company has a different way of accounting for capital spending. Some firms capitalize expenditures while others do not, and some have elected to capitalize expenditures in one year and not in another in order to inflate or deflate profits.

➢ Revenue Per Employee

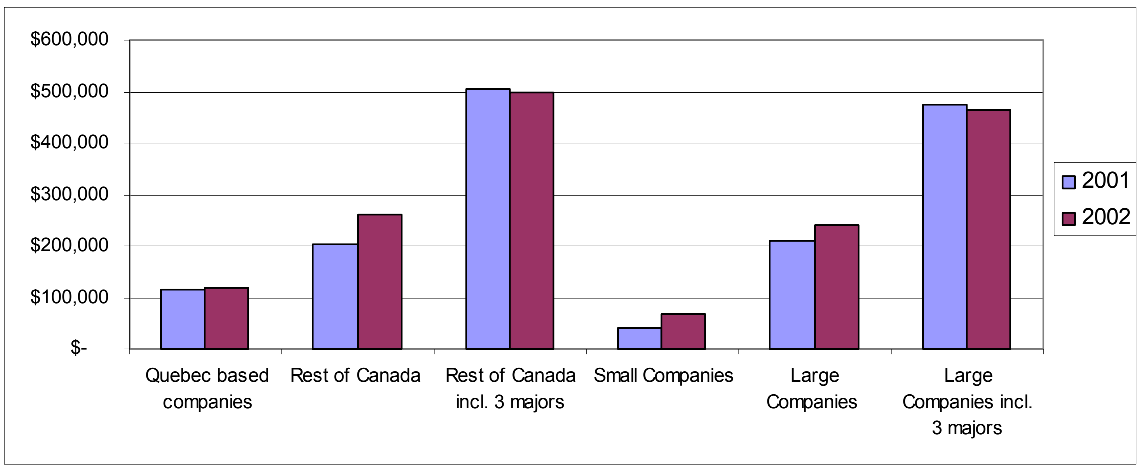
The definition for this ratio is as follows:

Revenue per employee= Total revenues divided by total employees.

This ratio provides an indication of the productivity of the company's workforce.

The following figure takes into account both full-time and part-time employees calculated as FTE (full-time equivalents). For purposes of comparison, we show Rest of Canada excluding and including the data provided by the three participating majors.[83]

Figure 47. Revenue per Employee – 2001 and 2002



Source: NGL tabulations and analysis

Overall, productivity as expressed by revenue per employee in the sound recording industry is quite low. This reflects the project-by-project basis of much of the industry and the lack of corporate memory and back-office systems that would allow for productivity gains.

Revenue per employee is higher among the companies surveyed in English Canada than for those in Quebec, although the difference is less marked when the majors are excluded. The Quebec-based companies reported a higher proportion of contract workers than those in English Canada. It would be interesting to verify whether firms with more full-time employees are more productive than those with more contract workers in the cultural industries and in the economy at large. The small companies surveyed show very low revenue per employee compared with the large companies.

The validity of the revenue per employee ratio calculations could be affected by the way companies account for government loans received. Some account for these loans as a reduction of expenses, while others treat them as an increase of revenue or as long-term debt.

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[83] Data from the participating majors is included only in the revenue per employee ratio as noted.

7.3.3 *Quartile Analysis by Ratio*

In this section we present a quartile analysis of the various financial ratios by size of the companies surveyed. Quartile analysis provides a frequency distribution of financial values. This methodology enhances the analysis presented in the previous section based on weighted average values of financial ratios. We selected 2001 as the reference year for comparison as this year provided the most comprehensive database.

Tables 8 to 10 show the actual quartile values for each ratio for all companies and for large and small companies (based on the threshold of $1M). The data for the three participating majors has been excluded. This is followed by figures 48 to 52, where the actual values as well as box plots and frequency distributions are presented.

Table 8. Quartile Analysis for All Companies Surveyed* – 2001

For All Companies	Min = Q0	Q1	Median = Q2	Q3	Max = Q4	Q3-Q1
Gross Margin	-0.32	0.27	0.45	0.73	0.99	0.46
EBITDA Margin	-1.25	0.01	0.08	0.17	0.38	0.15
Current Ratio	0.08	0.89	1.18	1.64	5.29	0.75
Debt Ratio	0.09	0.59	0.73	1.00	1.88	0.41
Revenue per Employee	$ 11,538	$ 55,950	$ 166,667	$ 293,500	$ 738,324	$ 237,550

Source: NGL tabulations and analysis
* excluding the 3 participating majors

Table 9. Quartile Analysis for Large Companies Surveyed* – 2001

For Large Companies	Min = Q0	Q1	Median = Q2	Q3	Max = Q4	Q3-Q1
Gross Margin	0.01	0.35	0.70	0.75	0.99	0.40
EBITDA Margin	-0.13	0.03	0.10	0.16	0.24	0.14
Current Ratio	0.08	0.98	1.15	1.50	1.92	0.53
Debt Ratio	0.51	0.69	0.77	0.93	1.11	0.23
Revenue per Employee	$ 43,790	$ 162,161	$ 287,382	$ 360,487	$ 738,324	$ 198,326

Source: NGL tabulations and analysis
* excluding the 3 participating majors

Table 10. Quartile Analysis for Small Companies Surveyed – 2001

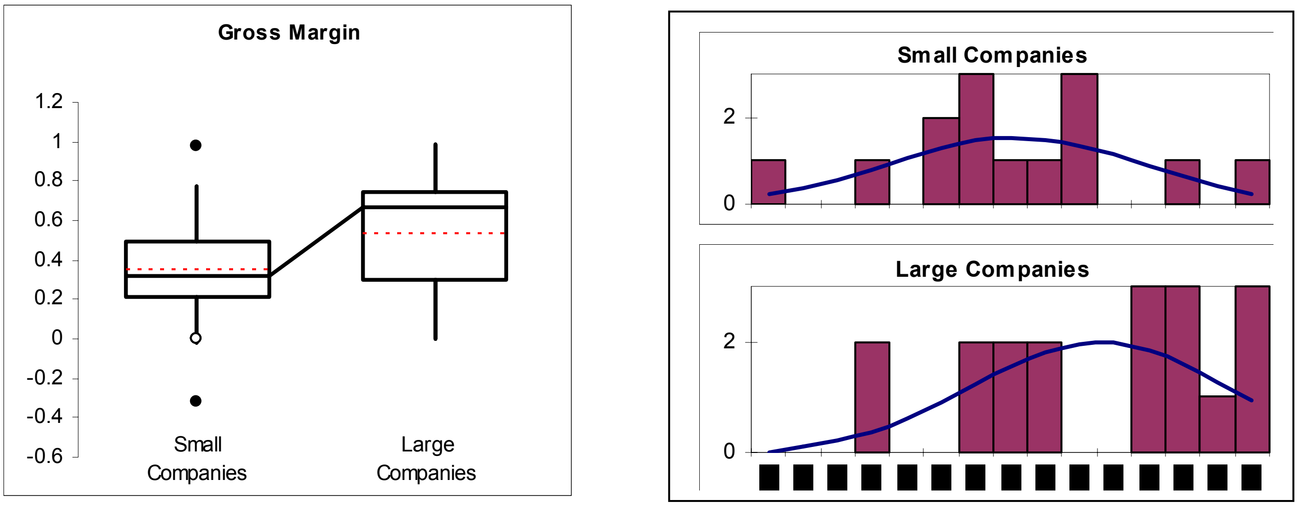
For Small Companies	Min = Q0	Q1	Median = Q2	Q3	Max = Q4	Q3-Q1
Gross Margin	-0.32	0.22	0.31	0.50	0.98	0.28
EBITDA Margin	-1.25	-0.18	0.05	0.19	0.38	0.37
Current Ratio	0.37	0.69	1.44	2.19	5.29	1.50
Debt Ratio	0.09	0.30	0.59	1.02	1.88	0.72
Revenue per Employee	$ 11,538	$ 34,490	$ 57,387	$ 79,970	$ 206,526	$ 45,480

Source: NGL tabulations and analysis

➢ Gross Margin

The following figure presents the box plots (left) and frequency histograms (right) for the gross margin financial parameter. In the box plot, the values by quartile: minimum (single point), quartile 1, median (quartile 2), quartile 3 and maximum (quartile 4 – single point) values for the small and large companies. The horizontal line connects the medians of small and large companies.

Figure 48. Quartile Analysis of Gross Margin – 2001



Source: NGL tabulations and analysis

For the small companies surveyed, gross margin ranges from a minimum of -0.32 to a maximum of 0.98, compared with a higher minimum for larger companies of 0.01 and a similar maximum of 0.99.[84] Half of the small companies surveyed have a gross margin of less than 0.31, while half of the large companies have a gross margin greater than 0.70.

The median for the large companies surveyed is much higher than for the small companies, with a heavier distribution of companies having a gross margin greater than 0.45. For the small companies, the concentration is greater around the median value of 0.3.

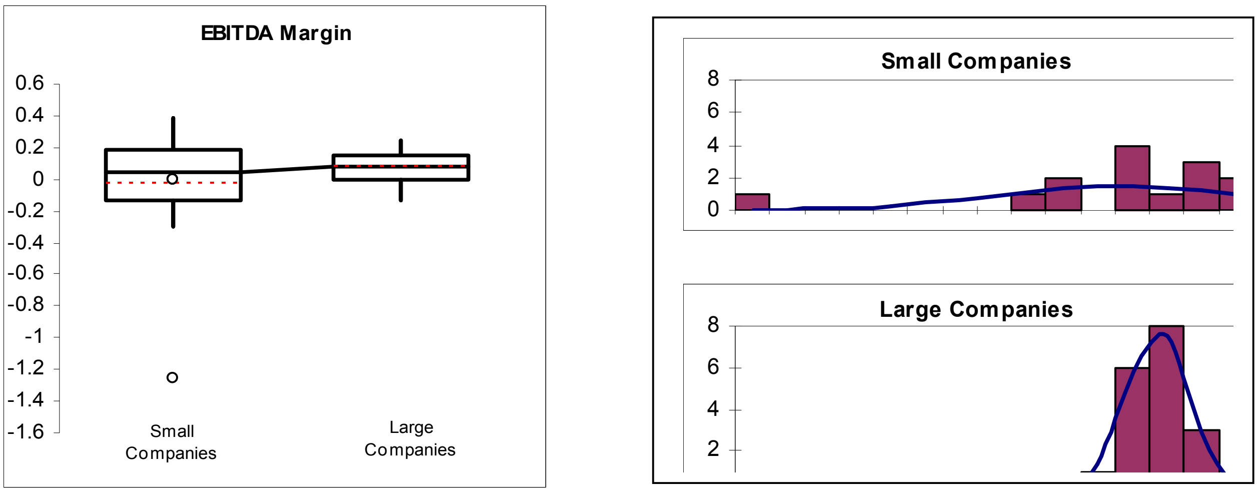
Overall, the distribution of gross margin values around the median for small companies is slightly less than for large companies.

[84] These extreme values for the gross margin ratio could be explained by the long business cycles in the music industry, where COGS are engaged in one year and revenues are generated years later. As explained previously, not all firms include the same elements in their COGS.

➢ EBITDA Margin

The following figure presents the box plots (left) and frequency histograms (right) of the EBITDA margin.

