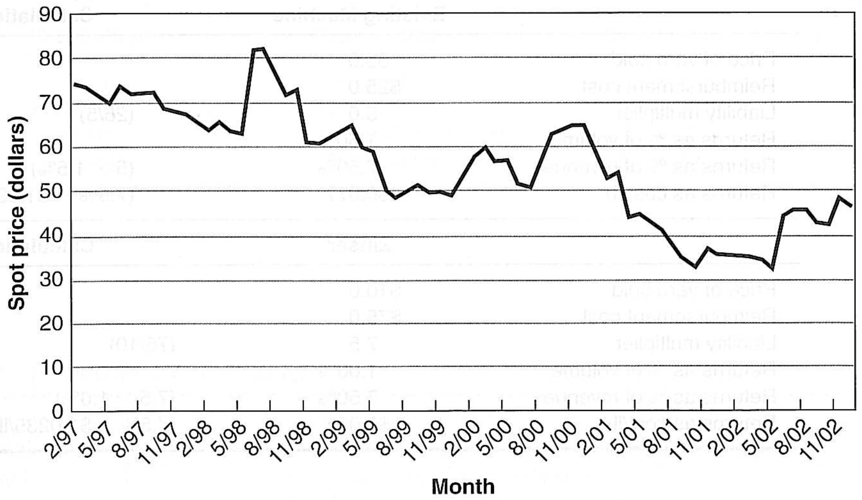
EXHIBIT 6 | Cotton Spot Prices (1997–2002)[1]



[1]Source: Bloomberg Database.

EXHIBIT 7 | Interest-Rate Yields: January 2003

U.S. Government (% yield)	
Treasury bill (1-year)	1.24
Treasury note (10-year)	3.98
Treasury bond (30-year)	4.83
Industrials (% yield)	
Prime rate[1]	4.25
AAA (10-year)	4.60
AA (10-year)	4.66
A (10-year)	4.87
BBB (10-year)	5.60
BB (10-year)	6.90

[1]The prime rate was the short-term interest rate charged by large U.S. banks for corporate clients with strong credit ratings.

CASE 21

Compass Records

Still bleary-eyed after an all-night drive from North Carolina, Alison Brown sat in the office below her recording studio near Nashville's famed "Music Row." It was late June 2005, and she had a moment to reflect on Compass Records, the artist-run record company that she and her husband, Garry West, had founded 10 years ago. The past few years had brought them great success, but managing the daily myriad decisions for the business remained a challenge. Foremost in her mind was whether to offer a recording contract to a talented new folk musician, Adair Roscommon, whose demo CD she was now listening to in her office.

Compass Records' tenth anniversary was a major milestone in the intense and unforgiving music business. With a roster of well-known and successful artists under contract, Compass had carved out a niche as an established player in the folk and roots musical genres. But unlike executives at the major record companies who typically had large budgets, every decision made by Brown and West regarding new musicians could have a major impact on their business. Compass could scarcely afford to squander resources on an artist in whom Brown and her husband did not believe strongly.

Brown was an acclaimed folk musician about whom the entertainment industry magazine *Billboard* once wrote: "In Brown's hands, the banjo is capable of fluid musical phrases of boundless beauty." Brown's assessment of another folk musician's artistic merit, therefore, had tremendous value, and she liked Adair Roscommon's work. Brown was also a former investment banker with an MBA who clearly understood Roscommon's potential as an investment for Compass. Intuitively, Brown grasped the implications of adding a risky asset, such as a new musician, to Compass Records' growing portfolio.

The central question for Brown, when contemplating any new musician, was whether to license that artist's music for a limited period of time or to produce and own the artist's master recording outright. In the short term, it was cheaper for Compass to license a recording, but it also limited the company's potential profit. If Compass

This case was prepared by Sean D. Carr, under the supervision of Robert F. Bruner and Professor Kenneth M. Eades of the Darden Graduate School of Business Administration. Certain persons and events in the case have been disguised, and some details have been simplified for expositional clarity. The case is intended to serve as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

Records purchased a musician's master recording and the album failed to take off, however, the company risked owning a significantly impaired asset. This issue and a host of others gathered momentum in Brown's mind while the gentle melodies of Roscommon's demo filled the thick southern air in her office.

