3 TRENDS REPORT

MUSICAL INSTRUMENT RETAIL: STRATEGIC SHIFT FOR $13 BILLION

COMPETITIVE FUTURES

EXECUTIVE SUMMARY

Musical instrument retail is caught between stagnation and disruption. Billions are at stake, and new players will emerge.

The musical instrument industry finds itself at a major crossroads. While the industry remains robust at $13 billion worldwide, there is little to suggest secular growth in the near-term future. Meanwhile, digital technologies are changing the very music business itself. Future success will be determined by those able to innovate to take existing market share from established firms.

STAGNATION

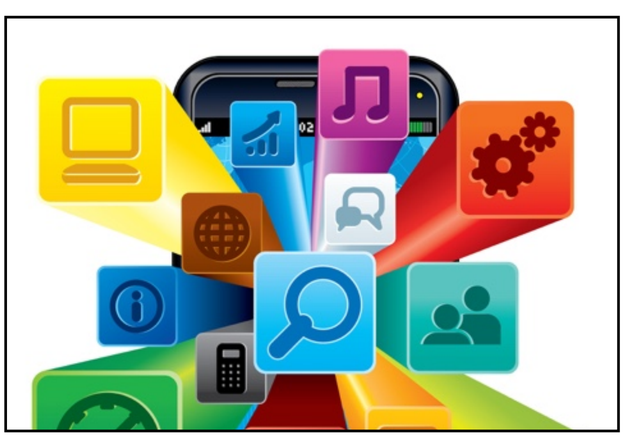
Trend #1

The data in this report will show that there is no case for secular growth in the musical instrument market because all leading indicators are flat, steady-state, or even decreasing.

BIG BOX GIVES WAY TO DIGITAL

Trend #2

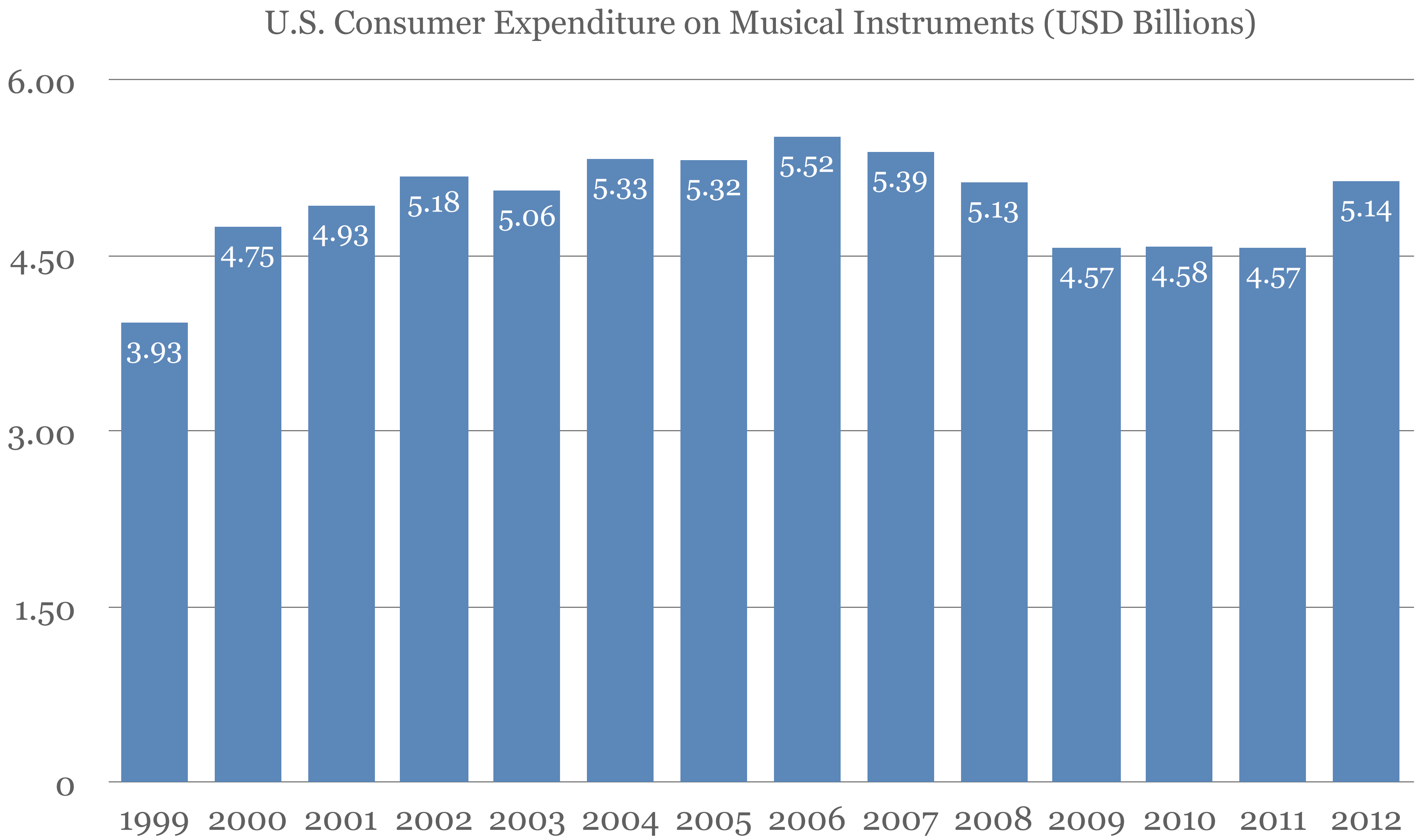
The big box model, led by industry hegemon Guitar Center, is highly unlikely to achieve significant organic growth; bankruptcy is certainly possible. Meanwhile digital retailers are making major inroads.



MUSIC DISAPPEARS INTO THE STREAM

Trend #3

Music is becoming just one more form of digital entertainment, sent to devices that are not music specific. This is devaluing the whole industry and the market for its tools of production.



Source: Statista, Americans for the Arts

This report is based on a flat trend line that can be seen in the above chart. The expenditure of American consumers on musical instruments - the industry's largest market - has flattened. There is nothing alarming about a consistent, steady state for any sector of the economy; mass market beer has looked like this for years. The main contradiction comes in the juxtaposition of this stagnation with an aggressive industry leader, Guitar Center, Inc., which promises to grow from $2 billion of a total $7 billion in the United States, to a total of $3 billion while simultaneously servicing almost $1 billion in junk-rated bonds.

Yet this is not a story of the big versus the small, but rather the fast versus the slow. Whether Guitar Center ultimately succumbs to the constant assault of online commerce on its business model is less important than the fact that a major trend of two decades has finally reversed. Innovation in the industry, as well as significant revenue growth, is being driven entirely by online retailers, be they the Amazon behemoth or start-ups leveraging apps to drive customer retention, rather than capital-intensive brick-and-mortar retailers. And while physical retail is not dead, the current model of big box MI retail flies in the face of the companies actually winning at brick-and-mortar.

Meanwhile, there has been a macroeconomic and cultural trend that represents the real future of this industry: the absorption of music into a larger, less-differentiated stream of digital entertainment. The other segments of digital content are blowing music away. Therein lies the challenge ahead, just beyond stagnation.

INCLUDED IN THIS REPORT

CHARTS

- Total U.S. musician population
- Total U.S. consumer spending on MI
- Share of U.S. adults playing music, by age group
- Revenue of musical instrument and supply stores
- U.S. adults taking a music class
- Concert sales in the United States
- iTunes revenue, by segment
- Global music industry revenue, by segment
- Sales revenue of physical and digital music
- U.S. median household net worth, by age bracket

FIRMS COVERED

amazon.com

Guitar Center

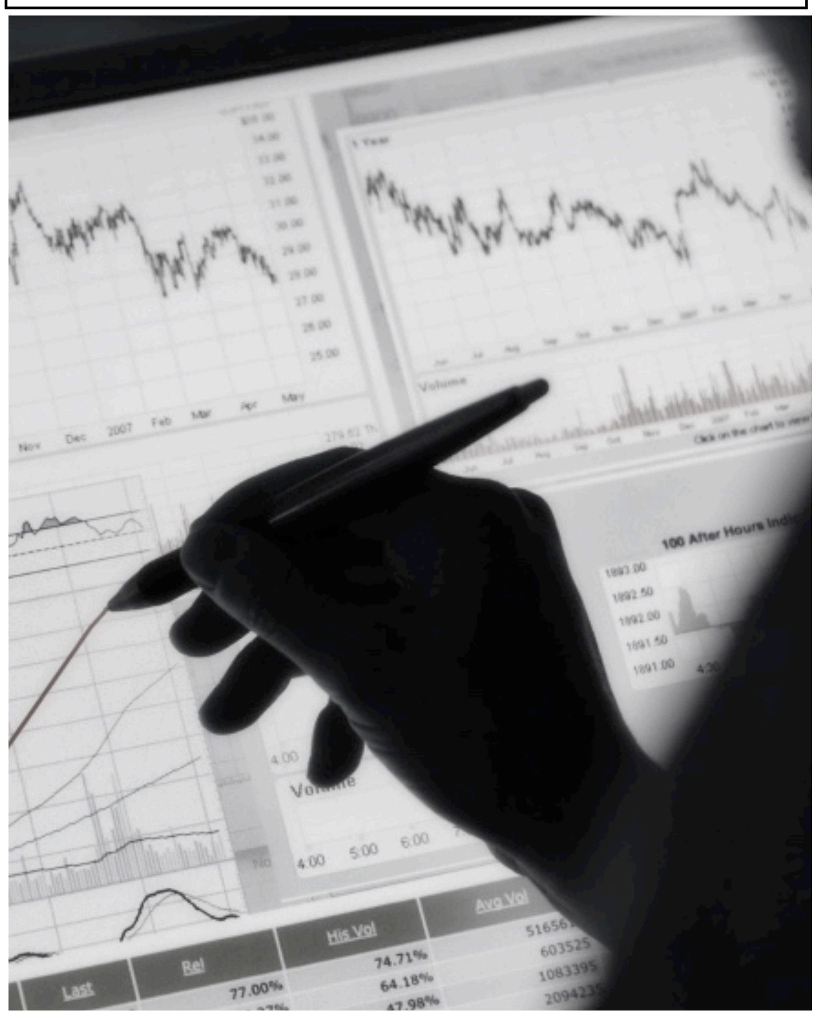
Sweetwater
Music Instruments & Pro Audio

Reverb

VINTAGE KING AUDIO

ANALYSIS

- Expanded trend analysis
- Competitive analysis of firms
- Implications for various stakeholders
- Actionable advice to achieve growth in the short-term