Figure 49. Quartile Analysis of EBITDA Margin – 2001



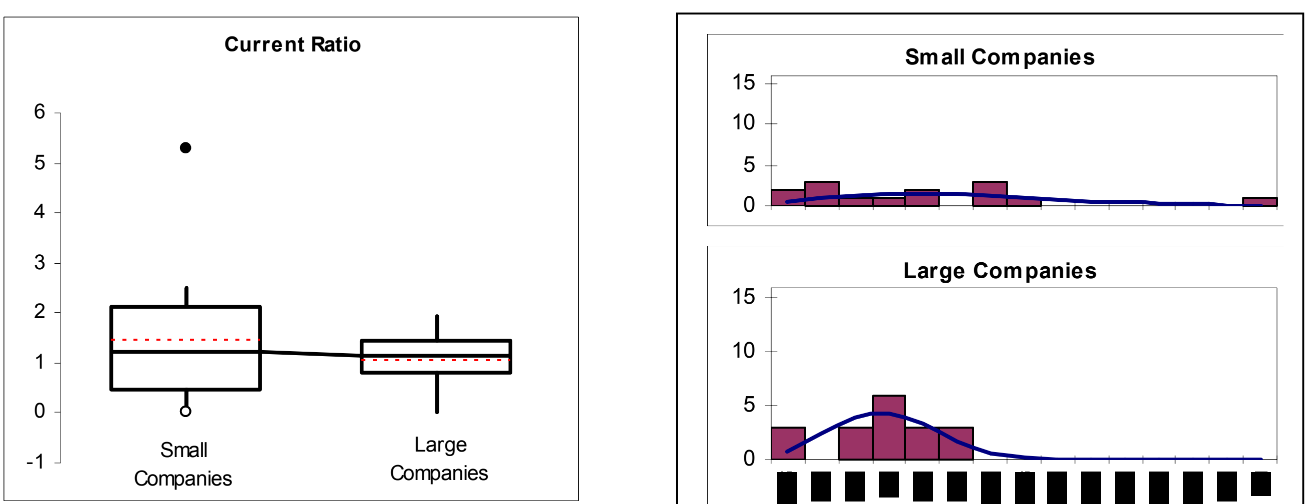
Source: NGL tabulations and analysis

For the large companies surveyed, the EBITDA margin is concentrated around the median value of 0.1. The small companies have a wider distribution range with a lower minimum and a higher maximum. (EBITDA margin ranges from -1.25 to 0.38 for the small companies compared with -0.13 to 0.24 for the large companies).

➢ Current Ratio

The following figure presents the box plots (left) and frequency histograms (right) of the current ratio.

Figure 50. Quartile Analysis of Current Ratio – 2001



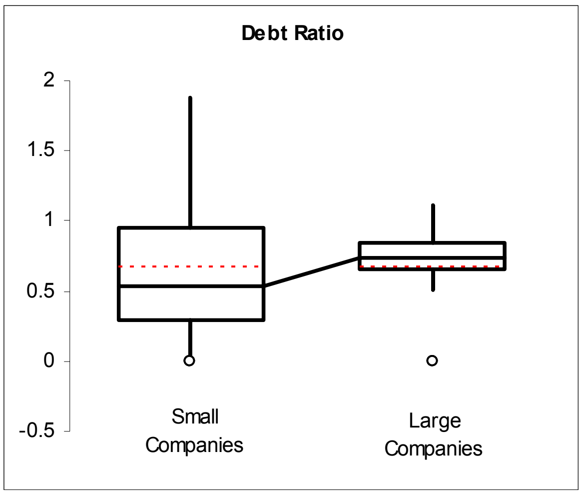
Source: NGL tabulations and analysis

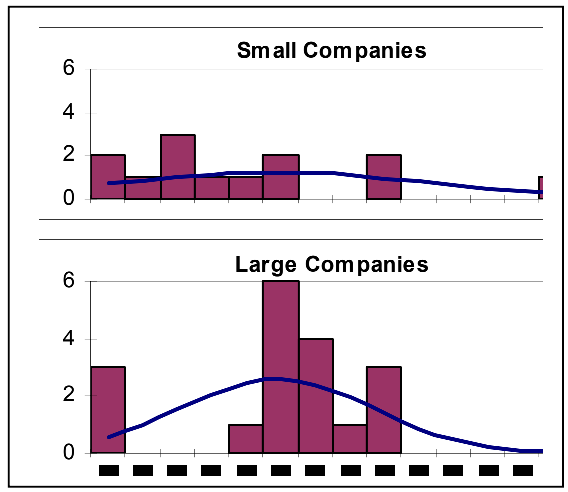
The distribution of the current ratio is more uniform for the large companies than for the small companies surveyed. For the small companies, the current ratio ranges from 0.37 to 5.29, with a quarter of the companies having a current ratio greater that 2.19. However, the two medians are comparable (1.44 for small companies and 1.15 for large companies).

➢ Debt Ratio

The following figure presents the box plots (left) and frequency histograms (right) of the debt ratio.

Figure 51. Quartile Analysis of Debt Ratio – 2001





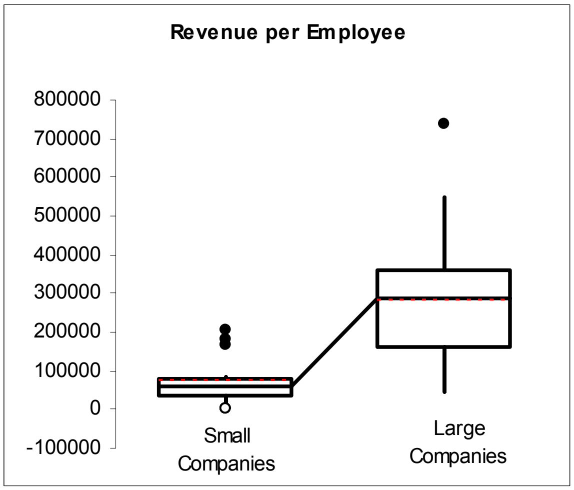
Source: NGL tabulations and analysis

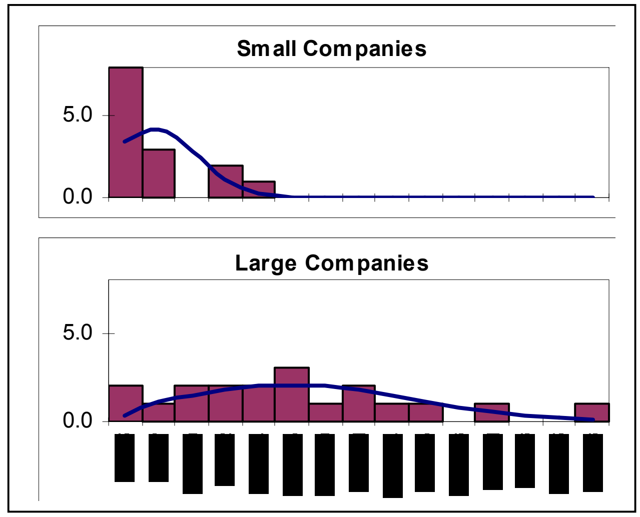
The debt ratio for the small companies surveyed ranges from a minimum of 0.3 to a maximum of 1.88 with a median of 0.59. The large companies have a more condensed frequency distribution around the median, ranging from 0.51 to 1.11 and with a median value of 0.77 (higher than the median value of the small companies surveyed).

➢ **Revenue per Employee**

The following figure presents the box plots (left) and frequency histograms (right) of the revenue per employee ratio.

Figure 52. Quartile Analysis of Revenue per Employee – 2001





Source: NGL tabulations and analysis

Revenue per employee presents a distribution different from the other financial ratios. The small companies have a lower median with a greater concentration around the median value. The large companies have revenue per employee values ranging from a minimum of 43,790 $/employee to a maximum of 738,324 $/employee with a median value of 287,382 $/employee.

Conclusion

For the financial ratios analyzed, the small companies surveyed have a larger distribution of values around the median than the large companies with the exception of the revenue per employee ratio, where large companies have a wider interval.

7.4 Analysis of Employment Data

This section analyzes the employment data for the 40 firms surveyed – 37 independents and three majors – in terms of job status, region (job location) and business activity. The results are further broken down by corporate location (Quebec vs. Rest of Canada) and company size (small vs. large). Employment is expressed as FTE (full-time equivalents).

Breakdown by Job Status and Corporate Location

Figure 53. FTE by Status – Quebec Companies

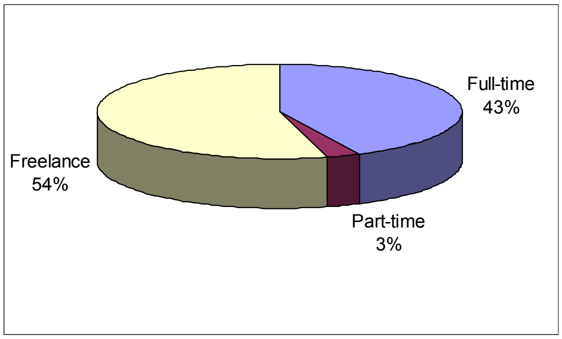
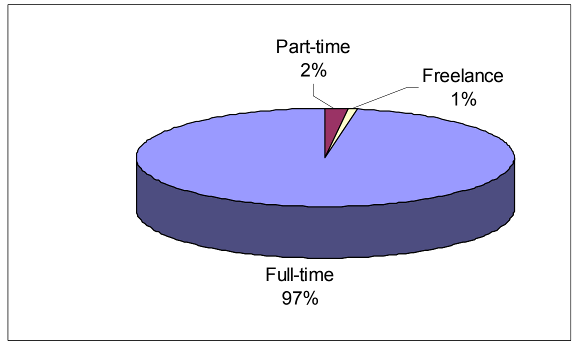


Figure 54. FTE by Status – Rest of Canada



Source: NGL tabulations and analysis

Most Quebec-based companies reported a predominance of freelance workers in the employment base. This corresponds with interview information indicating that, as margins have been squeezed, full-time employment has suffered. As well, many smaller companies have based their activities on long-term relationships among collaborators that are hired on according to each project's needs; in other words, only the firm's principals can be considered full-time employees.

Breakdown by Job Status and Company Size

Figure 55. FTE by Status – Small Companies

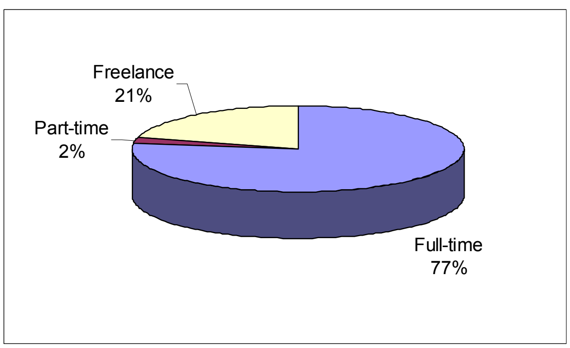
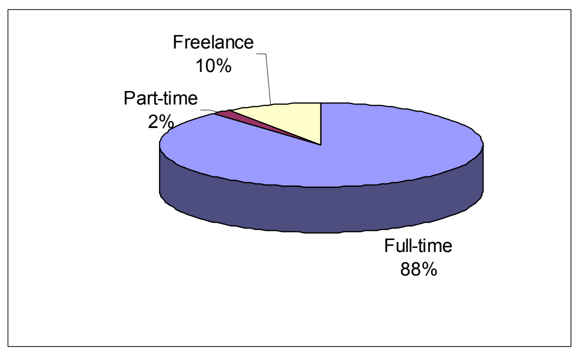


Figure 56. FTE by Status – Large Companies



Source: NGL tabulations and analysis

Breakdown by Region and Corporate Location

Figure 57. FTE by Region – Quebec Companies

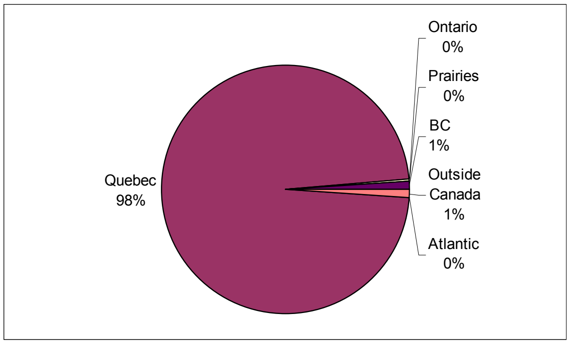
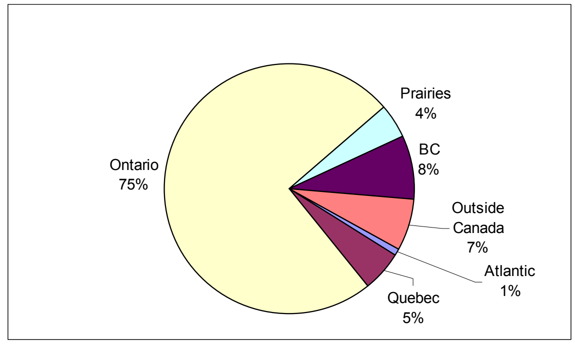


Figure 58. FTE by Region – Rest of Canada Companies



Source: NGL tabulations and analysis

The large majority of companies surveyed employed their workforce locally. Only 2% of Quebec company employees worked outside the province, either in British Columbia or outside Canada.

