MUSIC DISTRIBUTION IN CANADA

***PREPARED FOR*:**
DEPARTMENT OF CANADIAN HERITAGE

***BY:* LARRY LEBLANC**

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INTRODUCTION

This paper was prepared for the Department of Canadian Heritage Sound Recording Policy and Programs Directorate in 2002-2003. The purpose of this document is to provide a profile of the English and French-language components of the Canadian music distribution industry, and to identify principal issues facing the industry in order to help Canadian Heritage gain a better understanding of the distribution sector.

This paper is based on a wide review of existing documentation, secondary research as well as analysis and findings drawn from a series of 25 interviews conducted by Larry LeBlanc in the Fall of 2002 as the principal source of primary research. The list of interviews is included in Appendix 1.

The report is divided into four sections: Among the areas covered are the roles of distributors in Canada; an overview of retail and its practices in Canada; opportunities for the distribution of Canadian music internationally, and the developing dot.com world which is greatly reshaping music distribution.

The final section of this report reflects the findings reached concerning music distribution in Canada. It identifies key issues common to the industry as a whole, and proposes measures that appear likely in strengthening the distribution of Canadian music domestically and internationally.

EXECUTIVE SUMMARY

From the documentation, interviews and secondary research presented in this report it is evident that distribution plays a pivotal role in developing and marketing the musical works of Canadian artists and labels.

Distributors comprise those organizations involved in distributing product from the labels to the retailers or sub-distributors. They generally obtain rights to exploit catalog for a product for a defined period of time, and market and sell the products. The chief advantages of using a distributor is that it is organized to handle the time and costs of financing and administering the production, manufacture, marketing and distribution of recordings. It can also better absorb any financial risks, and has greater leverage in collecting from retailers and wholesalers.

From the interviews and analysis presented, it is evident that while the five foreign-owned multinationals based in Canada have made significant investments in developing Canadian talent, their core activity is maximizing the sale of products made by their parent and fellow affiliates.

Since the multinationals control their own distribution channels, and distribute both their own recordings, and those of Canadian-controlled record labels and production companies, they clearly dominate Canada's recorded music market.

In contrast to other parts of Canada, Quebec has a more centralized music industry with distribution of domestic, primarily French-language product, commanded by a single distributor/retailer, Groupe Archambault; and production dominated by some 50 independent French-language labels and production companies, of which 20 are significant.

Canada's independent distribution sector is an integral component of Canada's music culture. Independent distributors--along with Canadian independent labels and smaller retail outlets--give a voice to Canadian artists who might not have an outlet otherwise.

However, since the mid-'90s, according to several interviewees, fierce A&R competition from multinationals has hindered Canadian independent distributors and Canadian labels in attaining new acts. Also according to several Canadian independent distributors, multinationals have recently been more aggressive seeking out foreign-owned independent labels for distribution in Canada. This is a concern to Canada's independent distribution sector because access to foreign product is core to their businesses.

Interviewees generally contend that independent labels and independently-released artists are unable to competitively operate in the mainstream retail market in Canada largely due to the substantial and rising costs related to distribution, retail positioning and related marketing campaigns. They also cite inventory cutbacks at most major Canadian retail chains in the past 18 months, particularly HMV's move to centralized buying and marketing, as providing lessened opportunities.

With so few record store chains in Canada, major retailers have considerable bargaining power with record companies and distributors. Since labels and distributors must ensure that their albums are visible in retail stores in order to gain consumer awareness and sales, they usually meet retailers' growing demands. As a result, retail marketing has become significantly more expensive today because distributors and labels pay for advertising, promotional campaigns and product positioning with most major retailers.

Sources generally concur that the Canada Music Fund's Music Entrepreneur Program (MEP) may lead to the domestic music sector achieving greater strength. However, many criticize the lack of involvement of independent distributors in participating in the development of government-run programs. As well, they stress greater weight than in the past should be given to the marketing of recordings.

For Canadian-based record companies--from multinationals to independent labels--success internationally over the past decade by Canadian artists, coupled with increasingly working within the U.S. radio and tour market, has meant an appreciable expansion in opportunities. It is in the interest of Canadian-based companies to have their masters released in foreign territories because substantial profits may be earned from many major markets.

Whereas multinationals have the resources and the inter-company structures to launch acts internationally, Canadian independent labels rarely have the resources or market clout to do so with consistency. Nor are they often able to promote recordings abroad in continual support of a foreign licensee.

While retail stores are still the bulk of music sales today, a new dot.com world is developing which is expected to greatly reshape the distribution of music. Many within the independents sector are concerned that this may eventually lead to strengthening the multinationals' hold on distribution even further, presenting independent artists with even greater access challenges. Meanwhile, downloads, subscription and non-subscription services, digital radio, and interactive music sites are creating new ways for music to be widely known.

SECTION 1: DISTRIBUTION IN CANADA

i) Overview

Distributors comprise those organizations involved in distributing product from the labels to the retailers or sub-distributors known as rack-jobbers. They generally obtain rights to exploit catalog for a product for a defined period of time, and market and sell the products. Their role is to market and sell the products to maximize the financial returns. Among functions a distributor may assume include: advising and guiding labels on matters ranging from artistic creation to marketplace development and promotion.

Recordings are also distributed by licensees, like Columbia House - which sign a license agreement with a record company, direct mail, and television advertisers. These agreements allow the licensee to manufacture and distribute recordings, as opposed to buying and distributing goods manufactured by the record company.

The chief advantages of using a distributor is that it is organized to handle the time and costs of financing and administering the production, manufacture, marketing and distribution of recordings. It can also better absorb any financial risks, and has greater leverage in collecting from retailers and wholesalers. Additionally, a distributor may have a reputation in the retail community for a certain genre of music aimed at a more narrow and focused audience, such as jazz or electronica.

> *"(Independent labels or artists) need an organized distributor with enough (sales) volume to do all the basic stuff, and is healthy enough to grant credit. That's the basics of distribution. But indie distributors don't have the manpower to do the things that need to be done." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS*

> *"We are in the age of pricing and positioning. I can afford to put Faith Hill within 10 feet of the door in any store in this country. Can an indie label do that with their product?" STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA*

> *"We are with EMI out of necessity. We don't have what it takes to fulfill a (sales) rep network on commission, even though we handle 40 labels." PETER PIASECKI, MANAGING DIRECTOR, NAVARRE CANADA*

> *"(Labels and artists) have to deal in terms of clout with retailers. They pick from two evils--major or indie distributor. The only other option is putting a record out themselves, maybe sell 5,000 copies, and getting a 'buzz' so someone will pick it up. Maybe." BRIAN CHATER, PRESIDENT, CANADIAN INDEPENDENT RECORD PRODUCTION ASSOCIATION (CIRPA)*

Canada's music recording market has existed for over 100 years--beginning with the Berliner Gramophone Company opening in Montreal in 1898. The recording industry thrived here until the depression of the 1930s, leaving only Compo Company (distributing Decca), and RCA Victor surviving. Still, the U.S. major labels saw the emergence of the Canadian market as being beneficial for their recordings due to its retail similarities to the U.S. As revenues of the U.S. majors climbed following World War II, the market for music in Canada also grew.

Today, music distribution in Canada is dominated by five foreign-owned multinationals, and by a handful of key independent distributors who all derive most of their revenue marketing foreign product.

> *"Distribution is the dirty end of the music business. It widgets. It's moving one box from here, and out the door." IAIN WALKER, PRESIDENT, FAB DISTRIBUTION*

> *"We don't make hits. We are a distributor. As distributor, we are a glorified shipper. Our job is to make sure record stores don't run out of our product. We also try to make sure we get prime locations in the stores for our releases." GEORGES TREMBLAY, NATIONAL SALES MANAGER, DEP DISTRIBUTION EXCLUSIVE*

Whereas the multinationals generally provide mass products for a mass audience or a wide range of products for different groups of consumers, smaller record companies may concentrate on a limited product or genre. Thus the majors and the independents operate as two distinctly different strategic groups within an industry.

There are generally two types of independent record companies operating in Canada's music industry.

- First, there is a tier of independent companies which distribute their product with multinational or independent distributors by way of licensing or production and distribution deals (commonly known as P&Ds), often accessing the national sales and promotion provided by the multinational or independent distributors.

- Second, are "grassroots" independent labels operating through a network of localized distribution contacts. Many of these labels have developed around specific artists or styles of music being ignored by the mainstream music market.

To fully compete nationally at mainstream retail, a Canadian independent label has to be distributed by a major label or a major distributor capable of selling their music.

Canadian independent distributors and retailers interviewed indicate it is difficult for acts on Canadian independent labels or Canadian acts that release, promote, and market their own records to enjoy sizable success nationally. They are hampered in the mainstream retail marketplace by marketing costs associated with retail advertising campaign programs, and in-store positioning.

This is in sharp contrast to 1988-1996, when Canada's major retail chains HMV Canada and Sam the Record Man--coupled with substantial boosting by MuchMusic, CBC-Radio, and college radio--provided national springboards for many indie--distributed grass-roots acts, including Sarah McLachlan, Loreena McKennitt, Cowboy Junkies, Barenaked Ladies, and Sloan.

> *"The days of Barenaked Ladies and Loreena McKennitt getting their records racked coast-to-coast by themselves are over." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS*

The multinationals and major independent labels generally pay a royalty to directly sign Canadian artists which varies widely, (averaging 12%-15% of suggested list price or $1.40 to $2.00 per record), and entails advancing recording costs, and paying for 50% of video production costs. These costs are largely incurred up front, although recoupable if enough units are sold.

While foreign ownership and control of Canada's recording industry rarely raises issues of principle comparable to those that arise in broadcasting or publishing, where independence is a major policy concern itself, there should be reasons for concern. Since the mid-'90s, according to several interviewees, fierce A&R competition from multinationals has hindered independent distributors and labels in signing new acts.

> *"Our competition for signings is the majors. We can't compete with their money but we can offer closer attention, and a guaranteed U.S. release." RIC ARBOIT, PRESIDENT NETTWERK PRODUCTIONS, VANCOUVER.*

> *"When True North, Aquarius and Anthem started in the '70s there wasn't five aggressive multinationals or five major publishing companies signing acts in Canada. The majors weren't making Canadian records. The world was my oyster. From 1969 to 1980 I was able to sign Bruce Cockburn, Murray McLauchlan, and Rough Trade. The majors weren't even interested. I couldn't do that today." BERNIE FINKELSTEIN, PRESIDENT, TRUE NORTH RECORDS*

ii) MULTINATIONAL DISTRIBUTORS' PROFILE

The five Canadian-based multinationals--Universal Music, Warner Music, EMI Music, Sony Music Entertainment and BMG Music--distribute their own records, and those from their affiliates elsewhere as well as foreign-owned, and Canadian-owned independent labels.

The multinationals are vertically integrated, and have the ability to combine the contracting of artists with the technologies needed to press and package records, develop marketing and promotion campaigns and distribution network worldwide. Each multinational based in Canada is involved in signing and promoting domestic artists, and distributing their product to retailers and wholesalers. Several companies are also involved in music publishing.

Multinationals commonly view Canada as an integral part of the North American marketplace for music. The release of a top album, for example, is usually one date for all of North America, and its artwork and videos are assumed to fit. As well, promotion for the U.S. market--TV, music magazines, and video airplay etc.--often spills over and impacts on English Canadian consumers, although it has a lessened impact in francophone Canada.

