



**EMI Group PLC Case**

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June 23rd, 2014

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# Introduction

EMI group is a British music recording and publishing company that was founded in 1931. It is currently the world’s largest independent music company. Since the mainstream introduction of digital music and specifically music stored in a MP3 file format EMI has been struggling to keep revenues up and have seen a steady decrease in its top line over the last few years. This year is looking particularly bleak for the company as it has seen a bigger decline in revenue compared to previous years. The company’s stock price has fallen dramatically in the last few years and investor confidence has been shaken. Historically (since 2002) the company has been paying a fixed divided to shareholders and has already paid part of this divided for the current year. The decision for EMI now is do they pay the dividend as per the last few years or use the cash in other projects.

# Background Analysis

## Changing music market

The digital revolution is said to have started when Apple launched the iTunes Music Store and the iPod, which brought user friendly digital downloading and mobile enjoyment to the US, the world’s largest music market. Interestingly, iTunes sold it’s one billionth download in Feb 2006 and in the first quarter of 2007 Apple sold 21 million iPods, up from 15 million units in 2006 Q1 and 5 million units in 2005 Q1[[1]](#footnote-1). Approximately $2 billion in music sales was attributed to digital sales in 2006. Record companies’ digital music sales are estimated to have nearly doubled in value in 2006[[2]](#footnote-2). These numbers only strengthens the position that digital media will be the medium of choice for the music industry going forward.

However, while this new digital marketplace presents the opportunity to penetrate deeper into existing and new markets, it also presents a significant risk of piracy. The global music market has experienced a rapid decline in physical sales (25% from 2000 to 2006), and unfortunately the expansion of online music sales has not compensated for this decrease amounting to an overall decrease in sales by 3%. Credit Suisse estimated a paltry 1.1 to 1.5% growth in 2008 and 2009, respectively. However, Lehman Brothers have estimated no growth for the next couple of years stating that it will be a very tough time for the music industry as a whole. Correspondingly, the physical music market declined a further 20% in 2007 (according to Neilsen SoundScan).

## EMI losing market share to competition

As of 2007, there are four major players in the business of music recording and publishing. The relative market share for each company is the following (2007)[[3]](#footnote-3):

1. Universal Music Group: 25.7% up from 25.6% in 2005
2. Sony BMG: 21.2% (2006)
3. Warner: 13.8% up from 12.8% in 2005
4. EMI: 12.8% down from 13.6% in 2005

* Remaining 27.5% held by independent labels

Universal Music Group (UMG) is a subsidiary of Vivendi SA, a French multinational communications and entertainment telecommunications company. Vivendi’s business segments include Activision Blizzard (interactive entertainment software), SFR (mobile and broadband internet services), Maroc Telecom Group, Canal+ (television entertainment), and Universal Music Group. UMG is the world's largest recording company, boasting about 20 record labels, including Interscope Geffen A&M Records, Island Def Jam, and Motown Records. UMG’s Universal Music Publishing Group is the world's largest music publishing house, with more than a million copyrights under control and thus UMG owns the largest catalog of recorded music in the world.

Sony Music Entertainment (SME) is a US-based subsidiary of Sony Corporation of America (SCA), itself a subsidiary of Japanese conglomerate Sony Corporation. SME is the second-largest recording company in the world behind UMG and similarly is engaged in the publishing and sale of recorded music, under several US-based record labels such as Columbia, Epic, and RCA.

Finally, Warner Music Group (WMG) is the third-largest recording company in the world. The company operates numerous recording labels, including Warner Bros. Records, Parlophone Records, and Atlantic Records. WMG operates Warner/Chappell Music, one of the world’s largest music-publishing companies, and its music publishing business holds more than one million copyrights from over 65,000 songwriters making it the second largest catalog in the world.

## Takeover risk

While all other major competitors are subsidiaries backed by larger conglomerates, EMI is the only fully independent music label. Recently, EMI has experienced a revenue decline, which is attributed to poor US performance; EMI's share of physical album sales being only 10.2% of US market [[4]](#footnote-4). Furthermore, EMI’s digital album share is only 10.5%. Comparatively, Warner Music has benefitted greatly by an increase in digital market share (up to 16% in 2006), while Universal has the largest share of digital sales at 26.5%.