Of the 20 companies surveyed in the rest of Canada, 85% were based in Ontario, 10% in BC and 5% in the Prairies. This is reflected in the location of their workforce by region: 75% in Ontario, 8% in BC and 4% in the Prairies. However, 13% of the FTE of companies based in English Canada worked in Quebec, the Atlantic region or outside Canada.

Breakdown by Region and Company Size

Figure 59. FTE by Region – Small Companies

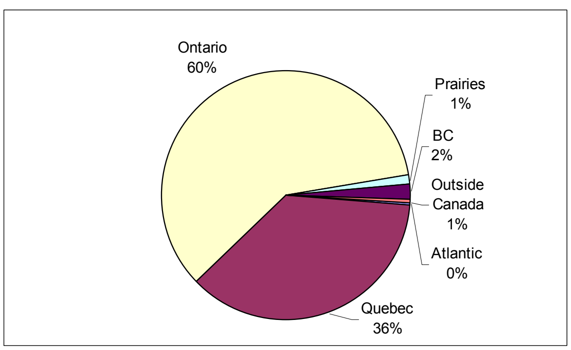
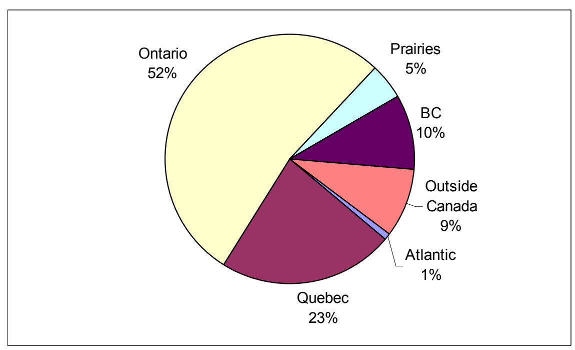


Figure 60. FTE by Region – Large Companies



Source: NGL tabulations and analysis

Among the small companies surveyed, 60% of total employment was based in Ontario, compared with 36% in Quebec, despite the fact that more of these companies were located in Quebec (9) than in Ontario (6) (see Table 5).

Among the large companies surveyed, 52% of employment was in Ontario, compared with 23% in Quebec, 10% in BC, 9% outside Canada and 1% in the Atlantic region. This may be related to the large employment base of the three majors that provided employment data for the study.

Breakdown by Business Activity and Corporate Location

Figure 61. FTE by Business Activity – Quebec Companies

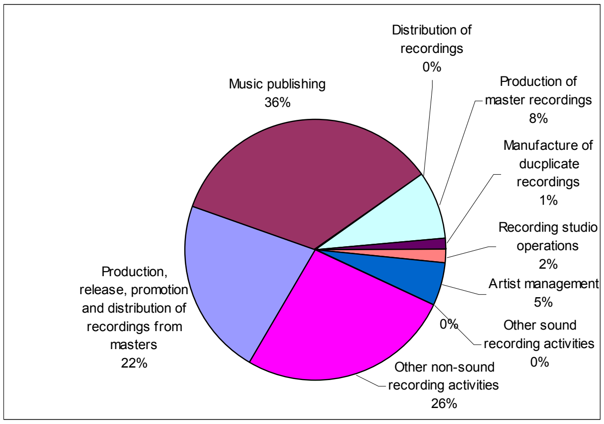
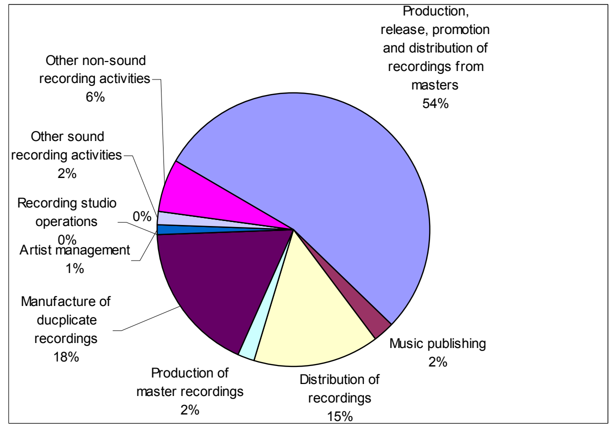


Figure 62. FTE by Business Activity – Rest of Canada Companies



Source: NGL tabulations and analysis

Employees of the Quebec companies surveyed worked mainly in music publishing and in the production, release, promotion and distribution of recordings from masters. These two activities generate most of the companies' revenues and are considered to be complementary.

Other non-sound recording activities account for a large share – 26% – of total employment and generate 21% of revenues for the Quebec companies surveyed.

A number of the Quebec firms indicated that their business model is shifting from traditional sound recording to non-sound recording activities: artist management for non-sound recording activities (e.g. management of advertising residuals), support activities for Web-based commercialization of product and DVD-related production activities.

The production, release, promotion and distribution of recordings from masters employs 54% of FTE in the companies surveyed in English Canada. It is also the primary activity, generating 46% of revenues. Distribution of recordings accounts for 15% of FTE (28% of revenues) and manufacture of duplicate recordings for 18%.

Breakdown by Business Activity and Company Size

Figure 63. FTE by Business Activity – Small Companies

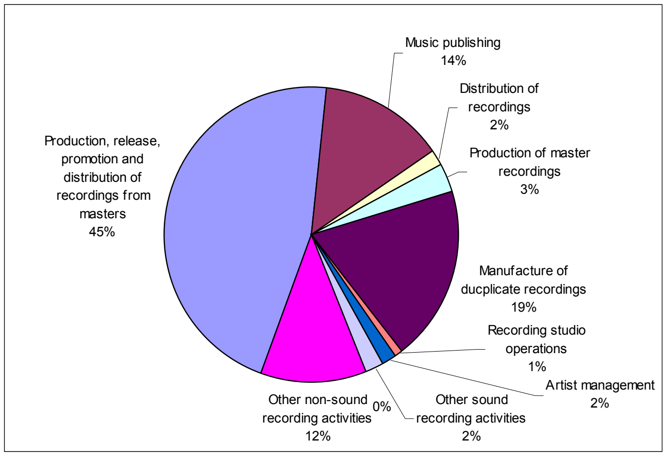
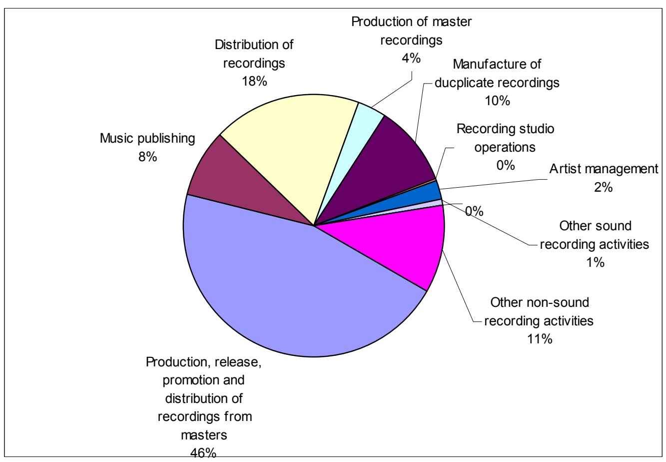


Figure 64. FTE by Business Activity – Large Companies



Source: NGL tabulations and analysis

Among the small companies surveyed, the activities that generate the most revenues do not necessarily employ most of the workforce. Music publishing generates 30% of revenues and employs only 14% of total FTE. Manufacture of duplicate recordings employs 19% of FTE but generates only 2% of revenues. In many small companies, the employees are multi-functional.

The production, release, promotion and distribution of recordings from masters is the activity that employs the largest share of FTE in both the small and the large companies surveyed, respectively 45% and 46%. It is also the largest revenue generator for the large companies, accounting for 43%. Music publishing employs 8% of FTE and distribution of recordings 18% (against respective shares of revenues of 24% and 15%).

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Le Groupe Nordicité ltée

7.5 Conclusions

Financial Performance Ratios

Overall, the financial ratio results indicate weak performance by the larger independents within the sound recording sector relative to firms in other cultural industries and firms in the economy in general.[85]

Table 11. Overview of 2001 and 2002 Financial Performance of Companies Surveyed

	2001		2002		2001		2002	
	Quebec	Rest of Canada	Quebec	Rest of Canada	Small	Large	Small	Large
Gross margin %	0.54	0.75	0.61	0.80	0.33	0.70	0.64	0.75
EBITDA margin	8.6%	4.5%	6.2%	-1.2%	-7.3%	7.5%	2.9%	1.5%
Current ratio	1.25	0.91	1.24	1.06	1.25	1.03	1.21	1.13
Debt ratio	0.84	0.74	0.85	0.81	0.48	0.86	0.78	0.84
Revenue per employee	113,862	204,750 505,828*	119,119	262,575 496,963*	39,881	211,785 475,851*	69,277	239,008 460,139*

Source: NGL tabulations and analysis
* Including the three participating majors.

- Gross margin: While gross margins improved in all categories over the 2001 and 2002 period, the ratios continue to be very low among Quebec companies and among smaller companies overall.
- EBITDA: Overall, the EBITDA margins of the companies – small and large, in Quebec and in the rest of Canada – are significantly lower than the thresholds required to attract outside investment.
- Current ratio: The current ratios are very low in the sound recording industry. The firms surveyed in English Canada were technically insolvent in 2001 and the large firms were only marginally solvent. While the situation for Quebec firms was significantly better and the current ratios for all categories increased from 2001 to 2002, the current ratios are very fragile.
- Debt ratio: The debt ratios in the sound recording industry are generally high and growing.
- Revenue per employee: Overall, productivity as expressed by revenue per employee in the sound recording industry is quite low. This reflects the project-by-project basis of much of the industry and the lack of corporate memory and back-office systems that would allow for productivity gains. Revenue per employee is higher among the firms surveyed in English Canada than among the Quebec firms and significantly higher among the larger firms.

[85] Published financial benchmark data are not generally available for the sound recording industry or cultural industries. However, financial ratios published by the CRTC indicate consistently strong financial performance by broadcasting firms. Source: CRTC Annual Financial Reports. Financial data are also available for publicly traded major Canadian publishing firms.

Quebec-based firms employ a higher proportion of contract workers than firms in the rest of Canada. Thus, it would be useful in future studies to develop separate benchmark indicators according to the ratio of full-time to part-time and contract workers.

In our interviews with industry players, the general consensus was that the weak performance of the sound recording industry will likely lead to further rounds of bankruptcies and consolidation in the industry.

Accurate and up-to-date financial data and key analytical tools – as summarized by the five ratios used in this study – are essential to assist the industry, including policy makers, funding agencies, associations, lenders and investors, individual firms, in making strategic and management decisions:

- Design and evaluation of assistance programs
- Benchmarking of an individual firm's performance relative to that of its industry peers
- Evaluation of financial performance and risk by third-party financial institutions for lending and investment decisions
- Selection of individual companies and evaluation of results within the context of managing existing programs
- Evaluation of industry performance, identification of problem areas[86] and allocation of funding among competing sectors

Employment Data

Despite weak financial performance, the sound recording industry increased its employment base by 23% between 1997 and 2003, from 2,121 to 2,618 persons. This translated into an average annual growth rate of 3.6%, well ahead of the overall economy (2.3%).

However, in many of the companies surveyed, full-time employees have been replaced by part-time contract workers or by freelancers on a project-by-project basis. This appears to be particularly true in Quebec.

While the large majority of the companies surveyed have a local workforce, the activities that generate the largest share of revenues do not necessarily employ the majority of the workforce.