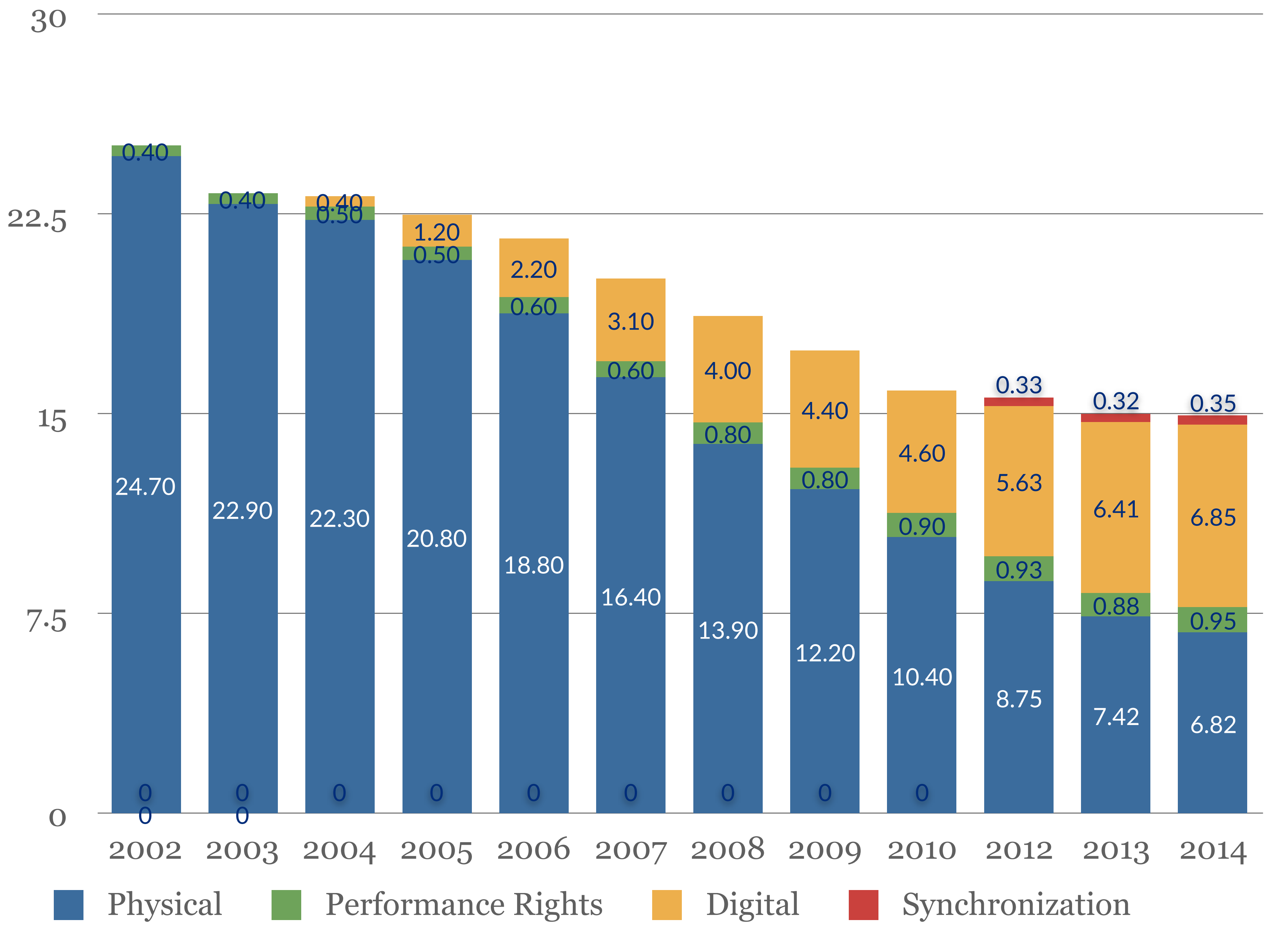
TREND #1

STAGNATION

The Macroeconomic Trends Show A Slow Future

The most important thing to know about the musical instrument industry is that it simply isn't getting any larger. Before going any further into the retail sector, let us begin with a fundamental concept: that musical instruments serve only two functions, either for personal enjoyment, or as the input costs for the music industry, serving professional musicians and entertainers. The trends in the recorded music industry tell of a commercial sector in gentle decline.

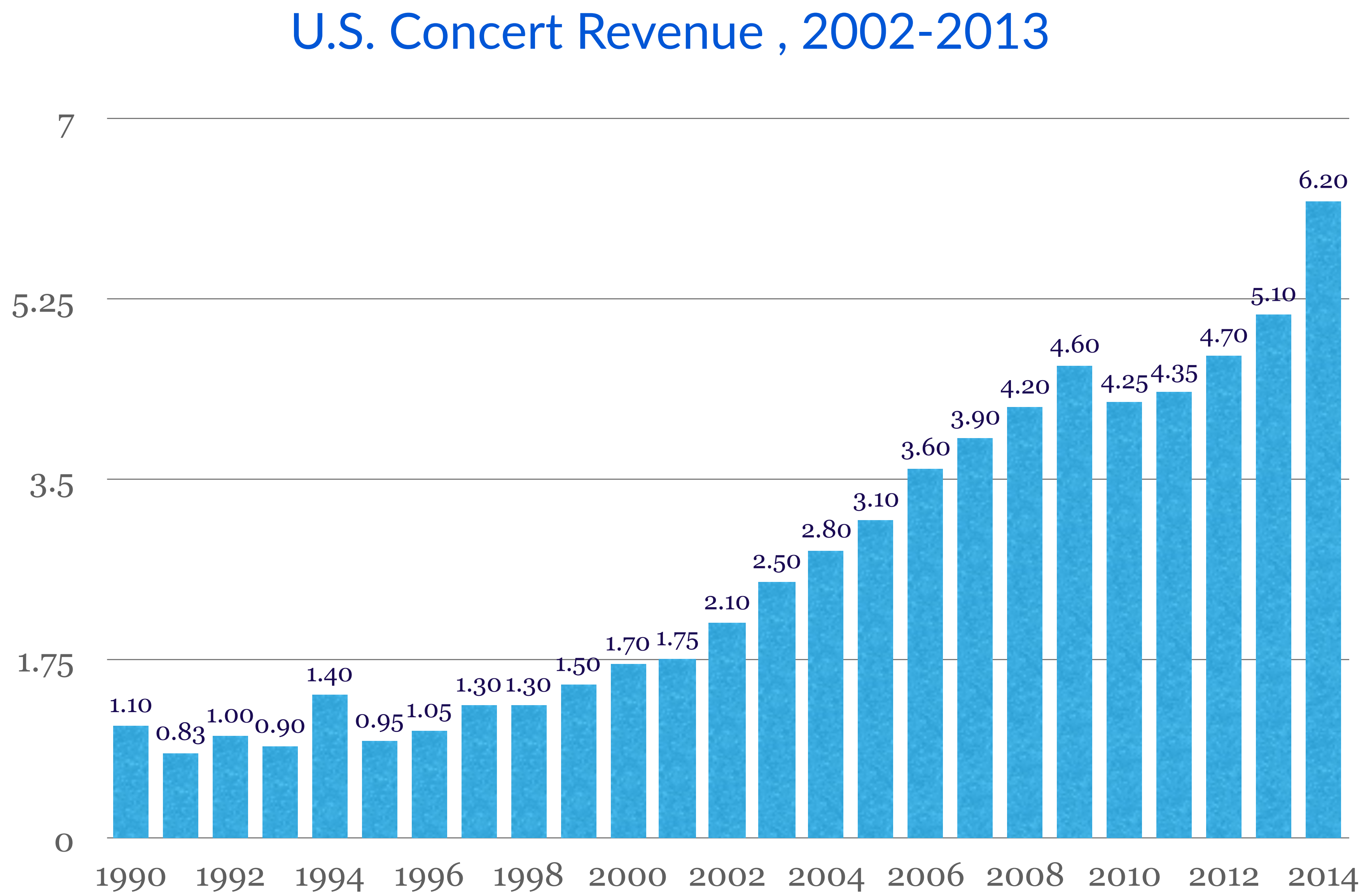
Worldwide Music Industry Revenue, by sector, 2002-2013 (USD Billions)



Source: IFPI

The recorded music business has not done well in the digital era. While some of this can be attributed to digital piracy, no explanation is sufficient. However, the trend is clear - the recorded music industry has lost about ten billion dollars, nearly a third of its revenue in around fifteen years. While not every guitar, amplifier, and piano sold goes to a professional selling recorded music, this trend at least gives no reason to expect explosive growth.

In fact, this trend is counterbalanced by data about the live events portion of the industry, which has grown at a robust rate.

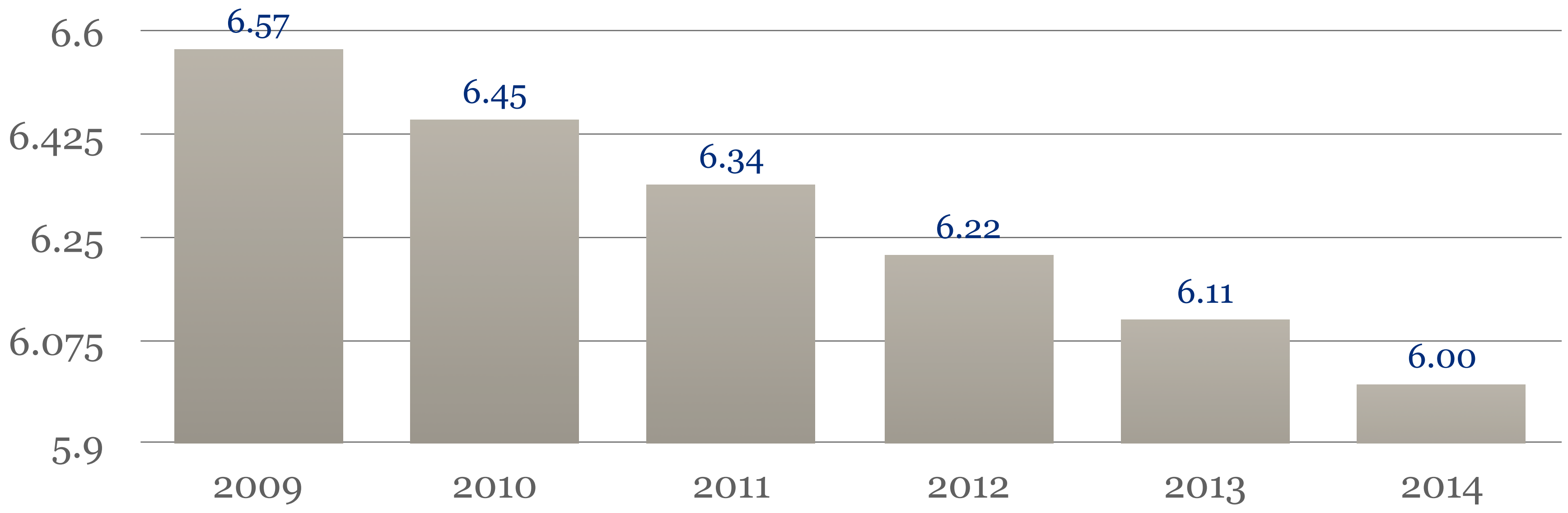


Source: Pollstar

People are not only going concerts, the rate of revenue growth reassures that all is not lost when it comes to the music business. Still, it should be noted that recent growth is partially due to skyrocketing ticket prices, mainly from acts popular with Baby Boomers. According to TiqIQ, the Rolling Stones and Fleetwood Mac collected ticket prices at $241 - $624, while their younger counterparts, Justin Timberlake and One Direction, sold tickets as high as $241 - $461. (http://247wallst.com/special-report/2014/03/08/the-10-most-expensive-concert-tickets/) Ergo, it may not be uniquely from a prevalence of live gigs as it is inflation of ticket prices aimed at a more elite demographic.