With EMI’s revenue steadily falling from 2003 to 2007 and the stock price dropping from roughly 600p in 2000 to 200p in 2007 there is serious risk of a hostile takeover by the other bigger players in the market or another external entity. Interestingly, EMI had attempted a buyout of Warner Music a year earlier (2005) amidst net profit gains of 14% during 2005 and strong US market growth[[5]](#footnote-5). However, currently the tables have turned as EMI recently rejected an unsolicited 260p-per-share merger offer from Warner Music. While this rejection indicates residual shareholder confidence, a looming decision by EMI CFO, Martin Stewart, to maintain the historical 8p-per-share dividend, given EMI’s recent performance, is being debated. EMI faces serious threat of takeover and boosting share price will be important to discourage future takeovers and maintain company independence.

## Internal Analysis

As of 2007, EMI has two main business areas: Music recording and publishing. Recorded music represents 75% of the overall revenues and focuses on the production and sales of recorded music albums and tracks. It is expected that in 2007, about 10% of recorded music revenues will come from digital formats, while the remaining 90% will be physical media. Between 30-35% of these sales will be existing (older) products, while the remaining bulk of sales will be new music. The second business area, music publishing, accounts for the remaining 25% of revenues and focuses on songs and song writing as intellectual property, and thus a source associated royalties.

## EMI Strengths

1. EMI has a long history, running back more than a century (established in 1897), and owns one of the largest music catalogues in the world, (including legendary artists as the Beatles, the Beach Boys, Pink Floyd, and Duran, Duran). As such, it has a strong brand image.
2. A quarter of EMI’s revenues are generated from the music publishing business, which appears stable and sees positive profits. Furthermore, it hasn't been affected by peer-to-peer downloads in the same way as the recorded music business.
3. Recently, EMI successfully rejected a 260p-per-share ($4.38 USD-per-share; c.2007) merger offer by US rival Warner Music, indicating that shareholder confidence remains present, despite recent revenue declines and gloomy forecasts.
4. Digital sales have increased from less than 1% of total revenues 2 years ago, to an expected 10% for 2007. This important as EMI is about to make a joint announcement with Apple: it will become the first company to offer its catalogue for digital download completely DRM-free, and with improved sound quality, albeit at a 30% premium. It is expected that this will generate more revenues, especially considering the rapidly-increasing digital sales.
5. The restructuring program in progress is delivering better-than-expected results, at a lower-than-planned cost. These new savings will help offset the effect of decreased recorded music sales.

## Weaknesses

1. EMI's main source of revenue, recorded music, is rapidly declining and led to a loss last year. Overall revenues are down 16% from last year. Earnings-per-share not only decreased, they are now negative (-36.3p compared to last year's 10.9p).
2. Attempts at setting up a subscription service to capture the digital download market has failed to deliver expected results and hasn't significantly slowed record sale erosion.
3. In January, EMI underestimated its initial forecast for 2007, announcing a revenue decline between 6-10%, and one month later had to review that forecast to a 15% expected decline. These consecutive negative announcements within the span of one month have shaken investors' confidence in the current management's competence, and the stock price dropped 12.8%, leaving them vulnerable to a takeover bid.
4. EMI's current business model in highly-vulnerable to current market threats, with 75% of its revenues coming from recorded music, of which 90% are still from physical records. While some attempts are being made at taking advantage of current opportunities (the joint deal with Apple, for example), and at protecting against current threats (restructuring project), it is not clear how effective those measures will be.

# Financial Analysis

Observing the company’s ownership, there are 7 substantial shareholders who own 48.4% of shares. From the information provided, most of these investors are money managers who most likely require a certain level of consistency in their portfolio’s returns. If EMI were to cut dividends, this will have a negative impact on those investment companies’ Cash Flow, whom in return might be forced to dump the stock to maintain liquidity. If that is the case, share price could significantly drop making the company a prime target for a takeover at low price.

Using the dividend-pricing model (R = D1/P + g), based on the fact that dividend payments have been flat for the past few years, an assumption can be made that growth is 0. With an average share price of 263.5 in 2007 and forecasted dividends of 8p, the market prices the security to yield a 3% return (8/263.5). If ever dividends were to be cut to 2p, at current market price, the yield would drop to 2/263 = 0.7%; much lower than the risk free rate. The market would most likely adjust; which would put extreme downwards pressure on the stock price forcing it even lower and making the company extremely vulnerable to a takeover. More specifically, in order to maintain the current 3% yield (assuming EMI’s risk is unchainged), the price could drop as low as 67 (2p dividend / 3% expected return). Since EMI recently disappointed investors by revising forecasted recorded music division decline in revenues from 6-10% to 15%, a second disappointment with a dividend cut could motivate investors to pull the trigger on the stock.

