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The Death of DRM
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Between 1999 — the height of the "illegal" download, Napster era — and 2006, music sales in Canada fell 47%, to $700 million from $1.4 billion. To some businesses the slump proved fatal, driving into bankruptcy iconic retailers like Sam the Record Man and Music World. Survivors, like the major record labels, were thrown into a frenzy of finger-pointing while they sought ways to reverse declining revenue trends. "When you're losing 50% of your market, desperate times call for desperate measures," says Graham Henderson, president of the Canadian Recording Industry Association.

For music labels "desperate measures" meant encrypting CDs and digital downloads with digital rights management (DRM) protection. CDs had copy-protection DRM (like DVDs today) and digital downloads were encrypted with DRM that limited how the music could be played; what worked on your computer might not transfer onto your iPod or other portable music devices. The four major music publishers — Sony BMG, Warner Music Group, Vivendi's Universal and EMI — embraced DRM as a necessary evil to protect revenue. Now, five years later, and within months of one another, they've all abandoned DRM.

"DRM was an attempt to combat piracy, but as a business tactic it failed miserably," says Michael Goodman, director of digital entertainment at Yankee Group in Boston. "It was a knee-jerk response by the music industry that did nothing to prevent piracy and frustrated consumers."

While all four labels refuse to comment on how much was spent on DRM development and implementation — partly because DRM is always rolled into other software platforms and not sold in isolation — Goodman estimates it's "in the millions." (All four labels refused interview requests for this story; Warner cited "regulatory processes for various acquisitions" while EMI said it was "in the middle of a very significant reorganization.")

DRM-protected digital downloads took off in April 2003 when Apple launched its iTunes store, creating the first "legal" marketplace for downloadable music with content from all four labels. Within four months, Apple sold nearly 10 million songs at 99 cents each, all encoded with Apple's in-house DRM, FairPlay. In September 2003, Dell launched a service similar to iTunes, the now-defunct MusicMatch, using Windows Media DRM, another proprietary technology.

In most cases, DRM was delivered by market-leader Akamai Technologies (NASDAQ:AKAM), which provides the backend security and delivery (promotional and paid content) for iTunes, Napster, Sony and others. Tim Napoleon, chief strategist for Akamai in San Francisco, says he accepts the death of music DRM. "It's great news for us. It means bigger demands for content, which we deliver, and we provide backend security. We're now delivering to a much larger market that more than makes up for any losses we might incur with a decline in DRM licenses."

In 2007, Akamai's net profit margin rose more than 15%, with total revenue of US$636.41 million. "Akamai benefits as demand for online content increases," says Steven Freitas, director of equity research at BMO Capital Markets. "They enforce the technology used to deliver content; whether or not it comes with DRM makes no difference."

What prompted the sudden exodus from DRM? "It's all about competing with Apple," says Michael Greene, research associate at New York-based Jupiter Research. By the time the labels embraced online music, Apple had already set up shop; it was Apple, not the labels, who called the shots online. "Apple dictated the terms — 99-cent songs — and the labels had no say; they'd lost control of their business." Now, only EMI is selling DRM-free music through Apple's iTunes Plus site (the original iTunes still sells DRM-protected music from all labels); the rest, including EMI, have removed DRM from their entire back catalogues but only for sale on Amazon.

"[The labels] hope DRM-free music will increase sales, but they know it won't reverse the downward trend," says Larry Witt, an equity analyst at Morningstar who covers Warner Music (NYSE:WMG), the only publically traded, pure-play music company of the four majors.

“Over time you might see a return to revenue growth, but that will take years.”

Still, digital music sales are up. Four years ago, Warner had virtually no digital revenue; now, in Q1 2008, digital revenue represents 14% of total revenue. “We’ve definitely seen a positive impact on the sale of full albums since introducing DRM-free downloads a year ago,” says a source at EMI who requested anonymity. "The first week we launched on iTunes Plus, sales of the Pink Floyd album *Dark Side of the Moon* jumped 350%." Still, overall revenue continues to decline, from US$3.5 billion in 2006 to US$3.4 billion in 2007, a loss of 3.7%.

Could the music industry’s downward sales spiral have been avoided, or at least slowed, if the labels had removed DRM sooner, say five years ago? “We’d still be in the same spot as far as revenue is concerned,” says Witt. “They should have done it eight years ago at the height of the Napster era, before music lost its perceived value. Back then, if you’d offered an easy, inexpensive way for people to buy music online, they would have done it. Now, it’s too late. The horses are out of the stable.”

While Witt rates Warner’s stock a Buy, calling the company a "relevant player,” other media analysts, such as Rich Greenfield at New York-based Pali Research, aren’t as optimistic. He cites as a bad omen the company’s 50% drop in share price since November 2007. In his report, Greenfield added, “Although the fundamentals in the music industry are weakening, Warner Music's market share gains might restrict the downside risk to the company's share price in the near term." For this reason, Greenfield recently upgraded Warner stock to Neutral from Sell.

Greenfield's position is slightly rosier than his late-2007 report, which noted "an increasing majority of worldwide consumers simply view recorded music as free." Case in point: Radiohead's pay-what-you-can digital album, *In Rainbows*. According to U.S. research firm ComScore, 62% of those who downloaded the album paid nothing.

While Warner stock ebbs and flows with music industry trends, its more diversified competitors — Sony, Universal, EMI — barely feel the change. "Music is the pimple on the backside for these companies," says Duncan Stewart, president of Duncan Stewart Asset Management Inc. in Toronto. "Their stocks trade on technology, not content."

Meanwhile, Apple (NASDAQ:AAPLE) — with total 2007 revenues of US$24 billion — continues to perform well despite Amazon's inroads. "It's too much to say this won't affect Apple's stock at all," says Rick Hanna, equity analyst at Morningstar in Chicago, who gives Apple a Buy rating. "Even though Apple is now the second-largest music retailer in the U.S., second [and now No. 1, according to recent Apple figures] only to Wal-Mart, the majority of revenue comes from hardware [the iPod, iPhone, computers]."

Sales of iPods will likely reach US$51.1 million this year, and as Apple moves into movies and games — both of which still use DRM — Hanna doesn't see any changes to Apple stock "at least as far as music content is concerned." Meanwhile, he adds, the company — with total 2007 revenues of US$24 billion — is on track to sell 45 million iTunes-enabled iPhones by the end of the year.

So even as the majors continue to pressure Apple by refusing to license their DRM-free music, the iPod nevertheless represents a staggering 80% of worldwide digital music player sales, and iTunes remains the dominant media playback software. In the face of this reality, propping up DRM has proven to be a fool's game with the labels having taken a bite not out of Apple's fortunes, but their own.