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CAN MITCH KOULOURIS LEAD HIS STARTUP OUT OF THE RED?

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The Upside of Downloads

PHOTO: JAYSON CARPENTER



DMGI HOPES TO RIDE THE DIGITAL MUSIC WAVE INTO THE BLACK

BY RICH EHISEN



Amazon, Netflix, eBay ... the Digital Music Group? Don't worry if you haven't heard of that last one; neither have most people. But after barely two years in business, the Sacramento-based digital music distributor definitely has both its investors and the financial markets buzzing over its against-the-grain business model and seemingly way-early IPO. Now, the question on everyone's mind appears to be whether Digital Music Group Inc.'s unconventional thinking will lead it to a spot in the online pantheon of cyber heavyweights or to the anonymity of the dot-com boneyard.

DMGI is in many respects a classic wholesaler, purchasing a product directly from the manufacturer and then marketing it to the consumer via a wide spectrum of retail outlets. Its product is analog music catalogs, primarily obscure or old works from artists long out of the music mainstream. The company puts those recordings into a digital format and sells the individual songs through online digital music stores, most notably Apple's iTunes Music Store, Rhapsody and Napster.

Given this model, it is perhaps better said that DMGI is a classic wholesaler for the 21st century, depending not on warehouses filled with widgets delivered by truck and train, but on hard drives filled with 1s and 0s sent via cyberspace.

To date, DMGI has acquired the rights to more than 200,000 songs, with approximately 65,000 available for sale as of March. And while the number of downloads tends to fluctuate with the seasons, the company says each available track is downloaded an average of eight times per month.

DMGI is, of course, not the only company providing digital content for download. The Orchard, for example, boasts more than 800,000 songs for sale through the very same digital online stores. But where DMGI separates itself is in how it gets those tracks.

While most competitors focus on short-term distribution "lease" deals — of sometimes only a few months and rarely longer than a year — DMGI has figuratively blown up the boxes by buying content, or at least locking up its distribution rights for several years.

While Chief Executive Officer Mitch Koulouris says DMGI does have some short-term distribution agreements, he notes that the company's efforts now are entirely aimed at long-term deals, particularly those where it can make "an outright purchase, where we buy the master recordings or the digital rights to the master recordings." Purchasing content, he says, allows DMGI to stay out of constant rights renegotiations and ultimately provides a far better profit margin than the industry's standard short-term, artist-friendly deals.

"We're the only company out there that has really flipped the model up-

side down," Koulouris says. "There are a number of companies doing zero money up front and the distributor getting 15 percent of what is left over after the seller gets their cut. But at the end of the day, you don't own anything that way except a bunch of one-year contracts that you have to constantly renew."

In that system, Koulouris says, a seller like iTunes keeps 29 cents of every 99-cent download, leaving everyone else to divvy up the remaining 70 cents.

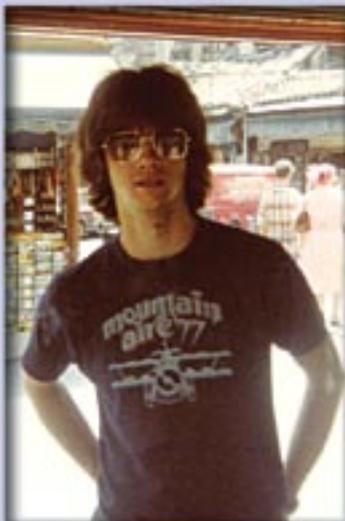
"If we're only keeping 15 percent of that, we make only a dime on every transaction," he says. "That just didn't seem very interesting to us or the shareholders. We figured that there had to be a better way here, and that better way is through ownership. If you own the content, you can flip that model upside down to where we get 80 percent and everyone else gets 20. And then we also have an asset that has real value that we can put on the books."

And how much value is there in digital downloads? The answer is that although digital music now represents only about 4 percent of the \$33 billion global retail music market, it is clearly becoming a player to be reckoned with.

According to the International Federation of the Phonographic Industry, a London-based trade association that tracks the worldwide music industry, there were more than 470 million digital songs downloaded either online or to mobile phones in 2005, up from 160 million the year before.

IFPI also notes that while physical sales of full-length recordings are down globally, sales of digital singles — both physical and online — grew 75 percent in 2005. Perhaps most telling, overall industry revenues from global digital sales rose from \$400 million in 2004 to more than \$1 billion last year. In short, while people haven't abandoned their CD players, digital downloads may someday take away a significant chunk of the market.

There are two basic beliefs at the heart of the DMGI business model. One, as already noted, is that owning is better than renting. The other is that there is a lot of money yet to be made from music that fell off the charts when



MITCH KOULOURIS

BORN: Sept. 1, 1960, in Stockton, Calif.