A multinational operating in Canada has significant advantages over Canadian-owned distributors and labels. This includes having sales revenues and working capital from its parent company's lines; having its own national distribution system; and having greater access to foreign markets for Canadian-based signings. Furthermore, it has the resources to invest in multiple projects thereby reducing the risk of losses from unsuccessful productions. One manner in which multinationals cope with market risk is through product diversification, i.e. they have enough releases annually to market varying musical genres and exploit catalogs. This also allows top-selling albums to cover off the costs of releasing the rest.

For recordings originating with its foreign affiliates a multinational based in Canada pays an internal-company licensing fee, averaging 32%-34% of wholesale to the affiliated company which has the artist signed. While the Canadian affiliate pays none of the recording, artwork or video costs, it usually still makes significant investments in marketing and promoting the recording.

In English Canada, the distribution of substantial Canadian-owned independent labels is primarily handled by the multinationals. This includes: EMI (Nettwerk Productions, Marquis, Aquarius, and Popular); Universal (Alert Music, True North, MapleMusic Recordings, Somerset Entertainment, 604, Radioland, and CBC Records); and Warner Music Canada (Linus Entertainment, Stony Plain, and The Children's Group). The multinationals' distribution agreements with independents generally includes access to their marketing and promotion staff.

> *"Successful independent record companies, such as True North and Anthem, have repertoire that is appealing to us. It's wonderful to have access to the catalogs of Bruce Cockburn and Rush through independent relationships." RANDY LENNOX, PRES./CEO, UNIVERSAL MUSIC CANADA*

> *"The potential revenue is huge for (having) a Canadian direct-signing. If we crack our own Nickelback, the rewards are so enormous. (Distributing Canadian indies) is a combination of growing market share, and having an adjunct A&R source." STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA*

With Universal Music Group's international restructuring in the mid-90s (as well as changes with its affiliated U.S. labels), coupled with Attic Records moving its distribution there in 1994 followed by True North Records in 1995, the company's domestic strategy in Canada broadened significantly.

In 2002, Universal Music Canada made an undisclosed equity investment in the two-year-old privately-held MapleCore Inc., the Toronto-based firm which is co-owned by Ideaca Limited, SDL Intervest, and Standard Radio Inc. The company operates E-commerce site maplemusic.com, an e-commerce Web site that sells CDs, concert tickets, and other merchandise and which also includes the on-line magazine UmbrellaMusic.com, the web development firm MapleSolutions; and Umbrella Music recording studio.

Following Universal's investment, MapleCore Inc. launched MapleMusic Recordings, distributed in Canada by Universal. To date, the label has released recordings by Sam Roberts, Kathleen Edwards, Pilate, Headstones, the Skydiggers, the Dears, and Slainte Mhath, Gord Downie, and Kinnie Starr.

Today, Universal Music Canada is the foremost player in distributing independent Canadian music. This includes the licensing of artist-run labels—such as with the Cowboy Junkies, Bet.é & Stef, Carmen Campagne, Denzal Sinclaire, Sarah Harmer, Hayden, Cash Brothers, Danko Jones, Joee, Metalwood, Pepper Sands, Snitches, Tegan & Sara, Luther Wright & the Wrongs; and distribution of the independent Canada labels True North, Anthem, Somerset, Alert Music, 604, Radioland, CBC Records and Zero Musique.

> *"The independents we have relationships with have staff providing support services for our company. That's critical in terms of us prioritizing their records inside our system. It is incumbent on them to provide (promotional) pull-through to get our attention on records." RANDY LENNOX, PRES./CEO, UNIVERSAL MUSIC CANADA*

For Canadian acts and labels, the benefits of being distributed by a multinational can outweigh being distributed by independent distributors. There are a myriad of distribution deals between the independent labels and majors. Their fee for services varies on the services provided.

> *"It's an industry where you need the resources to compete. It is very difficult for independent labels to get off the ground because the major labels have virtually unlimited resources." LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC*

> *"The smaller (the label) the more it looks to its distributor for services and the more the distributor charges them. Canadian-owned distributors can supply some sales efforts on their behalf, like co-op advertising, but they can't do marketing or promotion competitively. There are (independent) promotion and marketing people for hire but they don't get the same respect from radio, MuchMusic or*

retail accounts as the people who work for the big five." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS

"If I was in a niche-styled label I wouldn't need a major as a distributor. We are a mainstream pop and rock label. The majors distribute (pop and rock) better than independents." GEOFF KULAWICK, PRESIDENT/CEO, LINUS ENTERTAINMENT

"With a multinational, an independent label is always going to be the 10th or 11th tier down. They would have more of a chance with an independent (distributor) if they have good product." JONATHAN REES, VP OF PRODUCT, HMV CANADA

"I say to (our) distributed labels "Your job is to make your priority my priority.' The biggest mistake (indies) make is thinking that their priority is our priority. The other big mistake they make is not recognizing how expensive the retail game is to play." STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA

iii) INDEPENDENT DISTRIBUTORS' PROFILE

An independent distributor is a distributor not owned by a foreign multinational label. It distributes product for independent record companies and sometimes for a multinational if it seeks to supplement a certain market.

Canada's independent distribution sector is an integral component of Canada's music culture. Independent distributors--along with Canadian independent labels and smaller retail outlets--give a voice to Canadian niche-styled artists who might not have an outlet otherwise. There are many artists who sell 5,000-10,000 albums that majors are not interested in because sales of 10,000 can be a loss to them. If a small independent label or individual artist sells 10,000 albums, they can make a considerable profit, and the distributor involved also thrives.

According to Brian Robertson, president of the Canadian Recording Industry Association, the independent recording/distribution sector represents approximately 10% to 12% of the country's $1.2 billion Canadian music retail market.

Independent distribution in Canada has been dramatically transformed in the past decade. Since 1997, there have been the bankruptcies of such major distributors as Cargo Imports and Distribution in Montreal, Song Entertainment Distribution, and Quality Special Products, all based in Toronto; the closure of Denon Canada's distribution arm in Toronto; and the merging of Distribution Trans-Canada, with Select Distribution and GAM Distribution in Montreal. More recently, in April 2003, New York-based Pouschine Cook Capital Management purchased a majority stake in Montreal-based distributor St. Clair Entertainment.

> *"For the independent sector in Canada to reach its potential, there has to be an independently-owned distribution company with sufficient volume that it can satisfy retail. That has staying power. That could afford to hire marketing and promotion people which the indie distributors now do very little of. It would have to attract a mix of domestic and foreign labels. There's not a distributor like that today." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS*

> *"We still need another major distributor. Koch does a tremendous job as an indie distributor but the others don't have the clout at retail." ROBIN RAM, PRESIDENT, MAR INTERNATIONAL GROUP*

> *"There is no need for another distributor. For a small market, we are well served with distribution." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

Among the leading independent distributors in Canada today with both domestic and international product lines are:

<u>U.S.-owned Distributors</u>

Koch Entertainment Inc.
St. Clair Entertainment Group

<u>Canadian-owned Distributors</u>

Distribution Select
DEP Distribution Exclusive
Distribution Fusion III
FAB Distribution
Madacy Entertainment Group
Magada International
Outside Music
Page Music Distribution
Trend Music Group
Sonic Distribution
Scratch Recordings and Distribution
Festival Distribution

<u>Second-tier or Regional Canadian Distributors</u>:

Indie Pool Canada
Tidemark Music Group
CMC Distribution
Joe Radio
Spinner Music Group
Tall Ships Art Productions
No Distribution
D-Noy Muzik

Spirit River Distribution
Sunshine Records
'Nuff Entertainment
Distribution SRI
Distribution Plage
Landwash Distribution
Distribution Bros

Independent distributors range in size from about $1 to $3 million in annual music sales volume, although several, such as Outside Music, FAB Distribution, and Sonic Distribution gross between an estimated $5-$7 million; Distribution Fusion III at an estimated $13-$15 million a year; and Koch Entertainment Inc., at an estimated $18 million a year for its music sales.

These distributors range from operations that distribute product in one local or regional territory to those with branches in major Canadian cities and distribute product on a national basis. Several Canadian independent distributors represent 40-50 different labels with an active retail account base of 200, although there are an estimated 400 independently owned stores that don't directly deal with the multinationals.

> *"Apart from Fusion III with its label (Justin Time), the focus of the major independent distributors is on non-domestic product." JONATHAN REES, VP OF PRODUCT, HMV CANADA*

> *"We deal with single independent artists and small independent labels because we feel its part of our mandate as a Canadian distribution company to support Canadian music. At the same time whenever we take on a label, we are relatively sure some Canadian retailers need this product in their stores." LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC*

Koch Entertainment Inc., with an estimated 1.7% market share, has been the leading force in Canadian independent distribution since opening in Canada in 1995. The opening followed the U.S. launch of Koch International in 1987 (Koch's European music companies were sold to Universal Music International in 2001). Koch's Canadian affiliate handles 40-50 international labels, 11 Canadian-owned labels as well as its self-owned label group: Koch Records, In the Paint, Audium, DRG Records, Koch International Classics, Moonshine Music, Shanachie Entertainment, and Koch Jazz. The Canadian affiliate is also a leading video distributor with such distributed lines as the World Wrestling Federation, and Pokemon.

Many distributors operate such a distance from the mainstream market that they don't consider the multinationals or larger distributors competition. These smaller distributors generally sell to small independent record stores, and do little business with larger music retail chains. They measure success in thousands of sales, sometimes only hundreds. They usually specialize in niche genres including: punk, hard-core, thrash, metal, jazz, hip-hop, electronica, folk, reggae, and Christian.

"If we hit 20,000 units, we are in good shape. For us, 5,000 to 10,000 is a good records on Sonic Unyon." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS

"The majors think, 'How many Diana Kralls come along?' But (as an independent act) Bet.é & Stef did 50,000 units. We've done 35,000 units with Susie Arioli. Those are amazing figures. Those are pop (music) figures." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS

"Since they deal with so many different titles, as opposed to the majors, (independent distributors) have to be more on their toes. They have to be able to take little opportunities which add to their turnovers, more than a major would." JONATHAN REES, VP OF PRODUCT, HMV CANADA

Some independent distributors, such as Hamilton-based Sonic Distribution are part of an enterprise that also comprise a label, one stop, rack jobber, and a retail outlet.

From the outset in 1993, Sonic Unyon Records, owned by Tim Potocic and Mark Milne, has released and distributed its records nationally, including those by their own band, Tristan Psionic, as well as SIANspheric, the Dirtmitts, Treble Charger, Smoother, Shallow, Thrush Hermit, and Tricky Woo. In 1995, the label's distribution arm became Sonic Distribution and received a major boost by handling Toronto singer/songwriter Hayden. Sonic Distribution now handles 50 Canadian independent labels, including Alien 8, Noise Factory, Constellation, BattleAxe, and Meter. It exclusively represents 250 U.S.-based independent labels in Canada, including Fat Wreck Chords, Psychopathic, and Revelation.

What has been beneficial for some distributors has been diversifying, such as focusing on specific musical niches. For example, while such multinationals as Universal, BMG, and Sony frequently release electronica product, the genre is dominated in Canada through independent distributors; Koch Entertainment, and Distribution Fusion III.

