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Universal Acquires BMG: Concern for EMI & WMG

It is difficult being a distant third and fourth place in the music publishing industry: So Universal's bid to be the biggest publisher with its purchase of BMG Music Publishing is logical.

The acquisition increases the risk for EMI and Warner in particular. The recent merger between Sony BMG holds a valuable lesson: Second is a dangerous place to be. The merged company's market share declined from the sum of the shares before the combination, which widened the gap between Sony BMG and Universal, the leader.

The largest company in an industry tends to reap a disproportionately larger share of the rewards. Jack Welch, the former CEO of General Electric, often divested businesses that were not first or second in their fields. Mr. Welch was not the first to favor the market leader status: It is a 30-year-old tenet of marketing theory.

Bruce Henderson in "The Rule of Three and Four" (1975) postulated that no more than three major competitors could comprise a stable market, with a two-to-one ratio between the first, second, and third largest companies. A company less than one-quarter the size of the largest company cannot compete effectively in the mass market, he surmised.

Market share is one of the main determinants of profitability. Robert Buzzell and Bradley Gale reported in the *Harvard Business Review* in 1975 that a 10-percentage point change in market share produces a five-point change in pretax return on investment (ROI) on average, and gross profit margins increase faster than market share gains.

Market share is less important for frequently purchased low-cost products, like music, than for infrequently purchased items, such as costly durable goods, according to Buzzell and Gale. This is because the risk of buying something expensive is great, so consumers tend to gravitate to more established brands. This could mean that market share leadership may not matter for music publishers large and small.

The concern is that Buzzell and Gale found that market share is more important when selling to a fragmented market. Publishing, due to its own success, is diversifying its revenue stream across an increasing number of outlets. Although, the distribution channels for recorded music are consolidating, the distribution of music copyrights is expanding into ringtones, advertising, Broadway shows, etc.

The "Silver Medalist Theory" promoted by Adrian J. Slywotzky, James A. Quella and David J. Morrison supports Henderson's contention that all but the top two competitors are cash traps for investors. Slywotzky, Quella and Morrison conclude that the valuation for the second largest company is disproportionately smaller than the market leader. Although the silver medalist can be a potent competitor, it tends to be valued at one-third to one-twentieth of the value of the gold medalist.

Universal was wise to acquire BMG Music Publishing. Gaining share organically is expensive and takes time. This can benefit shareholders, while providing the aggregate market share needed to survive.

The bad news for EMI and Warner is that the gap between the market leader and the followers tends to widen. Worse, for these publicly traded companies, being second and third in publishing may severely affect their market valuations.

Marketing theory is a good predictor of reality, but it does not dictate the future. With solid marketing management and financial discipline, EMI and Warner, well-managed companies, do not have to be victims of the Silver Medalist curse.