Among the Quebec companies, music publishing employs the largest workforce share (36%), followed by non-sound recording activities. This reflects the shifting business model, from traditional sound recording into non-sound recording activities.

In the companies surveyed in the rest of Canada, the production, release, promotion and distribution of recordings from masters employs more that half the workforce.

[86] "Problem areas" in the sense of whether public funding can and should be allocated to alleviating or improving the situation or whether the problem is structural or systemic and cannot be fixed by pubic programs or policies.

8 Recommendations for Financial Ratio Analysis and Databases

This section sets out our recommendations for the development of an analytical framework and enhanced databases for the sound recording industry in Canada.

8.1 Financial Ratio Analysis

In section 7.3 we analyzed five financial ratios so as to provide an initial indication of the financial performance of the sound recording industry in Canada. In this section, we provide recommendations and rationale for further development of the ratio analysis approach and an overall analytical framework for financial analysis. This approach would be useful in sector- and firm-level performance assessment, program design and evaluation, and the selection of firms for existing programs.

In our research for this study, we consulted financial industry experts and academics to validate our selection of the initial financial ratios and to examine whether financial ratios could be used to develop performance thresholds for the sound recording and/or other cultural industries.

As the critical factor in developing a sound recording financial database is the availability and cost of data, we have provided a min/max strategy.

Ongoing Analysis Based on Five Ratios

The five ratios used in this report are gross margin, EBITDA, current ratio, debt ratio, and revenue per employee. These ratios provide a summary portrait of four key financial performance indicators – profitability, productivity, indebtedness and liquidity – for the sound recording industry and its various sub-sectors.

Recommendation: Require sound recording companies that benefit from public programs to provide financial data based on a standard accounting treatment of key activities and corresponding line items (loans, grants, administrative costs, royalties, etc.). Standard accounting treatment would allow for comparison of financial data among firms for any given year and for the measurement of industry performance and the impact of policy and programs over time.

Recommendation: Create a financial portrait of the overall industry through an ongoing study of the five ratios combined with other data sources, assuming that the level of information provided in this study can be maintained with the continued cooperation of industry members and associations (CRIA, CIRPA and ADISQ).

Recommendation: Develop benchmark indicators from other cultural industries and the overall economy in order to be able to readily compare the performance of the sound recording industry with other sectors.

Recommendation: Where appropriate, develop ratios and benchmarks specific to individual categories: English Canada, Quebec, large firms, small firms. For example, in the case of the revenue per employee productivity indicator, a separate ratio with benchmarks should be developed for firms employing mainly contract workers, as is the case in Quebec.

Enhanced Approach: Dupont, Credit-scoring, Linear Probability and Logit Models

The summary approach described above could be improved with the development of additional information on the long-term financial performance and financial risk of individual companies. While this information would be of importance principally to firms and third parties in their investment decisions (takeovers, establishment of bank loan portfolios for the sound recording industry, etc.), it would also be useful to policy makers and agencies. For example, in the event of further development of strategic funding initiatives (convergence strategies, development of key industry sectors such as multimedia, e-commerce, etc.), and if government agencies were to partner with financial institutions in developing loan portfolios specific to the sound recording industry, similar to those developed for the film and television production industry.[87]

However, this expanded approach assumes that significant improvements to current levels of financial information could be developed within the sound recording industry.

<u>**Recommendation:**</u> In the longer-term perspective that industry-government partnerships will be required to ensure the viability and development of the Canadian sound recording industry, we recommend an approach to developing additional financial information that incorporates various models including the Dupont, credit scoring, linear probability and logit models described below.

- **Dupont Model**

The Dupont model starts with a single core financial ratio – Net benefits/Net equity (ROE)[88] – that measures return on equity for shareholders. This is considered to be the key corporate performance indicator and can be used to measure a firm's financial performance relative to that of its peers in the sector. ROE varies according to a firm's stage of growth, events (e.g. change of management team) and financial ratios. It should be noted that the ratios are dependent on business cycles.

The ROE ratio can be decomposed into three sub-ratios:

- Net benefits/Gross sales, which measures profitability
- Sales/Assets, which measures productivity
- Assets/Equity, which measures indebtedness

The following models can be used to judge a company's credit risk, solvency and default risk.

- **Discriminant Credit-scoring Models**

Credit-scoring models such as Altman's Z-model can be used to calculate the probability of default for individual borrowers or to segregate borrowers into default risk classes, thus distinguishing between solvent, stable profiles and high-risk borrowers. These models use selected economic indicators and borrowers' financial information to classify them into default risk classes.[89]

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[87] Royal Bank and National Bank have developed loan portfolios based on tax credit and other incentive programs in cooperation with agencies such as Telefilm.

[88] Statistics Canada provides ROE as part of its financial analysis, by size of company.

[89] In contrast to linear probability and logit models, which project the expected probability of default for a borrower, discriminant models assign borrowers to high or low default-risk classes, depending on their observed characteristics (see Altman model in Appendix C).

As the original Z-model uses market value of equity, which does not apply to most sound recording firms, we used the alternative model wherein book value of assets is substituted for market value of equity in order to define high-risk borrowers.[90] The weakness of this type of financial model is that bankruptcy has a legal as well as a financial connotation.

- **Linear Probability and Logit Models**

Linear probability and logit models can be used to project a value for the expected probability of default if a loan is made. A linear probability model uses linear regression with financial ratios to explain historic repayment patterns. The relative importance of the ratios, as indicated by the regression results, is used to forecast loan repayment probabilities (see description of models in Appendix C). These models would be useful to the evaluation of performance and risk by investors and creditors.

Summary Overview of Indicators in the Enhanced Approach

The following figure presents the application of financial indicators in decision making under the enhanced approach scenario.

Figure 65. Application of Financial Ratios in Decision Making – Enhanced Approach

	Evaluation of Industry Sector Performance	Program Design and Evaluation	Selection of Firms for Programs and Evaluation	Benchmarking of Firm's Performance Relative to Peers	Evaluation of Performance and Risk by Investors / Lenders
Gross margin %	X	X	X	X	X
EBITDA margin	X	X	X	X	X
Current ratio	X	X	X	X	X
Debt ratio	X	X	X	X	X
Revenue per employee	X	X	X	X	X
Dupont model					
Return on equity (ROE)[91]				X	X
Net benefits / Gross sales				X	X
Sales / Assets				X	X
Assets / Equity				X	X
Credit-scoring models					X
Linear probability and logit models				X	X

As indicated in section 7.5, the underlying assumption for applying the five financial ratios used in this study to the program design and selection process is that information on a firm's financial stability and profitability is important to decision making even in the case of specific projects.

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[90] G. I. White, A. C. Sondhi and D. Fried, *The Analysis and Use of Financial Statements*, 2nd ed. New York: John Wiley & Sons, 1998. See Appendix C for calculation of the Z' ratio.

[91] Statistics Canada provides net profit margin, pre-tax profit margin, return on equity, receivables turnover.

8.2 Financial Definitions

As the sound recording industry adapts to new digital technologies and products and increasingly integrates the larger cultural and entertainment sector, activities and relationships in the value chain are quickly evolving. Financial definitions will also have to evolve in order to accurately reflect new industry activities. Our principal recommendation is that a wider range of revenues be attributed to the sound recording industry and that the definition of the industry itself be expanded to correspond to "music industry," rather than to sound recording alone.

Because it is important to be able to follow revenue and cost trends over time, in this section we look at the current revenue and cost definitions used by Statistics Canada, discuss how sound recording industry activity has evolved with technological, corporate and consumer trends and make recommendations for changes in future sound recording industry reporting.

Revenues

➢ **Sales of video product with sound recording content**

Currently, sales of video product with sound recording content (music videos, DVDs) are not considered part of sound recording industry revenues.

Sales of integrated sound/video product are outstripping those of pure sound recording product (vinyl, tape, CDs) and are inextricably linked to sound recording industry revenues.[92] Music videos typically contain outtake footage and are traditionally seen as a marketing expense. DVDs are now given out as bonuses with CD sales and vice versa. In the case of the Canadian independents and most majors,[93] production of music videos and DVDs is outsourced and considered separately from CD sales.

Recommendation: Consider sales of video product with sound recording content as part of sound recording industry revenues.

➢ **Merchandising, concerts, etc.**

Currently, merchandising revenues are not considered to be part of sound recording industry revenues. However, in the new sound recording industry value chain, it is increasingly common to see labels asking for a share of total artist revenues when signing artists. Similarly, concert ticket sales are not considered part of industry revenues. In the context of piracy, concert revenues often constitute a large part of newer artist revenues and the labels want their share.

Recommendation: Change the reporting base for the sound recording industry from sound recording activities to music industry activities, which include merchandising and concert ticket sales.

➢ **Net revenues**

Currently, the Statistics Canada definition is as follows:

> *Revenues: All the revenues of the financial profile sections are net, i.e., after deducting full returns, allowances and taxes.*

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[92] In the run-up to the Christmas period in 2003, mass-market retailers such as Future Shop replaced CDs with DVDs at "front of store" and DVDs generated more revenues than CDs.

[93] Universal being the possible exception among the majors

The sound recording industry typically uses the term "net sales," which correspond to gross sales net of returns and allowances. The industry does not include taxes in net sales.

Recommendation: Continue to use the current definition of the term "net revenues."

- **Net sales of sound recording product**

Statistics Canada defines the term as follows:

> *Net sales of compact discs, cassettes, etc., include singles, manufactured from masters either produced by the company or leased or bought from other organisations. It includes sales of only those recordings for which the company has exclusive distribution rights.*

Reporting companies are instructed NOT to include*:*

> *- Sales of imported finished compact discs, tapes, etc. (should be in non-sound recording revenue)*
> *- Sales of finished products distributed for another organization, e.g., buy and sell arrangements (should be in non-sound recording revenue)*
> *- Sales of music videos (should be in non-sound recording revenues)*

and NOT to include:

> *- Sales of compact discs, cassettes, etc., distributed for the company under licence by another organization.*

In the case of the majors, all revenues from the sale of distributed properties (known as "produced and distributed" or P&D) for which they hold distribution rights are considered to be part and parcel of sales of sound recording product. This includes the sale of foreign product. Typically, the majors undertake market trials of new foreign artist releases in Canada with batches pressed in the U.S. before deciding on a separate Canadian production run. The revenues from the sale of foreign product are reported as part of overall P&D revenues.

Pressing costs are typically a small portion of overall marketing and distribution costs, although the proportion is relatively greater for U.S. product, which benefits from spillover marketing from the U.S.

Recommendation: Widen the definition of sound recording industry revenues to include all P&D (produced and distributed) revenues.

Costs

Where changes are made to the revenue categories (above), the costs associated with the new definition of revenue categories (e.g. production and distribution costs of DVDs) should also be reflected in the financial profile of the industry.

8.3 Database Enhancement and Permanent Database

Comprehensive, accurate financial data is necessary for ongoing strategic and management decision making by sound recording industry players. The development of the ratios proposed in section 8.1 for use by government agencies and industry associations pre-supposes that accurate, up-to-date financial information is available.

The sound recording industry is undergoing fundamental changes at a pace not seen previously. Over the last three years, the structure and relationships in the value chain have changed fundamentally and its viability has been questioned. The sound recording industry is a keystone to other cultural industries including radio and television broadcasting, film and, more recently, games and multi-media. The loss of a significant number of viable independent sound recording labels would have negative impacts on companies throughout the cultural industries.

Federal and provincial cultural agencies and departments as well as associations and individual sound recording companies require reliable, up-to-date information for decision making and performance measurement in the sound recording industry. Agencies and associations need industry information in order to design and evaluate the performance of programs. Individual firms need financial data in order to measure their performance against peers and in order to negotiate financing with third-party financial institutions.

As noted in section 7.3.1, current public domain financial data sets are either not specific to the sound recording industry or too out-of-date to be useful for operational and strategic decision making by government funding agencies, policy makers, associations and private corporations.

