Music Labels Cut Friendlier Deals With Start-Ups

By BRAD STONE
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SAN FRANCISCO — With CD sales dropping fast, it is not hard to imagine how the major music labels could benefit from the growth of Web start-ups like Imeem. The company's service lets people listen to songs, discover new artists and share their favorites with friends. And in return, Imeem owes the labels licensing fees for use of the music.

When the song site Imeem, founded by Dalton Caldwell, was struggling to pay licensing fees, the labels renegotiated.

But two months ago, Imeem's founder, Dalton Caldwell, was ready to pull the plug. While 26 million people a month were using the service, Imeem owed millions of dollars to the music labels, and income from advertising was nowhere close to covering expenses. "It reached a point where it was not even clear it was worth doing any more," Mr. Caldwell said.

Then the ground shifted. This month, Warner Music Group forgave Imeem's debt, and both Warner and Universal Music agreed to relax the terms of their licensing deals with the site. That allowed Imeem to raise more money from investors and plan for a profitable future.

Imeem's amnesty is one sign that a new accommodation is being forged between Web music start-ups and the companies on which they are almost wholly dependent, the major music labels. The recording industry is considering an all-digital future in which it needs popular Web services like Imeem, both as sources of revenue and as supplements to older channels of promotion like radio and MTV.

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In Europe, Daniel Ek, left, and Martin Lorentzon founded the music service Spotify, which is free and plastered with ads.

As a result, music labels are now striking more favorable terms with Web companies, and the start-ups have come to realize they cannot rely on Web ads to support themselves. For example, as part of its new plan, Imeem will try to push users into buying more T-shirts and concert tickets, and will soon add its own MP3 download store similar to iTunes, sharing revenue with the labels.

It is not yet clear whether any of this is enough to produce sustainable online businesses — or even to help mitigate the chronic pain of the music industry. But it is offering some hope.

"We are trying to figure out how to restructure partnerships and develop a healthier ecosystem where entrepreneurs can continue to innovate," said Michael Nash, executive vice president for digital strategy at Warner Music. "Entrepreneurs are also realizing they need to spend as much energy on their business model as they do on technological innovation."

The changes stem from an unavoidable and unpleasant reality facing the music business: the economics of offering music free on the Web do not work. Companies like Imeem, striving to create an alternative to Apple's dominant iTunes Store, signed complex deals with the labels that required them to pay large upfront fees and then small royalties — typically a penny or less — each time a song was played online. Advertising recouped only a fraction of that considerable expense.

As a result, the online music landscape is littered with the wreckage of failed or troubled music start-ups. SpiralFrog, a free music download service supported by advertising, went out of business in March, citing financial difficulties. And music executives have roundly expressed disappointment with the money trickling in from MySpace Music, their joint venture with the News Corporation, which started last year and was talked about as a savior for the music business.

For many digital music entrepreneurs, there is new hope that music labels will now give them room to experiment and perhaps succeed. Last fall, Lala, a Silicon Valley start-up, introduced a distinctive service that lets people listen to a song once at no charge. Then it costs 10 cents to stream that song repeatedly on the Web and up to 99 cents to download it.

Lala executives credit the labels' cooperation in the unusual licensing arrangement and say they are selling hundreds of thousands of songs a month.

In April, the mobile phone operator Vodafone introduced a music service in Spain that gives subscribers unlimited access to a broad catalog of songs on their phones for 16 euros ($22) a month. The songs can be played on the phone or transferred to a computer. The service was possible only because the major music labels altered the underlying economics of their licensing deals, said Rob Glaser, chief executive of RealNetworks, which is supplying the music service.

"That flexibility wasn't there in 2008 anywhere in the U.S. and Europe," he said.

Napster, a pioneer in peer-to-peer music sharing that became a paid music service owned by the retailer Best Buy, reduced its subscription rate to $5 from $12.95 a month last week as a result of new deals with the labels, according to Chris Gorog, Napster's

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chief executive.

Also last week, Pandora, the rapidly growing Web radio service, said it would increase the number of audio commercials on its free service and offer an ad-free version, Pandora One, for $36 a year. The founder, Tim Westergren, said he expected the company to reach profitability next year.

“There was a generation of Web companies that signed up for deals that didn’t make sense, and unfortunately they set a precedent,” Mr. Westergren said. “Now that those deals turned out to be unsustainable, it made the labels realize that there was actually not hidden money they were missing out on. I think labels have a much better understanding of the economics of the business.”

Another music start-up seeking to take advantage of the new environment, one that seems to be collecting ardent fans and skeptics in equal numbers, is Spotify, based in Stockholm.

The service, which requires iTunes-like software that people download to their PCs, offers millions of free songs, supported by copious advertising and opportunities to buy merchandise, downloads and tickets. (A premium version, without ads, costs around $15 a month.)

Spotify plans to enter the American market later this year, and its founder, Daniel Ek, says that the music labels have given the start-up flexibility because they are attracted to a service that, with its unlimited free music, could convert illegal downloaders into monetizable consumers of music. “This is what has been lacking for 10 years. The only way to beat piracy is by actually creating a legal service that is just as good,” Mr. Ek said.

Spotify will not discuss the details of its arrangements with the European divisions of the music companies, and many music entrepreneurs and observers question whether Spotify — and other digital music start-ups, for that matter — can build enduring businesses.

“Until we start seeing these guys living on their revenues, as opposed to their investment, we are not going to know how effective their business models are,” said Mike McGuire, an analyst at the research firm Gartner.

ILike, a Seattle company that bills itself as a music discovery engine for users of social networks, has actually turned away from offering free music online in recent months, and is instead focusing on helping bands forge connections with fans and developing tools like applications for the iPhone. Ali Partovi, iLike’s chief executive, is not sure labels and start-ups have found complete harmony yet.

“There is an ongoing tension between what consumers want and what music labels want,” Mr. Partovi said. “It’s hard to know what model will satisfy both, and what will work over the long run.”

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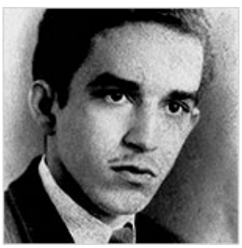

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