Following The Lead Of Others

As a comparatively small component of the national economy, the music industry tends to follow rather than lead. The recent trends that have transformed commerce—sourcing in China, retail consolidation, and internet sales—gained momentum in the realm of the *Fortune* 500 long before they had a significant impact on our business. Because of this, a recent bombshell announcement from Dell Computer caught our interest. On November 1 the world's largest seller of personal computers reported that it would miss sales and earnings targets for the third quarter by a wide margin: 12% and 52% respectively, to be exact. Dell's disappointing results startled investors, who had come to expect double-digit growth as almost a birthright. More significant than the financials was the assessment of Dell CEO Kevin Rollins, who noted, "We've overshot the elasticity curve." Translated into plain English, this means, "We cut prices but we didn't sell any more units, which is why our results aren't too good."

Hailed as one of the best managed businesses on the planet, Dell spent the past twenty years pushing the price of personal computers down and watching unit volumes soar. On a smaller scale, the music industry has experienced a similar dynamic. Better manufacturing methods, Chinese sourcing, and tighter retail margins have brought the prices down on most products and unit volumes have vaulted to levels no one previously dreamed possible. The idea that the industry would move three-million-plus guitars, nearly 200,000 drumsets, and literally millions of microphones, small mixers, and speaker enclosures was inconceivable even five years ago.

This altered pricing environment has also changed the buying process for consumers. The industry enjoys a level of impulse buying that never existed before, which is why Wal-Mart, Best Buy, and others are now interested in music and audio gear. Selling tactics have changed as well. The top guitar companies used to make not-so-subtle digs at competitors as if to say, "When you're getting ready to spend your hard earned money, buy my product because brands X, Y, and Z are inferior." In today's era of low-priced, high-value instruments where players own multiple instruments, the pitch has shifted to, "All brands are wonderful and buy my guitar because it's the perfect complement to all those other guitars you already own." The same "buy them all" dynamic can be found in microphones, snare drums, and even synthesizers.

Now that Dell Computer has stated categorically that lower prices no longer have the ability to drive ever-higher unit volumes, can the music business be far behind? If dropping the price of a personal computer to $299 from $399 doesn't attract any more customers, is it reasonable to think that a 10 to 20% price cut on music and sound products will drive more store traffic? We think not.

It will take time to determine exactly how this changed pricing dynamic affects the industry, but here are two quick thoughts. If lower prices lose some of their ability to "shock and awe" consumers, mass merchants may be less enthusiastic about the music products category. However this plays out, we think it will have little impact on the traditional m.i. retailer, as the two channels seem to attract a very different customer base. Suppliers, however, should use caution when ramping up production in anticipation of big orders from mass merchants. They could just find themselves with a lot more inventory than orders.

If lower prices become less of a draw, retailers will have to start looking at other ways to drive traffic. For starters, we would suggest that everyone re-evaluate their educational offerings. Learning and buying are inextricably linked; what's more, in-store teaching provides guaranteed store traffic. Another thought is an increased focus on accessories and "add-ons" as a way of making the most out of every sale.

Over the past five years deflation has been something of a mixed blessing. Lower selling prices have forced retailers to move more boxes just to stay even. On the positive side, however, prices have also expanded the industry's customer base and boosted store traffic. Looks like the industry will have to start thinking about adapting to a new environment.

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