Recommendation: Agencies involved in developing and administering support programs[94] and industry associations should make a joint effort to enhance the reliability and availability of financial data within the industry, as has been successfully undertaken in other cultural or entertainment industry sectors.[95]

Recommendation: The various agencies and associations involved in the sound recording industry should also promote the availability of audited data among larger firms and make this a prerequisite for program eligibility.

Recommendation: Maintain project funding targeting sound recording start-ups and smaller firms ("mom & pops," partnerships, etc). This funding would not require detailed firm-level financial data in recognition of the contribution of smaller companies to industry vitality, their prevalence in the industry and fact that they generally lack the resources and corporate organization necessary to produce financial data.

Recommendation: The financial data sets required for the five ratios used in this study should be updated on an annual basis

Recommendation: A decision on the development of supplementary financial data sets, such as those required for the three additional financial risk models, should be made following determination of needs and priorities in consultation with key industry stakeholders.

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[94] This would include the federal and provincial agencies directly responsible for setting policy and designing and administering the programs as well as Revenue Canada and Revenue Québec.

[95] The CRTC publishes annual financial data on the radio and television broadcasting industry. The CFTPA provides some financial data for the film and television production industry.

9 Potential Strategies and Business Models

The development of potential strategies and business models was based on the following three lines of evidence:

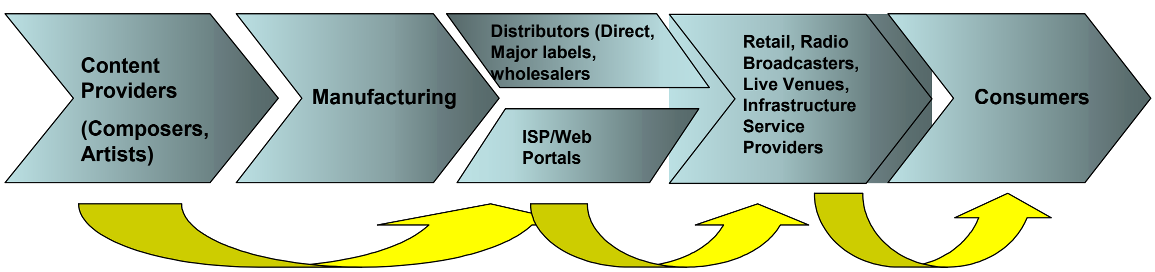
- Interviews of 40 key players in the Canadian sound recording industry, independents and major labels operating in the English and French markets
- Analysis of the results of a financial and labour survey of the independents and majors
- Review of previous studies of the Canadian and global recording industry

In this section we provide a viewpoint on what may be the new industry value chain, followed by potential strategies for the industry that would allow it to transition to new, sustainable business models.

9.1 New Industry Value Chain

The new value chain of the sound recording industry (expanded as to components and revenue streams) is likely to be based on a variety of interrelationships and profit-sharing arrangements that overlay the traditional model. Features of the new model would include industry player competition for consumer loyalty, leverage of electronic distribution via the Web as the principal (but not the only) retailing channel[96] and the need for player cooperation to build a winning combination that best responds to consumer needs. Understanding the core elements of the new industry value chain and their interrelationships is crucial to the industry's survival.

Figure 66. New Industry Value Chain



In the model pictured above, the sound recording industry is redefined to include the ISPs and IT infrastructure providers, and physical distribution of product is gradually removed from the value chain. Content creators and/or copyright owners generally continue to ally themselves with distributors for their specialized marketing and promotion knowledge, IT infrastructure and the financial resources needed to establish brand image. Artist managers take on the role of dealing with the distributors for their clients.

[96] The consensus among interviewees was that, while the retail model will always exist, the future lies in various combinations of online and retail revenue streams via innovative and technologically advanced distribution channels.

Who Owns the Consumer?

Under this construct, some infrastructure-based ISPs develop a primary relationship with the customer through bundling of subscription-based services (one likely cable/ISP bundle would be music services, cable TV, movies and VoIP telephony services), while other, non-infrastructure ISPs such as AOL capture the consumer through their service offerings.

Traditional bricks-and-mortar retailers lose their prime assets – "control over access and relationships with the consumer."[97] The importance of conventional channels of distribution and promotion is drastically reduced under the pressures of piracy, consolidation and downsizing. Increased competition slashes music retailers' margins and leads to traditional players losing market share. The decreasing importance of manufacturing and distribution reduces their dominant position in the value chain.

Mass-market retailers such as Best Buy and Wal-Mart use their marketing clout to dominate in the remaining traditional retail market and for a significant portion of online sales: the hits-driven "top 100" tunes. These sales are based on leveraging exclusive marketing arrangements with major labels for the sound recording product, which, in turn, drive additional sales in stores.

While most players thought that the majority of sound recording sales might remain in traditional retail for up to a decade, it was felt that the attractions of the Web, with its vastly larger, readily accessible sales inventory and ease of electronic purchasing for the average consumer, would result in the Web becoming dominant – likely sooner than later – and, correspondingly, in traditional retail becoming a secondary specialty sales channel. In this view, the specialty retail chain's role shrinks to that of a niche player for consumers who prefer physical product.

Indies vs. Majors

Digital technologies and the Internet have radically changed the sound recording industry value chain in a number of ways that reduce costs and barriers to entry. This will provide many more opportunities for independent labels to erode the major labels' historical domination over traditional retail distribution channels.

In the next few years, however, the independents will be threatened as traditional retail channels shrink and the majors give priority to solidifying their own sales with the big-box stores. This will exacerbate the current decline in sound recording sales by bricks-and-mortar retailers upon which independents largely depend for their viability.[98]

Both indies and majors are threatened by the increasing number of competitors eager to establish a presence in the digital marketplace. This makes it more difficult for record labels to control all rights over an artist's product and might force them to pay higher royalties.

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[97] Retail panel member, Canadian Music Week conference, March 2004.

[98] There has been a significant decline in retail sales. One CIRPA member (a larger independent label) estimated it to be as much as 30% and even greater (50-60%) in sales by independents, even those distributed by a major.

Consumer Choice in Sound Recording Product

Interviewees indicated that today's consumers are frustrated as they feel they are being forced to buy music bundled on albums. The availability of music on the Internet, large storage capacity on mobile devices and software that allows consumers to create personal catalogues and combine downloaded music with their own material have conditioned them to want personalized music repertories.

There was general consensus among the CIRPA members surveyed in English Canada as to how consumer choice will be satisfied in future:

- The main consumer trend will be the song instead of the album, which will force the record industry to adopt new, variable, demand-based pricing and a new infrastructure for identifying the sale of individual tracks.

- "Streaming subscription" services, which permit consumers to access their music from any device and from anywhere, will become the dominant way of delivering music. This will require technology that permits the consumer to be uniquely identified no matter where the access point.

- Bundling of games, ISP and music services.

- Internet users and music listeners are demographically similar. They are typically under 30, and the heaviest music buyers are going to the Internet to satisfy their music appetites.

- A handful of mega Internet music sites will emerge to provide subscription, community, e-commerce, information and other services beyond mere downloads or CD sales (e.g. Canadian Web-based music service Puretracks).

Copyright

As discussed in section 3.3, copyright is the legal expression of intellectual property rights in the sound recording industry. Downloadable music and its associated technologies have created a redistribution of power from major record companies to music consumers and, some interviewees argued, content creators. There appeared to be consensus that the balance between users and creators would gradually be re-established through a combination of legal, technical and consumer education means.

First and foremost, it was felt that new copyright legislation as well as better enforcement techniques would eventually address the piracy issue. It was also felt that a clear message from the courts was necessary for consumer education campaigns in the home and school to work. It further seems that there is a growing acceptance among artists that a new business model for the industry cannot be created without addressing individual acts of piracy.[99]

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[99] Artists cannot accept a business model that uses their music with no compensation, and, while going after teenagers is not what artists want, many feel betrayed by fans who claim to love them but still want their music free. Source: Interview with CRIA member, Canadian Music Week conference, March 2004.

Pricing of Sound Recordings on the Web

Industry experts appear to agree that the current online pricing strategy needs to become more sophisticated. Currently, iTunes and other download firms charge 99 cents per download. This "one price fits all" strategy has stalled the drive to create a significant commercial market for sound recording product over the Web and needs to be adjusted.

The continued leapfrogging of digital watermarking and piracy technologies makes it difficult to maintain high prices for sound recording product on the Web. With the geometric increases in storage capacity on mobile devices, there is a need to provide product cheaply or lose the Web market altogether to illegal channels. Thus, while a pricing premium can be obtained for new releases, old releases will likely have to be discounted significantly and/or bundled with value-added product such as merchandising based on the artist. In theory, older material would be provided at significant discounts, but in reality, the royalty structure limits the potential for pricing flexibility.[100]

Relationships of Labels with Creators and Labour

In light of the massive changes sweeping the industry, including very limited market windows for releases, it was felt that the labels that ultimately survive would be able to shift a portion of the risk to employees and creators and, correspondingly, that the latter would have to be included in the profit sharing of successful sound recordings. In this model, artists would have to be more flexible in their relations with their labels: more contract work, risk sharing, payment of royalties after COGS (cost of goods sold) are recovered, more teamwork and more multi-tasking.

Summary of Changes in the Value Chain

In short, the new sound recording industry business model would be driven by the following key trends:

- Various industry players form alliances in an attempt to control the interface with the consumer.
- Retail market share becomes linked to merchandising by big-box retailers like Wal-Mart and Best Buy; traditional music retailing declines to become a niche market for the minority of consumers that prefer physical product.
- Independents have a window of opportunity to capture market share back from the majors in Web channels.
- Consumers are offered product that corresponds to their preferences.
- Piracy, while still important, becomes manageable through a combination of legal, technological and societal measures.
- Independent labels share more risk and returns with their artists and labour.

[100] It should be noted that the royalties paid to artists do not vary with the age of the recording. Currently, the reference point of download is 99 cents for Puretracks, and the portion of online price that goes to royalties (all sorts combined) is generally said to be 65%.

9.2 Potential Elements of New Record Label Business Model(s)

In the previous section, we examined the key drivers in the value chain that would condition the business models for individual record labels. In our analysis of the financial ratios, employment structure and areas of focus of the larger Canadian independents, a number of companies demonstrated strong financial results. These results contrasted with the overall poor results for the independents surveyed and the industry as a whole. However, there was no single business model among the successful labels that demonstrated strong financial results. Some of these labels were notable for the following abilities:

- Ability to capture diverse, non-traditional revenue streams (e.g. a portion of their artists' total income, production of DVDs, etc.)
- Ability to target niche markets such as ethnic or older consumers (compilations, retro pop and smooth jazz)
- Development of strategic alliances upstream (with the majors in artist development) or downstream (with major retailers in terms of time-to-market, minimal inventory, pricing flexibility/avoidance of returns and joint promotion) in the value chain.

Changes in the value chain and the performance of the more successful independent labels suggest some potential elements for new sound recording industry business models as follows:

- Joint development and sharing of new revenue streams with artists
- Development of a hybrid online/traditional business model for labels
- Better focus on merchandising and inventory management techniques of traditional retail partners
- Production and marketing of combined video/sound DVD product for Internet and traditional retail consumers along with ongoing production of sound product (CD, tape, vinyl) for specialty retailers

Joint Development and Sharing of New Revenue Streams with Artists

There is a demand for music across the country as evidenced by retail sales, attendance at concerts, sales of merchandise and visitor hits on music websites. There is an opportunity for labels to diversify their revenue streams by assisting artists in developing and sharing in more downstream merchandising opportunities. This includes sales of CDs and merchandise (t-shirts, hats, posters, stickers, etc.) at concerts and in retail stores, Web-based sales of sound recordings and merchandising, and advertising and promotion residuals.

Development of a Hybrid Online/Traditional Business Model for Labels

While the Web may eventually become the most important delivery mechanism for music, there will be a lengthy transition period during which electronic distribution and physical distribution co-exist. In the new world of sound recording retailing, independents will have to lever their relationships with the players in both traditional and non-traditional sales channels to ensure retail sales. Up until now, they generally have depended on the majors or specialty chains for access to traditional outlets.

