Wireless Outfits Will Face the Music

Trying to provide their own digital-music services, rather than partner with market leaders, is a move they'll likely regret.

In recent years, cell-phone carriers have been gleefully astonished by the popularity of ringtones. These electronic snippets of sound have sparked a lucrative, multibillion-a-year trend, as people -- mostly younger people -- fork over $3 or more to get personalized rings on their cell phones. So you can't blame carriers for taking what seems like a bigger, even more lucrative step: Selling real songs, rather than digitally copied bits of them. As Dennis Strigl, CEO of Verizon Wireless, told BusinessWeek, "We have a tremendous opportunity to make a big impact in music." (See BW, 5/25/05, "iPod Killers?".)

Well, maybe not so tremendous. Here's why: Hardly any profit can be made selling digital songs. Just ask Apple (AAPL), which dominates this business with a 70%-plus share. While it makes healthy profits from selling its iPod music players, it had to sell nearly 300 million songs for its iTunes online music store to reach a sustainable level of profitability. Cellular carriers will spend a lot of time and money trying to build their own music services over the next few years. In the end, most will fail -- particularly in the U.S.

On paper, carriers have plenty of strategic reasons for wanting to sell songs. It beefs up their revenue per subscriber and might well help them sell other services. Ultimately, though, many will end up embracing Apple and its ilk. That way, they can cut the losses they'll have racked up trying to build their own music empires, ride the coattails of music partners, and focus on their core business: signing up more cell-phone subscribers. Think broadband, where SBC (SBC) has garnered millions of DSL customers via its partnership with Yahoo! (YHOO).

NARROW MARGINS. Some signs show that this might already be happening. For months, carriers have been drawing up plans for online music stores to zip songs over the air, right to their subscribers. But in recent weeks, some carrier executives have wavered, says Chris Gorog, CEO of Napster, the second-largest music-download store. "In our discussions with the carriers -- and we've had many -- they start out by talking about doing it themselves. And then they realize how hard it is," he says.

This isn't an easy business. Carriers pay a few dimes per ringtone, vs. 65 cents for a full-length song. But while the going rate for ringtones sold to consumers is $2-plus, the price of a song at almost all online music stores is 99 cents. Translation: much thinner margins.

And then there's the question of network capacity. Bill Dyer, director for mobile applications at Alcatel North America, points out that most ringtones are less than 30 kilobytes in size, vs. three to four megabytes for a song. So while current cellular networks don't break a sweat to ring up all those ringtone profits, carriers may have to make hefty investments in capacity to deliver songs.

NEW DESIGNS. Apple CEO Steve Jobs convinced the music labels to go with a 99-cent price. According to analysts, about 65 cents of that amount goes to the music label. Then about 12 cents goes to the artist and music publisher, and six cents or so to the credit-card company. Apple, after incurring the costs of setting up countless servers, hiring dozens of talented techies, and running customer-support operations, has managed to reduce its own operating costs to just over a dime per song, says Piper Jaffrey analyst Gene Munster. So, it's squeaking out a 5% gross margin -- and that's for a dominant market leader.

Carriers are going to have to invest big money to subsidize the cost of phones designed for music lovers, some equipped with pricey hard drives and stereo speakers. What's more, they've never shown much aplomb for doing more than selling...
basic connectivity. That's why so many people still use Yahoo, AOL (TWX), and the like for e-mail, news, and calendars -- despite all the attempts by phone companies over the years to build their own portals.

Indeed, carriers seem to know this isn't their strength, given that most are outsourcing operation of their music offerings to third-party companies such as Loudeye (LOUD). Outsourcing is great, but even outsourcers have to make a buck -- and that's a buck Apple doesn't have to pay. What's more, Apple isn't standing still. Having spurred runaway demand for iPod and iTunes, it's now turning its focus from increasing its markets to squeezing out costs, says one supplier.

**CELL-CENTRIC.** Some might argue that the phone companies will win this efficiency war once digital music goes truly mainstream. After all, they're bigger, can afford upfront losses, and are built to survive on thin margins. Just as Wal-Mart (WMT) now dominates CD sales, phone companies will figure this out -- or so the theory goes. But that could be years from now, and how much of a lead will Apple have by then? On Apr. 13, it posted a 558% increase in iPod sales, to 4.3 million units, for the quarter, and iTunes downloads hit an all-time quarterly high.

But all these economic arguments miss an even more important point: Most consumers aren't going to want to center their musical lives around their cell phone. Sure, some will -- particularly casual users who just want to listen to a song now and then. But cell phones are unlikely to be the foundation for a consumer's music experience.

Since carriers are trying to define their services by the thing they're uniquely positioned to do -- deliver songs over the air -- they'll have a hard time delivering to varied devices. That much is clear from what BusinessWeek Online has learned about the initial services in the works from big U.S. carriers. Songs will likely cost $2 or more -- twice the price on iTunes -- and you'll probably be able to hear them only on your phone.

**DIGITAL HUB.** Another problem: "If you listen to music on your cell phone for a few hours on the way to work and find that the battery is dead when you get there, that's not a good experience," says Jonathan Sasse, president of iRiver, a leading maker of MP3 music players.

Of course, these first offerings will improve with time. Phones will get more storage, longer battery life, and better interfaces. New distribution technologies will be created, so that songs purchased over the air at lower quality will be simultaneously delivered in top stereophonic sound to some wired device.

But even that might play back into the hands of the current leaders, since that wired device will more than likely be linked to an existing PC-centric music service, such as iTunes or Napster. "No one is going to want to have scores of songs stuck in their cell phone," says Napster's Gorog.

So what should the carriers do? Certainly, overseas players, such as SK Telecom in Korea, should continue to build on the early momentum they've created. Carriers should also focus on figuring out music-subscription businesses. They could appeal to casual music listeners, who might be more than willing to pay $5 or $10 a month to have music streamed to their phones, without the hassle of messing with digital song files.

**PARTNERING UP.** As for building their own music-download businesses, carriers would be better served striking partnerships with the likes of Apple, Napster, and Microsoft (MSFT). "From the consumer's point of view, it would be a great idea to have a phone with iTunes capability," says former Wall Street analyst Phil Leigh, who now runs the Web site Inside Digital Media. "But the carriers don't really care -- because they just want to make some revenue. I think it's unfortunate that they're taking such a narrow point of view."

In the end, those carriers may come to find their current approach out of tune with the times.

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