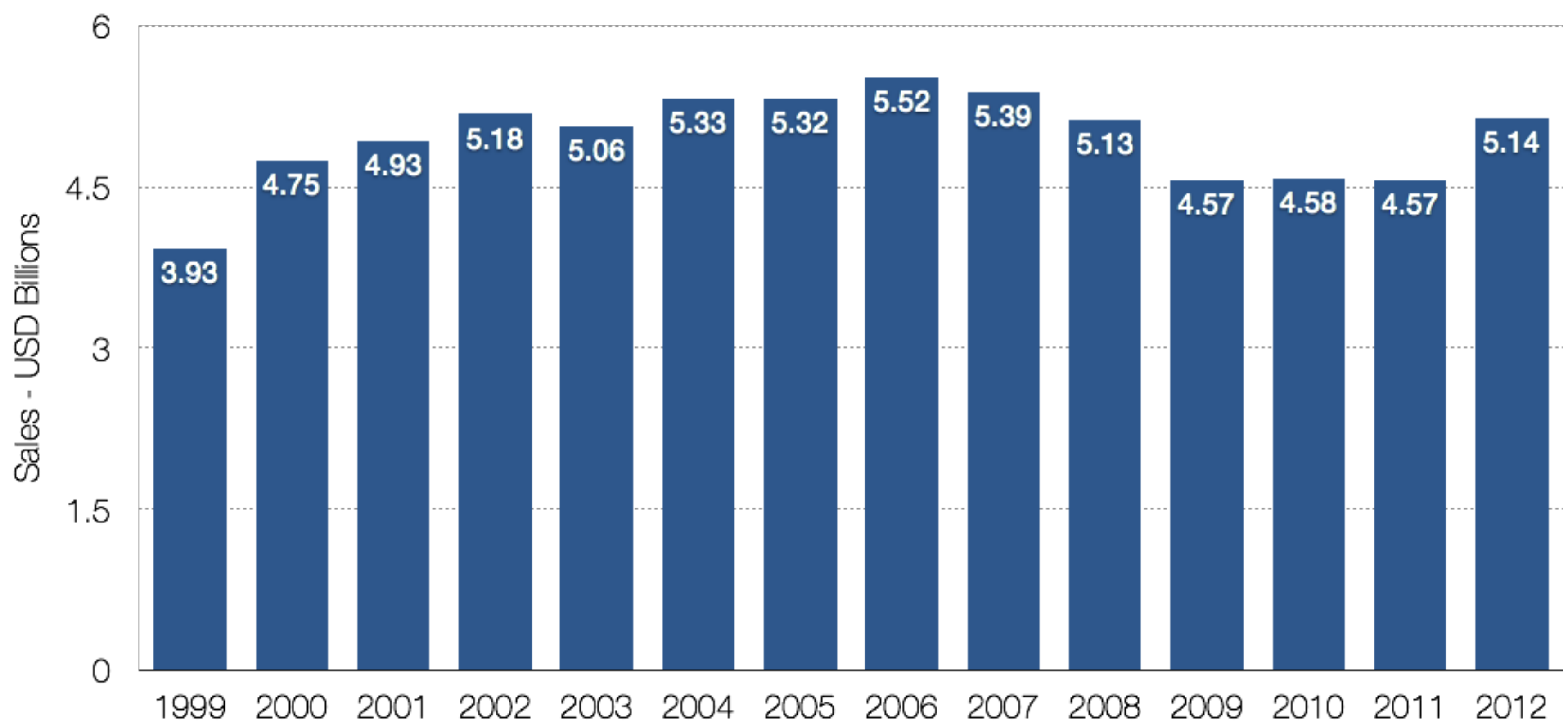
So then, what does this mean for the musical instrument industry itself? The industry is broadly assumed to be USD$7 billion in the United States, the largest market by far, and USD $13 billion worldwide. Taking just the United States market, revenue is either flat or gently declining. Considering the following two trends in total sales.

Revenue of Musical Instrument and Supply Stores, 2009-2014 (USD Billions)



Source: US Census Bureau, National Endowment for the Arts

Consumer expenditure on musical instruments in the United States, 1999 - 2012

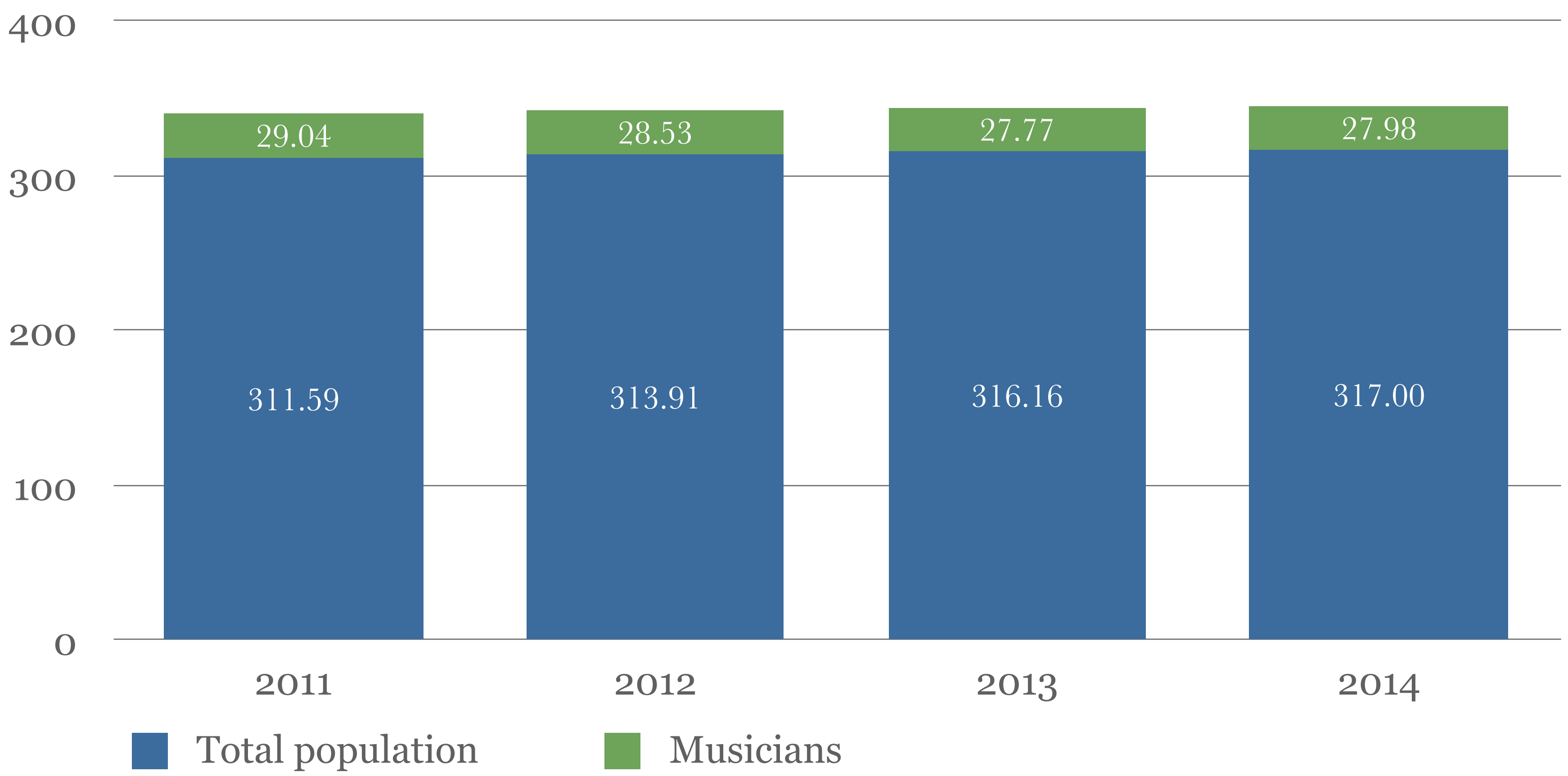


Source: Americans for the Arts

Musical instrument retail appears to have lost roughly a half-billion since the Great Recession, with the discrepancy in the total sales being from institutional sales of musical instruments and assorted supplies; corporate installations of audio equipment might still be more robust but counted in other economic indicators, so both of these charts are blunt tools. Yet one trend is clearly absent - the typical, post-World War II, year-over-year growth around which most American business management is centered. Most managerial techniques, most strategies, and certainly all corporate plans involving massive leverage are intensely dependent on this comforting pattern of constant growth - and it simply is not present.

Additional indicators give us some indicators as to why this is. First, the total number of musicians in America has remained either flat or has declined gently in recent years.

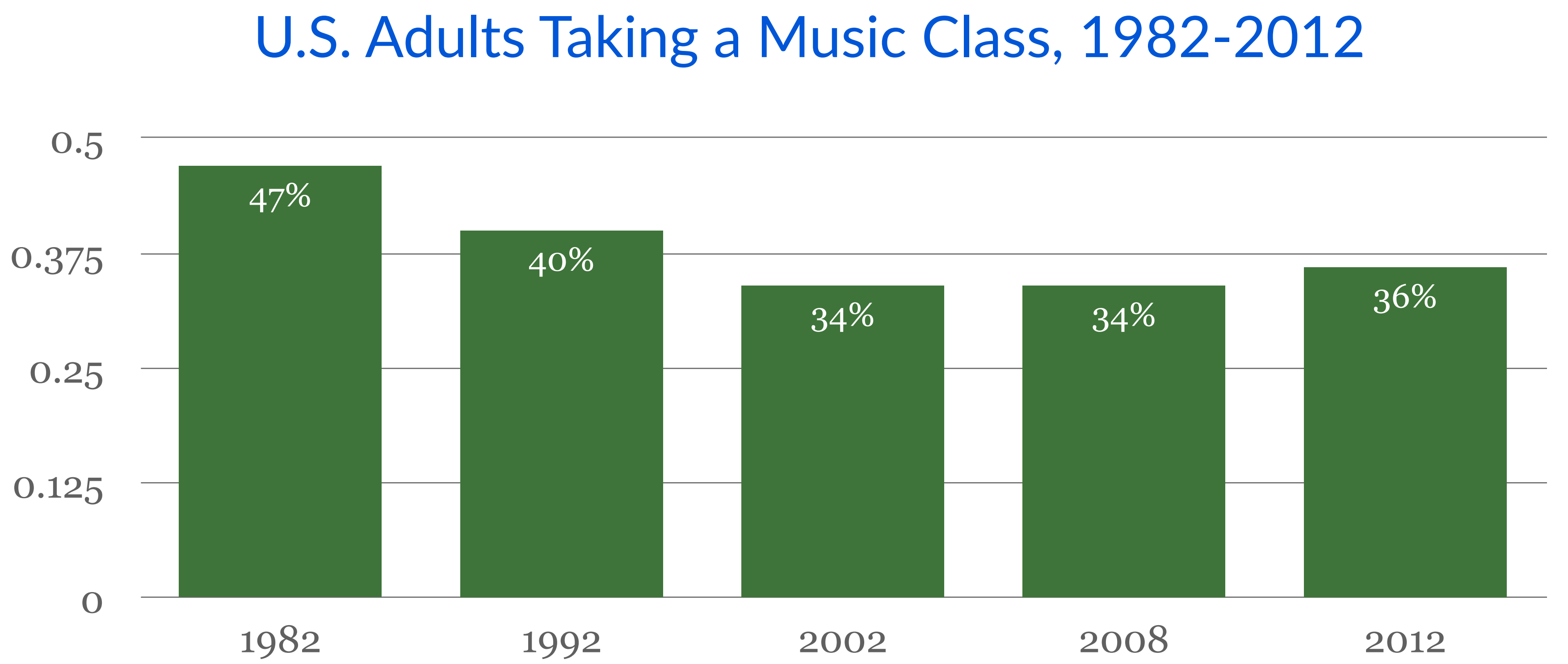
Total population versus people playing musical instruments in the United States, 2011- 2014



Source: Nielsen Scarborough

These are not dramatically shifting number, though there is a steady decline of a few hundred thousand musicians as the nation adds around two million persons per year. The numbers are therefore flat and declining in a relative term.