"Independent distributors know the electronica market and have staff selling it who know the market better (than the majors)." JONATHAN REES, VP OF PRODUCT, HMV CANADA

"The majors don't want electronica. They think, 'Why waste time for 6,000 copies when we can sell 140,000 units of Shania Twain next week?' Independents do a lot of little numbers, and the majors do big numbers. If I sell 10,000 copies, I'm very happy." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS

The past five years has seen the emergence in Canada of a number of niche-styled independent labels with strong independent distribution ties, including: Sonic Unyon, Mint, G7 Welcoming Committee, Smallman, Three Gut, Grenadine, Teenage USA, Stomp, Sound King, AntiAntenna Recordings, Endearing, Matlock, and Shipbuilding.

For the most part, these labels have geared themselves toward music that multinationals don't usually pursue. Such labels typically have lower sales and smaller operating budgets. Break-even point can be reached with sales of 2,500 units or less.

Many Canadian acts prefer to produce recordings and handle distribution themselves. With limited access to mainstream retail, they rely primarily on touring to promote and sell their recordings. Or they may coax retailers to take their goods on a consignment basis although only independent retailers deal with consignment product today.

However, many of these independents labels as well as artists releasing their own records, are practically shut out of mainstream retail, and commercial radio.

> *"The type of music we put out doesn't get (commercial) radio, and feature airplay is limited. College charts are also now riddled with major label releases. They never used to be in Canada. So we are now even competing for that market against the majors." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS*

Toronto-based IndiePool offers independent artists a two-tier national distribution service: passive and active.

- Passive distribution is essentially data base cataloging. An artist pays $5 per month to be placed in IndiePool's database. If there's a demand from a retailer IndiePool ships the order, invoices the retailer, and pays the artist.

- Active distribution consists of a $200 setup charge and a $20 per month fee. For this service, IndiePool sends play copies and faxes to designated retailers and promotes them via telephone. In each case, the artist sets the wholesale price to retailers. IndiePool's catalog consists of 4,400 independent titles, 100 of which are current.

> *"Too many artists look for distribution when they are not ready for it. They can sell more off-stage than at traditional retail and make more money. So many of them could be playing more, and getting more sales off stage." IAIN WALKER, PRESIDENT, FAB DISTRIBUTION*

iv) <u>PROFILE OF QUEBEC DISTRIBUTION</u>

In contrast to other parts of Canada, Quebec has a more centralized music industry with distribution, primarily French-language domestic product, commanded by a single distributor/retailer, Groupe Archambault, a subsidiary of Quebecor Media Inc.; and production dominated by some 50 independent French-language labels and production companies, of which 20 are significant.

Quebec music industry developed from the vacuum of the 1970s and 1980s, when the multinationals consolidated their A&R, manufacturing and head office functions in Toronto, and reduced their Quebec-based A&R activities. Quebec-based production companies and labels then established a dominating presence.

Today, the impressive domestic successes of top Quebec stars with independent ties include: Isabelle Boulay, Lynda LeMay, Daniel Bélanger, Kevin Parent, Jean Leloup, Les Colocs, Bruno Pelletier, Natasha St-Pier, Eric LaPointe, France D'Amour, Gabrielle Destroismaisons, Julie Doiron, and La Chicane.

Quebec's music industry, part of the province's larger entertainment industry, has various characteristics which distinguish it from English Canada. Foremost are language, cultural distinctiveness, and small market size - all of which act as natural deterrents to international English-language products flourishing there and resulting in the market being less attractive to the multinationals. Moreover, the multinationals are all headquartered in Toronto, and are less in touch with the changing climate of the Quebec market.

> *"The multinationals don't have a dominance in the Quebec marketplace, certainly not on domestic talent. The top multinational executives are English and are in Toronto. They don't know how to develop or how to sell acts in Quebec." DONALD TARLTON, CHAIRMAN, DONALD K. DONALD GROUP OF LABELS*

> *"The majors were in the market and then they left. They are back in it in the past two years. They used to have no more than 10% of penetration of French content in Quebec. Today, they are up to 30% with Céline Dion, Garou, and Lynda Lemay." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT*

Quebec's music distribution industry is dominated by Groupe Archambault's subsidiary Distribution Select with an estimated 40-65% penetration in the French-speaking marketplace and about 90% of the independent French-language labels in Quebec. Groupe Archambault also operates 12 Archambault superstores (15,000-25,000 sq. feet) in Quebec.

Distribution Select handles such formidable Quebec-based independent labels as Audiogramme, Guy Cloutier Communications, Analekta, Folle Avoine Production, GSI Musique, Disques Artistes, MPV, and Tacca, and product by such leading Quebec French-language acts as Isabelle Boulay, Bruno Pelletier, and Daniel Belanger.

> *"Archambault has helped to create the infrastructure for a very vibrant industry in Quebec. They have been great supporters of domestic repertoire, and local artists." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

Distribution Select also handles national distribution of several international companies, the most significant being UK-based Beggars Banquet Group. Significantly, Distribution Select does not seek to handle Canadian-owned independent English-language labels due, according to Natalie Larivière, Groupe Archambault's president/director general, to a lack of potential profitability.

While synergies do exist between Groupe Archambault's retail and distribution divisions they have been set up to operate independently.

> *"Our distributed labels expect us to at least cover Archambault efficiently. If we were inefficient they wouldn't understand. But they do understand that it is two different businesses. Also, while (competing retailers) must have Kevin Parent and Daniel Belanger (distributed by Distribution Select) we have to work hard on (getting their support for) other artists." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT*

Another key distributor of French-language product nationally is Montreal-based DEP Distribution Exclusive which distributes Quebec-based labels: D7 Recordings (See Spot Run), Diffusion YFB (Eric Lapointe, Melanie Renaud), Tox Records (Marie Chantal Toupin), Milles Pattes (La Bottine Souriante), Victoire (Sylvain Cossette), Lunou (Luce Dufault); and DKD/D-noy, co-owned and operated by Daniel Desnoyers and Donald Tarlton. DEP also represents the Toronto-based dance compilation label SPG Music.

> *"We handle 60-80 labels, 65% of which are from Quebec. My focus is to get product that will sell outside of Quebec. Most of that is English product. Our growth has to be as a national distributor." GEORGES TREMBLAY, NATIONAL SALES MANAGER, DEP DISTRIBUTION EXCLUSIVE*

v) GENERAL TYPES OF MUSIC DISTRIBUTION AGREEMENTS

Distribution agreements with multinationals or independent distributors range from an independent label or artist developing a master recording to being either licensed by or being sold to a multinational or distributor which finances the manufacturing, distribution and promotion costs; or the manufacturing and promotion costs are paid by the independent or artist which receive a higher return per record sale, and then funds their own advertising and promotion.

In most distribution cases, a distributor may hold back a "reserve" of 25% to 35% of a payment, which is liquidated over 12 months. Distributors usually get paid for goods in

60 days but, in the interim, has to pay the manufacturer and carry a receivable. The label also holds a reserve against the artist involved.

Pressing and Distribution (P&Ds) Agreements

In a pressing and distribution agreement (or P&D) deal, the multinational or independent distributor agrees to manufacture records for an independent label or production firm and to distribute them as a wholesaler. The label sells the records to the distribution entity for a wholesale price less a negotiated distribution fee. The distribution fee ranges from 18% to 25% of gross billings.

Under a P&D agreement, the production firm or label usually pays the costs of manufacturing and mechanical artist royalties. The distributing company generally offers no services in terms of marketing and in-store promotion etc. However, for a further 5% fee they will usually provide such services.

The rate of return with a P&D is substantially higher than a license agreement. However, because such costs as manufacturing, marketing, promotion, and mechanical licensee fees are the responsibility of the production firm or label, a P&D agreement is riskier for the owners of the master than a license.

> *"If you are selling product, a P&D deal with a major is the best way to go. If you are not selling product, it's the worse way to go because you are forgotten. (Their support) depends on how good the act is, and how good you are. You've got to be doing some (sales) volume." TOM BERRY, PRESIDENT, ALERT MUSIC*

License Agreements

A license agreement occurs most often between an independent label or production company and a domestic-based or foreign record company or distributor. Typically, it is a license of either a single or album master that is being released by the third party record company which acquires such rights. Compensations normally consist of an advance against royalties, plus royalties when the advance is earned out. A typical royalty range is 14%-18% of the suggested retail list price based on records sold through normal commercial retail channels in each territory. The term is usually for 3-5 years.

vi) DISTRIBUTION OF FOREIGN-OWNED INDEPENDENT LABELS

Canada has become attractive in recent years to foreign-owned independent labels. They recognize that there is a responsive market in Canada for their alternative rock, roots, jazz, and blues catalogs.

However, with Canada's low currency-exchange rate, these foreign-owned independent labels also often see lower returns on distributed product here than they do elsewhere. As a result, they are increasingly demanding that Canadian independent distributors provide increased marketing, and promotional services to maximize their sales in Canada. At the same time, few Canadian independent distributors have the staff to offer defined promotion and marketing strategies.

> *"Foreign labels usually expect 10% (sales) of their market. They expect marketing, and some media (support)." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT*

> *"Most of our distributed labels are American. They deal with Canada as an adjunct to the American market. The business practices are very similar. With European labels, costs are higher and they are more demanding. American product is easier to return (to labels) and there's often marketing support and a spillover from U.S media. Some labels require marketing support, some will hire independents (promoters) here to support the label." LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC*

> *"Distribution deals are either North American deals with different criteria for Canada and the U.S. or they are Canada-only deals or they are licensed deals. Over 40% of our business is licensed business today. It used to be 100% distribution." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

vii) MULTINATIONALS TARGETING INDEPENDENT LABELS

According to several Canadian independent distributors, some multinationals; specifically Universal Music Canada, EMI Music Canada, and Sony Music Entertainment Canada, have been aggressively seeking out foreign-owned independent labels for distribution in Canada. This is a concern to Canada's independent distribution sector because access to foreign product is core to their businesses.

> *"All the (international labels) are shopping for the best deals (for Canadian distribution). They are getting it from the majors and from smaller (distributors) who don't have much overhead. But these (small) distributors also don't have the cash flow to keep (labels) on an on-going basis if retailers strings them along on payment." ROBIN RAM, PRESIDENT, MAR INTERNATIONAL GROUP*

A momentous structural shift in Canada's distribution world occurred this year with the arrival of Sony Music's RED Distribution in Jan. 2003. RED Distribution Canada is a co-operative effort between America's leading independent distributor RED Distribution, and its Sony Music parent. Based in Toronto, RED Canada is utilizing Sony Music Entertainment Canada's sales team, its distribution services, warehousing, credit and collection functions. The Canadian-based affiliate is utilizing its U.S. parents' tracking system for inventory, and sales information.

Among the 17 U.S. labels signed by RED Canada to date are: Artemis (Jeffrey Gaines, Susan Tedeschi); ATC Records (Edwin McCain); D&D Records (Krumb Snatcha, Craig G and JO-S); Psychopathic Records (E-sham); and Trustkill Records (Open Hand Poison The Well, and Eighteen Visions).

> *"The majors are swooping in and trying to get anything they can. In the process destroying it." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS*

> *"We can't compete for an independent (label) against a major. They have the charisma of international success, and having a great sales and promotion forces. They also give big advances." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT*

Generally, Canadian-based independent labels--unlike multinationals or U.S. independent distributors--are unable to secure the Canadian distribution rights to significant foreign product. They lack the capital to provide necessary advances, or to market key international product effectively.