Alison Brown and Compass Records

Alison Brown grew up in a family of lawyers, and had she not been influenced by music at an early age, she might have ended up becoming a lawyer, too. After moving with her family to La Jolla, California, when she was 11, she immersed herself in banjo playing and developed a burgeoning talent. By the time she was 14, Brown was playing publicly, and by 15, she had won the Canadian National Five-String Banjo Championship. In 1980, Brown carried her passion for playing the banjo with her to Cambridge, Massachusetts, where she earned degrees in history and literature from Harvard University. She spent her extracurricular time traveling the bluegrass circuit in New England, and continued to develop herself as an artist.

Still thinking that music was an avocation and not a career, Brown enrolled at the University of California–Los Angeles, where she earned an MBA in 1986. Afterward, she accepted a position as an associate in the public-finance department at Smith Barney in San Francisco. During the next two years, Brown continued to kindle her passion for the banjo, even though playing publicly was incompatible with her new life as a banker. Brown eventually realized that she had a calling. "I knew people who would wake up in the morning and get in the shower and think about how they were going to refund a particular bond issue," Brown once said. "I would wake up in the morning and think about music." During a six-month hiatus from her office job, Brown was invited to play for the award-winning band Alison Krauss and Union Station. That job lasted three years and launched Brown into a new career.

By 1992, not only had Brown been named Banjo Player of the Year by the International Bluegrass Association, but she had also released her first album, which was nominated for a Grammy.[1] After leaving Alison Krauss, she accepted an invitation to join the world tour of folk-pop artist Michelle Shocked, where she met her future husband, Garry West. "About two months into [the tour] we realized there were a lot of things we wanted to do," West later said. "We were in Sweden, sitting around over strong coffee and pastries, wondering how we could encompass our vision of the good life: an outlet for our work, other recordings, publishing, and management." As Brown described it, they laid out their vision on the "proverbial napkin," and mapped out a plan for a business that would satisfy their needs.

In 1993, Brown and West started Small World Music and Video in Nashville, Tennessee, selling folk, world, and environmental records produced by a company they had discovered while on tour in Australia with Michelle Shocked. That same year, they were approached by a potential investor who had heard an interview that Brown had done on National Public Radio and who believed in what Brown and West wanted to do. With support from that investor, the two started producing their own projects and, in 1995, they launched the Compass Records label.[2]

[1]The Grammy Awards were presented by the Recording Academy, an association of recording-industry professionals, for outstanding achievement. The Grammies were awarded based on the votes of peers rather than on popular or commercial success. The awards were named for the trophy, a small, gilded statuette of a gramophone.

By 2005, Brown and West's intuitive strategy was serving them well. Compass Records had grown to include nearly 50 artists under contract, and the company averaged about 20 releases a year. Their label was largely centered on roots music, and included marquee names like Victor Wooten, who was considered one of the best bass players in the world; Kate Rusby, a sensation among fans of traditional Anglo-Irish music; Colin Hay, the former front man and songwriter for the group Men At Work; Glenn Tilbrook, the former lead songwriter for the 1980s pop group Squeeze; Fairport Convention, one of the inventors of the folk-rock sound; and, of course, the dynamic bluegrass-jazz fusion of Alison Brown, who won a Grammy for her 2000 release, *Fair Weather*.

Compass Records in Context

Within the context of the global music business, Compass Records was tiny. The \$32-billion music recording industry was dominated by a handful of large, multinational corporations, which accounted for 86% of the market for global recorded music. Those companies included Universal Music Group, with 29%; Sony/BMG, with 30%; Warner Music Group, with 16%; and EMI, with 11%. See **Figure 1** for a pie chart showing the percentages.

The major labels' dominance, deep pockets, and global distribution systems helped them to survive a turbulent and uncertain decade in the music industry. While the global market for recorded music had grown from \$2 billion, in 1969, to \$40 billion, in 1995, it had stagnated ever since. According to the Recording Industry Association of America (RIAA), the industry had registered no growth in any single year since 1995. By 2003, the recorded-music sector had shrunk to 1993 levels (\$32 billion), and annual dollar sales were estimated to have declined at a compound annual growth rate of 5%.

