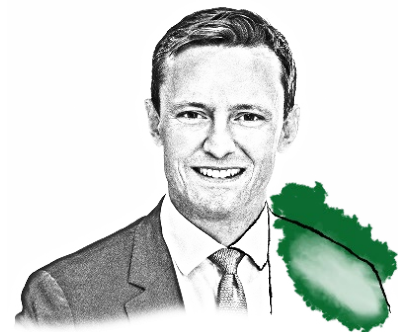


FOR USE BY INSTITUTIONAL INVESTORS ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

TAKING ON TIKTOK

FIRST PUBLISHED APRIL 2024

The US government isn't the only one taking on TikTok. Universal Music Group (UMG) has recently removed its content from the platform as it fights to ensure adequate compensation as well the protection of its valuable catalogue as AI-generated content proliferates. As the world's leading music company, UMG is again demonstrating its industry leadership whilst also supporting its artists and driving future revenues. Here we consider the company's history, the strength of its current strategic position and its outlook.



PAUL LOUDON
Investment Manager



It's been a bad few months for TikTok. In March, the US House of Representatives approved a bill to demand that TikTok be sold to a non-Chinese company within six months or be banned from US app stores. The previous month, Universal Music Group (UMG) pulled its entire catalogue from the app.

Despite what seems like a draconian move by US legislators, consensus amongst the media and tech community seems to be that TikTok's parent company, ByteDance will find a way to separate its US business and avoid any ban. Its negotiations with UMG will perhaps be less straightforward.

“UMG is the world's leading music company representing most of the top 10 selling artists today”

With estimates of over 1.12 billion users worldwide, and an approximate 150 million users in the US, it would seem reasonable to assume that TikTok might have the upper hand. That assumption, however, underestimates the ease to which TikTok users might effortlessly prioritise one of the numerous other short-form video platforms and, more importantly from our perspective, it also underestimates the bargaining power of UMG, its track record of successfully defending and protecting its intellectual property and its resolute motivation.

UMG is the world's leading music company representing most of the top 10 selling artists today, including Taylor Swift, Drake and The Weeknd amongst others. Its catalogue also includes recording artist 'royalty' such as Elton John, The Beatles, Queen and U2 and as content and publishing rights are pulled from TikTok, the extent of its market position and influence spanning its portfolio of 'independent'

labels, its distribution agreements and its publishing rights has become more evident than ever.

Lucian Grainge, who joined UMG in 1986 becoming CEO in 2010 and is today its Chair and CEO, was widely credited with the defence of music companies, and their artists, as streaming services took off in the mid-2000s. He, and the team at UMG, are again leading the industry to demand due payment from these multiple digital services platforms (DSPs) like TikTok. But the dispute with TikTok goes beyond a quest to ensure adequate compensation for record labels and artists, this a fight to ensure that in an age of generative artificial intelligence, intellectual property is protected. Beyond an uptick in fees Grainge and his team are also demanding guarantees that its property isn't simply consumed into TikTok's LLMs (large language models).

UMG is working to ensure that these DSPs cannot just scrape its valuable content, without compensation, into their models which might in time allow users to create, share and potentially profit from their own AI versions of those hit tracks entirely without cost or rebuke.

FROM 1924 TO INDUSTRY LEADERSHIP TODAY

UMG's origins date back to 1924 and the founding of Music Corporation of America (MCA). MCA then merged with Decca in 1962 creating an industry heavyweight that was acquired by Japan's Matsushita Electric in 1990. Five years later, Canadian conglomerate Seagram bought an 80% stake and the following year MCA was renamed Universal Pictures and its music division relaunched as Universal Music Group. Seagram added music company PolyGram to the group and later UMG was acquired by French media conglomerate Vivendi. BMG Music Publishing, Sanctuary and EMI were then added and in 2021, UMG listed on Euronext Amsterdam.