The Census Bureau and the National Endowment for the Arts bring us data that shows a steady decline in the number of Americans taking a music class.

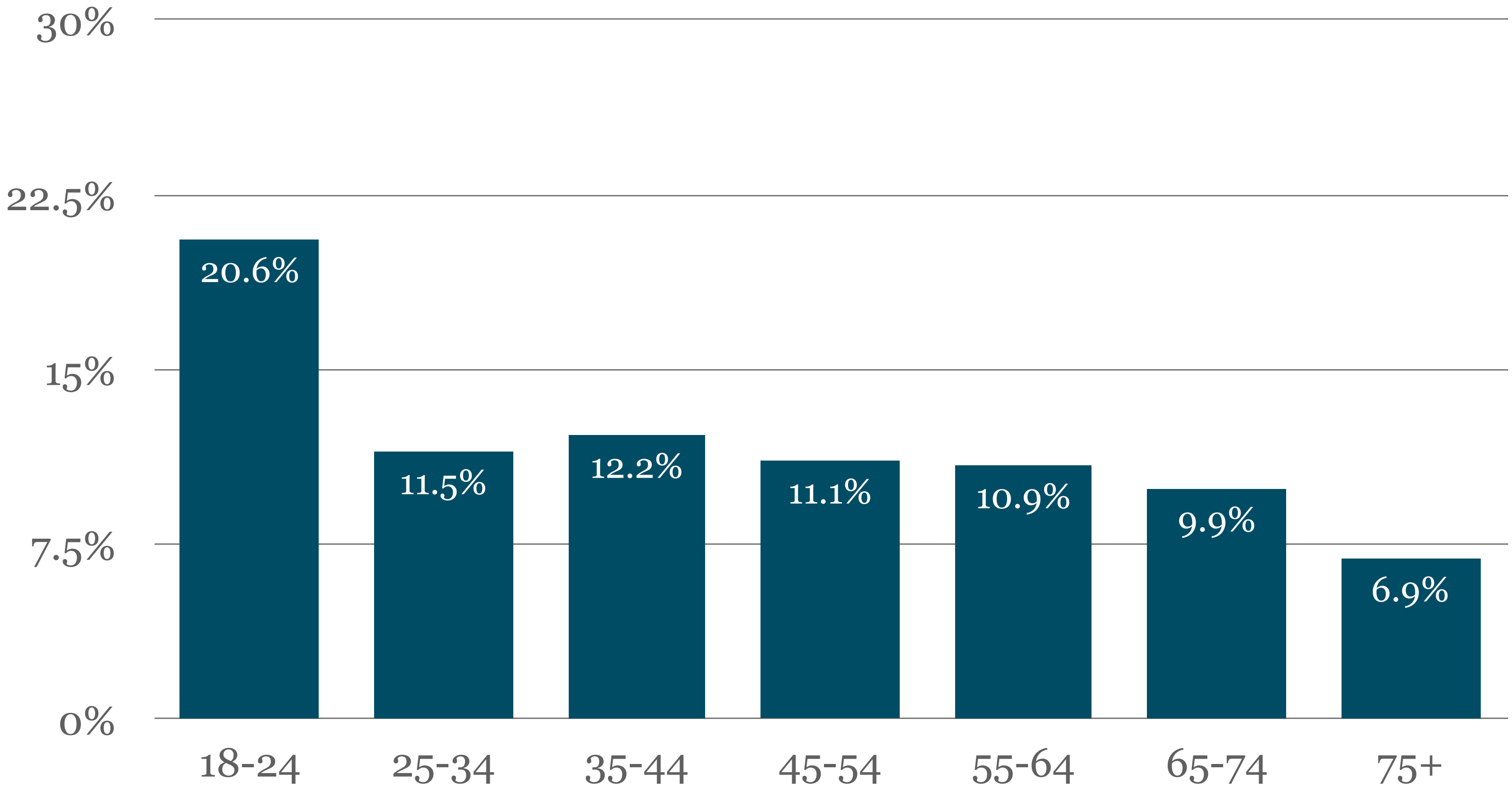


Source: US Census Bureau, National Endowment for the Arts

Here we see a significant drop compared to thirty years ago, but the numbers have remained steady and even increased slightly between 2008 and 2012. It is impossible to determine the exact reason for the increase, but the imminent retirement of Baby Boomers with extra free time might be a plausible explanation.

Speaking of age, it is critical to ask demographic questions about the buyers of musical instruments.

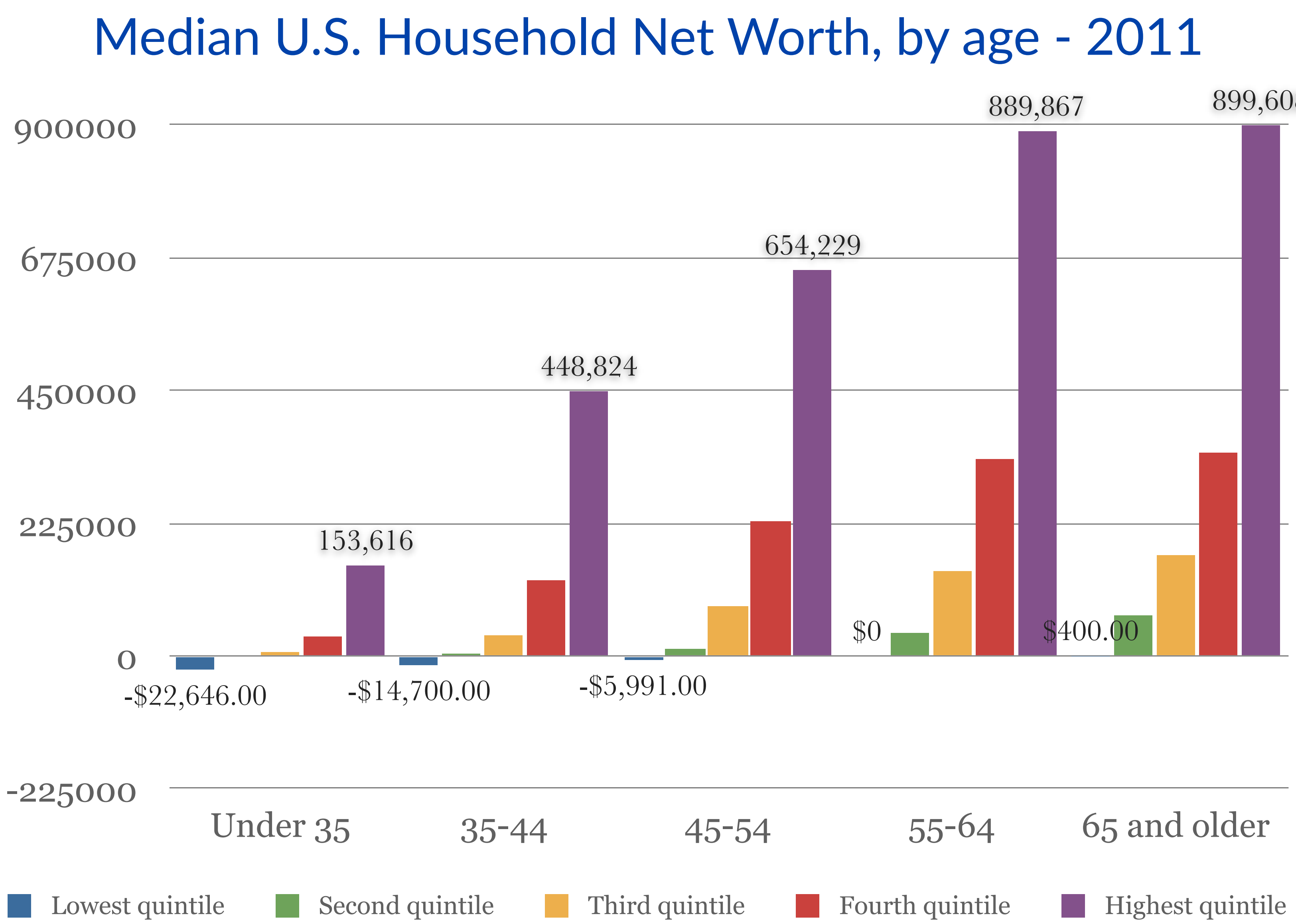
Share of US adults playing a musical instrument, by age group



Source: US Census Bureau, National Endowment for the Arts

Given the role of schools in teaching music, it probably is not a surprise to see the 18-24 demographic as the dominant group. Also, rock and roll is more of a young person's game as we all know, except for those who charge $500 per ticket. This asks a question of what the economic health of that Millennial demographic is really like, both to understand current numbers and to even forecast future performances.

The macroeconomic picture of the under-35 demographic paints a vivid picture of why revenues may remain flat or on the general decline for years to come.

