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| Why the Audio CD Is Dying... ...And What Will Replace It | |
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|  | Independent Trend Analysis | Trend Analysis Report |
| | Why the Audio CD Is Dying... And What Will Replace It | |

The Situation

We all know the story

- **Sales of Audio CDs are on a steady decline...**

Sales of music CDs are painfully predictable in their steady decline: for several years now, every year has been worse than the previous in terms of sales, **and it seems extremely unlikely that this tendency will reverse any time soon.**

- **...while paid downloads are increasing (but not enough)**

In the meantime, **legally downloaded music is increasing significantly**, but not enough to make up for the lost business from CD sales.

- **Illegal downloads are perceived as the key culprit**

It is tempting in this situation go for a simplistic analysis of current music-use and blame illegal downloads for the woes that are befalling the record industry. **We believe that this approach is insufficient:** Illegal downloads are certainly a bad thing and don't help, but there is little evidence that peer-to-peer file-sharing actually replaces the buying impulse to the extent that is claimed, **nor have we seen market research that shows with sufficient sociocultural granularity that music users switched from buying to stealing music.** The truth is, we just don't know.

What we do know is that the music business has changed almost beyond recognition, and that these changes are probably only in their early stages.

Are we looking at the wrong issues?

- **The problems may be much more complex**

We believe that the problems the music industry as a whole is facing are significantly more complex than most analysts indicate.

Everything is in flux: How and by whom music is produced, how we find out about it and consume it, how we share it, how the media deals with it—every single aspect of the music ecosystem is undergoing profound changes, which makes it all the more difficult to understand the underlying shifts.

This report examines at **some of the less frequently discussed aspects** of the music industry's Big Bang, deepening ideas and concepts that can be helpful in understanding a revolution that is just getting started.

If you have any comments or suggestions, please let us know: you can reach us at **research@pfeifferreport.com**

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| The Situation | |
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Are We Looking at the Wrong Issues?

Music has always been shared

- **Sharing is human**

Exchanging music is part of our culture, and hopefully it always will be: it is about sharing something we like, and of course it will always be done for free. **Trying to regulate this impulse is not only a truly bad idea, it is also doomed to fail.**

Digital encoding added a world-wide dimension and unprecedented ease to the mix, but there is no conclusive proof that the direct causal link between pirate copying and decreasing music sales is as clearly established as the music industry claims.

Illegal file-sharing is of course part of the record companies' problem, but the real issues are linked to the way digital lifestyle has changed the way we relate to music and use it; **these underlying shifts are the key reason why the audio CD a less and less attractive product.**

- **Of course kids get music where they can**

Let's face it: adolescents never paid much for music. First there was the transistor radio. Then there was the cassette deck, and hours spent taping somebody else's LPs or CDs.

In the seventies, the inner sleeve of vinyl albums in the UK often carried the inscription "Home taping is killing music" to alert unaware music lovers to the impact of making tapes of records they didn't own. Sounds familiar?



About the Audio CD

- **A hybrid product...**

Part of the problems the CD is facing are linked to the fact that it **is a derivative, hybrid product, an intermediary step** between the vinyl record and the digital music file, combining some aspects of the physical carrier, with some of digital content.

While the CD was a giant leap forward in sound quality and portability, it was also a step backwards in terms of physical attraction of the product. The audio CD was a compromise: a product where physical attractiveness was set aside (in most cases) for convenience. That's one of the reasons why Audio CDs are singularly threatened by downloads: they are just not very interesting as a product; even DVDs stand a better chance of survival, since their packaging tends to be more attractive.

- **...and an overpriced one at that**

In addition, the music industry used the high production costs for early CDs as an excuse for significantly raising its price over vinyl records. When CDs became commonplace, the price drop in terms of production costs did not ripple through to the consumer. **Today, production costs of CDs are extremely low, yet store prices of CDs have hardly changed over the years;** recent price-cuts are likely to be too little, too late: today, the issues CDs are facing go far beyond high purchase price.

Physical vs. Digital

- **Surprise, surprise: Attractive products sell better**

We know now that **when facing the competition of digital content, physical products stand a better chance if they are attractive, pleasant to touch and to manipulate.**

It might be argued that Vinyl records would have fared better against the onslaught of music downloads than the CD. **In fact, as a niche product, vinyl records may well survive longer than Audio CDs.**

- **Welcome to the post-digital media world**

The future of media is a rich combination of both digital and analog media instances (See also: *The Emergence of the Post-digital Media Cloud*, Pfeiffer Report on Emerging Trends and Technologies, 2007), and music is no exception. The question will not be "CD or digital download", but which format meets customer requirements best in a specific situation.