> *"Canadian distributors and labels will remain as niche players without any significant international catalogs so long as the majors have free rein to pick up foreign catalogs. I'd like to carry more international lines but I can't afford a bidding war. As soon as an international label becomes meaningful, the multinationals go after it. The only hope for independent labels and distributors to compete is that a restriction be placed on the multinationals distributing un-owned product, like there is for the Canadian film business." GEOFF KULAWICK, PRESIDENT/CEO, LINUS ENTERTAINMENT*

vii) GOVERNMENT FUNDING PROGRAMS

Since 1986, the government of Canada has played a pivotal role in creating a supportive policy and program environment with the goal of building a domestic sound recording industry that promotes the creation, dissemination and preservation of cultural works that reflect Canada's cultural and linguistic reality.

Revenues for Canadian content music product from the domestic music market may be modest in comparison with the market leaders, but the independently-owned label sector is widely recognized as being a primary market window for Canadian music rights holders.

While federal efforts have laid the foundation, increased economic globalization and digitization has impacted the industry. To ensure that the industry develops the tools it needs to succeed in the future, the Government of Canada renewed its commitment to the sound recording industry in 2001 by developing a new Canadian Sound Recording Policy. The principal means for achieving the goals of the policy is the Canada Music Fund. The Fund introduces a range of programs designed to deliver on the policy's vision of supporting diversity, capacity and excellence in sound recording at every level, from creators to audience. The Canada Music Fund comprises the following initiatives:

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

The Musical Diversity Program's Specialized Distribution Program, administered by the Canada Council of the Arts for the Department of Canadian Heritage is the main support mechanism available to independent distributors. The intent of the Specialized Distribution Program is to assist Canadian specialized music distributors to effectively produce, promote and distribute non-mainstream music recordings that are reflective of Canadian voices - in order to increase their availability to the public.

While other programs under the Canada Music Fund are more specifically focused to offer assistance to the Canadian-owned label and/artist/songwriting sector, both FACTOR[1] and Musicaction[2] do provide some funding assistance to distributors looking to market and promote Canadian music.

> *"We wouldn't be where we are without FACTOR's help. We couldn't have made Sarah McLachlan's "Surfacing" in 1997 without FACTOR. If (funding) worked for us, it can work for others." RIC ARBOIT, PRESIDENT NETTWERK PRODUCTIONS*

> *"The funding programs have served a valuable place but they have been program driven. They have not been infrastructure-driven. Indies haven't had an*

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1 *FACTOR, founded in 1982 by radio broadcasters CHUM Ltd., Moffat Communications Ltd., and Rogers Radio Broadcasting Ltd., as well as the Canadian Independent Record Production Assn. (CIRPA) and the Canadian Music Publishers Assn. FACTOR administers the CMF's New Musical Works and Collective Initiative Program.*

2 *Musicaction, formed in 1985 by broadcasters and Quebec-based-labels to fund a wide range of grant and loan production assistance programs. Musicaction administers the CMF New Musical Works and Collective Initiative Program.*

opportunity to build a team." STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA

"We don't do one-off deals. We take labels. That's the problem with FACTOR product. Acts come to us and we try to steer them to (our distributed) labels. But everybody is knocking on our door." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA

Administered by Telefilm Canada, the Music Entrepreneur Program (MEP) was created to ensure that Canadian music entrepreneurs build a strong sustainable industry that continues to foster Canadian expression. With a budget of approx. $23 million for a three-year period, its goal is to enhance the competitiveness of companies and help them meet the challenges of the digital economy and the globalization of markets.

Sources interviewed generally concur that the Canada Music Fund's Music Entrepreneur Program (MEP) may lead to the domestic music sector achieving greater strength. However, several independent distributors criticized the lack of consultation with their industry in developing and operating the various government run funding programs which directly effects their business of distributing domestic releases.

Furthermore, they emphasize that due to varied changes in both the record industry and the retail marketplace that greater weight should now be given to the marketing of recordings.

"A program like the Canada Music Fund will help the infrastructure of the Canadian indies. It represents a fighting chance." DONALD TARLTON, CHAIRMAN, DONALD K. DONALD GROUP OF LABELS
"With MEP, more FACTOR records might be picked up, and they might get sold more internationally." BERNIE FINKELSTEIN, PRESIDENT, TRUE NORTH RECORDS

"I would give (government funding) to distributor to hire (promotion) people, but the promotion plan should stay with the label. There are some labels that are efficient and I wouldn't want to determine their promotion plans. Others need help." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS

"Business plans of (Canadian) independent labels should include distribution, and retail strategy or marketing plans as much creative content. (Funding) should almost be 80:20 in favour of marketing. Labels and artists put a lot of effort and money on producing albums but not the same amount of money in selling them." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT

"Out of a 100% budget, (independent) labels and artists put 95% on recording budget. Then they don't have a dime to promote it. Their budgets should be 20%

for production, and 80% for marketing." GEORGES TREMBLAY, NATIONAL SALES MANAGER, DEP DISTRIBUTION EXCLUSIVE

SECTION 2: MUSIC RETAIL IN CANADA

i) OVERVIEW

Retailers comprise those companies involved in the final chain of distribution, namely to the consumers.

In the music industry's earliest days, retailers mostly purchased product directly from the few record manufacturers there were. As retail volume grew in the 1940s, manufacturers began to service retailers through regional distributors. In the 1950s, one-stop, rack jobbers, and record clubs began operating in Canada.

Distributors can tailor their distribution strategies to reach one of three types of retail distribution outlets. These are described below:

Mass Merchants Retail

Leading music retailers in Canada include HMV Canada, CDPlus, Archambault Musique, Music World, A&B Sound, Sunrise Records, Virgin Music, Future Shop, Best Buy, and such mass retail department stores as Wal-Mart, Zellers, Price Club, and Costco.

While there is a significant range of material available on CDs, often only a small percentage is available for consumers to purchase. This is, perhaps, most evident at such department store chains as Wal-Mart Canada and Zellers and chains like Future Shop, Best Buy, and Costco which often use a top selection of pop titles as loss leaders to generate traffic into their stores.

Rack-jobbers (Wholesaler)

Distributors also deal with sub-distributors or rack jobbers, which act as a wholesaler for department stores and other outlets, including Canadian-owned Record On Wheels (ROW) Entertainment, and Pindoff Record Sales; and U.S.-owned Handleman Company which service mass-merchandise outlets, department stores, and variety and discount stores that prefer to buy their music from one company instead of having to deal with all of the individual record companies.

> *"The success of Wal-Mart and Costco is mind-boggling. The mass merchants market share is growing dramatically. It is probably between 26%-27%. Traditional retail is about 60%; and 'mom and pop' stores is less than 10%." GARRY NEWMAN, CEO/PRESIDENT, WARNER MUSIC CANADA*

Rack jobbers carry a very limited selection of titles, usually under 2,000. In their servicing, rack-jobbers select product, organize displays, supervise a sales force (employed by the outlet), exchange unsold goods, and develop advertising and merchandising programs.

Rackjobbers have varied types of contracts with stores. The three most common are:

1) The rackjobber rents space from the retailer for a flat monthly fee. The rackjobber retains all of the money collected from sales;

2) The rackjobber pays the store a percentage of sales;

3) The rackjobber and store proprietor work out a minimum lease fee. If sales exceed an agreed-upon figure in any given month, the rackjobber pays the proprietor a percentage of the overage.

<u>Independent Stores</u>

Although the ranks of independent stores in Canada is said to be thinning, distributors say there is still a core of independent merchants weathering the storm of decreasing sales, stiff competition with others retailers and aggressive pricing by mass merchants and electronic chains. Many of these retailers obtain their mainstream product from wholesalers, including ROW Entertainment, or from independent distributors, FAB Distribution, Outside Music, and Sonic Distribution.

> *"With the growth of CDPlus and Zellers in every small town, and product being available through Amazon on the Internet, and downloading, it's a shrinking market. There are only about 30 viable 'mom and pop' stores left." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

Higher sales, in some cases, permits the retailer additional discounts from both multinational and independent distributors, including extensive advertising allowances, bonuses or "free goods" which are provided to the retailer without cost. Free goods may range from 10% to 15% of product .

Consumers of niche product generally do not shop at an HMV or WalMart. As such, smaller, independent retailers don't solely rely on just selling mainstream albums. While they can't compete on pricing with mainstream music chains or the mass merchants, smaller independent retailers deflect the price emphasis by exploiting musical niches that the bigger stores rarely cover; having musically knowledgeable staff that appeals to their customers; and by carrying a larger diversity of product than generally available through local franchised stores.

> *"We sell to the major retail chains but for the most part, the money is with the small guys, the independent retailers." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS*

"We don't pursue Wal-Mart and Zeller's. We don't have the product they require. They concentrate on top 40, and budget product." LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC

"The local independent store has its own clientele that would probably shop there anyway. People are selling and buying music there because of the music. They are not buying it because of spins on MuchMusic. People are there because they want that product." JONATHAN REES, VP OF PRODUCT, HMV CANADA

"Niche product, like folk, jazz and punk can sell in independent outlets. You are not dependent on radio to break those records." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA

ii) RETAIL TODAY

While Canada's music sector endures reduced sales, other forms of entertainment are increasingly competing for consumer dollars at retail. Music labels are increasingly losing merchandising space and sales to film-related DVD product and video games at retail outlets.

With so much product being released each month, a distributor establishes a priority of releases, and develops a marketing campaign that ties in with the nature of the product. At the same time, its' merchandising staff formulate point of purchase (P.O.P) stimuli which can include special racks, window displays, posters, banners, and stand-up displays. Its' advertising department will devise--if budgeted--prints ad, and perhaps TV or radio spots.

At the same time, the cost of distributing music product--shipping, processing and warehousing--and marketing costs associated with advertising, in-store positioning, and retail campaigns has soared significantly, adversely affecting both retailers and distributors.

With diminished sales, and soaring distribution costs today, Canadian retailers are controlling inventory more tightly, and are being cautious with their initial and follow-up purchases of music. Where they once bought 30-60 days supply of goods, they are now limiting buys to between three and five days' supply. This more frequent retail ordering, resulting in more frequent deliveries to retailers, is impacting negatively on costs to labels and distributors. Label executives also contend that with such conservative buying patterns, few mainstream retailers are seeking to break new acts today.

"I'd say that 80% of the records released are dead after the first week, maybe in two weeks. But I will hang onto a good record if I think our staff can sell it. " TIM BAKER, BUYER, SUNRISE RECORDS

iii) COST OF DISTRIBUTING

With so few record stores chains in Canada, major retailers have considerable bargaining power with record companies and distributors. Since labels and distributors must ensure that their albums are visible in retail stores in order to gain consumer awareness and sales, they usually meet retailers' demands. Retail marketing is significantly more expensive today because distributors and labels pay for advertising, promotional campaigns and product positioning with most major retailers.

Co-op advertising originally was a joint expenditure split between the record companies and the retailers. In recent years however, record companies have been forced to pay the full expense of co-op ads and to commit to spending a fixed amount per year on co-op ads for major retail accounts.

With Canadian retailers being so cautious with purchases, labels and distributors have been increasingly aggressive in persuading them of the viability of recording--particularly by a new act and whether domestic or international. Retailers are mostly convinced through offers of a generous rebate program or the label spending on a retail campaign. If an independent label doesn't have marketing and advertising funding available, their product will almost certainly be relegated to the back row in racks or not carried by the retailer.