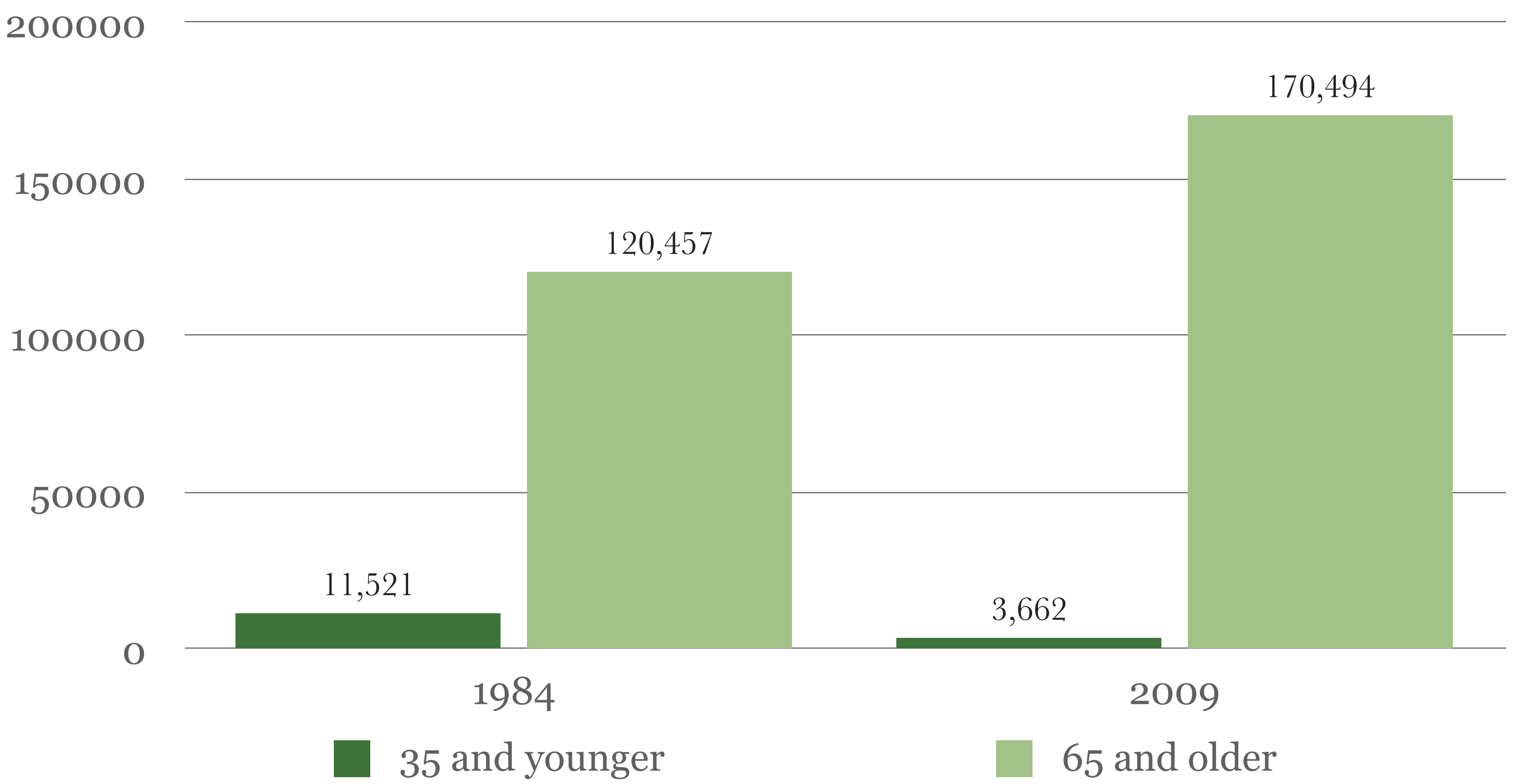


Source: U.S. Census Bureau

What emerges here is unsurprising in the sense that households tend to have a higher net worth as the years go on, but there is also a story of income inequality, ripped from today's headlines. The top 20% of households have a disproportionate amount of national wealth and may not represent a similar proportion of the nation's musicians. Moreover, anyone reading this report is aware that professional musician households are statistically unlikely to be in the top quintile of wealth.

When looking at the younger demographics specifically, a more stark image emerges - the first three quartiles of the under-35 demographic has either negative or almost no net worth, living hand to mouth. This begins to turn around in later decades, but the bottom line is that the largest group of musicians remains in dire financial straits. Moreover, this inequality has actually worsened in the past thirty years.

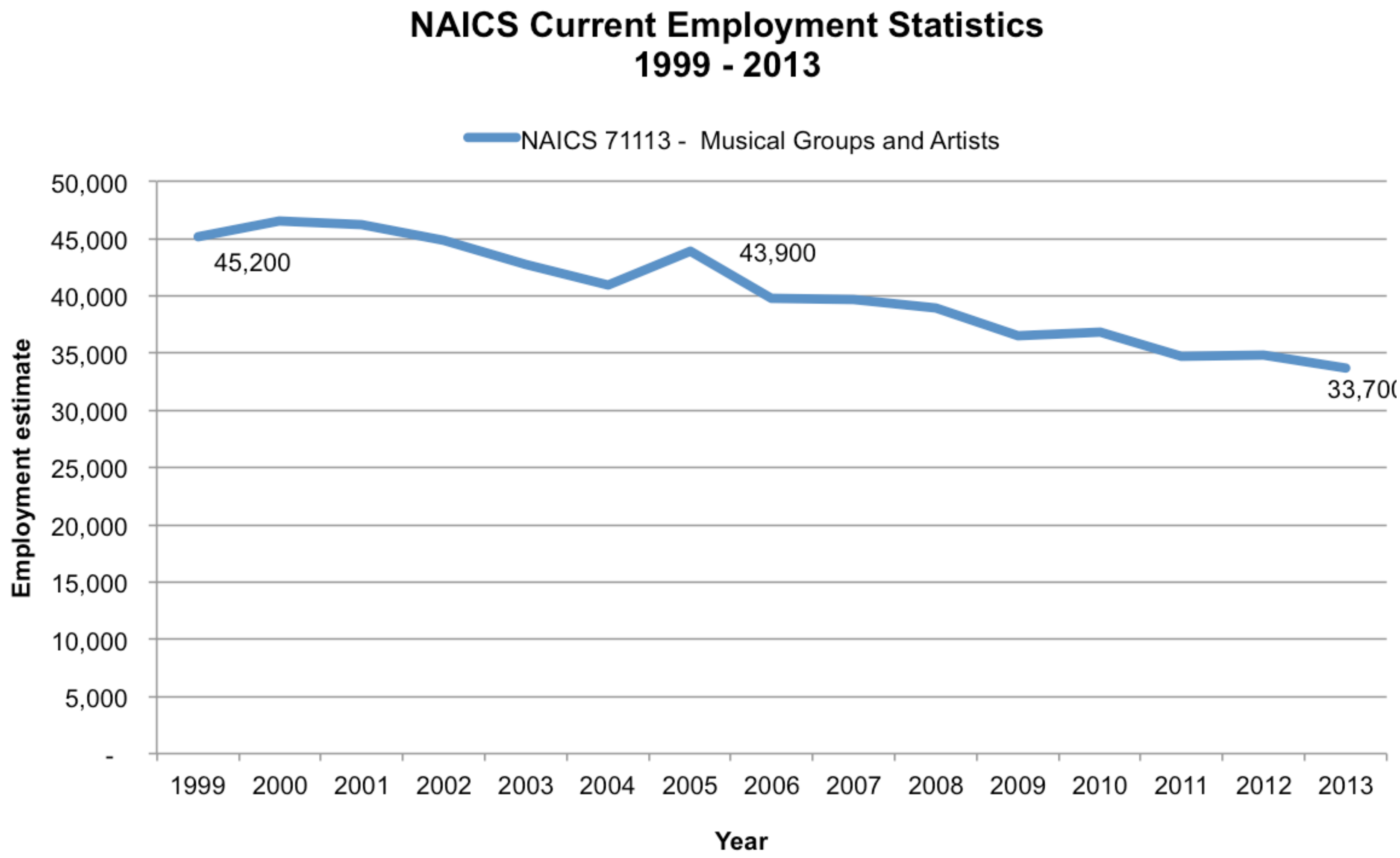
This data from the Pew Research center shows that the median net worth of the under-35 has actually declined by more than two-thirds in the years since their parents' generation was the same age.



Source: Pew Research Center

There are likely many contributing factors to the relative impoverishment of the key musical instrument industry customer demographic. More jobs require university education, delaying the earning of wages in favor of taking on student loan debt. The cost of university itself has more than doubled in this timeframe, and student loan payments represent purchasing power lost to the consumer. Asset prices for housing have been kept high due to central bank policies, meaning more money is spent every month on rent or a mortgage. Then there is the cost of health insurance, which has galloped ahead of the Consumer Price Index for years. All of these factor contribute to a key customer demographic that is less able to afford the niceties of music as a source of personal enjoyment.

As an additional data point, the decline of professional musicians also plays a role, as the U.S. Department of Labor data will show.



Source: U.S. Bureau of Labor Statistics

Even if one is buying musical instruments for professional reasons as opposed to entertainment financed by disposable income, the trends are no more disposed to sudden growth.

In brief, Millennials do not posses the household wealth to guarantee growth, ergo the overall outlook for the musical instrument industry is to remain in a steady state year-over-year, to decline gently as the Baby Boom generation ceases to drive the industry.

If your business is not wedded to aggressive growth targets because of financial debt covenants, then this need not be excessively alarming. However, the largest single firm in the industry is in precisely that situation.

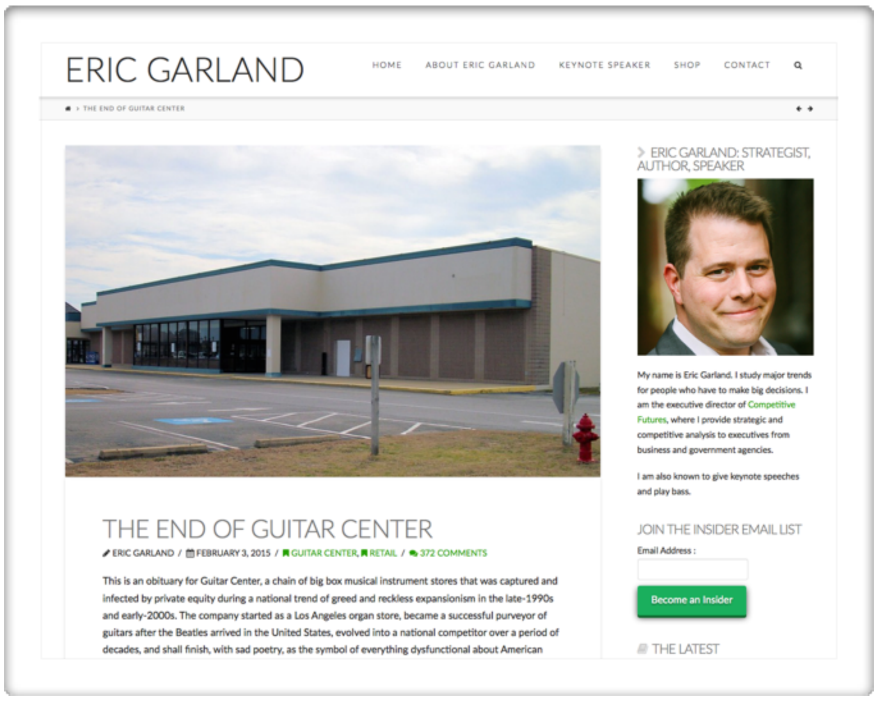
TREND #2

BIG BOX GIVES WAY TO DIGITAL

The 1990s Model Slowly Unwinds, Starting With Guitar Center

So far we have established that aggressive growth rates for the musical instrument industry are not only unlikely in the near- to mid-term future, they are structurally impossible. Demographics and economics make historical return impossible in mature markets such as the United States, Europe, and Japan, leaving emerging nations as the only remaining target for robust growth.

There is one firm that is most endangered by this: Guitar Center, Inc.



The saga of Guitar Center's seemingly endless financial crises can be examined in great detail on (Competitive Futures' Managing Director) Eric Garland's personal author site. As nearly the entire musical instrument industry knows, a simple blog post summarizing Moody's downgrade of Guitar Center bond rating to junk led to a massive over-reaction from the company's executives, and thus began a series of articles about the real status of the company, a more detailed, less forgiving assessment than that found in the industry's regular press outlets. If the reader is unfamiliar with the story thus far, then this free resource should prove instructive.

GUITAR CENTER UPDATE, JULY 2015

Recent performance of Westlake Village, CA-based Guitar Center, Inc. has shown continued weakness in the company's inherent business model, despite sanguine reports from traditional MI industry media.

In September 2013, Guitar Center executives reported to the Securities and Exchange Commission that it did not expect to be able to honor debt covenants in the short- to mid-term, and thus it voluntarily wrote off one-third of a billion dollars in goodwill from the value of the company. At the end of the fourth quarter, 2013, the company ended the winter holiday rush with $170 million in free cash. In its report on fourth quarter 2014, the company admitted to having just $17 million in free cash for a $2 billion-dollar organization, a catastrophic 90% reduction in cash on hand on a year-over-year basis.