The world is moving towards a media environment where digital and physical products will coexist happily and interact, not compete. **In any case, it would be shortsighted to assume that we will just live in front of computer screens without any need for physical materialization of the digital data we own.**

Overlooked Issues

Overlooked Issues

Buying music is a bad experience

- **Customers have to be really motivated to buy music on CD**

Today, the bricks-and-mortar CD store is possibly the worst shopping experience one can have: Rows and rows of identical looking, tightly sealed plastic boxes that show very little information about the product itself. **Finding a specific record in a record store is laborious, sampling the music is difficult if not impossible. Browsing and discovering new records is awkward at best.**

By comparison, even shopping for detergent seems like fun. No wonder the iTunes Music Store is a big success...



- **It's all about the user experience**

Compare any contemporary record store with a book store à la Barnes and Noble, and it becomes clear that downloads are not the only problem the music business is facing. **Greater emphasis is needed on the underlying truth: attractive products sell.**

Compared to CDs, books are sold by their physical, tactile attractiveness: leafing through books is a pleasant experience, and many bookstores encourage customers to sit down and read, even while sipping a coffee. We perceive a book as a enjoyable experience, not a mere information carrier. Which is more than can be said about a CD in a music store. By a long stretch...

The physical representation of music

- **The materialization of music is changing**

Music is the most intangible of the arts, yet the materialization or physical representation plays an enormous role in our relationship with music. **The fact that we are buying fewer and fewer CDs does not mean we have lost the need for materialization of music in general**, nor that the need of material storage of music is coming to an end.

- **We need physical representation of the things we feel strongly about**

We need to have a symbolic representation of the things we are passionate about, and music has developed a complete ecosystem of material and immaterial goods that help us do that. The sound file we listen to is only a small part in this process. A change in delivery methods does not mean that the overall mechanism has been challenged. Image has never been more important in music than today.

- **Profound shifts in symbolic representation**

For the music-business, the situation has become extremely convoluted over the past two or three decades. **In the sixties, the album WAS the music.** It was one of the primary carriers for symbolic representation and identification music fans had; associated merchandise existed, but played a much less important role than today. Even more importantly, music-related media were in their infancy: there was no MTV, no video clips, no MySpace, and the art of merchandising in itself was still very young.

By comparison, the Audio CD plays an almost insignificant role today in the way we relate to music: a band's MySpace page or web-site is probably much more influential in shaping perception of a band or a song than the physical CD one can buy.

- **A shift, not a disappearance of a need**

But we are talking about a shift, not the disappearance of a need. The Audio CD has become an outdated product because it does not play a significant role any more - yet the need for materialization of music remains. We may not miss the physical CD itself in our music experience, but the visual identity it procured is still essential: One of the most popular features of iTunes is the "cover-flip" mode that lets users thumb through the songs on their harddrive interactively, as if going through a stack of vinyl records.



Overlooked Issues

About Ownership

- We need to own, and we need symbols of ownership

Our relationship with music is manifold and complex, and our attitude to owning/paying for music reflects this complexity (see chart): some songs we may find pleasant to listen to at a party, others interesting enough to copy them (twenty years ago we would have recorded them onto a cassette). Others we like enough to go out of our way to get, and finally there will always be some tracks or records that deeply resonate in us and which we would buy over and over again since they carry a symbolic charge for us.

The stronger we feel about music (or any other form of content, like a book or a movie), the stronger will be our need to own it, and also the desire to have tangible proof of ownership. The way we access music will change, but it is unlikely that this basic behavior will go away. Apple's iTunes Music Store owes part of its success to the fact that it was the first to recognize the need to own, even when we are dealing with digital data. (See also: *Think About It: Digital Ownership*, Pfeiffer Report on Emerging Trends and Technologies, 2003)

| Depth of Involvement Matrix: Music | | | |
|------------------------------------|--|---|--|
| Level of involvement | Attitude to cost | Attitude to Access | Attitude to Ownership |
| Accidental consumption | Always free (bars, clubs, parties) | None (Basic like/dislike) | Indifference |
| Casual Appreciation | Casual effort to get, unwillingness to pay | "I'd like to copy that" | Proof of ownership is unimportant |
| Strong Appreciation | Strong effort to get, willingness to pay | "I'll go out of my way to get it, price is not a problem" | Proof of ownership is appreciated but not essential |
| Emotional Attachment | Price no issue, will buy over and over if necessary | "This is essential for me, I want it at my disposal at all times" | Proof of ownership is essential and source of satisfaction |

Overlooked Issues

Why digital is bad for business

- **Digitization decreases perceived value**

The perceived value of digital content has a tendency to approach zero. This applies to music, but also to other content, such as photos, videos. We have great difficulty in perceiving value in an immaterial file that can be duplicated at will without degradation.

Digital files are convenient, but convenience is not value: convenience is expected ease of access. There is little doubt that we see less value in a folder of mp3 files on our hard drive than in a CD with a printed booklet, and less in a simple CD in a jewel case than in a collectible limited edition box set.