> *"It's important to gain the confidence of retailers. That's the first step in getting product in. The second step is making sure that if it doesn't sell that we replace it with something that will. Just because a record is good, and it could sell isn't reason enough for retailers to stock it. It has to be in a proper marketing program plus have some retail marketing behind it--whether it's for co-op advertising, listening posts, or for shelf space. And retailers can't support everything. They have to prioritize records. Even if we have money to support a certain record there's no guarantee it would get shelf space." LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC*

> *"It's getting harder to put product into stores. Everybody is fighting for shelf space, and more retailers are selling their shelf space. We're paying for every ounce of space now. (Retailers) are also saying, 'We can't keep all of this product. We have to make space." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS*

> *"We have had to give and spend more than ever before to get product into stores. Give more on the discount side, and spend more on the marketing side. Based on an order we might be spending $2 a unit on marketing." PETER PIASECKI, MANAGING DIRECTOR, NAVARRE CANADA*

> *"I have to give retailers so many incentives to have them bring in enough stock for a presence at retail. It never ends." RIC ARBOIT, PRESIDENT NETTWERK PRODUCTIONS*

iv) <u>EMERGENCE OF HMV NORTH AMERICA AS MARKET LEADER</u>

Sources pinpoint the emergence of HMV North America--an affiliate of UK-based HMV Media Group-- as the country's market leader in the past decade as having spurred many of the changes at Canadian music retail in recent years.

HMV North America's arrival began in Canada in 1987 when it acquired the assets of Mister Sound and the Sherman Music chains after EMI Capitol Records left retailing. HMV started in Canada with 20 stores and a 2.5% market share. Today, with 97 stores and a 21% market share, it is Canada's national music retail leader. HMV also has seven U.S. stores overseen in Canada.

The arrival of a HMV in Canada coincided with the closure of such major national music retail chains as A&A Record Stores, Sound Insight, and Adventure Electronics. The bankruptcy of the A&A Records and Tapes chain with 269-stores in 1991, and the subsequent closing in 1993 of its predecessor, A&A Music Entertainment with 147 stores, led the way for significant national growths of the HMV, Music World and CDPlus chains.

> *"HMV brought a sophistication to the marketplace." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

> *"HMV had a contemporary look, and had a different (racking) system. They had 100 stores more on top of things. You could get a head office deal and make it work." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS*

However, problems in recent years at HMV's North America division, particularly in Canada, have impacted greatly on Canadian distribution.

HMV Media Group's dissatisfaction with its North American market results, which has been significantly behind other markets, particularly Europe, led to widespread executive shuffles at HMV North America in 2001, culminating in Peter Luckhurst's resignation as president of HMV North America in January 2002. Chris Walker was then brought in to oversee HMV North America on an interim basis in addition to continuing to act as managing director for HMV's Asia-Pacific operation. Since his arrival, Walker has rebuilt HMV's head office team and overseen a review of the company's business.

However, according to HMV's Group half-year results, ending Oct. 26, 2002, problems still persist. Revenues at HMV North America fell 8.8% in the half-year period to £67 million led by a "severe decline" in Canada. North American operating losses rose 0.6% to £2.9 million.

v) <u>INCREASED CENTRALIZED BUYING AND INVENTORY CUTBACKS</u>

Distributors cite inventory cutbacks at most major Canada retail chains in the past 18 months, particularly HMV's move to more centralized buying and marketing, as providing lessened opportunities to market and sell product in Canada.
HMV's centralized buying shift began in 1996 when the chain altered its buying strategy, whereby store managers ordered for their individual stores. The change was to allow HMV to take advantage of label discounts and national advertising buys. In 2002, HMV took away much of the flexibility enjoyed by its stores' management by moving even further toward a centralized buying and advertising strategy.

> *"HMV doesn't have a central warehouse anymore so you have to sometimes call on every store (to promote). A distributor has to have the manpower to call on every HMV store, preferably in person, if not at least on the phone." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS*

> *"Even with regional promotions, you now talk to HMV's head office first." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA.*

> *"Prior to HMV's (centralization) it was very labor intensive to get (nationally distributed). Not only was it labor intensive but it was really hard getting everybody on the same page saying, 'This record deserves to be looked at.' We're now seeing more opportunities there." IAIN WALKER, FAB DISTRIBUTION.*

> *"We've have had to buy into programs at HMV and CDPlus to get sufficient quantities (of albums) into stores. It is either buy (programs) and get the product in one shot or spend time, effort, and money on the phone with all of the individual managers. The big retail programs are pretty good (for indie distributors). (Retailers) will bring in the product because we're a guaranteed sale on every piece of product they sell. They know they can send it back if it doesn't sell. There's no risk." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS*

In June 2002, to the consternation of Canada's independent label and artist sector, HMV stopped accepting consigned product--a practice, initiated in the early '90s, which sparked Canada's indie boom.

> *"The reason we (stopped consignment) was (due to) the amount of time it was taking stores and head-office to deal with small amounts of product. We had 3,500 to 4,000 individual consignment accounts in effect." JONATHAN REES, VP OF PRODUCT, HMV CANADA*

vi) <u>SELLING TO RETAILERS / RISKS AND RETURNS</u>

Records are sold to major retailers with the privilege of returning a percentage of unsold copies for credit or exchange. The return privilege allows retailers to order more freely and take chances with new and unproven products. Industry returns in Canada, according to sources, run at an average of 9%-12% of purchases today. In contrast, returns ran at 25% a decade ago.

Major retailers and rackjobbers can return to the multinationals product generally without penalty that is not sold up to 15%-17% of their total annual purchases. These returns are not based on the purchases of individual albums but on the total purchases. Therefore a retailer can return its entire inventory of a particular album without incurring any costs. Several majors also have incentive/disincentive programs where retailers receive discounts on their purchases, against penalties on the costs of returns.

Independent distributors, in contrast, have to offer full return privileges to retailers with product. If an imported album doesn't sell or the distributed label goes bankrupt, these distributors are stuck with the product and related costs.

> *"Giving a 100% return is the only way the labels or distributors get into these retail outlets." ROBIN RAM, PRESIDENT, MAR INTERNATIONAL GROUP*

Rack jobbers allow their accounts to return 100% of unsold product. Yet, rack jobbers are usually limited to returning 15%-17% of purchases to the multinational distributors. As a result, rack jobbers are conservative about buying new product or hesitant about buying it without backing of a substantial marketing campaign. They are generally unwilling to stock product from small distributors, as it is unlikely that these distributors would have a broad inventory range to support a significant inventory exchange.

High returns, in particular, cripple independent distributors. If they are being paid in returns, it can prove fatal. Many small independent distributors don't sell to the major retail chains because of the risk-taking involved. Larger music chains generally get terms of 60 days, which may turn into 120 days, and if they return 50% of purchases the independent distributor is financially harmed.

> *"You rely on receivables so much, and if you're paid in returns it hurts. Importing records is not like pressing a domestic record, where you don't bear your royalties until you've sold it. When you import, you pay the custom duties, shipping, as well as the price of the record." JIM WEST, PRESIDENT OF DISTRIBUTION FUSION III/JUSTIN TIME RECORDS*

> *"With one-off deals, you get hammered as a distributor. When I ship 4,000 units and 3,500 come back in 6-8 months and I pay in three months for 75% for what's sold through, I'm hurt. I keep a reserve of 25% but what happens if 60% come back? What happens if the guy is broke or if I*

manufactured the record for him?" JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS

"What we represent is 100% returnable. If it doesn't sell, the label (being distributed) is responsible. But we don't load. Even with our big releases, we run incredibly clean. We run at 5-6% returns." IAIN WALKER, PRESIDENT, FAB DISTRIBUTION

"The risk we have is in financing promotion and marketing of labels. We end up paying the labels faster then we get paid from retail. If the product dries up, we are not protected with their returns. If the label falls into the red how do they pay you back? If it's a Canadian label how are they supposed to survive?" DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA

"Returns are coming back quicker. Retailers get (product) back to you the moment it dies off. It is pretty much 90 days. Occasionally, you don't get paid that fast. So they are often getting credit for product they haven't yet paid for." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS

As demonstrated in the following table, retailers generally contend that one advantage in dealing with the independent distributors and labels is their pricing. It is important to note that pricing to retailers can vary significantly for titles by developing artists and/or superstars. This variance is reflected in the consumer price list.

	Cost/album paid by Distributor	**Cost/album paid by Retailer**	**Consumer List Price**
Independent Distributor	$7.00 to $8.00	$8.50 to $9.50	$13.99 to $17.99
Multinational Distributor	varies	$13.99-$15.29	$16.99 to $18.99

"By and large (smaller distributors) work on small margins which is obvious to the retailers so they are fair to us. They know we have to remain profitable. Fifty percent of our business remains with the independent stores but we still have important records for HMV, and A&B Sound whether it's Tom Waits or Dolly Parton. We have records they turn turn turn (sell quickly and are re-stocked/ordered frequently). Arguably, the margins (on these records) are healthy as well." IAIN WALKER, PRESIDENT, FAB DISTRIBUTION

"Most of our new (domestic) releases are going out at $12.99. Generally, (international labels) sell us product from $7-$9 U.S. Canadian are selling us

product at $9-$11. Generally, our pricing at retail is from $10.99 to $15.99." TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS

"Independent labels think their albums should be cheap because they are independent. They then don't invest in developing the product because of it having a lower cost." JONATHAN REES, VP OF PRODUCT, HMV CANADA

vii) RETAIL BUYING: Nielsen Soundscan/BDS Data

In recent years, Canada's music industry has had the use of Nielsen SoundScan for gauging music retail sales and Nielsen BDS data for gauging radio airplay of records.

Nielsen SoundScan and Nielsen BDS data enables the music industry to pinpoint precisely where a record is getting the most active response. By knowing where a record is being bought and where people are listening to it, advertising and promotion support can be developed at a suitable time. While Nielsen SoundScan and Nielsen BDS data can identify positive early sales and airplay, it can also show the lack of sales and airplay which may convince a label, distributor, retailer or radio programmer to drop support of a record prematurely.

Nielsen Soundscan

Nielsen SoundScan measures retail record sales by analysing the information from electronic cash registers that read bar codes on records sold at reporting stores. SoundScan data is sold to record companies, radio and other users.

Prior to Nielsen SoundScan's launch in Canada in 1997, the industry had relied on sales ranking provided weekly by select retailers. Record companies only knew how many records had been manufactured and were shipped to retailers. Stores provided no exact sales figures, only a listing of top sellers and often failed to include country or other genres in the listings. Accurate sales figures were not readily available until retailers had shipped unsold product back to the label--sometimes months later.

Nielsen SoundScan data has enabled manufacturers to fine-tune the manufacturing and distribution process, resulting in reducing returns. Labels are now able to pinpoint with some accuracy where sales are, and be able to be in a position to target regions for promotion. Furthermore, most retailers have significantly upgraded their automated in-house inventory system data, and point-of-sales (POS) data systems in recent years.

However, several sources contend that Nielsen SoundScan's immediate monitoring of inventory is also substantially reducing the life span of many albums today. Previously, an album might stay on a shelf for months until the proprietor got around to doing a store-wide inventory. This afforded time for the album to receive attention from radio programmers or music media and, perhaps, to catch on. Today, the shelf life of an album, particularly by an unknown artist, can be weeks. Albums are shipped back once they fall below a sales minimum.