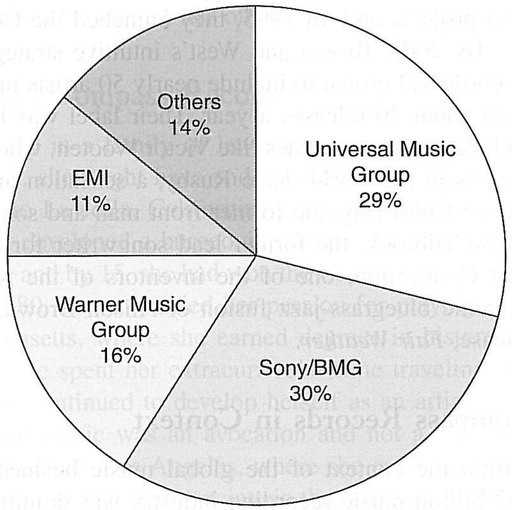
As the major labels battled to preserve their slices of the shrinking pie, a number of new independent labels,[3] such as Compass Records, had begun to emerge. Smaller and more nimble, these companies saw opportunities in markets where the major record companies could ill-afford to go given the scale of their economies. "The trouble with those huge corporations is that they have to have enough sales volume on a

[2]A record label was a brand created by a company that specialized in manufacturing, distributing, and promoting audio and video recordings in various formats, including CDs, LPs, DVD-Audio, Super Audio CDs, and cassettes. The name was derived from the paper label at the center of the original gramophone record.

[3]Technically, an independent record label, or indie, operated without the funding or distribution network of one of the major record labels. In practice, the boundaries between majors and independents were ambiguous. Some independents, especially those with a successful roster of performing artists, received funding from major labels, and many independent labels relied on a major label for international licensing deals and distribution arrangements.

FIGURE 1 |

2004 U.S. Recorded Music Market Shares



Source: Nielsen *Soundscan*, Morgan Stanley Research.

release to feed this huge infrastructure," said Brown. "And yet something like 98% of all records sell fewer than 5,000 copies, so if your benchmark is a million, or even 100,000, you're obviously overlooking a lot of good music that sells well enough to deserve being out there."

Brown estimated that 40% of Compass Records' albums sold 5,000 units or more; only a few of her artists were popular enough to sell more than 20,000 units. "For a major label, 5,000 units is a failure," Brown said. "Only an indie can make this a success." Compass Records turned a profit on 80% of its titles in 2005 (versus a 10% success rate for the major labels). **Exhibits 1** and **2** provide Compass Records' balance sheet and income statement for the fiscal year ended December 31, 2004. **Exhibit 3** offers the company's historical income and expenses.

Music-Business Fundamentals

Recording Contracts

Recording contracts were agreements between a record label and an artist whereby the label had the right to promote and market recordings of the artist's music. Under such contracts, the record company could either license an artist's finished recordings for a limited period of time or produce the recordings and own them indefinitely. If the label negotiated to "produce and own," it was entitled to exploit the music through the sales of CDs and electronic downloads, as well as through licensing the music to other record companies or to firms that wished to use the music in other media, such as commercials, television, or film. When Compass Records opted to produce and own a master recording,[4] the artist received no payment up front.

Under a licensing contract, the record label licensed a work that had already been recorded and packaged. It had the right to exploit that recording only for a predetermined period of time, typically five to seven years. Unlike a contract to produce and own a master, a licensing contract obligated the label to pay the artist an up-front fee (advance), which was intended to defray some of the costs the artist had incurred in developing the album. Compass generally negotiated advances of $3,000 to $5,000. If the artist sought a very large advance (i.e., $20,000 or more), Brown believed that it made more sense to own the master recording instead. Under a licensing arrangement, additional costs included updates to the album's packaging (around $500) and touch-ups to the master itself, although generally not required. Marketing and promotional costs associated with the licensed recording were usually the same as those for the purchased master.

