

# An Alternative Operating Model for the Record Industry Based on the Development and Application of Non-Traditional Financial Models

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## I. INTRODUCTION

Is the well drying up for record companies? Are the days of monster profits coming to an end? What alternatives do record labels have, and where do they go from here?

Traditional recordings<sup>1</sup> made available by the music industry to the marketplace have steadily declined each year since 1999.<sup>2</sup> During the same time period, sales of digital downloads, both in single and album formats, have risen year over year.<sup>3</sup> The trend is not a secret, nor is it a surprise to the music industry and the record labels. This paper will propose a novel financial model, which advances a transformation to a

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<sup>1</sup> Traditional recordings include, *inter alia*, compact discs, compact disc singles, cassettes, and cassette singles.

<sup>2</sup> RIAA.com, Recording Industry Association of America 2005 Year-End Statistics, <http://www.riaa.com> (last visited May 1, 2007).

<sup>3</sup> *Id.*

sustainable structure for the record industry in light of the current sales trends.

Few financial models serve as roadmaps or templates for future models. Understanding what hedge funds, private equity funds, and insurance products are and how they operate provides a basis for developing a new financial operating model for the recording industry.

As a result of technological advances and the availability of affordable, powerful personal computers, the barriers of entry into the music marketplace have all but been removed for recording, producing and manufacturing musical recordings. Musicians can create, record and produce their own recordings using computers and recording equipment that they own, essentially creating their own private studios. Furthermore, musicians can then make their digital recordings available to their fans without encountering many of the obstacles that existed before the advent of affordable technology. The low barrier of entry into the music marketplace, coupled with numerous digital music services, leads to musicians being more “discoverable” today than at any other time in the past.

What if a financial vehicle, akin to a hedge fund, private equity fund, or insurance product, were created whereby a musician’s intellectual property (“IP”) is acquired and placed in a portfolio similar to those found in conventional financial products?

This paper begins by exploring the history of the hedge/private equity fund, insurance and music industries. The formation and structure of traditional funds will be discussed, and these products will be distinguished from the financial model proposed in this paper. Additionally, the valuation methodology of the IP will be explored by looking at a couple of valuation processes (e.g. predictive or regressive modeling). Ultimately, this financial model can be used as an alternative operating method for the record industry as it struggles to adapt to future business and technological developments.

## II. BACKGROUND

### A. *Hedge funds*

The definition of “hedge fund” is not found in federal or state securities laws, nor is the term defined by the industry.<sup>4</sup>

Since hedge funds do not register with the Securities and Exchange Commission (“SEC”), their actual data cannot be independently fol-

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<sup>4</sup> HedgeCo.net, *Hedge Funds: What is a Hedge Fund?*, <http://www.hedgeco.net/hedge-funds.htm> (last visited May 1, 2007).

lowed; therefore hedge fund data is self-reported. There are over 9,000 hedge funds in the U.S. today. Hedge funds are estimated to manage \$1.3 trillion in assets. Estimates of new assets flowing into hedge funds exceeded \$25 billion on average for the last few years. The term “hedge fund“ is loosely defined and does not always imply a hedging technique is being used. Hedge funds today employ all different types of strategies, and the appropriate description could simply be conveyed as ‘any unregistered, privately-offered, managed pool of capital for wealthy, financially sophisticated investors.’<sup>5</sup>

Just after World War II, *Fortune* magazine hired sociologist Alfred Winslow Jones to write an article.<sup>6</sup> His task was to research and develop forecasting models for the stock market.<sup>7</sup> As Jones became more and more involved with the project, he began to develop the concept of an investment fund.<sup>8</sup> Before his article was published, Jones set up an investment fund with himself as general partner. The fund was designed in such a way that the long positions in undervalued equities would be offset by short positions in others. This ‘hedged’ approach allowed him to leverage the capital so that large wagers could be made with limited resources. Jones also invented the idea of the “performance fee” that was tied to profits and gains.<sup>9</sup>

However, Jones’ greatest notoriety stems from his innovation that specific limited partnerships, if structured correctly, are exempt from regulatory control under the Investment Company Act of 1940. This exemption allows managers to utilize techniques, such as leverage and short-selling, which typically binds other mutual funds and investment companies. Consequently, many copy-cats mimicked the fee structure, but not the “hedge” mentality and philosophy that Jones inspired. It was not until another *Fortune* magazine article, in 1966, which branded the market-neutral strategy that Jones designed as a “hedge fund”.<sup>10</sup>

#### B. *Private equity funds*

Another type of financial product that the recording industry can look to as a model is the private equity fund.