Both indies and majors have an economic incentive to make product available on the Web – reasonably priced and tailored to niche audience tastes – in order to entice the new generation of consumers to become commercial buyers rather than pirates, and to build their brand. The labels, together with their e-commerce business partners, need to better their understanding of online consumer tastes, bundling and price sensitivity.

The inventive online music business models currently in use include the following:

- **ITunes, Puretracks, etc.:** Consumers can buy individual tracks via micro payment of less than $1 or albums for $9.99 and up, and buy as few or as many tracks as they want. After downloading music to their hard drives, they can burn it to CDs, copy it to portable music players or, if they have the right equipment, stream it around the house by way of their existing entertainment centres. There is no specific definition of micro payments but the term usually describes the purchase of a single song or track costing less than $1. The model suggests that the sale of digital downloads at these prices is not economical.
- **Subscription model.** Consumers pay a monthly fee for the right to download a specified number of songs each month.
- **Streaming model**, such as the one used by RealNetworks' Rhapsody. Music lovers pay a monthly fee, and then listen to as many songs a month as they can stand. Downloading is extra, usually less than a dollar a track.

The new construct requires indies to develop their own individualized business models that target niche markets through retail channels including the Web, direct sales and traditional retail. They must be nimble in recognizing trends and market opportunities among very small but loyal audiences. For example, it was suggested that there is a niche market for "creative & educational" record shops targeting kids and young adults.[101]

Independent labels will have to develop skills in creating awareness and brand preference, or "buzz," for their sound recordings among target markets on the Web and in traditional media. Currently, demand for new recordings is channelled by word of mouth/peer-to-peer and through guerilla marketing initiatives such as contests and promotions, integrating Web coverage of live events, and leverage of related information (artist bios, etc.) on the Web. For example, some artists and labels have created online databases that afford members easy, value-added access to their favourite singer's concerts and promotional items, as well as the opportunity to engage in personal communication.

It appears that the most successful indies in Canada are those that have recognized the potential of "virtual concept" and positioned themselves either as online value-added distributors or as providers of music content to sites that offer a broader range of other non-music product. Besides direct CD sales, the successful digital business model requires a constant update of the value-added services (digital downloads, samples, artist album information, ticket sales, etc.). Labels and artists will have to develop new revenue streams from royalties on the use of music in new media (electronic games, Internet radio, ringtones, etc.). Labels will need to create and support new package formats and product diversification into non-traditional product lines such as DVDs in order to respond to evolving consumer tastes. As indicated in section 7.2.1, the Quebec firms surveyed appear to be further along in diversifying their revenue streams into non-traditional industry activities – including DVDs and live events – than their counterparts in English Canada.

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[101] Interviews with indies (classical and children's labels)

Independent labels need to develop their financial and general business planning skills in order to translate their knowledge of consumer tastes and preferences into commercial opportunities, organize third-party financing and manage their personnel. Often the first time an indie develops a business plan is as a requirement for a government grant, rather than for internal planning purposes.

In the hybrid market, record labels, both indies and majors, will have to learn data-mining techniques to follow their buyers' purchase decisions over time in order to be able to manage marketing and promotion programs, and to identify appropriate new product offerings and bonuses targeted to individual consumers. However, it is becoming increasingly challenging for record labels to effectively capture and "mine" consumer data. Commercial databases often fail to capture the key 12-34 demographic because these consumers' primary music sources are file swapping, direct purchase at concerts, etc. With so many media and other commercial entities seeking to capture the youth demographics through various lists, there is also a problem of consumer fatigue and cynicism with commercial messages.

Digital rights management (DRM) is seen as a keystone in the re-establishment of viability in the sound recording industry. DRM is the application by copyright holders (i.e. labels) of technical restrictions on the use of sound recordings (both physical and electronic product) in order to control/reduce the illegal use and piracy of sound recording product. The technical restrictions typically include encryption and programming that limit the number of times a sound recording can be played and/or identify the users authorized to access the product. As a technical solution, DRM is subject to ongoing challenges by software pirates. A portion of the consuming public considers unlimited access to sound recording product to be a "right." Some technically sophisticated users have actively sought to break the encryption and programming elements that limit usage, and to disseminate their pirate software solutions among music consumers. Thus, many industry experts believe that, in order to for DRM to be effective in re-establishing IP rights and industry viability, it must be combined with legal and societal initiatives.

The majors will probably have to strengthen their alliances with the indies and diversify their revenue model to include a share of the larger revenue pie generated by music-related activities including direct sales of DVDs and CDs, merchandising, advertising, etc. They may also have to work with Apple's iTunes and the Canadian Puretracks to ensure the right pricing and packaging of product.

Alignment with Merchandising and Inventory Management Techniques

Independent labels have not always kept up with retailers' requirements for merchandising, ordering, pricing and inventory management.[102]

Success in sales of sound recordings will likely require modern merchandising techniques of bonusing, bundling and attractive packaging: sales of CDs with value-added double albums, book offerings, DVDs, bonus CDs/bonus tunes, promotional and merchandising offers. While a significant portion of newer artists will no doubt continue to bypass the industry value chain by marketing directly to their fans via concert venues and the Web, players considered this more a

[102] One CIRPA member interviewed indicated that independents are generally unable to meet retailers' standards for next-day delivery, or to set realistic price points and adjust those price points over time to minimize inventory returns.

media clutter issue than a commercial threat because of the lack of professional sound quality and commercial promotion ability.

In the new retail world of big-box multi-sector retailers and Web retailing, independent labels will have to ensure that their inventory and pricing standards meet those of their retail partners, including just-in-time inventory, next-day order processing, compatibility of inventory management software and exchange of information for order processing, and flexibility in pricing with markdowns to minimize product returns.

Diversification of Product and Outlets

The demand for DVDs has increased dramatically and labels are starting to produce DVDs to respond to consumer demand. It is also likely that there will be an ongoing demand for pure sound recording products in specialty niche markets.

However, the capital investment and COGS (cost of goods sold) for a combined sound and video recording are much higher. As many independent labels lack the capital and production experience to produce DVDs, early releases have been of mixed quality, which may adversely affect the appetite of consumers for domestic DVD product. It is likely that a number of independents will have to outsource the production of DVDs, as they did with CDs, to the majors or other specialized third-party firms.

Appendices

Appendix A: Survey Questionnaire

This appendix includes the English version[103] of the questionnaire and the up-front notes for the interviewer.

Instruction Notes for Interviews

Thank you for agreeing to collaborate in this study of the music Industry. Our previous communications with you/your office were intended to explain the nature of the study, its benefits and allow you to prepare for the interview. In summary, this study should help the Ministry of Canadian Heritage, government agencies and associations (ADISQ, CIRPA and CRIA) to establish baseline data for design and evaluation of programs as well for strategic and management decision-making.

It is important to note that all information specific to the companies will remain confidential and that respondents will remain anonymous; only the consolidated results will be revealed.

The questions are gathered in three separate categories: corporate questions, questions about employment and financial questions. The process should last approximately 20 to 30 minutes. If you agree, we will contact your office again to obtain the missing data.

A. Corporate Profile

1. In which region is your company based?

__ Quebec
__ Ontario
__ BC
__ Atlantic
__ Prairies

2. What is the legal name of company? ___________________________________

3. What is the operating name of the company? _____________________________

4. What is the corporate address of the company?

[103] Note: NGL developed the questionnaire in both English and French. The English version presented here corresponds to the online version used to input the responses into electronic format.

5. What is the legal status of the company?

__ Incorporated for profit
__ Incorporated not for profit
__ Unincorporated - sole proprietor
__ Unincorporated partnership
__ Other (please specify) ____

6. Under which of the following corporate categories does your company fall under?

__ An independent firm
__ A subsidiary of another company
__ A parent company

7. If the company is a subsidiary, are the financial statements reported on a consolidated basis?

__Yes
__No

8. What are the primary business activities of the company, according to the following categories (check all that apply)?

__ Production, release, promotion and distribution of recordings from masters
__ Music publishing
__ Distribution of recordings
__ Production of master recordings or production company
__ Manufacture of duplicate recordings
__ Recording studio operations
__ Artist management
__ Other sound recording activities
__ Other non sound recording activities

9. What are the percentages of the primary business activities of the company, according to the following categories (total must sum to 100)?
(% of revenue)

__% Production, release, promotion and distribution of recordings from masters
__% Music publishing
__% Distribution of recordings
__% Production of master recordings or production company
__% Manufacture of duplicate recordings
__% Recording studio operations
__% Artist management
__% Other sound recording activities
__% Other non sound recording activities

10. In which country is the controlling interest of the company held?

__ Canada
__ Foreign country (including US)

11. What are the principle genres of music produced by the company (mark all that apply)?

__ Instrumental,
__ Country,
__ Urban / rap,
__ Pop vocal,
__ Rock,
__ Jazz,
__ Children's
__ Classical,
__ Alternative,
__ Dance / Electronica,
__ R&B / Soul,
__ Aboriginal,
__ Folk / Roots / Traditional
__Blues,
__Christian / Gospel,
__World,
__Comedy / Spoken Word

12. What are the percentages of the principle genres of music produced by the company (total must sum 100)?
(% of revenue)

__% Instrumental,
__% Country,
__% Urban / rap,
__% Pop vocal,
__% Rock,
__% Jazz,
__% Children's
__% Classical,
__% Alternative,
__% Dance / Electronica,
__% R&B / Soul,
__% Aboriginal,
__% Folk / Roots / Traditional
__% Blues,
__% Christian / Gospel,
__% World,
__% Comedy / Spoken Word

13. What is (are) the principle linguistic or ethnic market(s) targeted by the company's releases? (mark all that apply)

__ English
__ French
__ Aboriginal
__ Other language groups

14. What are the percentages of the principle linguistic or ethnic market(s) targeted by the company's releases (total must sum to 100)?

__% English
__% French
__% Aboriginal
__% Other language groups

15. Comments

B. Employment

1. Over the last reporting year, what was the average total full-time equivalent staff (working under direct contract), as measured by full time equivalents or 'FTE's in your firm?

______

2. FTEs broken down by:

______ Full-time employees (works at least 30 hours per week). Exclude employees of companies that performed contract work (e.g., recording studios)
______ Part-time employees
______ Freelancers and other persons employed on contract as individuals

3. Please provide the following breakdowns for the FTEs: FTE broken down by region. (Total should be equal to response 1 above)

______ Atlantic
______ Quebec
______ Ontario
______ Prairies
______ BC

______ Outside Canada

4. Please provide the following breakdowns for the FTEs: FTE broken down by business activity (Total should be equal to response 1 above)

______ Production, release, promotion and distribution of recordings from masters
______ Music publishing
______ Distribution of recordings
______ Production of master recordings or production company
______ Manufacture of duplicate recordings
______ Recording studio operations
______ Artist management
______ Other sound recording activities
______ Other non sound recording activities

5. Comments

C. Financial profile

Revenues: All the revenues of the financial profile sections are net, i.e.: After deducting full returns and allowances. Net revenues do not include taxes.

Net Sales of compact discs, cassettes, etc., include singles, manufactured from masters either produced by the company or leased or bought from other organisations. It includes sales of only those recordings for which the company has exclusive distribution rights.

Do NOT include:
- Sales of imported finished compact discs, tapes, etc., (should be in non sound recording revenue)
- Sales of finished products distributed for another organization, e.g., buy and sell arrangements (should be in non sound recording revenue)
- Sales of music videos (should be in non-sound recording revenues)

Do NOT include sales of compact discs, cassettes, etc., distributed for the company under licence by another organization.

1. Total company net revenues (net revenues after deducting returns, allowances and taxes) ______________

2. Company net revenues originating from sound recording activities ______________

3. Company net revenues originating from non sound recording activities ________________

4. Net sales of compact discs, cassettes, etc (including singles) ________________

5. What are the governmental programs received
   MEP / PEM
   FACTOR ________________
   Other (please specify ________________________) ________________

6. Amount received by sound recording firm, from governmental programs according to following categories' (for MEP)
   Loans ________________

7. Amount received by sound recording firm arising from governmental programs according to following categories' (for FACTOR and Musicaction)
   Subsidies, bursaries, etc ________________
   Loans ________________

8. Amount received by sound recording firm arising from governmental programs according to following categories' (For other programs)
   Tax credits ________________
   Subsidies, bursaries, etc ________________
   Loans ________________

9. Which accounting treatment was used for subsidies and / or tax credits where these were offered as part of specific programs (FACTOR / Musicaction, others)?