Certain recording contracts also gave the record company options on additional albums by the artist (with a purchased master, the label usually had three options, although it was not uncommon to have seven or eight options). Those options were particularly important with new artists because the label made significant up-front investments to launch a new act for which the company might not realize a return until three or four records down the road. Recording contracts customarily gave record companies the exclusive right to record an artist during the term of the agreement. If an artist failed to fulfill her obligations, most contracts permitted the company to suspend the contract. An artist could also request to be released from the contract, which the company might be willing to grant if it were repaid its recording costs and/or granted an override, or a percentage on the sales of the artist's records released by another company.

Royalties and Recoupment

Regardless of the type of recording contract, record labels paid royalties[5] to artists for the use and sale of their music. The two most common types of royalties were *mechanical royalties,* which were paid to songwriters and music publishers[6] for the use of their musical compositions, and *recording artist royalties,* which were paid to an artist for the recorded performance of those compositions. Each type of royalty worked somewhat differently.

In 2005 in the United States, mechanical royalties were fixed at a statutory rate of $0.085 per song. If the song were included on a CD, then the record company would pay the artist and/or the publisher that amount for each CD unit sold.

[4]A master recording, or master, was an original recording from which copies were made.

[5]A royalty was a payment to the owner for the use of the owner's property, especially patents, copyrighted works, and franchises.

[6]A music publisher was a company that worked with a songwriter to promote her musical compositions. Publishers negotiated partial or total ownership of an artist's copyright for her work, and she received a share of the mechanical royalties from the use of that work, typically about 50%.

Many record contracts, especially those with artists who were both the songwriter and the recording artist, included a *controlled composition*[7] *clause*. Because those artists received both mechanical and recording royalties, the clause allowed the label to limit its mechanical expense. Compass Records, for instance, often negotiated a 10-song per CD maximum for mechanicals, which capped the mechanical expense at $0.85 per CD sold.

Recording artist royalties were not determined statutorily, but were negotiated between the artist and the record label. The recording royalty varied widely, and often depended on the stature of the artist. It ranged between 8% and 25% of the suggested retail price of the album. Recording artist royalties also differed with the type of contract. At Compass Records, the average recording artist royalty for an owned master recording was $1.45 per unit sold, whereas the royalty for a licensed recording was around $1.75 per unit sold. Recording royalties were generally lower for produce-and-own contracts because the record label was underwriting the expense of album production.

The record label, however, did not pay any recording artist royalties until certain costs incurred in making and promoting the album had been recouped. All the costs of recording and preparing the music for manufacture were recoupable. About 50% of the marketing and promotional costs were recoupable. For licensing contracts, the advance was completely recoupable. An artist reimbursed the record label for those recoupable costs at her contracted royalty rate. For example, if the artist's royalty rate was $1.45, the record label reduced the amount of the total recoupable expense by $1.45 for every unit sold. When the label had recovered all recoupable expenses, the artist would begin to collect the recording artist royalties. (Mechanical royalties were not subject to the requirement that recoupable expenses be recovered first.)

Record companies' justification for the practice of recouping certain costs from an artist was that the label had invested its resources and had borne the financial risk of making and promoting the album. Some labels argued that this was similar to a joint venture in which production costs and overhead were repaid before the partners divided any profits. As an accounting matter, Compass Records recorded its recoupable costs as an asset on its balance sheet. On average, the company expensed those costs after two years.

Production and Manufacturing

If a record label negotiated a contract to produce and own an artist's master recording, the cost of producing that recording would depend on the size of the project, the complexity of the recording, and the level of perfection desired. The costs for producing an album would typically include fees for producers, arrangers, copyists, engineers, and background musicians, as well as the charges for studio and equipment rental, mixing, and editing. For relatively new artists signed by a major label, those costs could range between $80,000 and $150,000 for a single album, while established artists were known to run up production costs in excess of $500,000.

[7] A controlled composition was a piece of music that was written or owned by the recording artist.