> *"If a record isn't moving, it's out of there. Retailers want 'just-in-time' inventory. They don't want to take risks." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA*

> *"Retailers are willing to keep things in that are steadily moving but if there's no movement, they want to return it right away. In most record companies policies you must keep new releases for 120 days. Retailers are now asking us to take the stock back in 60 days. They are also ordering less while ordering more often. The cost of distribution is going though the roof with this constant re-ordering." GARRY NEWMAN, CEO/PRESIDENT, WARNER MUSIC CANADA*

Nielsen BDS

Nielsen BDS launched in the U.S. in 1989, and in Canada in 1996. It can track airplay of recordings by radio stations, including by format and provide access to stations' playlist.

Utilizing computers in major and secondary markets to "listen" to radio stations 24 hours a day, Nielsen BDS technology recognizes songs aired by those radio stations. Recordings are first entered into the system's computer to the firm's Kansas City headquarters, which, in turn, creates a digital fingerprint of that material. The fingerprint is downloaded to BDS monitors in individual markets. These monitors recognize the fingerprint when the recording is broadcast, and this detection history is transmitted to the Nielsen BDS central operations facility where chart positions are tabulated.

SECTION 3: INTERNATIONAL DISTRIBUTION

i) GLOBALIZATION TRENDS

One of the world's foremost distributed industrial products, recorded music - crosses political and cultural barriers.

For Canadian-based record companies--from multinationals to independent labels--success internationally over the past decade by Canadian artists, coupled with increasingly working within the U.S. radio and tour market, has meant an appreciable expansion in opportunities. It is in the interest of Canadian-based companies to have their masters released in foreign territories because substantial profits may be earned from many major markets with strategic planning and exploitation.

Prior to the 1960s, the American and British music industries--the two traditional leaders of recorded music in the world--remained domestically based and oriented. While their music was sold abroad, the resulting revenues were small. Foreign revenue was regarded an incremental, as such companies did not maintain consequential overseas organizations or significantly modify their music to suit tastes abroad.

Beginning in 1986, when Bertelsmann AG purchased RCA Music, the music industry has consolidated into five global media and entertainment organizations. It evolved from regional businesses to diverse conglomerates overseeing production, distribution and consumption of cultural goods on a global scale, and operating in multi-mediums, including: music, films, television, cable television, and book publishing.

Following takeovers and mergers in the music industry and with the arrival of new technologies, the multinationals began to increasingly cater to an international audience.

The multinationals generally view the global music marketplace in pan-regional blocs, such as United States/Canada, Europe, and Japan/ South East Asia. They generally divide the world into primary, secondary and tertiary markets. These divisions correspond to the economic sales potential and the strategic importance of specific national territories.

In terms of total retail sales the primary markets for popular music are the United States, Japan, United Kingdom, Germany, and France. In recent years, these territories have regularly accounted for 75.6% of the total world sales of recorded music. In 2001, according to figures provided by the International Federation of the Phonographic Industry (IFPI) Canada ranked no. 6 with 2%.

The enormous impact the multinationals have on music globally is based on their control or access to a range of different types of media and distribution. They can cross-market or negotiate product across multiple media: through recordings, films, television and advertising.

Whereas multinationals have the resources and the inter-company structures to launch acts internationally, Canadian independent labels rarely have the resources or market clout to launch acts into the international marketplace with consistency. Nor are they often able to promote recordings abroad in continual support of a foreign licensee i.e. such as being able to have artists touring or doing media in foreign territories on a consistent basis.

> *"We're available now in 30 countries. It's hard coordinating international release dates and having artists touring. When you are a major you have offices in every major city. It's a nightmare for an independent." JIM WEST, PRESIDENT, DISTRIBUTION FUSION III/JUSTIN TIME RECORDS.*

> *"It is possible for indies in Canada to get their product retailed in Japan and Australia through us but the band has to tour there. We would give them in store racking and have them play stores. The acts that really make it there are ones that go there every year. CHRIS WALKER, PRESIDENT/CEO HMV NORTH AMERICA*

From its earliest days in the mid-80s, Vancouver-based label Nettwerk Productions looked outside Canada for support of its roster. Its owners realized that the type of music they were releasing was not as in demand in Canada. Nettwerk exported Canadian product to the U.S. and Europe early on, and secured North American rights to albums by foreign alternative bands.

> *"You can't survive if you are only thinking locally. About 60% of our acts get released outside of Canada. I have four people who concentrate on Europe, and Australia and Japan." RIC ARBOIT, PRESIDENT NETTWERK PRODUCTIONS*

ii) SECURING INTERNATIONAL DISTRIBUTION: AN INCREASING PRIORITY FOR CANADIAN LABELS

Multinationals

Acknowledging the significance of markets abroad, multinationals based in Canada have increasingly sought in recent years to develop artists capable of moving beyond international boundaries. They have also developed or greatly strengthened their international departments. These changes were partially attributable to global alignments within each multinationals, a higher presence of Canadian acts internationally and an increased partnerships with affiliate labels, particularly in the U.S.

When an artist signed directly by a Canadian-based multinational has an album released--or licensed--in another country by an affiliate, the Canadian company is paid an inter-company royalty while marketing and promotion costs are covered by each territory's affiliates. These inter-company royalties range from 32%-34% based on published prices to dealers. The royalty is standard through all of the multinational's subsidiaries and is divided amongst the record label, the artist, and publisher(s) involved as rights holders.

There is some variance in this "all-in fee" between companies, for example tour support or video support may be deducted before the revenue comes from the affiliate abroad.

> *"The only thing foreign affiliates are responsible for under most inter-company royalty agreements are on-ground, in-territory costs. We pay to get an act anywhere." STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA*

Generally, Canadian-based multinationals attempt to build an impressive sales success at home before trying to secure a "meaningful" release from as many of its international affiliates as possible, including a coveted U.S. release. Affiliates will be more attracted to Canadian acts which have achieved some success in Canada.

Independent Labels/Artists

For those Canadian independent labels or acts seeking distribution outlets outside Canada, the obstacles are significant. Independents may be able to survive in the domestic market, but in the worldwide market they lag behind the multinationals due largely to lack of finances or contacts.

While Quebec's independent labels have distinct advantages domestically over independents operating elsewhere in Canada, they also face sizable obstacles elsewhere. Opportunities for most French language artists abroad are primarily limited to other French-language markets. Still, many of Quebec's record production companies and labels have built close ties with European labels over the past 15 years.

> *"Independent Quebec companies were having success in Quebec but difficulty exporting their talent. But in the past five years there's been success stories with Isabelle Boulay, Lynda Lemay, and Garou." NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT*

The most direct way for an independent label or artist to attain foreign distribution is by either signing directly with a Canadian-based multinational or by having them distribute. Both can lead to distribution with the multinational's affiliates in other territories.

> *"If you develop a good relationship with your (multinational) distributor, they can be helpful in getting your masters to their companies all around the world." TOM BERRY, PRESIDENT, ALERT MUSIC*

While multinationals have affiliates in most foreign markets, most Canadian independent labels distributed by a multinational in Canada must license their catalogs or specific product abroad either through a single worldwide deal with a multinational or on a territory-by-territory basis with a multinational or independent distributor. A Canadian independent label distributed in Canada by an independent distributor is practically back to square one looking for distribution abroad. They usually have to shop their recordings to individual distributors--either multinationals or independent distributors--in individual territories.

The advantages for an independent label or artist with a worldwide deal--usually with a multinational--are:

- It is less costly to enter into a single international agreement than to negotiate numerous sub-licensing agreements;
- Administration is less complicated;
- The licenser can utilize the local resources and reputation associated with the multinational; and,
- A specific label of the multinational may be utilized on a worldwide basis.

In territory-by-territory deals, the independent label or artist enters into separate licensing agreements with numerous companies representing particular countries or territories. The advantage of this type of deal includes:

- Total advances from all licensees will likely be more substantial than provided by a single deal with a multinational; and,
- There may be stronger representation in some territories if an individual company needs the product more than the multinational which has its own product lines to deal with.

The duration of such licensing agreements generally runs three years. The licenser generally grants the licensee right to manufacture, distribute, and sell product. Royalty rates for sale of product by foreign licensees in their territories range from 14% to 18% based on the published price to dealers.

Independent labels or artists working in specialized fields, like electronica, folk, punk, hard-core, Celtic, children's music, and worldbeat, etc., can tap more directly into foreign territories with similar-like niche distributors which tend to be quite small.

Niche categories may not sell substantially against the market leaders but many niche-styled Canadian independent-based artists have been successful in developing markets outside Canada, including Loreena McKennit, Fred Eaglesmith, Be Good Tanyas, Jesse Cooke, Hayden, Danko Jones, and such electronica DJs as Ritchie Hawtin, , Misstress Barbara, and Freaky Flow.

> *"Canadian dance and electronica repertoire is well respected in the United States, in the U.K. and in Germany. Labels like Turbo or Bombay in Montreal*

might sell 5,000 records of a title on average in Canada, another 10,000 in the U.S., and 5,000 in Germany. They can end up selling 60,000 units." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT CANADA

A striking example of the potential of niche strategizing is Somerset Entertainment--formerly Solitudes Ltd.--which has evolved in the past decade from a peripheral "nature sounds and music" entity to being a leading producer/distributor of entertainment products to non-traditional channels worldwide, with annual gross revenues of $42 million--80% of which is from foreign sources.

Headquartered in Toronto, the company also has offices in Chicago, Raleigh, and Essex, England. It operates five labels---Solitudes, Avalon, Reflections, Platinum Legends, and Mother's Love Music--and has a catalog of over 400 albums of nature, contemporary acoustic, children's, classical, jazz, and Celtic.

"The uniqueness of our product has allowed us to go to (foreign) markets. We have something that is different than what is there." ANDY BURGESS, PRESIDENT SOMERSET ENTERTAINMENT

SECTION 4: THE FUTURE OF DISTRIBUTION/ DOT.COM WORLD DEVELOPING

While retail stores are still the bulk of music sales, a new dot.com world is developing that will greatly reshape the distribution of music. Downloads, subscription and non-subscription services, digital radio, and interactive music sites are also creating new ways for music to be widely known. Also the main currency of the record industry is becoming the song instead of the album.

However, as unlimited free content continues to proliferate on such peer-to-peer networks as KaZaA, iMesh, Grokster, Gnutella, and Audiogalaxy, major intellectual property-holders---labels, and publishers--are intent on keeping a tight rein on the Internet.

With subscription services, a legitimate on-line marketplace may be beginning to develop to the benefit of the commercial market as a whole. All the major-label subscription services enable consumers to purchase permanent downloads, which can then be transferred to portable devices or burned to a blank CD. It remains a question, though, how much a consumer would be willing to spend monthly or annually, or unlimited access to music.

While E-commerce still pales in comparison to brick-and-mortar retail in selling recorded music, the traditional business way of selling music to consumers will likely remain a significant business for some time.

In fact, according to a 2002 survey “Global Music Industry: Facts and Forecasts,” by the London, England-based media information provider, Informa Media Group, while on-line sales of traditional and digital product will increase globally through 2007, this will account for only 6.5% of total music sales. On-line sales, the report indicates, have “been exaggerated and will not prove to be the industry's long-term savior”, and that sales of digital music will remain “a niche sector.” By 2007, digital sales are expected to account for only 1.2% of the global total.