__ Generation of revenue
__ Reduction of expenses

10. Total amount received by sound recording firms for specific programs. (Please give the dollar amount per program)
    FACTOR ________________
    Others ________________

11. Sound Recording Revenues generated by linguistic or ethnic market(s) targeted ($value)
    English ________________

French ________________
Aboriginal ________________
Other language groups ________________

12. Sound recording Revenues by music category
    - Instrumental ________________
    - Country ________________
    - Urban / rap ________________
    - Pop vocal ________________
    - Rock ________________
    - Jazz ________________
    - Children's ________________
    - Classical ________________
    - Alternative ________________
    - Dance / Electronica ________________
    - R&B / Soul ________________
    - Aboriginal ________________
    - Folk / Roots / Traditional ________________
    - Blues ________________
    - Christian / Gospel ________________
    - World ________________
    - Comedy / Spoken Word ________________

13. Revenues by business activity(ies) of the company, according to the following categories
    - Production, release, promotion and distribution of recordings from masters ________________
    - Music publishing ________________
    - Distribution of recordings ________________
    - Production of master recordings or production company ________________
    - Manufacture of duplicate recordings ________________
    - Recording studio operations ________________
    - Artist management ________________
    - Other sound recording activities ________________
    - Other non sound recording activities ________________

14. Sound recording revenues generated by geographical market
    - Canada ________________
    - Foreign markets ________________

15. Sound recording revenues generated according to the origin of the releases with breakdown for
    - Canadian releases ________________
    - Foreign releases ________________

16. Earnings before taxes, interest, depreciation and amortization (EBITDA)
    - Total (Sound Recording and non Sound recording) ________________
    - Sound Recording (if available) ________________

17. Interest expense
    - Total (Sound Recording and non Sound recording) ________________
    - Sound Recording (if available) ________________

18. Depreciation and amortization
    - Total (Sound Recording and non Sound recording) ________________
    - Sound Recording (if available) ________________

19. COGS
    - Total (Sound Recording and non Sound recording) ________________
    - Sound Recording (if available) ________________

20. Administrative fees
    - Total (Sound Recording and non Sound recording) ________________
    - Sound Recording (if available) ________________

21. Assets
    - Cash ________________
    - Inventory ________________
    - Accounts receivable ________________
    - Short term assets ________________
    - Intangible assets ________________
    - Net fixed Assets ________________
    - Other Assets ________________
    - Total Assets ________________

22. Liabilities and shareholders equity
    - Accounts payable ________________
    - Short Term debt ________________
    - Current liabilities ________________
    - Long-term debt ________________
    - Total Liabilities ________________
    - Total shareholders' equity and retained earnings ________________

23. Capitalized expenses (if any)
    - Deferred expenses ________________
    - Rights ________________
    - Advances with shareholders ________________

Other ______________

24. Advance/Royalties to the artists (If any)
(please specify the dollar amount; the detail of accounting treatment is in the supplementary questions section.)

____

25. Comments

C. Supplementary Questions

1. Capitalized expenses: e.g., deferred expenses; rights, advances with the shareholders? Please provide detail and justification.

2. Advance/Royalties to the artists? Please specify what they cover.

3. Comments

Appendix B: Financial Data

Revenue Breakdowns
Quebec-based vs. Rest of Canada (RoC)

	2001		2002	
	Quebec-based	RoC	Quebec-based	RoC
Total sound recording net revenues	**$28,849,017**	**$32,439,580**	**$25,404,909**	**$36,905,998**
SR revenues by linguistic/ethnic market targeted	**$28,849,018**	**$32,439,578**	**$25,404,950**	**$36,905,998**
English	$11,274,905	$30,691,413	$7,489,956	$35,097,363
French	$15,824,404	$1,524,564	$16,678,047	$1,543,366
Other language groups	$1,641,502	$0	$1,236,947	$0
Aboriginal	$108,207	$223,601	$0	$265,269
SR revenues by music category	**$28,849,020**	**$32,439,579**	**$24,003,739**	**$35,805,036**
Instrumental	$340,842	$88,825	$125,073	$105,173
Country	$486,481	$27,950	$149,125	$203,159
Urban/rap	$157,198	$4,319,091	$155,634	$3,689,935
Pop vocal	$14,460,786	$5,289,825	$10,962,355	$4,053,735
Rock	$4,184,493	$9,674,997	$4,818,343	$16,965,491
Jazz	$1,556,132	$1,785,845	$1,876,880	$1,436,226
Children's	$830,152	$2,859,053	$517,620	$2,205,071
Classical	$3,377,302	$581,192	$3,161,482	$785,519
Alternative	$166,689	$486,347	$1,060,921	$666,315
Dance/Electronica	$340,531	$3,668,513	$242,886	$3,278,744
R&B/Soul	$295,330	$98,177	$39,745	$327,600
Aboriginal	$33,815	$419,252	$0	$497,380
Folk/Roots/Traditiona	$414,326	$1,596,260	$291,322	$1,466,533
Blues	$195,822	$121,752	$235,928	$124,156
Christian/Gospel	$88,050	$0	$108,650	$0
World	$1,764,803	$1,422,502	$108,650	$0
Comedy/Spoken wor	$156,268	$0	$149,125	$0
SR revenues by business activity (ies)	**$28,849,020**	**$32,439,582**	**$25,404,911**	**$36,905,998**
Production, release, promotion and distribution of recordings from masters	$11,540,978	$15,207,765	$9,731,851	$15,627,377
Music publishing	$13,497,088	$3,423,541	$12,790,017	$4,330,659
Distribution of recordings	$0	$9,225,322	$0	$8,578,219
Production of master recordings	$1,982,983	$658,652	$1,692,427	$813,833
Manufacture of ducplicate recordings	$60,000	$167,701	$80,000	$198,952
Recording studio operations	$367,226	$261,801	$20,000	$312,635
Artist management	$1,400,745	$3,439,250	$1,090,616	$7,001,823
Other sound recording activities	$0	$55,550	$0	$42,500
Other non-sound recording activities	$7,794,636	$180,335	$5,923,485	$85,000
SR revenues by geographical market	**$28,849,018**	**$32,439,581**	**$24,504,909**	**$36,905,998**
Canada	$25,400,237	$21,473,283	$22,430,631	$20,733,740
Foreign markets	$3,448,781	$10,966,298	$2,074,278	$16,172,258
SR revenues by origin of releases	**$28,849,047**	**$32,439,581**	**$25,404,909**	**$36,905,998**
Canadian releases	$25,295,761	$22,861,805	$23,805,056	$27,661,581
Foreign releases	$3,553,286	$9,577,776	$1,599,853	$9,244,417

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Revenue Breakdowns

Small vs. Large Companies

	2001		2002	
	Small	Large	Small	Large
Total sound recording net revenues	$8,224,605	$53,063,992	$10,356,483	$51,954,424
SR revenues by linguistic/ethnic market targeted	**$8,224,603**	**$53,063,993**	**$10,356,523**	**$51,954,425**
English	$3,316,814	$38,649,504	$4,697,726	$37,889,593
French	$4,624,924	$12,724,044	$5,125,919	$13,095,494
Other language groups	$59,264	$1,582,238	$267,609	$969,338
Aboriginal	$223,601	$108,207	$265,269	$0
SR revenues by music category	**$8,224,604**	**$53,063,995**	**$9,011,122**	**$50,797,653**
Instrumental	$88,825	$340,842	$106,242	$124,004
Country	$47,673	$466,758	$51,788	$300,496
Urban/rap	$226,743	$4,249,546	$539,873	$3,305,696
Pop vocal	$3,631,867	$16,118,744	$3,099,389	$11,916,701
Rock	$1,146,680	$12,712,810	$1,041,485	$20,742,349
Jazz	$248,441	$3,093,536	$623,310	$2,689,796
Children's	$780,351	$2,908,854	$762,631	$1,960,060
Classical	$1,129,839	$2,828,655	$1,737,453	$2,209,548
Alternative	$24,544	$628,492	$0	$1,727,236
Dance/Electronica	$109,200	$3,899,844	$168,249	$3,353,381
R&B/Soul	$98,177	$295,330	$39,745	$327,600
Aboriginal	$419,252	$33,815	$497,380	$0
Folk/Roots/Traditional	$59,998	$1,950,588	$306,322	$1,451,533
Blues	$19,722	$297,852	$18,628	$341,456
Christian/Gospel	$0	$88,050	$0	$108,650
World	$173,572	$3,013,733	$0	$108,650
Comedy/Spoken word	$19,722	$136,546	$18,628	$130,497
SR revenues by business activity (ies)	**$8,224,607**	**$53,063,995**	**$10,356,484**	**$51,954,425**
Production, release, promotion and distribution of recordings from masters	$2,063,949	$24,684,794	$3,897,007	$21,462,221
Music publishing	$3,386,978	$13,533,651	$3,361,359	$13,759,317
Distribution of recordings	$992,191	$8,233,131	$1,076,645	$7,501,574
Production of master recordings	$556,526	$2,085,109	$338,704	$2,167,556
Manufacture of ducplicate recordings	$227,701	$0	$278,952	$0
Recording studio operations	$276,801	$352,226	$332,635	$0
Artist management	$664,911	$4,175,084	$1,028,682	$7,063,757
Other sound recording activities	$55,550	$0	$42,500	$0
Other non-sound recording activities	$4,844,549	$3,130,422	$465,393	$5,543,092
SR revenues by geographical market	**$8,224,607**	**$53,063,992**	**$10,356,483**	**$51,054,424**
Canada	$6,797,166	$40,076,354	$8,643,235	$34,521,136
Foreign markets	$1,427,441	$12,987,638	$1,713,248	$16,533,288
SR revenues by origin of releases	**$8,224,606**	**$53,064,022**	**$10,356,483**	**$51,954,424**
Canadian releases	$7,435,231	$40,722,335	$8,102,428	$43,364,209
Foreign releases	$789,375	$12,341,687	$2,254,055	$8,590,215

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Employment Profile

Quebec-based vs. Rest of Canada (RoC) and Small vs. Large Companies

	Quebec vs. Rest of Canada			Small vs. Large Companies	
	Quebec-based	RoC (*)	RoC	Small <1 million	Large >= 1 million
Total FTE	**327**	**971**	**293**	**546**	**752**
FTE broken down by	**327**	**971**	**293**	**546**	**752**
Full-time	140	945	269	421	664
Part-time	10	18	16	12	16
Freelance	178	8	8	113	73
FTE broken down by region	**327**	**971**	**293**	**546**	**752**
Atlantic	0	7	2	1	6
Quebec	319	52	2	199	172
Ontario	1	723	166	326	398
Prairies	0	43	11	7	36
BC	3	80	46	10	73
Outside Canada	4	66	66	3	67
FTE by business activity (ies)	**325**	**970**	**292**	**546**	**749**
Production, release, promotion and distribution of recordings from masters	72	522	202	252	342
Music publishing	114	24	14	75	63
Distribution of recordings	0	146	18	10	136
Production of master recordings	27	18	4	16	29
Manufacture of ducplicate recordings	4	173	3	104	73
Recording studio operations	5	2	2	4	3
Artist management	17	9	9	10	16
Other sound recording activities	0	17	17	10	7
Other non-sound recording activities	86	59	23	64	81