As a small independent label, Compass Records incurred production costs that were significantly lower than the major labels'. Compass even had an advantage over some other indie labels because Brown and West had acquired a recording studio in May 2004. The wood-paneled, digital studio, which had cost Compass about $100,000 to equip, gave the label and its artists more flexibility in the creative process and saved the company about $500 a day, which it would otherwise have spent on studio rental. Compass Records might spend between $15,000 and $25,000 to produce an album.

Regardless of whether a record company opted to license or to produce and own an artist's album, the next major expense for the label was the manufacturing of the CDs. The manufacturing cost—which included pressing the CD, purchasing the standard jewel case, shrink-wrapping, and attaching a label to the top spine—was about $0.70 per unit. There was an additional unit cost of about $0.20 for printing the booklet and other materials contained inside the CD case. Compass had an arrangement with a CD manufacturer in Minneapolis, Minnesota, whereby the minimum initial order required was 1,000 units; thereafter, Compass could order in increments of 500. Because the manufacturer could turn around an order in three to five days, Brown and West tried to keep very tight control over their inventory.

Marketing and Distribution

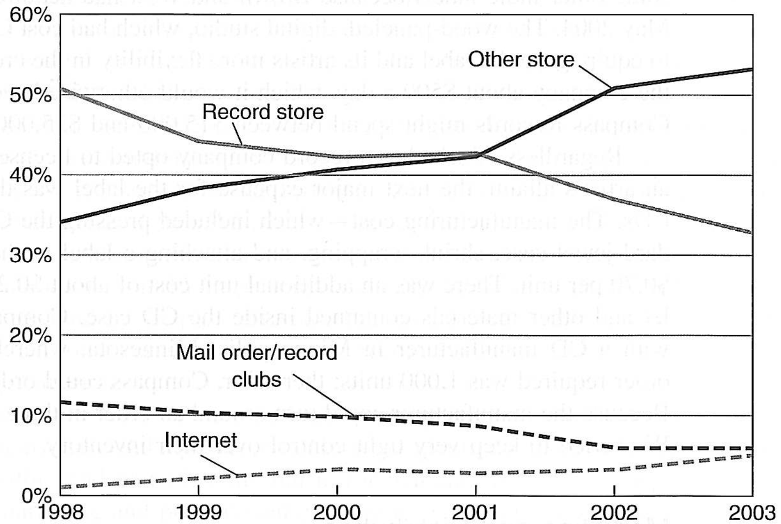
For the major record labels, promoting an album depended on obtaining regular airplay on radio stations around the country. This process began with an album mail-out, which provided free copies of the recording to radio stations and music journalists. For a small independent label like Compass, promotional efforts were highly specialized and targeted. Compass focused on local radio programs and record stores in coordination with the performer's tour schedule. A typical album mail-out for Compass Records included 2,000 CD units. Compass usually negotiated a reduced rate of $0.50 per unit with its manufacturer for making the promotional CDs; the postage and collateral materials cost an additional $2.00 per unit. None of those costs were recoupable.

For Compass's artists, a major component of the marketing effort was venue sales at live concerts. Fans of folk, Celtic, and roots music were often known to postpone purchases of an album by a favorite artist until they could buy it at the concert, even if the album was locally available in stores. To encourage local fans to attend concerts by new artists, therefore, Compass usually paid for local print-advertising campaigns ($3,000), posters and press photos ($500), e-card mailings ($1,000), and the services of an independent radio promoter ($2,500).

With respect to CD distribution, major labels had divisions that handled the placement of millions of units worldwide. Independent labels such as Compass, however, secured deals with independent distributors to place their albums in regional retail outlets. Domestic distributors charged the label a fee; for Compass, this fee was 21% of the standard wholesale price of $11.45 per unit. The distribution of recorded music was also subject to a return privilege. All unsold CDs or cassettes were completely returnable by retailers. "This business is 100% consignment," Brown said. Compass was paid only for the CD units that sold, not for the number shipped. Retailers

FIGURE 2 |

U.S. Sales by Channel



Source: Recording Industry Association of America.

returned unsold units to the distributor, which then returned them to the record company. Because of the return privilege, Compass typically manufactured about 30% more units than it estimated would actually sell at retail outlets; the company would usually write those units off after two years.