Since the company produced a deficit in 2007, it is not possible for EMI to distribute proceeds from NI as dividends. Fortunately, cash levels rose from 191M in 2006 to 332M in 2007, which could be used to cover the dividend. Even by making a 63M dividend payment to shareholders, cash on the balance sheet would still be 269M; substantially higher than in 2006, thus providing the required liquidity to see the recent restructure to completion and invest in innovation that will help drive up sales. On the liability side, dividend payment will only decrease retained earnings deficit by 2.6%.

Observing the income statement, from Exhibit 4, the 2007 287M deficit includes 307M of “exceptional items” which should not be recurring every year. Furthermore, 125M were pending on the ongoing restructure, which should generate subsequent savings of 110M annually. Just by removing the cost of the restructure and adding expected savings, the NI should be back close to break even. Adding on to this the forecasted growth, there is no doubt that the forecast presented in exhibit 7 is realistic (and optimistic).

If EMI were private, it would make sense not to pay dividends in order to preserve cash. But since the company is public and therefore should be focused on increasing shareholder equity, dividends should be paid to maintain share prices constant and avoid a massive sellout. The dividend payment will squeeze cash reserves for the next few years, but NI is forecasted to be back to positive levels in 2009, including dividend payments. Overall, this reduction in cash should have a much smaller impact on share price than cutting dividends.

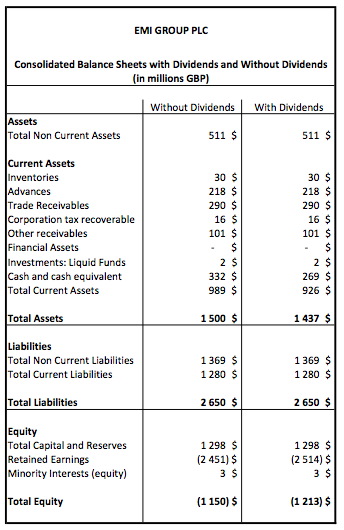
# Recommendation

After the analysis has been done it becomes clear that EMI is in a very difficult situation. The music market is in a state of flux and competitors seems to have a better handle on adjusting to the changes than EMI. With physicals sales declining sharply and digital sales not growing quickly enough EMI’s future does not look bright. It is now faced with another difficult decision of having to pay the rest of the usual 8p which comes to GBP 47.25-million dividend or rather invest the money in new projects that can potentially turn the decline in revenue around.

In a world where share price does not matter and hostile takeovers will not result because of woefully low share prices EMI would have kept the dividend and invested in projects that would increase the availability of EMI’s music catalog online. The market is moving from physical sales to digital sales so an all-out digital distribution action plan is probably the most important objective the company can set for itself in the long term. The collaboration with Apple is a step in the right direction but a more aggressive push is necessary in order to turn the company’s fortunes around.

However with the current investor sentiment that EMI is already struggling cutting the divided by any amount has the potential of sinking the ship completely. If the current stock prices falls even marginally lower EMI will almost be certainly gobbled up by the other players in the market. EMI has to do everything in its power to keep its share price up and make it gain some of its lost value. Luckily for the company it has enough cash at the moment to be able to pay this dividend.

As shown in Exhibit 7 projected net income will start to turn positive again in 2009 even with paying the full 8p dividend. Thus the recommendation is that the company pay the 8p dividend in order to keep its share price from falling even further.



1. http://commons.wikimedia.org/wiki/File:Ipod\_sales.svg [↑](#footnote-ref-1)
2. http://www.ifpi.org/content/library/digital-music-report-2007.pdf [↑](#footnote-ref-2)
3. http://uk.reuters.com/article/2007/07/18/uk-share-idUKL1781138320070718 [↑](#footnote-ref-3)
4. http://uk.reuters.com/article/2007/07/18/uk-share-idUKL1781138320070718 [↑](#footnote-ref-4)
5. http://online.wsj.com/news/articles/SB114836856610160431 [↑](#footnote-ref-5)