Many people are familiar with a significant round of layoffs at corporate headquarters, including much of the team that arrived with departed CEO Mike Pratt, many long-time veterans of the company, and even Gene Joly, head of Musician's Friend. The goal behind this appears to have dual purposes. First and most obviously, the layoffs were to increase their critically low cash flow, but the official line, according to sources who have interviewed for positions at the firm in recent days, is also that the company was getting rid of dead weight. In the case of dismissal of Dustin Hinz, responsible for the very successful Guitar Center Sessions, this seems disingenuous, but the result is the same.

Further attempts to free up cash flow came out of the pockets of sales staff. Music industry thought leader Bobby Owsinski reported in *Forbes* that a new commission structure would cut compensation by a whopping 75% compared to a very complex "fade on gross profit" system that already chased out talent and forced workers in New York, Chicago, and Las Vegas to organize under the Retail, Wholesale, and Department Store Union.

This leads us to the reporting of financial results in the past two quarters, specifically where EBITDA is concerned. In Q3 2014, EBITDA dropped significantly, causing secondary bond markets to trade the company's paper at ultra-junk levels and resulted in the summary dismissal of CEO Mike Pratt in favor of Darrell Webb, former head of JoAnn Fabrics and The Sporting Authority, two big box stores financed by private equity firms. All eyes were on the next quarters' performance.

When Q4 numbers were finally released at an unusually late date in April, the results were decidedly mixed. Top-line revenue increased 3.6% for the quarter (year-over-year) and 2.1% for the year, with gross profit declining from 29.2% to 27.6% (YoY). Most interestingly, the company claimed that EBITDA had surged a robust 8.5% to $58.6 million over $54 million the year prior due primarily to a one-time gain from cash received from the auction of "aged inventory" through a third-party liquidator. Experts in corporate finance might immediately notice that the purpose of referring to certain expenses as "one-time charges" is to remove them from the calculation of EBITDA, which is supposed to give a picture of the fundamental health of the business, aside from unexpected events such as a legal settlement or the repair of capital equipment after an accident. Only a single bond analyst called this out in the pages of *Music Trades*, that such accounting is aggressive and even deceptive because without the auction of secondary inventory, EBITDA actually dropped some 30% for the quarter. Still, the bond markets generally applauded the quarter as-is, and trades of the bond trended steadily upward.

The most important metric in the Q4 2014 report was woefully under-reported - that unlike nearly every other player in the MI industry, the online components of Guitar Center, Inc., Musician's Friend and Music123, actually experienced "revenue declines" about which the company refused to provide specific numbers. The hottest trend in musical instrument retail, as we will cover in the next section, is e-commerce, and the industry's largest player actually managed to lose ground, and over Christmas no less.

A report on Q1 2015 followed hot on the heels of this report, with YoY sales growth at 0.1%, with gross margins increasing to 30.7% from 29.4% due to a reduced clearance of inventory at discount prices. The company claimed a 40% increase in EBITDA, due apparently to tighter inventory controls and a reduced headcount. Yet cash on hand shrank to only $11 million dollars. Same-store sales were not released publicly. Since the coupon for its bonds, costing roughly $35 million every six months, would come due on April 15, 2015, it would be an understatement to call the company in a liquidity crisis. *Music Trades* reported this with the optimistic headline, "Guitar Center Cash Flow Up 40%."

This should be placed in the context of the company's stated goals for growth. In August, 2014, Guitar Center CFO Tim Martin claimed that the strategic goal of the company would be to reach $3 billion in annual sales by 2020. This would require a compound annual growth rate of 7.39%. The last two quarters of top-line sales growth year-over-year have been 3.6% - growth almost entirely from the fire sale of aged inventory - and 0.1% thereafter, all while the company's cash flow dwindles very near to the level of insolvency. There is very little secular reason for the industry hegemon in a steady-state to declining sector of the economy to post growth rates of that level over a sustained five-year period, especially since the company's very survival is due to extraordinary managerial decisions that carry serious, negative externalities.

DIGITAL COMPETITORS SURGE

Meanwhile, as Guitar Center fires expensive talent, slashes sales commissions, and cuts hours for workers, many companies reported extremely successful performance in 2014 and beyond. The main area of growth is clear: the robust expansion of e-commerce.

Sweetwater, the third-largest retailer in America, reported a 28% growth compared with 2013, with December sales surging 30%.

Chicago Music Exchange/Reverb, is one of the fastest growing startups, claiming growth rates of its online segment at 55% on a quarter-over-quarter basis.

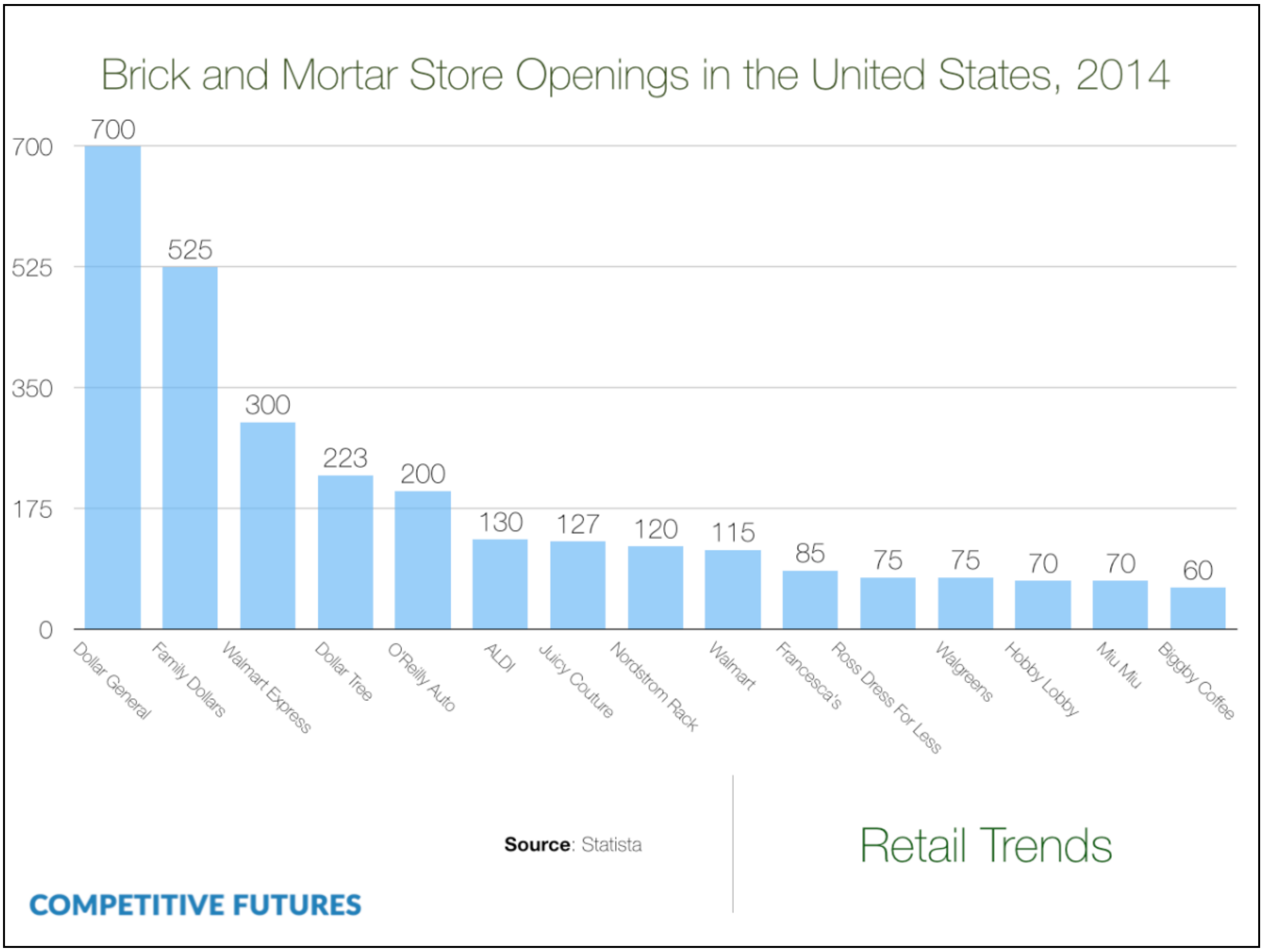
Vintage King - the company specializing in boutique pro audio doubled its sales targets for 2014 and has reported 20% year-over-year growth in sales for seven straight years, with e-commerce serving as major part of its strategy.

Amazon - it is impossible to break out sales figures, but let us assume that the Borg have continued to make inroads.

Guitar Center is actually losing ground in this segment, making its forecast of $3 billion in revenue perhaps overly optimistic considering the timeframe given by the company's CFO.

WHITHER BRICK AND MORTAR?

A natural follow-on question is whether brick-and-mortar stores are completely passé, with no hope for the robust growth curves that all executives and investors would love. The answer is that physical retail is growing, but not for every demographic. Consider the top fifteen brands to open brick-and-mortar retail stores in the United States in 2014.



There have been 2000 new brick-and-mortar installations in the United States in a single year for "dollar stores" and Walmarts. For the reasons why, check the household wealth statistics in the last chapter. Very little of the growth in brick-and-mortar is from retail aimed broadly at the middle class. This is critical importance for the MI sector, especially those companies promising rapid growth.