At the retail level, there had been a major shift from specialty record shops to mass- market and on-line retailers (see **Figure 2**). Record stores' share of U.S. music sales declined from 51%, in 1998, to 33%, in 2003, while the mass-market stores' share grew from 34% to 53% over the same period. Getting a record well placed with the large retailers was expensive. Brown estimated that Compass might spend around $5,000 for a new artist on in-store listening stations and other retail programs. The average retail list price for a Compass CD was $17.98 per unit.

Retailers gave an album only about 90 days from its release date to generate meaningful consumer demand; if that failed to occur, they exercised their return privilege. Therefore, in order to ensure high demand by an album's release date, sufficient publicity and promotion had to occur months in advance. "From a financial point of view," Brown said, "that means incurring all your recording, preproduction, and manufacturing costs six months or more before you will ever see any return." To keep an album available in the stores, a record label had to sell at least 50% of the total forecast sales in the first three months after the release date, and perhaps reach 75% in the first year. After that, sales might fall off quickly, with most of the remaining inventory sold the following year.

The Roscommon Decision

Adair Roscommon, an Irish singer who played fiddle, mandolin, and guitar, had been called "the Dublin folk scene's hottest up-and-comer" by one reviewer. She had begun her musical career as a teenager with the Irish traditional band Fairlea Brigham, and after reading history at Trinity University in Ireland, Roscommon started writing her own songs and touring with other artists in the United Kingdom and the United States. Her self-released 2003 album, *Swallows Fly,* did well—she sold 2,500 copies of the album from her van—and led to her being voted "Best New Artist of 2004" by the listeners of the influential Boston folk radio station WUMB. That local success caught the attention of Alison Brown. She liked how Roscommon combined the sophisticated, modern folk music of her native Ireland with the soulful strains of bluegrass; she had a sharp, accessible sound that was both classic and modern.

Brown and her husband believed strongly in Roscommon as an artist, but they were still undecided about whether Compass's contract with her should be to produce and own her next master or simply to license the finished recording. Purchasing her music would mean producing a master recording, which Compass Records would then own and from which it could potentially generate revenues indefinitely. Licensing the recording might be less expensive on the front end, but there was a finite life to the future cash flows associated with the recording. "If you fund a master, then it costs more than if you license [a finished recording]," Brown said, "but licensing means renting the material."

On the one hand, Brown believed she could negotiate a deal to produce Roscommon's next recording for $20,000, which included the standard options to produce and own three additional albums. As part of the deal, Compass would also negotiate a copublishing arrangement with Roscommon. Typically, an artist such as Roscommon, who wrote all her own songs, would split 50% of the mechanical royalties earned on an album with a music publisher, with which she would contract to promote her written compositions. Under this deal, however, Compass would be the publisher of the songs on the album. If Brown and her husband chose this alternative, therefore, Compass would effectively reduce their mechanical royalty expenses by half.

On the other hand, if Compass licensed Roscommon's finished recording, Brown thought the advance would be about $3,000, and Roscommon might be willing to include a performance-based option in the contract. With this option, if Compass achieved a sales target of 10,000 units, then it would earn the right to license her next album. "If we succeed with Roscommon under the license deal and make her a more well-known and viable act," Brown thought, "it's very possible that another label could swoop in with cash and promises of bigger things and reap the benefit of Compass's investment in her." Thus, having this additional clause in the licensing deal offered Brown some security. "We have a good feeling about her long-term potential," she said, "but we realize it may not show itself for a few albums."

Brown and West thought hard about their projections for Roscommon's album. "Only 1 in 20 albums will be the grand slam," Brown thought. For Compass, a grand slam might be 50,000 units, but success would depend on the up-front recording and marketing costs. They estimated that Compass could safely sell 5,000 units of

Roscommon's album in the United States through its domestic distributor. Because Roscommon already had a fan base overseas, they also believed they could generate international sales through distributors in other regions. Brown forecast sales of another 2,000 units in the United Kingdom, Ireland, and Europe; 1,000 units in Japan, New Zealand, and Australia; and 500 in Canada.[8] Roscommon herself could also probably sell at least 1,500 CDs from her van; she would pay Compass $6 per unit, and she would receive no artist or mechanical royalties on sales from her van. Brown used the industry's standard 12% discount rate for her analysis. Compass Records' marginal corporate tax rate was 40%.

