EDITORIAL

Why Smart Guys Sometimes Look Dumb

The music and audio business isn't the place to go if you're interested in making a fast buck. This is hardly news for the majority of our subscribers. On a daily basis, our retail readers cope with cash-starved customers haggling for a better deal, kamikaze internet operators willing to sell for a few bucks over cost, and hefty inventory requirements. Our supplier readers, are under similar pressures: a global excess of manufacturing capacity forces most of them to price at razor-thin margins. Need anymore details? Just consult our letters column, where readers routinely spell out, in careful detail, the numerous obstacles to making a profit. Thus it's always somewhat interesting when supposedly sophisticated outside investors stub their toe wading into the music industry.

Over the past three decades, these events have had a story line that's every bit as formulaic as a Hollywood action flick. Slick investor enters stage left with fanfare, makes an industry acquisition, and promises to revolutionize the business with the application of advanced management techniques, incredible operational expertise, and generally unspecified "vast resources." Everyone is supposed to live happily ever after, but reality has a way of upsetting the script. A few years later, when the mundane music business hasn't been transformed, the humbled investor heads for the exit, trying to hang on to as much of his pride and investment as possible.

Two recent deals follow this plot line to a "t." In July of 1999, American Capital Strategies acquired MBT/Musicorp, the large distribution firm. John Thornton, a principal of the private equity company, declared, "We look forward to combining our internet resources and management expertise with the team at MBT/Musicorp to spur dramatic growth. With our proven internet expertise and management depth we will add a new dimension to the company's business-to-business capabilities." After acquiring Midco and M&A Music along the way, American Capital ultimately invested approximately $27 million in the music business. Last month it sold the business to Kaman Corp. for $30 million. After management fees and transaction costs it's debatable whether the deal made money for investors or not. One thing is clear: given the modest premium Kaman paid, American Capital's management expertise hardly added a "new dimension," and the "dramatic growth" didn't materialize.

The saga of Rutland Capital follows a similar trajectory. In early 2003 the British investment firm paid about $53 million for the musical instrument division of Boosey & Hawkes, (Buffet clarinets, Besson brasswinds, Keilwerth saxophones, Winter cases, Höfner violins and guitars, and Rico reeds). After renaming the company The Music Group, Rutland chairman Michael Langdon declared, "This business will ben-

efit from Rutland's active management approach, which will entail a complete operational overhaul with a focus on manufacturing efficiency, improved financial controls, and a higher level of profitability." In the past two years Rutland has largely sold off the parts of The Music Group; Rico Reeds was sold to J. D'Addario & Co.; and Buffet Crampon, Höfner, and Winter Case were purchased by management groups. Based on the prices fetched by the components, Rutland may yet earn a slight profit on its investment. But the deal's break-even yield suggests that Rutland's "active approach" didn't significantly improve operations or profits.

Why is it these smart investors can't seem to transform music companies? The short answer can be found in the Old Testament proverb: "Pride goeth before a fall." Going into a bit more detail, they routinely underestimate the challenge our industry presents. Because music businesses tend to be small in scale, outsiders can mistakenly conclude they are easy to run. Consider the assessment of a former Baldwin Piano director with a sterling resume who quipped in the late '90s "What can go wrong with a little piano company?" Along with overlooking the unique problems of running a music company, some outsiders also have the equally destructive tendency to dismiss industry insiders as "unsophisticated" and disregard their counsel.

This is not to say that there aren't outsiders who have had success in the industry: investors in Fender, Steinway, and Loud Technologies are a few that come to mind. The difference between them and the less successful is largely a factor of humility. They realize that in a business with demanding customers, intangibles like "tone," and a deeply felt sense of tradition, it takes more than good B-school credentials and proficiency with an Excel spreadsheet to get the job done. As we said at the outset, it isn't an easy business.

Brian T. Majeski
Editor
Email: brian@musictrades.com