Still labels and artists have increasingly shifted their marketing strategies in recent years to the Internet--particularly in the absence of mainstream retail and radio airplay support. The Internet is being seen as an inexpensive promotional tool in previewing new album releases in conjunction with media campaigns that build a “buzz” ahead of an album’s release date. Promotions can also include exclusive downloads, artist-specific streaming channels, behind-the-scenes footage, videos, artist chats, and retail links.

Most independent labels and artists operate on-line sites where interested parties can listen to music, download MP3s or order music. Independent labels and artists generally view the Internet, not as a threat, but as an indispensable selling tool--along with off-stage sales. However, unknown and even known artists have come to realize that many of the traditional roles of record companies, such as marketing and distribution, are not easily replicated. Having product available or having a single site does not provide a vehicle to draw interest on its own.

i) PRIVATE COPYING, UNAUTHORIZED DOWNLOADING/ CD-R BURNING

Industry sources generally blame the downturn in recorded music sales in Canada in the past three years on private copying and CD-R burning from Internet sources.

CRIA--commissioned studies indicate the majority of Canadian music consumers are unaware of the illegality of unauthorized downloading. CRIA launched its "Value Of Music" national media campaign in 2003. It is intended to educate Canadians that widespread downloading of digital music from unlicensed "peer-to-peer" services, and CD-burning are having a negative impact on Canada's music sales.

> *"Downloading doesn't affect our business as much as it affects the major labels' business. People download hit singles or entire hit albums. Our product is niche. People buy it mainly to collect." DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT INC. (CANADA)*

It is becoming apparent that stopping file sharing may be technologically impossible. It is the nature of the Internet. Legal challenges effectively shut down Napster in 2002, so it's demonstrably possible to stop centrally controlled digital-music piracy through legal means. However, stopping peer-to-peer distribution may not be possible by technical or legal means.

ii) COPYRIGHT PROTECTION

While the Canadian Copyright Act does cover digital downloads as a means of distribution, and CRIA can close down unlicensed sites offering music, the U.S. music industry has more tools in dealing with Internet service providers (ISPs) because of protection under its Digital Millennium Copyright Act of 1998.

The Canadian government has yet to fully deal with copyright protection in the digital age. Its' delay in enacting the two World Intellectual Property Organization (WIPO) treaties—the Performances and Phonogram Treaty and the Copyright Treaty—continues to leave the domestic industry weakened. While the treaties were signed in 1997, they have yet to be ratified.

However, in a landmark decision, Canada's Federal Court of Appeal ruled in May 2002 that if ISPs in Canada act as more than "passive providers"—for example, by storing music on their servers—they are responsible for paying music copyright royalties. The court, however, also ruled that if ISPs generally act as "common carriers" they are not liable for paying.

The decision, in effect, addressing the question of liability for music on the Internet in Canada for the first time, supports the licensing of Internet transmissions of music in each country to which they are transmitted, no matter where the music originates.

iii) WILL CONSUMERS SUPPORT SUBSCRIPTION SERVICES?

2003 is being hailed by the music industry as the first real year of operation for the subscription-based Internet business in the U.S. via a range of E-commerce and subscription partners including MusicNet, Pressplay, Alliance Entertainment, Ecast (owner of RioPort), Liquid Audio, MusicNow, Rhapsody, Roxio, and Streamwaves.

However, whether increased content and portability will be incentive enough to motivate consumers to abandon free peer-to-peer services remains unclear.

Five on-line subscription services, MusicNet, Pressplay, Music Match, Moontaxi (Puretracks.com) and Galaxie are preparing to launch in Canada. Moontaxi and Galaxie are Canadian-owned companies.

CRIA, on behalf of its members, has been brokering an on-line licensing Agreement (OLA) for the competing digital-music services with songwriters and publishers, represented by Canadian Music Reproduction Rights Agency (CMRRA). Among the issues to be settled are establishing a compatible royalty structure that labels will pay publishers for use of their works in these digital services.

MusicNet, the U.S.-based service from Warner Music Group (WMG), BMG Entertainment, EMI Recorded Music, Sony Music Entertainment (SME) and Real Networks, first launched in the U.S. as part of RealNetworks' RealOne media player in Dec. 2001. Pressplay, the joint venture between Sony Music Entertainment (SME) and Universal Music Group (UMG), also launched in the U.S. Dec. 2001.

Meanwhile, UMG, WMG, EMI, and BMG expanded their own commercial download initiatives in 2002 bringing the number of tracks available for full-ownership purchase from each company into the tens of thousands.

Following a year of negotiations to expand their major-label repertoire offerings in the U.S., Pressplay and MusicNet reached agreements in late 2002 to fully cross-licensed repertoire from all five multinationals in the U.S. followed by FullAudio’s MusicNow in March 2003.

Listen.com's Rhapsody had been the first of the digital services to offer a fully crossed-licensed product since early 2002. Listen.com is an independently owned private company in which the five majors collectively hold a stake of less than 2%.

Since their advent, the commercial digital-music services in the U.S. have been criticized for their limited content and functionality. With these new label deals in place, however, services are beginning to make headway in building catalogs that can compete with unauthorized peer-to-peer networks. Content availability in digital music services will remain a problem in part due to many artists continuing to withhold distribution approval. A substantial number of older contracts do not cover digital distribution ―and bigger acts have the power to block its inclusion.

Since the U.S. launch of Apple's iTunes music store on April 28, 2003 talks have intensified between the major record labels, various leading Internet services and technology providers to more effectively offer paid download singles to U.S. online consumers.

The quick acceptance of Apple's iTunes has taken the music industry by surprise. However, unlike the unwieldy restrictions of rival online music services, Apple's a la carte model is simple. Users pay 99 cents (U.S.) and can play songs from the five major labels on an iPod or share them on as many as three Macintosh computers.

With its singles-oriented strategy, Apple may indeed be the first service to effectively tap into the file-sharing culture by offering a higher-quality music file that is easier to attain than on the likes of KaZaA. However, a legitimate and unrestricted online music service for mass market consumers may still be a long way off because copy protection is still a hurdle.

iv) POSSIBLE FUTURE DEVELOPMENTS

Although several functions of the music industry's traditional roles, such as A&R, marketing and promotion lend themselves easily to migrate on-line--others, including manufacturing and physical distribution--will likely be replaced by a virtual market of digital downloads, file sharing and subscription services. These developments could also result in the creation of new record labels entirely based on the Internet.

In a move that may be a significant indicator of the gathering momentum for legitimate on-line music services, AOL launched its version of the MusicNet subscription service February 2003. The four-tier initiative marks the first significant push by AOL to sell premium music services to its customers. The company is banking on its established marketing muscle in music, coupled with the fact that AOL users will not have to re-enter credit-card information to subscribe to MusicNet, to help the service expand faster than other for-pay digital music options.

AOL may be able to use its established music-marketing muscle to attract a financially meaningful number of paying customers to the service. It may also be able to produce substantial subscription volume by potentially bundling music at discount rates with other content and services while having advantages in economic, and packaging costs over retailers.

As digital distribution matures, existing distribution channels will likely be cannibalized, leaving traditional music retailers increasingly competing for consumers against media

companies selling subscription services. Consumers now have access to multiple points of purchase, on a worldwide scale, 24 hours a day.
Several independent distributors interviewed contend that electronic distribution may eventually lead to strengthening the multinationals' hold on distribution even further, and may present independent artists with even greater access challenges.

> *"Pressplay--and, to a lesser extent, MusicNet--are about creating artificially constructed avenues for the distribution of music that preserves the major labels' cartel on an interactive platform." Former Jupiter Media Metrix senior analyst Aram Sinnreich in Billboard (Aug. 18, 2001 issue).*
>
> *"With digital distribution, the indies stand a good chance of being shut out (of the marketplace) by the majors." BRIAN CHATER, PRESIDENT, CANADIAN INDEPENDENT RECORD PRODUCTION ASSOCIATION (CIRPA)*
>
> *"I will still have an alternative. There's always going to be someone set up with a system that we will be able to put independent music through. There will always be someone." JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS, MONTREAL.*

POLICY ISSUES/RECOMMENDATIONS

The following observations/recommendation, proposed by interviews with industry decision makers, were identified as being central to developing a stronger national presence of Canadian music in distribution and at retail in Canada:

1. That the improvement of Canadians' access to sound recordings with Canadian content is linked with labels and independently released artists having increased access to national distribution and retail channels in Canada.

2. That independent Canadian-owned labels be provided with resources to support their products in the marketplace, specifically funding be made available to market domestic recordings. Several suggest a 80:20 funding balance for launching new recordings. If 20% of funding available is spent on recording of a project, 80% would be allotted to its marketing at retail.

3. That there is a need for professional marketing and retail development programs to effectively heighten retail awareness of Canadian recordings.

4. That there is a need for a broad range of skills upgrading within the Canadian label and distribution sectors, particularly in the development of marketing management and training in the use of new technologies.

5. That an industry study be undertaken on the future of the electronic distribution of music and that it focus on the roles of the multinationals, independent distributors and labels.

6. That Canadian-owned independent labels be provided with financial resources or that government policies be enacted that would allow them to compete effectively with majors in securing distribution rights to foreign labels in Canada.

7. That there should be increased funding available to Canadian-owned labels and artists to secure and maintain distribution in foreign territories.

8. As foreign-owned independent labels are increasingly pressing Canadian independent distributors to provide marketing, and promotional services to maximize their sales in Canada, Canadian independent distributors need further staff to offer defined promotion and marketing strategies, including supporting national touring of acts. Interviewees suggest that profits earned from foreign product sales, would likely benefit the infrastructure of Canadian distribution.

9. That there should be consultation with Canada's distribution sector in developing and operating the various government run funding programs in place for Canadian music.

APPENDIX I: INTERVIEW SOURCES:

In proceeding towards the goal of providing the Department of Canadian Heritage with a profile of the English and French-language components of the Canadian music distribution industry, and to identify the principal issues facing the industry, the industry was broadly polled. The following are aware of this report and agreed to be interviewed and quoted.

INDEPENDENT DISTRIBUTORS

NATALIE LARIVIÈRE, PRESIDENT AND DIRECTOR GENERAL, GROUPE ARCHAMBAULT, MONTREAL.

GEORGES TREMBLAY, NATIONAL SALES MANAGER, DEP DISTRIBUTION EXCLUSIVE, MONTREAL.

IAIN WALKER, PRESIDENT, FAB DISTRIBUTION, MONTREAL.

JIM WEST, PRESIDENT DISTRIBUTION FUSION III/JUSTIN TIME RECORDS, MONTREAL.

DOMINIQUE ZGARKA, PRESIDENT, KOCH ENTERTAINMENT INC. (CANADA), TORONTO.

LLOYD NISHIMURA, PRESIDENT, OUTSIDE MUSIC, TORONTO.

TIM POTOCIC, CO-OWNER SONIC DISTRIBUTION/SONIC UNYON RECORDS, TORONTO.

WALTER GIARDETTI, SALES MANAGER, UNIDISC MUSIC, MONTREAL.

PETER PIASECKI, MANAGING DIRECTOR, NAVARRE CANADA, TORONTO.

GREGG TERRENCE, INDIE POOL CANADA, TORONTO.