TREND #3

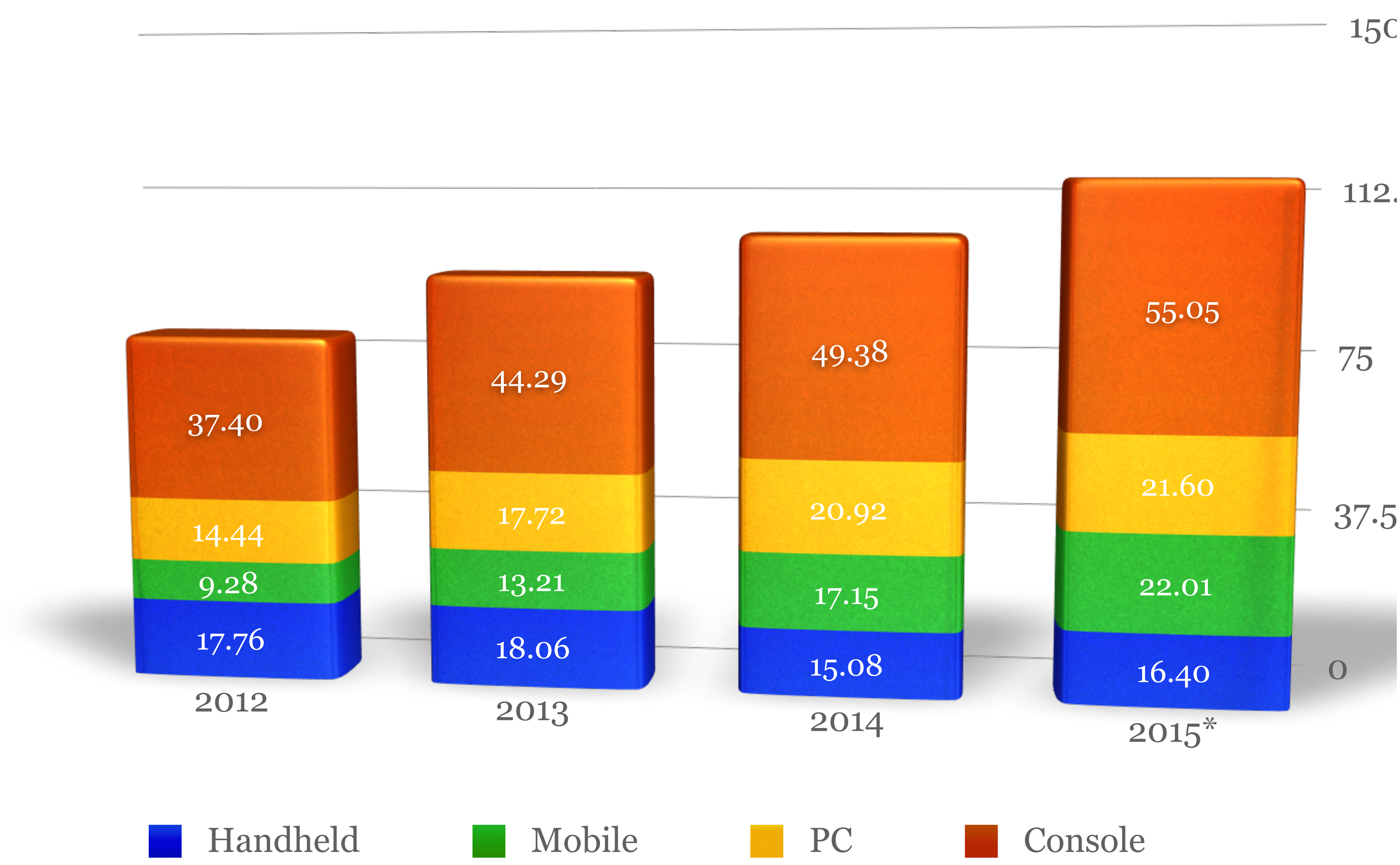
MUSIC DISAPPEARS INTO THE STREAM

Music Becomes Just Another Form Of Digital Entertainment

Finally, it is crucial to understand the broader context for the musical instrument industry by looking at the music business compared with the rest of the consumption of culture.

In Trend #1, we looked at the decline in the world of recorded music, but note, it is not joined by stagnation in other forms of content. Consider the growth of the global video game industry

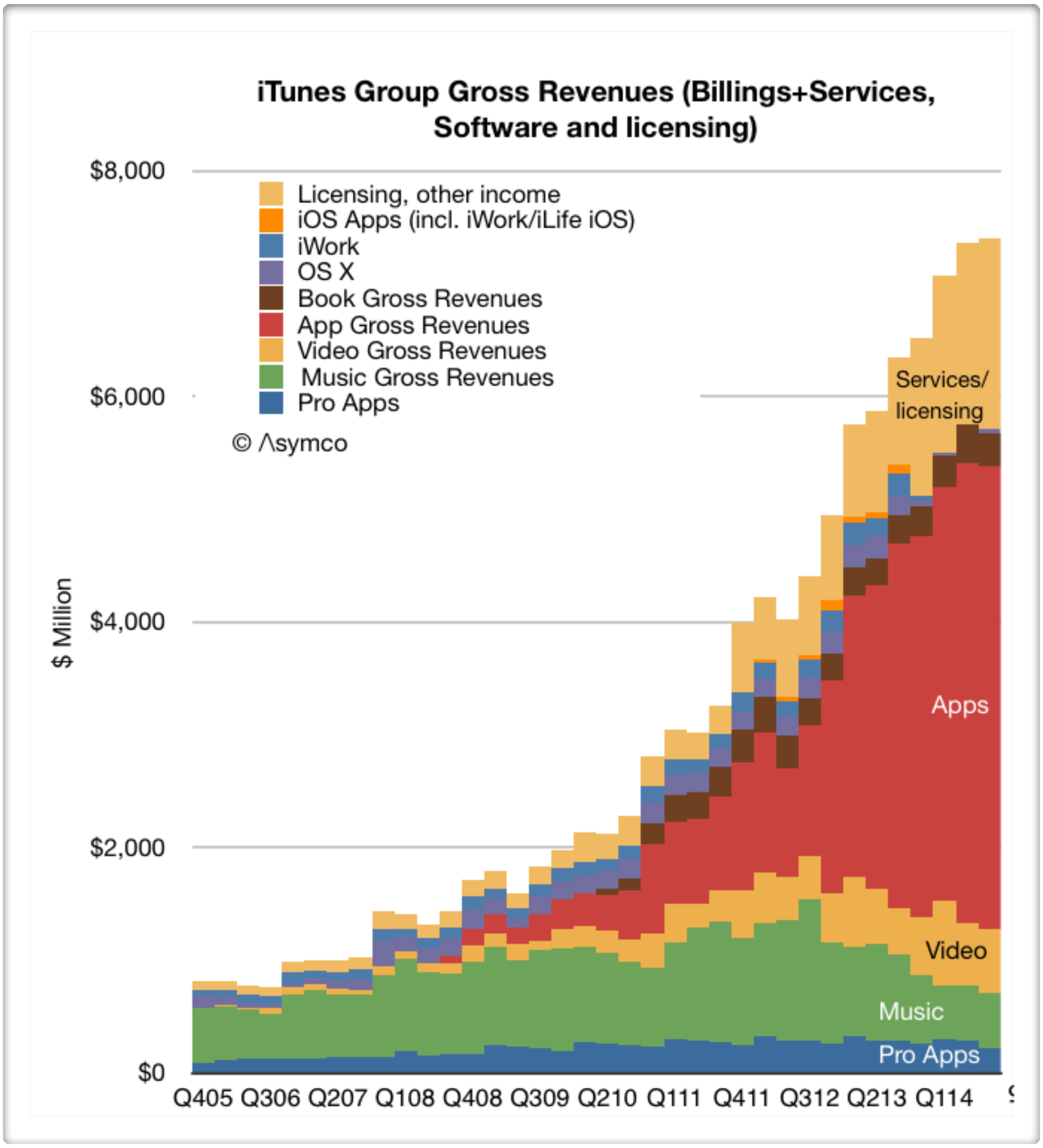
Worldwide Video Game Revenue, 2012-2015*, (USD Billions)



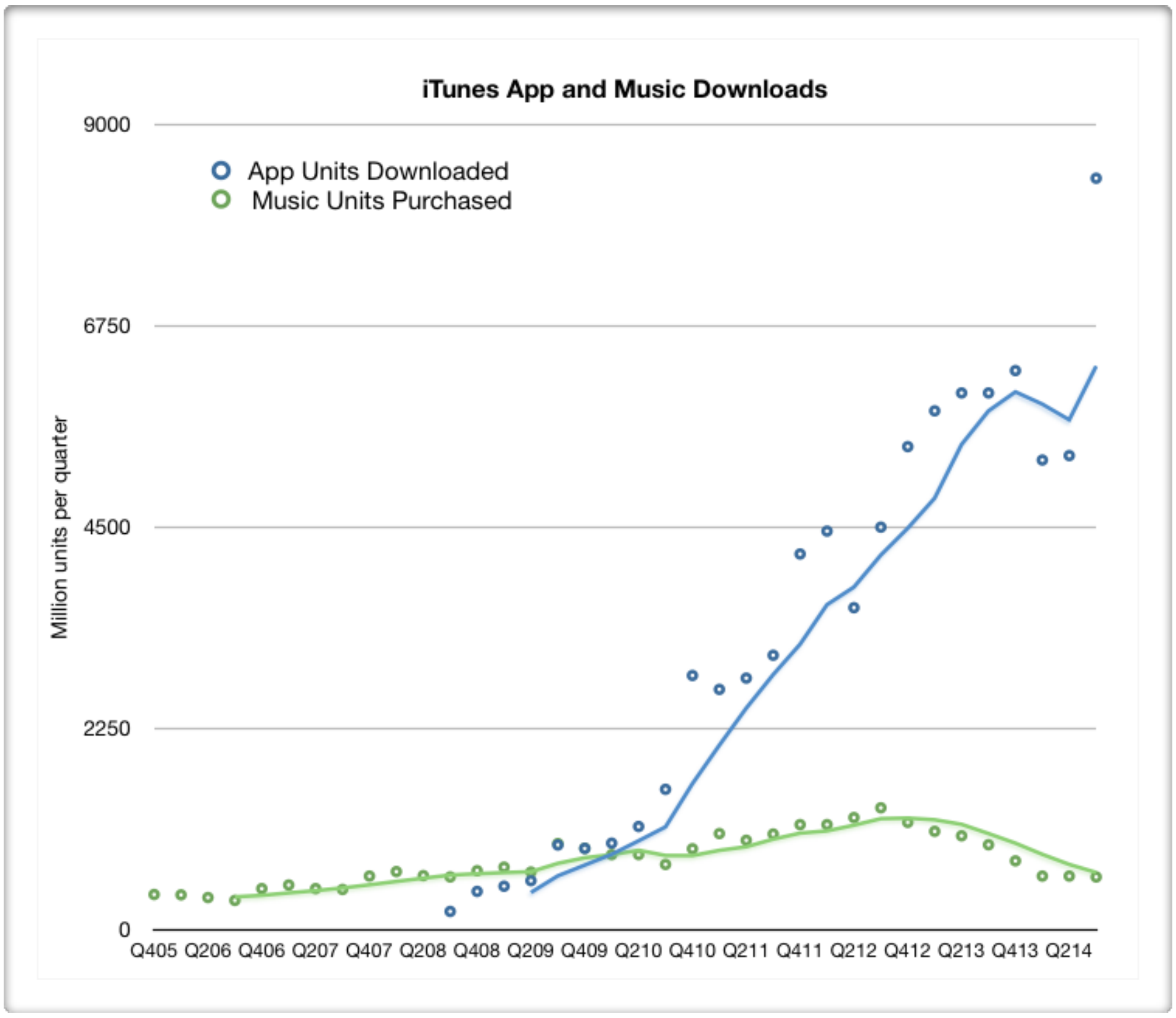
While the global music business slips to under under $15 billion, the mobile gaming market alone is at $22 billion, with the total segment topping $100 billion. The movie business, by contrast is $88.3 billion in annual revenue, worldwide.

That's right, video games are now bigger than Hollywood and Bollywood *combined*. So where is music?

As this chart from Asymco (http://www.asymco.com) shows, ten years ago music represented the majority of the revenues in Apple's iTunes/App Store channel. Today it is dwarfed by apps.