JOB: CEO, Digital Music Group Inc.

FAMILY: Lives in Elk Grove with his wife, Nancy, and their daughters, Sara and Katherine.

EDUCATION: Associate degree from San Joaquin Delta College, plus three years of study at the San Jose State School of Journalism.

WORK ETHIC: "Never put off until tomorrow what can be accomplished today."

LIFE PHILOSOPHY: "Life happens every day right before our eyes. Take some time to notice everyday things with your family and kids. Ordinary things all of a sudden become precious moments in time that you'll cherish forever."

America still liked Ike. Both views have come from the world's oldest teacher: experience.

Like almost everyone associated with rock and roll, the Stockton-born Koulouris has crammed a lot of living into his years of existence. He originally attended San Jose State to study broadcast journalism. He says he was good at it, but not passionate enough about the work to make it a career. So he returned to his pre-college employer, Tower Records, where he says he not only developed his appreciation for a wide variety of musical styles, but also his understanding of consumer buying habits.

"Tower had all the hits, and their motto was 'Stack 'em high, sell 'em low,'" he says. "But they also carried classical music, a lot of jazz, a lot of country soundtracks, even sound effects comedy records."

Koulouris spent several years in the main office, where he helped to develop the store's first computerized inventory system. He left Tower in 1990 to start his own publishing company, the Informant Communications Group, which specialized in putting out newsletters and magazines like Paradox Informant. It was successful financially, but more

"We're the only company out there that has really flipped the model upside down."

— Mitch Koulouris, CEO, Digital Music Group Inc.

importantly, it whetted his appetite for technology and business.

Inspired, Koulouris and his brother, Peter, started Digital Musicworks International in 2004, which they billed as "the world's leading full-service, all-digital music label." The intent was to function both as a content distributor

DMGI HAS ACQUIRED THE RIGHTS TO MORE THAN 200,000 SONGS; THE TOP 20 MOST-DOWNLOADED ARE:

| TRACK | ARTIST |
|--|-----------------------|
| 1. Sugar Sugar | The Archies |
| 2. The Night Chicago Died | Paper Lace |
| 3. She | Charles Aznavour |
| 4. Hooked on a Feeling | B.J. Thomas |
| 5. My Way (Live)..... | Frank Sinatra |
| 6. Those Were the Days | Mary Hopkins |
| 7. Massachusetts..... | Bee Gees |
| 8. That's What Friends Are For | Dionne Warwick |
| 9. Raindrops Keep Falling on My Head | B.J. Thomas |
| 10. Make Your Own Kind of Music | Mama Cass Elliot |
| 11. Save Your Kisses for Me..... | Brotherhood of Man |
| 12. Knock Three Times..... | Tony Orlando and Dawn |
| 13. I'm Into Something Good | Herman's Hermits |
| 14. You Sexy Thing (Original arrangement) | Hot Chocolate |
| 15. Never Ending Story | Limahl |
| 16. New York, New York | Steve Lawrence |
| 17. Itsy Bitsy, Teenie Weenie, Yellow Polka Dot Bikini | Brian Hyland |
| 18. Can't Take My Eyes Off of You..... | Andy Williams |
| 19. Where Do You Go to, My Lovely?..... | Peter Sarstedt |
| 20. Another Somebody Done Somebody Wrong..... | B.J. Thomas |

and as a record label that sold all of its artists' music in digital format over the Internet.

Although it did sign some respected artists, DMI did an abrupt about-face last year and dropped that concept in favor of the current owner-distributor vision. Koulouris won't elaborate on why they yanked that plug, but he will say, diplomatically, that developing talent is costly and frustrating.

While the idea of cultivating original artists didn't really take off, the vision of turning old music into new money did. Thus began a few rounds of private-equity fundraising, including getting a million dollars in Series A funds from Stockton uberdeveloper Alex Spanos before the company's initial public offering in February.

The company reformed as Digital Music Group Inc. in August 2005, a move that also consolidated them with Rio Bravo Entertainment of Austin, Texas, another digital music distributor doing business as Psycho Baby. But the initial public offering drew criticism from some financial observers who openly questioned the wisdom of such a young company with absolutely no history of profit taking itself public.

"There were some really negative articles when they announced the IPO," recalls Gillian Parillo of the Sacramento Angels investment group, which was in on the early rounds of capital acquisition when the company was still Digital Musicworks International. "Think about it. The company has never made money and it has a lot of losses."

Parillo says there was also concern within her group that "this was the whole dot-com thing all over again," where a seemingly good idea held sway over bottom-line reality. She notes that several members openly questioned "if the IPO would really give them a legitimate first-mover advantage."