Private equity funds are the pools of capital invested by private equity firms. Although other structures exist, private equity funds are generally organized as limited partnerships which are controlled by the

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<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

private equity firm that acts as the general partner. . . . The limited partnership is often called the “Fund,” and the general partners are sometimes designated as the “Management Company” (although, at times, that is a separate company affiliated with the general partner). The fund obtains capital commitments from certain qualified investors, such as pension funds, financial institutions and wealthy individuals to invest a specified amount. These investors become passive limited partners in the fund partnership.<sup>11</sup>

Private equity investments in 2005 reached \$135 billion. Private equity fund raising in 2005 totaled \$232 [billion], up three-quarters from 2004.<sup>12</sup>

### C. *Insurance*

In the United States, the insurance industry has existed for centuries. Insurance is defined as “a contract (insurance policy) in which the insurer (insurance company) agrees for a fee (insurance premiums) to pay the insured party all or a portion of any loss suffered by accident or death.”<sup>13</sup> In the case at hand, the loss would not be accident or death, but rather the loss attributed to the lack of return produced by certain IP compared to the general pool of IP making up a fund portfolio.

## III. DISCUSSION

One way to think about online distribution is as changing the shape of the expected-value lottery from the perspective of the aspiring musician. A kind of caricature of the old model might look something like this: You’ve got a large probability of either never catching on, or perhaps breaking even and covering your production costs, a small probability of enjoying some moderate success, and a tiny probability of hitting the jackpot and becoming a massive cash cow. So the economic component of someone’s decision of whether to devote time and resources to making and distributing music consists of a lottery over those outcomes.<sup>14</sup>

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<sup>11</sup> Private Equity, at <http://www.answers.com/topic/private-equity> (last visited May 1, 2007).

<sup>12</sup> *Id.*

<sup>13</sup> Law.com, Legal Dictionary: Insurance, <http://dictionary.law.com/default2.asp?selected=990&bold=|||> (last visited May 10, 2007).

<sup>14</sup> Posting of Julian Sanchez, Notes from the Lounge, You Mean. . . I’m Not Getting Paid For This? [http://juliansanchez.com/notes/archives/2007/04/wait\\_you\\_mean\\_im\\_not\\_getting\\_p.php](http://juliansanchez.com/notes/archives/2007/04/wait_you_mean_im_not_getting_p.php) (last visited May 11, 2007).

The fund will purchase a diverse portfolio of artist IP with the goal that some proportion of the portfolio becomes popular.<sup>15</sup> In turn, if a share of the songs or artists become popular, the overall risk is diminished compared to an artist who acts alone.<sup>16</sup> As artist IP is consolidated into a diverse portfolio, the cumulative risk of the pool, as a whole, is reduced. This strategy is analogous to the strategy used in assembling traditional investment portfolios. In a traditional portfolio, some investments are riskier than others. However, taken cumulatively, high-risk investments assembled alongside less risky investments mitigate overall risk. The biggest payoff is smaller, but the probability of at least being able to cover your costs for a release is higher.<sup>17</sup>

The financial product proposed in this paper exhibits some of the characteristics of a private equity fund. As such, the product is structured as a private venture, in the form of a limited partnership. Control and management of the fund vest with the limited partnership's general partner. The general partner is typically an entity that organizes and establishes the fund. At the onset, the general partner's primary task is to raise capital by soliciting investors. Although private equity funds are loosely regulated, typically entities that invest in these funds are accredited investors. The investors in the fund become the limited partners of the partnership. Limited partners do not take part in the management or control of the fund.

The general partner charges a performance and management fee for performing its duties. Furthermore, a "high watermark"<sup>18</sup> is tied to the performance and management fees.

A hedge fund manager may receive several forms of compensation. The manager often receives a performance allocation equal to a percentage (usually 20%) of realized and unrealized appreciation of the hedge fund's assets payable on a yearly basis. In addition, the manager typically receives a management fee equal to a percentage (usually 1% annually) of assets under management, which may be payable quarterly or monthly. When two management entities are used, ordinarily the general partner receives the performance allocation, and the management company receives the management fee. In such instances, the management company is responsible for paying the hedge fund manager's overhead expenses (e.g., rent, furniture, equipment) and employs

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<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> "This means that the manager does not receive incentive fees unless the value of the fund exceeds the highest net asset value it has previously achieved." Hedge Fund, [http://en.wikipedia.org/wiki/Hedge\\_fund](http://en.wikipedia.org/wiki/Hedge_fund) (last visited May 10, 2007).

the manager's personnel. The general partner, however, should not employ any personnel and be solely responsible for managing the hedge fund's assets.<sup>19</sup>

Once the fund is established and the general partner raises equity, the general partner must assemble and manage the fund's portfolio. Typically, a private equity fund's portfolio is made up of securities<sup>20</sup> that are not traded or listed on any public exchange. The portfolio of the financial product that is proposed here consists of musicians' intellectual property that the general partner acquires on behalf of the fund. Most importantly, what distinguishes this product from a traditional private equity fund is the composition of the portfolio.

