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Closing the Value Gap

Recommendations on how copyright owners and advertising supported platforms can come together to find market equilibrium

Summary: Advertising supported platforms like YouTube are important to the music eco-system and music rights-holders should be grateful for their consumer reach and investment in label tools like Content ID. However there is a gap between what paid music streaming services and free ad-supported services like YouTube (and Facebook) deliver in terms of revenue per stream to music rights-holders. One way rights-holders can close the gap in value delivered is to charge a fixed CPM (cost per thousand views or streams). This fixed CPM could be fixed and based on each agreed upon business model and territory irrespective of the platform. In the future Apple, Google and Spotify could pay the same on a per stream basis. The retailers control their platforms and reap the benefits of their success (such as enterprise value in the stock market). Rights-holders on a rev-share don't control the platforms or reap the rewards of success yet bear the risk of platform failure. The fixed CPM strategy aligns with the risk/reward tradeoff in that it shifts the business execution risk to the platforms and away from rights-holders.

Details: In August 2017 YouTube Head of Music Lyor Cohen publicly claimed YouTube delivered a $3.00 CPM to music rights-holders. However the truth is much more nuanced. Three major items are not clear in using this number:

- **First, this number is quoted only on the basis of <u>monetized</u> video streams which is not a true number**. A public survey of the site ascertained that approximately 40% of video playbacks have an advertisement served. *This means 60% of video streams are unmonetized*! Therefore the effective CPM (eCPM) in the United States on the basis of all video streams is $1.20, not $3.00. This is less than half the number provided by YouTube. eCPM is the proper metric to use to create an apples to apples comparison between digital music and video platforms because premium streaming platforms like Spotify and Apple generally pay on a per stream basis (granted there can be minimum guarantees with breakage and corner pricing cases).
  - **Spotify Comparison**: In data sampled for August 2017 in the United States Spotify had an advertising supported eCPM of $2.11 and a paid subscription eCPM (revenue/1000 streams) of $6.19.
    - Therefore Spotify is paying approximately 75% more than YouTube for its advertising supported model and 515% more for paid streaming.
    - That said, due to Spotify having a majority of free ad supported users, when accounting for both its advertising supported and subscription tiers, Spotify had a blended eCPM of $3.01 in the United States in the data sampled.
  - **Apple Comparison**: Apple has no free tier and thus its eCPM is higher at $6.38 for the same period.

- **Second, YouTube is a part of Google, a vertically integrated corporation that creates gross margin at every step in the waterfall**. Google controls each function in the advertising value chain from the demand side platform used by the advertiser to place their purchase (AdWords) to the Ad Exchange (Google Display Network) that resolved the strike price of bids with their supply side platform (AdSense) as well as the ad server (DoubleClick) and the publisher (YouTube). $3.00 CPM is reported by YouTube, the last level in the waterfall. Every business unit at Google takes a fee for their service. Based on extensive advertisement purchasing experience, we believe the gross dollar flowing into the Google machine at the AdWords level is $6-8 CPM for general US based video targeting (although it fluctuates based on time of year and gets a LOT more expensive for specific targeting). See the screen shot below.

  This combined with SEC filings showing Google has a 60.12% gross margin suggests that Google is grossing an average $7.50 CPM with $3.00 CPM paid to rights-holders, but again at a 40% fill rate only equaling $1.20 eCPM. By contrast Spotify pays out $2.11 eCPM on advertising supported and $6.00 on paid streams and has a gross margin of approximately 16%. While this is anemic and healthy is probably 20% to 30%, if Google was in line with music industry practices it would increase its advertising fill rate and pay through at least on par with Spotify at $2.11 eCPM in the United States ($3.51 CPM at a healthy 60% fill rate or $5.28 CPM at today's 40% fill rate) and still have 53% or 30% margins from ad supported streaming, respectively. The recorded music industry can view Spotify ad supported streaming as part of the paid streaming sales funnel and indeed Spotify puts many restrictions on it. YouTube should do the same or it stands to reason it would be appropriate to pay a higher rate for free streaming since they are a substitute cannibalizing some portion of the potential market for paid streaming. To really get into this we need to analyze market segmentation and price elasticity which is beyond this paper.
    - **Sidebar:** Google as a conglomerate looks at their business from a total lifetime value per customer versus total cost to acquire a customer. Music can and perhaps should be a loss leader for them to attract and retain customers that they monetize in a myriad of other ways through services like Gmail, Android, Chrome, Waze, etc. For retailers like Amazon and Wal-Mart it is all about basket size and share of wallet. Entertainment has always been a loss leader that drives customer traffic, basket size and share of wallet.

- **Third, we live in a global economy. The United States alone isn't a good measure. YouTube's monetization rates in most countries outside the United States are very low.** Globally in August 2017 on a blended per sound and video recording stream basis:
    - YouTube was <$0.50 eCPM
    - Spotify was >$2.00 eCPM
    - Apple was >$6.00 eCPM

  It is worth noting that YouTube had a substantial advertising issue earlier in 2017 where a substantial portion of their major advertisers pulled out over brand safety concerns. Their advertisements were being targeted to content that was objectionable. As a result YouTube has created business rules and algorithms that emphasize brand safe content and de-emphasize other content. While this is admirable it has had the impact of lowering CPM's on the site substantially and is the new normal. Again this is a risk factor that rights-holders don't control but have had to bear the economic loss from.

Closing: There are different segments of music consumers. There is a place in the world for customers who are unable or unwilling to pay for music to consume it for free in an advertising supported environment. For example, 70% of Latin America is unbanked and can't easily pay for music. **That said, music has value and music labels should be able to set a wholesale price for their music thereby shifting the economic risk to the consumer platform.** The consumer platform should bear the risk because they also stand to realize the reward. Google and Facebook, by way of example, should then in turn decide if they are willing to use music as a loss leader to acquire customers and retain them. If the total lifetime value of a customer acquired using music or the increase in basket size or share of wallet for existing customers is profitable then it makes sense. One way rights-holders can close the value gap is to charge platforms like Spotify and Google a fixed CPM based on business model and territory regardless of the platform. In the future Apple, Google and Spotify could pay the same on a per stream.