Because of DMGI's dependence on old and obscure music, critics dubbed the move a "long-tail IPO," a reference to the relatively new theory used to explain online success stories like Netflix.

According to the long-tail concept, advancing technology is changing the demand curve for any number of media products, including movies and music. While the head of that curve is still heavy with the major hits, the back end, or tail, has become fertile ground for consumers looking for hard-to-find

products that media companies traditionally stop distributing due to low demand and high distribution costs.

For instance, someone going into the local brick and mortar music store in search of a single song from an obscure blues musician like Big Joe Turner or Z.Z. Hill — or an oldie like the Archies' "Sugar Sugar" — would most likely be disappointed.

Now, with digital technology making it possible to offer those products without having to tie up gobs of money in hard inventory, doing so seemed like the ultimate no-brainer. And that, Koulouris says, is why the IPO went off when it did. To make the model work, he and his partners needed the financial muscle to get their hands on as much available product as they could grab as soon as they could grab it.

"We could chunk out \$3 million here and \$5 million there and do a Series C round of \$10 million, but we knew we needed around \$30 million to really take advantage of this market and acquire content," Koulouris says.

"We could get \$10 million in venture capital in a Series C, prove the model for 18 months, and then 18 months from now try to do an IPO or a Series D and get another \$10 [million] or \$20 million," he continues. "But we felt that if we got \$30 million [right away], we would be able to really get some rocket fuel in the engine and get super aggressive in acquiring content. That made a lot of sense because we would be the only company out there well-funded enough to do so."

Going public produced just over \$33 million in capital. As promised, DMGI has been "super aggressive," acquiring an eclectic mix of catalogs since the IPO closed in February. Those include several direct buys and long-term deals with classical, Celtic and independent rock labels such as Southern California-based Lobster Records.

"We hate to say the word, but it really is a land grab," Koulouris says. "That can be construed positively or negatively, but that's what it is. It's all about getting as much content as you can today, right now, at fairly beneficial terms and for long periods of time."

That is often more difficult than it might sound. Music contracts are notorious for having song rights scattered amongst the songwriters, performers and others, making some acquisitions a lesson in forensic accounting.

But acquiring the catalogs is only part of the process; converting them to a digital format also takes time and technical know-how. DMGI employs three full-time tech heads and several part-timers to manage conversion using automation machinery to rip and process content.

For now, there is a significant interoperability problem between the major digital formats. "The physical CD world is much simpler because you rep-

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— Mitch Koulouris

licate your master CD literally millions of times, you send it to every record store in the world, people buy it and it plays on every player in the world," Koulouris says.

"Digital music is exactly the opposite," he continues. "If you buy it at Apple iTunes, it only plays on one player: the iPod. If you buy music at Napster, that plays on a different player. We have to encode a different standard for Apple, for Napster, for Microsoft, Yahoo and the rest. It's all sorts of goofy technical stuff that takes time, money and effort to automate."

The delays are costly in more ways than one. The difference between collecting huge royalties on 200,000 songs being downloaded eight times a month and royalties on only 65,000 songs is pretty staggering.

But in spite of the slow pace of getting the product to market, DMGI's May earnings report was its best so far. According to that summary, revenue for the first quarter of 2006 reached \$721,000, a whopping jump from the \$41,000 gained in the first quarter of 2005. The company's net loss for the first quarter of 2006 was down to \$414,000, or 7 cents per share, slightly better than the \$513,000 — or 23 cents per share — lost in the first quarter of 2005.

That was good news for sure, but whether DMGI ultimately has what it takes to ride out the lean times is the big question. Red ink, after all, is still red ink. Koulouris appears undaunted, noting that with more and more songs getting into the queue and portable listening devices on the rise, making it into the black is more realistic than ever.

"Our top priority is to process all the tracks we have under contract and get those done as quickly and efficiently as possible, because every track that we put out there has an impact on revenue and ultimately profits," says Koulouris.

Shareholder Gillian Parillo preaches patience. "A year and a half ago, there weren't too many people downloading music to iPods," she says. "Now it seems everyone has one."

The company recently announced a deal to distribute digitized classical music under the For Dummies brand; those recordings will also be sold on the For Dummies Web site. And although the lag time and compatibility issues are frustrating, Koulouris says he is confident format standards will eventually merge and make digital downloading even more popular — and profitable.

"We're optimistic, we're striving for profitability, and we think we can get there. When? That remains to be seen," he says. "We've got a lot of work to do, and we have to execute."

If they don't reach profitability, Koulouris and his colleagues may have to take solace in singing along with their own top-selling single to date, Fats Domino's classic, "Ain't That a Shame." 