These additional charts, also from Asymco, break this out further into total downloads and gross billings, both of which show where music is dwindling away.


iTunes App and Music Downloads
9000
6750
4500
2250
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App Units Downloaded
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Million units per quarter
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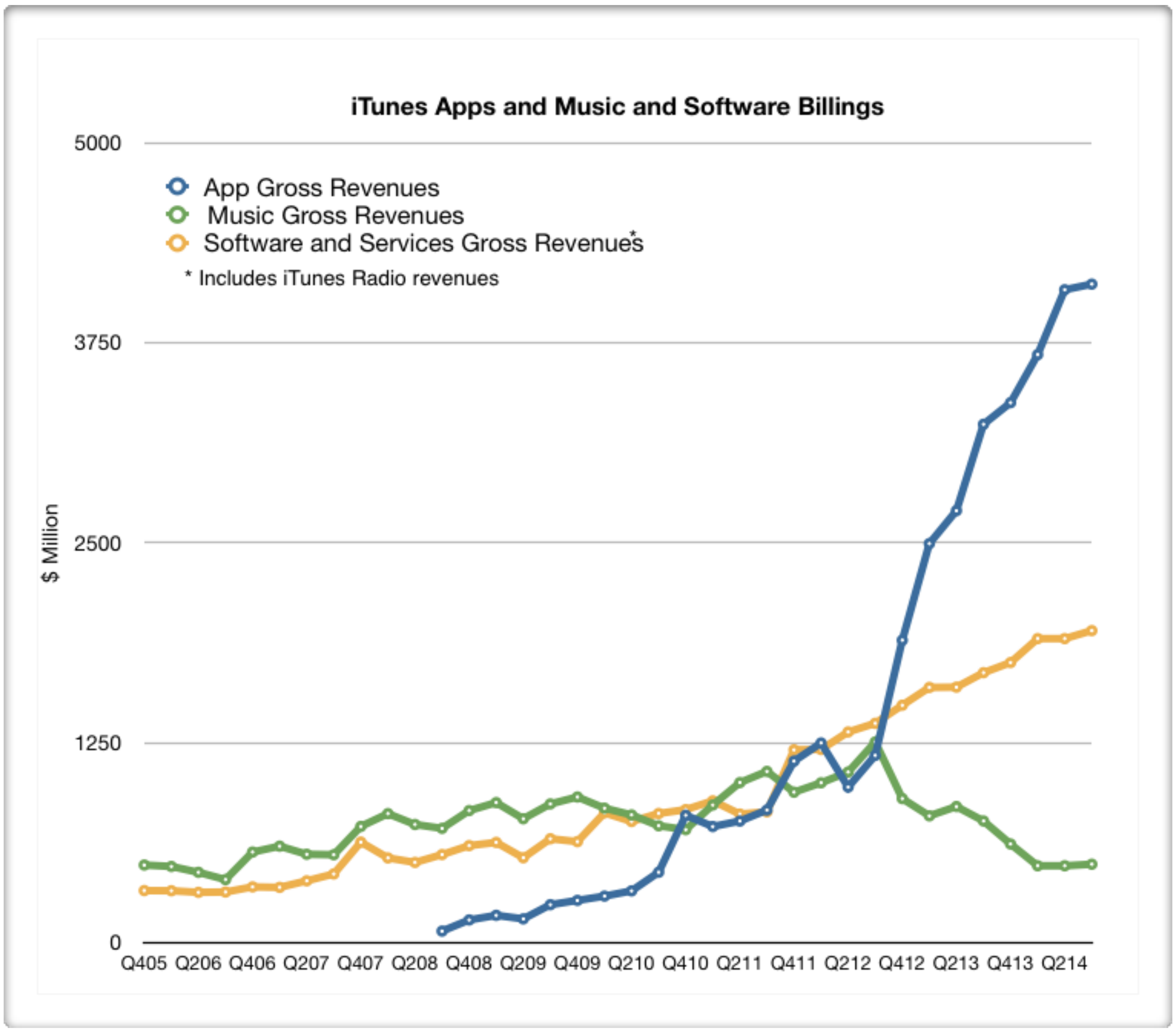
iTunes Apps and Music and Software Billings
5000
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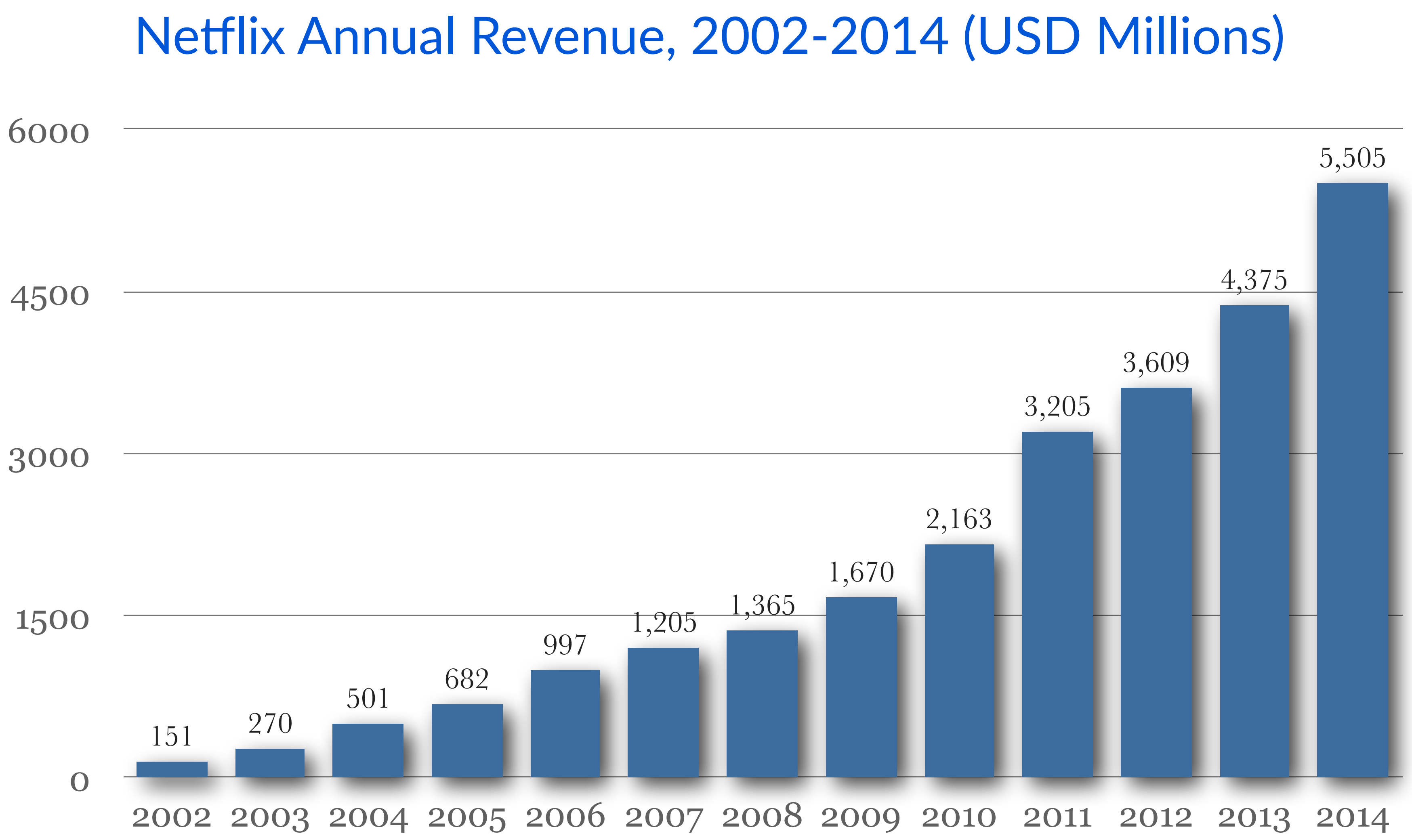
Music has made a permanent, transformative shift. While it seemed at the time as if the MP3 and digital piracy were the biggest issues, we submit that an even more disruptive shift has come from music's transition to delivery via multi-use devices.

In many ways, music has now become a commodity, sold in bulk, undifferentiated and facing falling prices and tepid interest from the general public. The revenues from streaming services such as Spotify, Rhapsody, and the newcomer Tidal are a fraction of the revenues lost from per-unit sales. They crowd the headlines, but the money just isn't there. Moreover, while the industry itself pretends that the main issue around streaming is figuring out how to "pay artists," the reality is that the digital streaming play is about the mass monetization of the back catalogs of record companies and other intellectual property rights-holders.

Note the massive difference between the effect of mobile, Internet-enabled digital devices on the video game business versus the music business. The former is able to find billions of dollars in new revenue streams; the latter is simply getting cannibalized. Netflix would be another pertinent example of how some forms of entertainment have thrived in this new environment.



The Stream, the massive global flow of ones and zeros made into IP packets, has been a rich source of innovation and robust revenue growth - for nearly every type of monetizeable content *except* for music. This state of affairs presents a tremendous risk and an equally large field of opportunities for the musical instrument retail business.

CONCLUSIONS & IMPLICATIONS

THE RACE TO INNOVATE

Firms in the musical instrument industry have two choices: take market share from existing companies, or find out ways to grow the category. Both initiatives will only find success at firms that exhibit an urgent desire to innovate new strategies and service offerings - before their competitors do.

Competitive Futures sees the following initiatives as potential courses of action for a broad range of stakeholders in the musical instrument industry:

EDUCATION

The only way to grow the consumer demographic for the industry will be to educate and cultivate new musicians. In a world, of over-scheduled young children, this may be easier said than done, but two main avenues are suggested. In the United States, this would be realized by engaging NAMM toward even more lobbying for national arts and education policies aimed at creating more musicians coast to coast. The second avenue would be private advocacy by individual firms, branded campaigns to support and promote the creation of musicians of all ages. The slow decline of musicians combined with a weak commercial sector for music make it even more important to create a secular increase in the number of potential customers in any way that is feasible.

GET ONLINE, GO BEYOND THE CATALOG

For retailers, it is clear that the only way to achieve significant growth is by expanding e-commerce revenues any way possible. Clearly, the main driver of market share will be from the leveraging of new, mobile, Internet-based technologies to enhance the retail experience. The explosive growth of Reverb shows that one can take an older business model, such as online second-hand product retail, add something special, such as the addition of a social aspect and some online education, and watch revenue growth take off. Using Reverb as an example, we see that the solution is not merely to create an online, mobile version of a 1990s-style direct response catalog but to do something that was technically impossible before.

Could it be Tinder for guitarists looking for decent bassists? The first musical instrument retailer to deliver emergency "GigSaver" services to drone deliver a replacement kick drum pedal right to your gig in a pinch? There are innumerable possibilities, which should make this next phase exciting.

OPTIMIZE EXPERIENCES PER SQUARE FOOT

For those businesses dependent on brick-and-mortar, all hope is not lost. Physical retail can still be successful, so long as it leverages its competitive advantage of being a center for curated products, special experiences, and services. Attempting to compete uniquely on price will be a strategy quickly overwhelmed by the algorithms at Amazon; it's not an attractive game to play. However, physical retail will have something irreplaceable: human beings. Music remains a social pursuit, and physical retail will maintain an advantage so long as it continues to be run by unique individuals capable of delivering value to a community of musicians and would-be musicians.

RIDE THE VIDEO GAME WAVE

Record companies have known for more than a decade that the fastest way to break a new single is to associate it with the launch of a major video game franchise such as Madden NFL or Call of Duty. The numbers are compelling: any time you are dealing with $100 billion in B2C revenue, you are reaching a considerable number of people. There is money to be made in this area; Guitar Hero and Rock Band may only have scratched the surface. It's time to get creative and figure out how have fun and make money through this synergy.

EMBRACE FEMALES AS PURCHASER-IN-CHIEF

If there is an example of the $20 bill in the pants on the way to the laundry, a pleasant surprise just waiting to be discovered, it is the progress that could be made simply by marketing more effectively to females. Women, particularly marginalized in the male-dominated world of guitar-based music, still make 85% of all consumer purchasing decisions. Simply by doing a better job of marketing to women, the industry might make significant progress.

Look to the recent rebranding of National Battery and Tire, which went from a standard, sorta-greasy garage, to a brightly lit, clean, showroom that is designed to look like a mobile phone app, covered in pictures of happy women. They figured out who actually got the oil changed, and it wasn't guys. The musical instrument industry would do well to come to a similar realization.