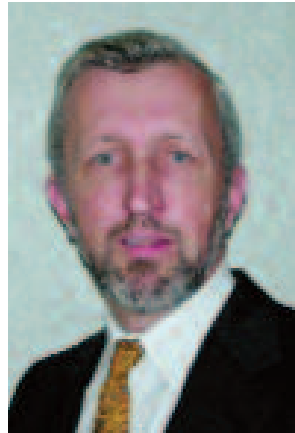


Finding The Bright Spot In The Guitar Market

The current meltdown in the housing market illustrates a deeply ingrained human tendency to seamlessly extrapolate the recent past into the distant future. A decade of rising housing prices and low default rates prompted otherwise rational lenders and borrowers to throw caution to the wind, and bet big that the trend would continue forever. It didn't, and we're all feeling the effect of billions in bank write-downs, vast numbers of foreclosures, and collateral damage that has yet to be fully tallied. Closer to home, but on a far smaller scale, the guitar industry is experiencing similar shock and dismay as sales rates diverge from past trend lines. Just as a sizable percentage of the citizenry used a few years of results to forecast an eternally sunny housing market, many in the guitar business are now predicting a gloomy future based on two years of less than stellar results. We think that the concerns are more than a little overblown.

Guitar sales dropped by about 7% in 2006 and all indications are that 2007 will be another down year. Top retailer Guitar Center has publicly complained about softness in the guitar market, as have most of the industry's key suppliers. Yet for all the hand wringing, guitar sales this year will still be over double the level of a decade ago. Furthermore, the current complaints sound eerily similar to those voiced in 1996 and 1997, the last two occasions guitar sales hit a speed bump. Summing up the industry mood in 1996, we wrote, "After five banner years, the industry is bracing for tough times. It's probably unrealistic to expect the growth to continue." Happily events proved us wrong. A few years later though, in the aftermath of the 9/11 catastrophe and the bursting of the dot.com bubble, guitar sales turned down, as did industry spirits. "Market conditions are a lot tougher and we don't expect any improvement," declared one CEO.

So why do we think a dire outlook is unwarranted? Based on a recent analysis we conducted of manufacturer warranty cards, about 60% of new guitars are purchased by males between the ages of 14 and 26 years old. According to the U.S. Census, this age and gender category currently includes 33 million individuals. Given that the industry has sold close to 10 million new guitars in the past three years alone, for one of the first times in history we are facing something bordering on market saturation. One guitar for every three core buyers is a pretty amazing number.



Guitars are durable products that don't change much from year-to-year, leading some to conclude that this "saturation" is a long-term problem that will dog the industry for years to come. We're not so sure. A few years ago, Red Octane was a nine-employee video game designer struggling for survival. Unable to come up with the cash to license big-name sports figures or cartoon

action characters, the company took a major gamble on a game about becoming a rock 'n' roll guitarist. Today, Guitar Hero has become a national craze and ranks as the top-selling video game in the world, with three million units sold. What's more, a slew of imitators are in the works. From this unexpected success, we conclude that kids find the guitar just as alluring as their grandparents did when they were mesmerized by the Beatles in 1964, and the industry will enjoy a bumper crop of new customers.

Better yet, in the next decade, the potential customer base will be nearly twice as big. Here's why this is more than just a pie-in-the-sky estimate: Our warranty card analysis showed that among guitar purchasers over the age of 18, 80% were male. Under the age of 18, however, the gender breakdown shifts dramatically to just 63% male. In other words, after a decade of trying, it would appear that the industry is finally making headway with a younger generation of female buyers.

Considering the broad-based consumer interest in the guitar, coupled with a dramatically larger customer base, it seems reasonable to conclude that whatever the industry's current woes, they will soon be forgotten as sales resume an upward trajectory.

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