A portfolio comprising artist IP is a novel concept. How should the portfolio be assembled? There are numerous factors that will impact the make-up of the portfolio. Music genre, music preferences by geographic region, and current pop-culture trends and tastes, will all have an impact on the portfolio's composition. MySpace alone lists sixty-six different searchable music genres, while iTunes lists twenty.

#### A. *Record company functions*

Most record companies are large corporations that own a number of record labels.<sup>21</sup>

"These corporations usually consist of a parent company that owns more than one record label. In today's economy, most large record companies are actually huge conglomerates that own a variety of subsidiary record labels. Often, the subsidiary labels are each mini-companies operating under the umbrella of the larger corporation."<sup>22</sup>

A record label is made up of a number of departments.<sup>23</sup> A record label will typically have the following departments: A&R (artist and repertoire), Graphic Art Department, Artist Development, Business Affairs, Label Liaison, Legal, Marketing, Promotion, Publicity and Sales.<sup>24</sup> (see table 1)

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<sup>19</sup> Forming a Hedge Fund, [http://www.hedgefundworld.com/forming\\_a\\_hedge\\_fund.htm](http://www.hedgefundworld.com/forming_a_hedge_fund.htm) (last visited May 1, 2007).

<sup>20</sup> The test for a "security" is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others so that whenever an investor relinquishes control over his funds and submits their control to another for the purpose and hopeful expectation of deriving profits therefrom he is in fact investing in a security. Black's Law Dictionary 1355 (6th ed. 1991); *Investment Co. Institute v. Camp*, D.C.D.C., 274 F.Supp. 624, 642.

<sup>21</sup> Allison Klein, *How Record Labels Work*, <http://entertainment.howstuffworks.com/record-label.htm> (last visited May 7, 2007).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

TABLE 1 FUNCTIONS OF A TRADITIONAL RECORD LABEL<sup>25</sup>

Department	Functions of a Traditional Record Label
Artist and Repertoire (A&R)	Discovering new talent Signing new talent Assisting artist with song selection Arranging album/song production Arranging and selecting studio selection
Art Department	Creates album artwork Creates advertisements Creates displays at stores
Artist Development	Develops the careers of the artists Assists with artist promotion and publicity
Business Affairs	Runs the business operations
Label Liaison	Serves as a liaison between the record company and the distribution company
Legal	Handles all legal issues and tasks
Marketing	Manages overall marketing for each album
Publicity	Publicizes new and established artists by getting articles in newspapers and magazines and getting artist's interviews on radio and TV
Promotion	Promotes artist to radios to get radio airplay
Sales	Coordinates the retail facet of the record business Coordinates with Promotion, Publicity, Marketing

In the traditional model, there are nearly a dozen functional departments in a record company. Each department must be funded, and these funds come primarily from one source: record sales.

#### Record Labels and Hedge Funds

At a typical record label, the success of each artist affects the overall success of the label. But in a Private Equity IP Fund, the portfolio is assembled by assigning different IP an individual risk rating. Therefore, the portfolio can be assembled to address different investment strategies. A fund can be formed as a high-growth, high-risk fund or, as a low-growth, low-risk fund. A middle ground fund could be created by mixing high-risk and lower-risk IP.

Revenue generated by the IP fund will not be distributed to the many departments that make up a traditional record company. If the IP fund is adopted, the nearly dozen departments of a traditional re-

<sup>25</sup> *Id.*

cord company can be whittled down to four functional departments. (see table 2) This is possible because many functions of the conventional record label are eliminated or consolidated. For example, artist development and art department are completely eliminated because individual artists can now perform this function. The distribution function is also greatly reduced as physical copies of the music are no longer created. Since physical recordings are not created and reproduced *en masse*, the supply chain, including movement of the physical recordings to brick-and-mortar stores, is significantly reduced. Additionally, promotion of artists to radio stations to get radio airplay can be eliminated because it is no longer a viable expenditure or function.

Music can now be discovered in a variety of ways. The radio is no longer the ultimate place where musicians strive to be heard. Services such as Pandora<sup>26</sup> and Musicoverly,<sup>27</sup> along with other internet radio outfits and social network services such as MySpace and Facebook, make artist exposure widespread and artist discovery more frequent than via yesteryear's radio-airplay model. Ultimately, it is not just the fans who can use the internet to discover musicians. The IP fund discussed in this paper would identify potential IP by scouring these sites.

TABLE 2 FUNCTIONAL DEPARTMENT OF A PRIVATE EQUITY MUSIC IP FUND

Department	Functions of a Private Equity Music IP Fund
Fund Manager/General Partner	Creates the Fund Raises the initial capital by attracting investors Runs the business operations
Portfolio Management	Discovers new talent Assembles portfolio by purchasing IP from artists or obtaining exclusive license of IP from artists Manages online distribution by coordinating with online retailers
Marketing	Manages overall marketing for the portfolio Publicizes and promotes new and established artists (used to be Publicity function) Coordinates with Promotion, Publicity, Marketing (used to be Sales function)
Legal	Handles all legal issues and tasks

<sup>26</sup> Pandora, <http://www.pandora.com>.