RETAILERS

CHRIS WALKER, PRESIDENT/CEO HMV NORTH AMERICA, TORONTO.

JONATHAN REES, VP OF PRODUCT, HMV CANADA, TORONTO.

TIM BAKER, BUYER, SUNRISE RECORDS, TORONTO.

MULTINATIONALS

RANDY LENNOX, PRES./CEO, UNIVERSAL MUSIC, TORONTO.

GARRY NEWMAN, CEO/PRESIDENT, WARNER MUSIC CANADA, TORONTO.

STEVE KANE, SENIOR VP/MANAGING DIR., WARNER MUSIC CANADA, TORONTO.

INDEPENDENT RECORD LABELS

RIC ARBOIT, PRESIDENT NETTWERK PRODUCTIONS, VANCOUVER.

DONALD TARLTON, CHAIRMAN, DONALD K. DONALD GROUP OF LABELS, MONTREAL.

TOM BERRY, PRESIDENT, ALERT MUSIC, TORONTO.

BERNIE FINKELSTEIN, PRESIDENT, TRUE NORTH RECORDS, TORONTO.

GEOFF KULAWICK, PRESIDENT/CEO, LINUS ENTERTAINMENT, TORONTO.

OTHERS

BRIAN CHATER, PRESIDENT, CANADIAN INDEPENDENT RECORD PRODUCTION ASSOCIATION (CIRPA), TORONTO.

BRIAN ROBERTSON, PRESIDENT, CANADIAN RECORD INDUSTRY ASSOCIATION (CRIA).

ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS, TORONTO.

ROBIN RAM, PRESIDENT, MAR INTERNATIONAL GROUP, TORONTO.

APPENDIX II: MUSIC INDUSTRY OVERVIEW

In the past five years, due in part to evolving new communication technologies, there has been a dramatic shift in the record industry. Downloading of music via the Internet and widespread CD-R copying, coupled with competition from such leisure products as DVD video, and computer games, have adversely affected recorded music sales, particularly in such developed and technologically advanced markets as North America, Japan and Western Europe.

As a result the global music market is in a sales slump. According to a 2002 survey "Global Music Industry: Facts and Forecasts" by the London, England-based media information provider, Informa Media Group, global music sales are expected to continue to decline in value until 2005.

In the first half of 2002, according to the International Federation of the Phonographic Industry (IFPI) (Oct. 10, 2002 report) world sales of recorded music dropped 9.2% in value and by 11.2% in units. Sales of CD albums had a 7% fall. Single sales dropped by 17%, while cassettes continued a long-term decline, falling by 31%. Compared to the same period in 2001, the world's largest markets, the United States and Japan, which represent more than 50% of the world's music sales, saw sharp drops. The U.S. was down 6.8% in value and Japan was down 14.2% in value.

Music sales in the U.S. stumbled for the first time in over a decade in 2001, and fell again in 2002, according to Nielsen SoundScan, which measures stores sales. Total album sales finished down 10.7% with about 681 million units scanned, vs. 762.8 million units in 2001.

Canada's music market is locked into a three year-long sales slump. Canadian Recording Industry Association (CRIA) statistics for 2002 show the net value of trade shipments in Canada fell 5%, from $684 million to $650 million from 2001. Units also dropped 5%, 58 million units to 54.9 million units in the same period. According to Nielsen SoundScan, Canadian music sales finished down 16.3% for 2002 with 49.9 million units scanned against 59.7 million units in 2001.

APPENDIX III: DIVERSIFIED CANADIAN INDEPENDENT LABEL MODELS

*Operating from Terry McBride's apartment living room Nettwerk Productions was founded in 1984 by McBride, Mark Jowett, Tom Ferris and Cal Stephenson with a $5,000 loan as a production company to relaunch the career of Jowett's promising group, Moev. Soon after its start-up, the production company established its multi-faced corporate structure and was recording, managing and publishing such Canadian acts as Skinny Puppy, the Grapes Of Wrath, Ginger, Delerium, and Rose Chronicles. McBride and Jowell assumed control of the company in 1985. Ric Arboit became its third partner in 1987.

Nettwerk Productions has since evolved into a label/publishing/management mini-empire with offices in Vancouver, Los Angeles, New York, and London, and with affiliated Internet, graphics, and video production companies. Nettwerk's label roster currently includes Canadian acts Sarah McLachlan, Swollen Members, Martina Sorbara, Be Good Tanyas Delerium, Gob, Tara MacLean,The Hermit, K-Rec, Lester, and the Verbrilli Sound

Until the mid-90s, Nettwerk Productions was primarily managing acts on its roster but that focus changed with Nettwerk Management launching in 1995; the signing of Barenaked Ladies in 1996; and the North American breakthrough of Sarah McLachlan's "Surfacing" album in 1997, coupled with its production of the annual Lilith Fair festival which ran from 1996 to 1999.

Today, Nettwerk Management handles Avril Lavigne, Sarah McLachlan, Maren Ord, Tara MacLean, Chantal Kreviazuk, Barenaked Ladies, Swollen Members, Treble Charger, Gob, and Moist; UK act Dido; and U.S. act Six Pence None The Richer, Moss Eisley, Fisherspooner, and Toby Lightman. As well, Nettwerk co-manages Sum 41, Our Lady Peace, and Coldplay.

*Montreal-based entertainment conglomerate Le Groupe DKD is headed by Donald Tarlton; a major presence in Canada's concert world since founding the booking, concert and promotion firm Donald K. Donald Productions in 1966.

Tarlton and several partners set up English-language Aquarius Records in 1969. The label, distributed nationally by EMI Music Canada, has released more than 75 albums to date, including top-selling albums by Canadians SUM41, Serial Joe, April Wine, Corey Hart, and Sass Jordan. Among its newest signings are All Systems Go, Crowned King, and Pigeon-Hole.

Tarlton's French language label Tacca Musique, distributed by Distribution Select, has had success with Kevin Parent, France D'Amour, Jorane, Jodie Resther, Marie-Chantal Toupin, Lennie Gallant, and Nicola Ciccone.

Le Groupe DKD also operates the labels DKD Disques (La Chicane and Ric Maheu), DKD Vibes (Jodie Resther and McAuley), DKD Awesome (Speck, Platinumberg, and

Jenna Gawne), IndiK (Grimskunk), Core DKD (Micro Maureen), On Last Gang Records (Metric, Slan), DKD D-Noy (home of “DanseXpress” compilation series), and Aquarius International (Evermore, Golden Horse, the Brunettes).

In addition, Le Groupe DKD operates a national tour production company, DKD! Spectacle, and an artist development agency, Generation.

> *“(To survive) you have to be a record company, a publisher and eventually you have to get involved in tour production. You have to look at newer revenue models when you sign acts, like partnerships. Going in with an act with all chips in. When we sign an act it’s for records and publishing. I pretty well have co-publishing on everything. We don’t have management but that doesn’t mean it can’t be there in the future.” DONALD TARLTON, CHAIRMAN, DONALD K. DONALD GROUP OF LABELS*

*Two year-old Toronto-based label Linus Entertainment was set up to be both an independent label and publisher. To date the label has released albums by the Canadian Brass, Tuuli, By Divine Right, Harpoon Missile, and Not by Choice. It has also licensed recordings by Canadian singer/songwriter Rob Sexsmith.

The key to Linus thriving, according to its president/CEO Geoff Kulawick, will be it retaining rights to its masters and acting as a co-publisher/administrator for acts directly signed. Nor will Linus concentrate on a specific musical genre.

> *“I see an opportunity for an A&R driven and a small-to-medium artist development enterprise being able to develop artists and then license them internationally. We'll build the company by being both a label and a publisher. Many (Canadian) independents aren’t taking ownership. They are providing a service, really. I’m building assets, and a company with a value.” GEOFF KULAWICK, PRESIDENT/CEO, LINUS ENTERTAINMENT*

Kulawick formed Linus after resigning as director of A&R at Virgin/EMI Music Canada. Kulawick signed a pressing and distribution deal with Warner Canada in April, 2001.

As director of A&R for six years at Virgin Music Canada, Kulawick had developed its eclectic domestic roster, which ranged from Toronto rapper Choclair to the Ontario-based Celtic family group, Leahy. In his earlier post as creative director at Warner/Chappell Music, Kulawick had signed urban acts Maestro, and Rupert Gayle; alternative rock bands the Tea Party and the Rheostatics; and Celtic rockers Spirit of the West.

APPENDIX IV: SONG CORP.

A downturn in music sales, the failure to attract key labels for distribution, and high returns from retail appear to have been contributing factors in the 2001 bankruptcy of independent publicly-traded Song Corp. and its subsidiaries: Song Entertainment Distribution, Song Publishing, Song Recordings, and Attic Music Limited.

The two-year-old Toronto music group, headed by CEO Allan Gregg and operated by several Canadian music industry veterans, including company president/COO Bill Ott and vice chairman Alexander Mair, folded with reported liabilities of $8.2 million.

Song Corp. had aimed to build a full-service label/distribution/publishing company offering labels marketing and promotional support. There was a perceived gap in Canada's independent distribution sector following the 1997 bankruptcy of Montreal-based Cargo Imports, and 1998's closure of Denon Canada's music distribution arm in Toronto

> *"A distributor has to have sufficient volume to be able to be on the same level as the big five (majors). That's what Song Corp. set out to do." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS*

Among the prominent international labels distributed by Song Corp. were Navarre, Edel, Metal Blade, Razor & Tie, First Night, Concord Jazz, Magna Carta, and Permanent Press. It also distributed Canadian labels Page Music and Hi Bias and the imprint labels of Canadian acts Molly Johnson, Pavlo, and Quartetto Gelato.

Among the Song Corp. assets of 138 album masters and a 7,000-song publishing catalog were the recording and publishing assets that Song Corp. acquired from Attic Music Group in 1999. Co-founded by Mair in 1974, Attic was Canada's foremost independent label for two decades.

Publishing assets held included those of the Music Publisher (TMP), which was acquired in 1999 for $2.2 million Canadian ($1.4 million) from joint owners Canadian film company Alliance Atlantis Communications and A&F Music Ltd. (co-owned by artist managers Sam Feldman and Bruce Allen). Song Corp. also owned controlling interests in the publishing catalogs of the Tragically Hip, the Watchmen, and Big Wreck

By the summer of 2000, Song Corp. was seeking an equity partner. Its problems deepened with the termination of its Canadian licensing agreement with Roadrunner Records on Dec. 31, 2000. Roadrunner subsequently signed a distribution deal with Universal Music Canada.

Al Mair and Allan Gregg had a very good idea, which still appeals to me, but they executed it poorly. They had too much staff, poor A&R out of the gate, and didn't have the product flow." BERNIE FINKELSTEIN, PRESIDENT, TRUE NORTH RECORDS

"More than ever there is a need for a Canadian-owned distributor with sufficient volume to be able to supply the services that (independent) labels need." ALEXANDER MAIR, PRESIDENT, MHL COMMUNICATIONS

APPENDIX V: BIOGRAPHY OF LARRY LeBLANC

Larry LeBlanc has been associated with the New York-based music trade Billboard since 1991. He is currently its bureau chief for Canada. He was the co-founder of the late Canadian music trade, the Record. LeBlanc has acted as a consultant for The Canadian Competition Bureau, The Canadian Private Copying Collective, and the Neighbouring Rights Collective of Canada.