(*) including the majors participating in the survey

Ratio Analysis by Region

Quebec-based vs. Rest of Canada

	2001					2002				
	Quebec-based	Participation		Participation		Quebec-based	Participation	RoC	Participation	
Revenues	$29,945,653	16	$40,949,915	17		$30,362,228	16	$52,514,903	17	
Production costs	$13,764,120		$10,187,191			$14,053,792		$10,466,642		
Gross margin	$16,181,533		$30,762,724			$16,308,436		$42,048,261		
%Gross margin	**0.54**		**0.75**			**0.54**		**0.80**		
EBITDA	**$2,432,041**	**15**	**$1,715,791**	**15**		**$1,929,456**	**17**	**-$599,650**	**15**	
Revenues	$28,184,522		$38,266,928			$31,328,394		$49,674,222		
EBITDA margin	**8.6%**		**4.5%**			**6.2%**		**-1.2%**		
Interest										
Depreciation and Amortization										
EBT										
Short-term assets	$12,992,233	15	$11,655,777	15		$13,723,169	15	$15,326,025	14	
Current liabilities	$10,398,777		$12,760,180			$11,083,854		$14,394,585		
Working capital	**$2,593,456**		**-$1,104,403**			**$2,639,315**		**$931,440**		
Current ratio	**1.25**		**0.91**			**1.24**		**1.06**		
Total Debt	$14,960,678	16	$12,474,033	14		$15,315,029	15	$22,231,033	14	
Total Assets	$17,897,823		$16,901,948			$18,090,909		$27,292,993		
Debt ratio	**0.84**		**0.74**			**0.85**		**0.81**		
Interest	$ 209,801									
EBITDA	$ 2,617,393									
DA	$ 996,864									
EBIT	$ 1,620,529									
EBIT/Interest	**7.72**									
Interest	$ 209,801									
Liabilities	$ 13,068,169									
Interest/Liabilities	**1.6%**									
	Quebec-based		RoC(*)		RoC	Quebec-based		RoC(*)		RoC
FTE	263	16	878	19	200	263	16	878	19	200
Revenues	$29,945,653		$444,116,915		$40,949,915	$31,328,394		$436,333,903		$52,514,903
Revenue per employee	**$113,862**		**$505,828**		**$204,750**	**$119,119**		**$496,963**		**$262,574.52**

(*) including the majors participating in the survey

Ratio Analysis by Size

Small vs. Large Companies	**2001**					**2002**				
	Small	participation	Large	Participation		Small	Participation	Large	Participation	
Revenues	$6,301,154	14	$64,594,414	19		$9,979,615	17	$72,897,516	19	
Production costs	$4,250,384		$19,700,927			$3,585,611		$20,934,823		
Gross margin	$2,050,770		$44,893,487			$6,394,004		$51,962,693		
%Gross margin	**0.33**		**0.70**			**0.64**		**0.71**		
EBITDA	**-$420,746**	**13**	**$4,568,578**	**17**		**$300,797**	**13**	**$1,029,009**	**17**	
Revenues	$5,801,154		$60,650,296			$10,345,781		$70,656,835		
EBITDA margin	**-7.3%**		**7.5%**			**2.9%**		**1.5%**		
Interest										
Depreciation and Amortization										
EBT										
Short-term assets	$2,743,011	12	$20,119,302	17		$5,117,539	16	$23,931,655	13	
Current liabilities	$2,190,445		$19,565,971			$4,215,972		$21,262,467		
Working capital	**$552,566**		**$553,331**			**$901,567**		**$2,669,188**		
Current ratio	**1.25**		**1.03**			**1.21**		**1.13**		
Total Debt	$2,976,249	13	$22,658,761	16		$5,758,261	16	$31,787,801	13	
Total Assets	$6,264,992		$26,418,523			$7,381,137		$38,002,765		
Debt ratio	**0.48**		**0.86**			**0.78**		**0.84**		
	Small		Large(*)		Large	Small		Large(*)		Large
FTE	158	14	983	21	305	158	14	983	21	305
Revenues	$6,301,154		$467,761,414		$64,594,414	$10,945,781		$456,716,516		$72,897,516
Revenue per employee	**$39,881**		**$475,851**		**$211,785**	**$69,277**		**$464,615**		$239,008.25

(*) Including the majors participating in the survey

Appendix C: Financial Models

Discriminant Credit Models – Altman

Discriminant models assign borrowers to high or low default-risk classes, depending on their observed characteristics. This type of model contrasts with linear probability and logit models, which project the expected probability of default for a borrower.

One such discriminant credit model is that developed by E. I. Altman for manufacturing firms. Altman's model expresses the measure of the default-risk class of a borrower (Z) in terms of several financial ratios: indicators of liquidity, solvency, profitability and activity/production. The higher the value of Z, the lower the borrower's default-risk class.

Altman's discriminant function is: Z= 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 1.0 X5

Where:
X1: working capital/total assets ratio
X2: retained earnings/total assets ratio
X3: earnings before interest and taxes/total assets ratio
X4: market value of equity/book value of long-term debt ratio
X5: sales/total assets ratio

According to Atman's credit-scoring model, a firm with a Z score of less than 1.81 should be classified as high-risk borrower. In fact, it concluded that all firms having a Z score of greater than 2.99 clearly fall into the non-bankrupt sector, while those firms having a Z below 1.81 are all bankrupt. The area between 1.81 and 2.99 is defined as the "zone of ignorance" or "grey area" because of the susceptibility to error classification.

As the original Altman Z model was created for manufacturing firms, a key variable is the market value of equity. Given that the equity of many firms in the sound recording industry is limited to intellectual property or copyright, we substituted book value for market value of equity to gauge impact. The following Z model was derived:

Z'=0.717X1 + 0.847X2 + 3.107X3 + 0.420X4 + 0.998X5

Note: In this variation of the model, X4 = book value of long-term debt ratio.

The appropriate cut-off point for bankruptcy / non-bankruptcy and the grey area are: Z' score < 1.23: bankruptcy; 1.23 <= Z' score <= 2.90: grey area; Z' score > 2.90: non-bankruptcy.
So, we can conclude that, according to this variation of the Atman Z model, a firm with a Z score of less than 1.23 should be classified a high-risk borrower.

Atman's credit-scoring model classifies any firm with a Z score of less than 1.81 as a high-risk borrower. However, as noted in section 8.1, the weakness of this type of financial risk model is that bankruptcy has a legal as well as a financial connotation.

Linear Probability and Logit Models

There are a number of discriminant and logit models that are used to establish the probability of default by lenders.

In contrast to discriminant credit models (discussed above), which assign borrowers to high or low default-risk classes depending on their observed characteristics, linear probability and logit models project the expected probability of default for a borrower,

For example, suppose that there are two observed characteristics of the borrower that explain past default behaviour: profit margin and asset turnover. Now, suppose that the linear probability model for the probability of default for borrower 'i' is represented by the equation Zi = 1- pi, and is estimated as: Zi = 0.45 (profit margin) + 0.2 (asset turnover). If borrower's profit margin equals 35% and its asset turnover ratio is 25%, the probability of default for the firm can be estimated as: Zi= (0.45 * 0.35) + (0.2 * 0.25) = 20,75%, where 0<=Zi <=1.

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Appendix D: Glossary

Term	Definition
Album	A collection of recorded songs/tunes issued together on a medium such as CD or DVD
Artist	Music industry contract term for a musician or performer
Big-box stores	Large-scale, high-volume, multiple-product retail chain stores that sell a limited selection of sound recordings with little or no mark-up (Wal-Mart)
CD	Compact disc
CIRPA	Canadian Independent Record Production Association
CMW	Canadian Music Week
Compilation	Album of previously recorded popular music (*Best of Elvis on Tour*) re-issued and typically commercialized through big-box stores and mass-market retailers (record clubs). Compilations compete for shelf space and consumer dollars with sound recordings by current artists and creative teams.
Copyright	The exclusive legal right of the creators and/or copyright owners (managers, labels) of a creative work to control its use and benefit from the revenues it generates.
Creative content / Creative work	Music, words and, more recently, video creative components, typically commercialized as a sound recording (CD, tape, vinyl) or combined sound and video recording (DVD). Creative content is generally produced by teams of music authors, composers, sound recording engineers and artists/performers.
CRIA	Canadian Recording Industry Association
Current ratio	Current assets divided by current liabilities
Debt ratio	Total liabilities divided by total assets
DRM	Digital rights management
DVD	Digital video disc
EBITDA	Earnings before interest, taxes, depreciation and amortization
Exclusive deal	Contract between content originators (authors, composers), performers, managers and recording companies to promote, distribute and sell sound recordings on an exclusive basis in exchange for legal rights to share in future revenues
Expenses	Costs incurred by a company in the course of running the business, including wages and salaries, rent, equipment depreciation, marketing and administrative expenses, etc.
FACTOR	Foundation to Assist Canadian Talent on Records

Term	Definition
Format	Type of physical or electronic medium in which music is made available (CD, MP3)
FTE	Full-time equivalent. Employment expressed in terms of person years. Excludes purchase-of-service personnel.
Genres / Music genres	Various types of music found in retail distribution (adult contemporary, soft rock, smooth jazz)
Government grant	Government funding with no obligation to repay
Government loan	Government funding with an obligation to repay
Grammys	Annual U.S. awards for excellence in the recording industry
Gross margin	Revenue (sales) minus COGS (cost of goods sold)
Gross margin percentage	Revenue minus COGS divided by revenue
Hybrid online and traditional business model	Business model for sound recording firms that combines online procurement and traditional retail
Independents / Indies	Independent Canadian record labels or sound recording firms
Intellectual property (IP)	The product of original creative endeavour. IP is the principal asset of sound recording firms and, in contrast to physical inventory in the "old economy," it is intangible. Various forms of IP can be protected by patents, copyright, trademarks.
iPod	Portable device combining a digital audio player and hard drive and providing significant (in gigabytes) storage, from Apple
ISP	Internet service provider
iTunes	Online pay-per-download music service for digitized sound recordings operated by Apple
Label	Industry term for sound recording company
Majors	Canadian-based subsidiaries of the five major multinational/ foreign companies: BMG, Sony, Warner, EMI and Universal
MEP	Music Entrepreneur Program. Canadian Heritage financial assistance program administered by Telefilm Canada, which focuses on developing sound recording firms, as opposed to specific projects
MP3	Standard technology format for compressing a sound sequence into a very small file
Music	Composition of tunes and lyrics, which form the creative basis of the sound recording industry
Music venue	Place where a concert is held
Piracy	Illegal copying and/or accessing of sound recordings, typically by downloading from the Web to software files on PC hard drives without permission or payment for creative content
Puretracks	Online pay-per-download music service for digitized sound recordings operated by a consortium of Canadian labels

Term	Definition
Revenue per employee	Total revenue divided by total employees
Revenues	Total amount earned by a sound recording company from the sale of sound recordings and services. Normally expressed net of any discounts or returns by wholesalers/retailers.
RIAA	Recording Industry Association of America
Ringtones	Melodies for cellular phones that are often repurposed/adapted from sound recordings and purchased via online services
SOCAN	Society of Composers, Authors and Music Publishers of Canada. Performing rights collective
Sound recording industry	Group of firms involved in commercial sound recording activities, primarily the following: • Production, release, promotion and distribution of recordings from masters • Music publishing • Distribution of recordings • Production of master recordings (production company) • Manufacture of duplicate recordings • Recording studio operations • Artist management
Star system	Commercial promotion of artists and sound recordings on multiple media platforms such as youth-oriented magazines (*Rolling Stone*), radio and TV programs that promote artists (*Entertainment Tonight*, *American Idol*), theatres, the Web, industry awards, etc. In some cases, these platforms are owned by a single media group. The start system in Quebec is dominated by Quebecor/Vidéotron.
Streaming subscription services	Online music services available for a monthly fee that permits unlimited listening. Extra charge for downloading to personal fixed and mobile devices (PC, iPod).
Subscription services	Online music services available for a monthly fee that permits subscribers to download a specified number of songs/tunes
Value chain	A series of linked business processes that together create value in products and services, generate revenues and ultimately ensure delivery of sound recordings to consumers
VoIP services	Voice over Internet Protocol: In the wider digital communications industry, telephony and information of all kinds, including sound recordings, provided over the Web on a point-to-point basis.

Nordicity Group Ltd.
Le Groupe Nordicité ltée

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