<sup>27</sup> Musicoverly, <http://www.musicoverly.com>.

Money saved by eliminating traditional record label functions can be used to focus on promotion and marketing the artist IP portfolio. As the promoted artists generate revenue, the value of the fund increases. In turn, as the value of the fund goes up, the value of the investments increases.

## B. *Valuation*

In order to determine the value of a musician's IP, business analysts would need to develop an appropriate mathematical model.

"Any valuation model for IP assets must take into account both business parameters and legal issues. The effect of legal considerations on business projections is key to deriving a quantitative value for IP assets."<sup>28</sup>

In developing a valuation model or formula, there are many independent variables that need to be identified to determine the value of the IP (in this case, the dependant variable).

A formula must include variables for the strength of the asset and the projected market and how the strength of the IP extends or maintains or reserves market share over the life of the IP. The formula may also take into account the state of development of the business which the IP protects. . . . This increase in value stems from the increase in the value of the underlying business and arises as an increase in net present value of the business.<sup>29</sup>

IP valuation consists of an interdisciplinary work drawing upon the understanding of technology, law, economics, finance, accounting and investment. In the case at hand, some of the independent variables that need to be considered include the following:

- Music genre
- Artist skill level
- Artist technical music knowledge
- Geographic origins (Where is the band from? Is a "new scene" developing in this area?)
- Current trends in popular music
- Current cultural factors
- Innovation in sound (creating a new "sound")
- Artist creativity
- Lyrical strength
- Past sales
- Exposure (TV, radio, live, internet, film)

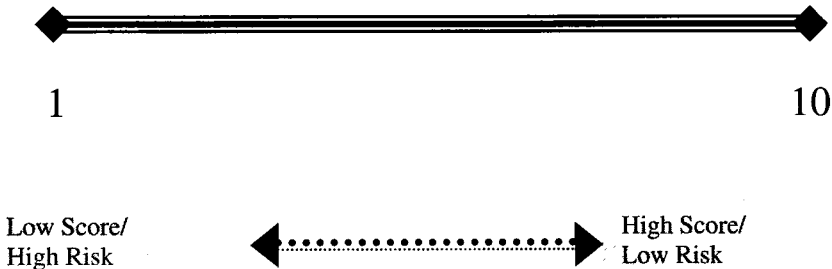
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<sup>28</sup> Valuation Model, <http://www.patentassets.com/valuemodel.htm> (last visited May 8, 2007).

<sup>29</sup> *Id.*

- ▶ Web presence (websites, social network pages, etc; need to be verified)

This list is not exhaustive by any means. It is just the preliminary list of independent variables required to develop the valuation formula in this model. Information related to each variable would need to be collected and the data comprehensively analyzed in order to develop the formula to evaluate the IP in the fund portfolio. From this formula, an investment spectrum would be created where one pole represents IP with a low score or value, while the other pole represents IP with a high score or value and is thus worth acquiring. Acquiring IP with a low score represents high-risk investment, while acquiring IP with a high score represents low-risk investment. (see below)



The fund manager evaluates various IP and assembles a portfolio. Artists that are not popular would be willing to part with their songs and IP rights because they would not otherwise be able to make a return on these assets without expending massive energy on promotion. The cost to an independent unsigned artist would outweigh the benefit to undertake this endeavor. However, if a fund manager were to assign a value to an artist’s IP, the artist may be receptive to parting with his or her IP rights because the cost/benefit would be a fair exchange for the artist.

#### IV. CONCLUSION

While traditional music sales have been on the decline, the sales of digitally downloaded music has been on the rise. One of the major contributing factors to this trend is the advent of affordable recording technology and the availability of affordable powerful personal computers. At the same time, the barrier to entry into the music marketplace has been significantly diminished. Musicians are able to record, produce and distribute recordings absent the help of recording compa-

nies or record labels. This in turn has allowed the musicians to make their digital recordings available directly to their fans.

Forming and managing private equity funds that invest in musicians' IP (through purchase or license) is a viable alternative operating structure for the record industry. The flexible, dynamic and diverse characteristics of a private equity fund and the low barrier to enter the marketplace for individual musicians, taken together with the numerous digital distribution channels and virtual "venues," can reinforce the record industry's move towards this sustainable operating model.

The recording industry has been around for well over a hundred years. It evolved by adopting new technologies and responding to consumer trends and tastes as well as artistic progression and development. If the recording industry begins to implement alternative operating strategies, it will continue to evolve and attract a future generation of music consumers.