At Compass, Brown had historically preferred to license rather than to own records. "It gives me the chance to wait and see," she said. But it wasn't always so simple. Compass's new distribution agreements in Europe and Asia created opportunities to sell an artist's CDs in new markets around the world, and Compass's recently built studio made producing an album easier and cheaper.

"We used to own only about 30% of the whole catalog for an artist, but with the studio we now own about half of them. The only rule of thumb is our experience," Brown said. She knew that an artist's success depended heavily on how active they were. A new artist that toured heavily and consistently could achieve 50% of their total sales at venues alone. "The rest just seems to come down to karma," Brown thought. "One thing we've learned is that you can't sell a record before its time; the hard part is guessing whether or not it's an artist's time."

[8]For sales in the United Kingdom, Ireland, and Europe, Compass typically received (euros) EUR7 per unit. For sales in Japan, Australia, and New Zealand, Compass received (U.S. dollars) USD6.50 per unit; for Canadian sales, Compass received USD7.00 per unit. Compass's international distributors did not charge an additional distribution fee. In mid June 2005, the USD/euro exchange rate was 1.224.

EXHIBIT 1 | Compass Records' Balance Sheet

		Dec. 31, 2004
Assets		
Current assets:		
Cash		$ 68,074
Accounts receivable		1,038,026
Other current assets		801,850
Total current assets		1,907,949
Fixed assets		433,608
Other assets:		
Accumulated amortization		(53,393)
Organizational costs		22,293
Start-up costs		3,510
Recoupable artist costs		908,226
Total other assets:		880,636
Total Assets		**$3,222,193**
LIABILITIES & EQUITY		
Liabilities		
Accounts payable		$ 280,907
Short-term debt		48,282
Other current liabilities:		
Accrued royalties payable	304,736	
Royalty reserve account	322,737	
Payroll tax payable	35,102	
Sales tax payable	8,108	
Credit card rec. issues	(567)	
Franchise tax payable	(5,670)	
Foreign taxes payable	6,105	
Line of credit	1,024,216	
Total other current liabilities		1,694,767
Total Liabilities		**$2,023,956**
Equity		
Paid-in capital		$270,000
Additional paid-in capital		530,053
Retained earnings		398,184
Total Equity		**$1,198,236**
Total Liabilities & Equity		**$3,222,193**

EXHIBIT 2 | Compass Records' Income Statement

	Jan–Dec 2004
Ordinary Income/Expense	
Income	
CDs	$4,634,967
Downloaded music	141
Consignment merchandise	1,625
Videos	2,225
DVDs	52,280
Studio rental income	14,128
Total Income	**$4,705,366**
Cost of Goods Sold	
Cassettes	$ 724
CDs	767,858
DVDs	7,006
Videos	805
Merchandise	210
Consignment	145
Total Cost of Goods Sold	**$ 776,748**
Gross Profit	**$3,928,618**
Expense	
Distribution expenses	$ 781,771
Royalty expense	570,565
Payroll expenses	466,542
General and administrative	576,583
Payroll tax expense	38,754
Other tax expense	15,786
Miscellaneous	36,167
Advertising	334,225
Promotion expense	71,116
Mailing expense	154,761
Travel & entertainment	48,558
Tour support	25,477
Graphic artist fees	33,064
Project expenses	24,244
Project costs not recouped	(3,375)
Total Expense	**$3,950,985**
Net Ordinary Income	**$ 754,381**
Other income	34,511
Net Income	**$ 788,892**

EXHIBIT 3 | Compass Records' Historical Income and Expenses

	Total	
Year	**Revenues**	**Expenses**
2003	$2,702,840	$2,720,477
2002	2,734,773	2,755,426
2001	3,097,362	2,877,749
2000	2,898,315	3,075,899
1999	3,039,806	2,900,359
1998	1,343,050	1,389,010
1997	911,588	962,912
1996	770,094	906,439
1995	837,748	866,908