Physical qualities sell

- **Tactile richness enhances perception of value**

Subconsciously, we associated tactile qualities with value. A paperback book with an embossed text or metallic imprint is perceived as more attractive than plain four-color printing. Book-publishers have been using these tactile qualities for decades to make their offerings stand out, and while some attempts to do this with Audio CDs exist, the vast majority of music CDs are anonymous looking jewel boxes.

- **Value schemes are changing profoundly.**

Consumers generally have no problem paying for something if there is perceived value. The problem in the merging post-digital media space is that value schemes are changing dramatically, and that we do not see value in the same things we used to. The good news is that in the end we will figure it out.

From ubiquity to uniqueness

- **Ubiquity breeds a need for scarcity and exclusivity**

As digital content becomes increasingly prevalent, its ubiquity is the single most important factor to decrease perceived value. Once the first excitement of being able to access any song in a music library subsides, it quickly becomes the new status quo: it's no longer an exceptional possibility, but a convenience we take for granted.

On the other hand, ubiquity creates a need for scarcity: As we are immersed in all sorts of constantly available content and information, we increasingly seek out scarce and rare experiences and objects.

Uniqueness will become an increasingly strong selling point: Collectible items are selling increasingly well. Limited edition objects, books, special edition items will become a central form of music materialization. **When ubiquity is free, uniqueness fetches a premium.** This trend is likely to explode in the music business, and limited edition merchandise will become a growing revenue stream.

Short-Term Recommendations

Forget DRM

- **Digital Rights Management is dead**

DRM for music is not going to last. Much has been said for and against DRM, and there is no need to warm up an already stale debate.

Embrace a DRM-free music environment. Music producers must get used to this new world: in the end it will make the life of music producers easier, not more difficult.

Reinvent the music carrier

- **Growing numbers of downloads do not mean there is no room for physically stored music any more**

Yes, music downloads are growing steadily, while CD sales are decreasing. **But convenience isn't everything.** Once consumers have a real choice, many of them will realize that not having to think about storing and managing downloaded files has its benefits too.

In its current form, the CD is a dying product. But the format has some very substantial advantages: Ubiquity of reading devices, universally accepted format, high audio quality, to name a few. Just because the CD in its current form looks painfully "has-been" in the light of music downloads does not mean that "music-carrying objects" are a thing of the past.

Think about it: there is the music you may want to own in a slightly more reliable format than your computer hard drive. And then there are gifts of course, and special editions, and collectibles. **In short, there are many occasions when a re-invented music-carrier makes enormous sense.**

And once you have gotten used to the idea of a DRM-free world, perhaps a CD that comes with a code to download the songs to your computer, complete with lyrics and cover art, is not such an outlandish idea after all. Or with a download service that will make sure you get your music back even if you crash your hard drive...

In the end, it will all be about the experience, rather than the object. **But that experience will contain physical as well as digital components. Both are essential. Neither will go away.** The more one embraces this basic dichotomy of music-related products, the better one will fare in the market.

Don't fight digital, think physical

- **Rethink music materialization and representation**

Re-invent music merchandise. Rethink how fans can identify with their favorite groups and singers. If the CD doesn't carry the load any more, what does? Which object will give a fan the impression of belonging to a special group?

But don't get stuck in the details: rethink the music environment, and take it from there. **You can't beat the convenience of digital, but you can deliver a physical experience nothing digital can ever reach. It's time to think outside of the (jewel)-box.**

Mid-Term Recommendations

Re-invent music buying

- **Reinvent the music store**

Rethink the music ecosystem as a whole. **CD sales may be down, but music-related spending isn't.** Reinvent the music-store. The music store needs to be a place that is cool, accessible—fun, in short, the best place to be if you are into music: a lounge, coffee bar, even a nightclub.

- **Make it easy and pleasant to discover music**

Make it easy to locate and to listen to CDs. **Any CD on any shelf.**

Most consumers are not yet aware of it, but there is a considerable difference in quality between most MP3 files and an Audio CD. **Make the listening equipment such that consumers can actually tell the difference between an MP3 file and a CD.**

Let your customers **experience the music.**

- **Don't fight the on-line world**

Instead of fighting iTunes, embrace it. Have computers available where you can browse the web, listen to samples, connect to MySpace or YouTube, even download music.

- **Deliver a unique experience**

Let people have a coffee while they listen to a pile of CDs. **If Starbucks can produce music, music stores surely can sell drinks and pastries.** Make the music store cool enough to meet a date there, a place one enjoys hanging out in.

- **Make the music store a lifestyle experience**

Music is about lifestyle. Make the store a lifestyle experience and see what happens. Sell all the add-on merchandise you can imagine, but in a way that makes sense for your audience. Make it the best place to find out cool stuff about the musicians you like.

And while on the subject of lifestyle: make specialist stores for specialized audiences.

In a nutshell...

- **Rather than competing with the iTunes and Amazons of this world, focus on bringing your customers what no online service can deliver: a true post-digital music experience.**

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