Today UMG, headquartered in the Netherlands but with its operational headquarters in Santa Monica, has the copyright to over three million recorded songs. It discovers and develops artists and invests in record creation, distribution, marketing, promotion, collaborations, royalty administration, merchandising and more. Its range of labels span iconic brands such as Motown, Island and Def Jam Recordings, as well as music genres whilst offering the combined scale to negotiate with music platforms and DSPs. UMG also has a music publishing business that adds to its industry influence and offers a complex but valuable collection of revenue streams.

FUTURE GROWTH

The company's dispute with TikTok has provided a timely reminder of the extent of that influence and balance of power and during a meeting with the company's CFO, Boyd Muir and Chief Digital Officer, Michael Nash in early March we discussed industry developments as well as what might come next.

“Streaming has undoubtedly transformed the music industry for the better”

Despite widespread fears, Muir re-iterated the point that streaming has undoubtedly transformed the music industry for the better. Historically UMG's biggest customers would have been retailers and record stores, today it is the music streaming platforms, Spotify, Apple, Amazon, Pandora, Tidal, Deezer and YouTube. With that change, gone are the days of lumpy, seasonal, hit-driven CD sales and instead the company now benefits from recurring and visible earnings, and growth. In 2023, UMG also introduced its 'Artist-Centric Model' that will further ensure artists



are rewarded for creating unique, sought-after music at the expense of AI-generated noise.

It would undermine all those efforts to continue to allow TikTok to pay less, and whilst far from ideal, UMG can afford to wait. That TikTok has always paid less limits the financial impact of the current boycott by UMG and previous disputes that led UMG to withdraw its content from TikTok in Australia and India showed the readiness of users to switch platform. UMG estimates that up to 70% of TikTok users also use one or more of Instagram Reels, YouTube Shorts or Snapchat all of which offer far better take rates than TikTok so any market share gain at other short-form video platforms is a positive for UMG.

In our March meeting, we also talked through other initiatives aimed at further securing the company's leadership and drive revenues. Growing the company's presence in emerging market music is one such area. The Anglo-Saxon world has very much dominated the music industry but UMG have seen a marked rise in interest in local language music and local artists. Spanish-language music has seen particular growth alongside Korea's K-Pop and with Africa soon set to have the largest absolute number of new music customers in the world, there is much to work towards. UMG has long had a broad global presence but with its market share in emerging markets half what it is

elsewhere, the company is confident that it can tap into meaningful growth in these markets over time.

“Demand in search of a product”

Monetising the power and potential ‘Superfandom’ is another area of focus. Few will be unaware of the phenomena around Taylor Swift and her Swifties fanbase, and the devotion of many to their favourite band and UMG has successfully tapped into merchandising income as well as sales of CDs and vinyls on the back of this. Whilst many had assumed these were in inexorable decline, demand remains robust in the superfan world, to the somewhat surprising extent that half of those who purchase vinyl don't have anything to play the vinyl on. But beyond the ‘merch’ and the vinyl, “there is demand in search of a product” as Boyd put it. Whilst everyone is paying the same for unlimited music consumption there is significant dispersion in the appetite to pay for music of individuals and so UMG is looking at premium services that might be offered on a DSP with early access to new releases or behind the scenes content.

WHAT'S NEXT

In the short term, it is hard to envisage that UMG's content won't be back on TikTok at some point soon. But we would also confidently predict that resolution will not come from UMG agreeing to a ‘cheap’ deal nor compromising on the

protection of its intellectual property as generative AI continues to evolve and expand. As UMG put it in its open letter to the artist and songwriter community in January, titled, ‘We must call time out on TikTok’¹: *“TikTok's tactics are obvious: use its platform power to hurt vulnerable artists and try to intimidate us into conceding to a bad deal that undervalues music and shortchanges artists and songwriters as well as their fans. We will never do that”*.

We also remain confident that UMG's market leadership across content and publishing will support its continued dominance of this growing industry. As the New Yorker magazine concluded in an article on UMG in February², *“he (Lucian Grainge) presides over a public company worth more than fifty billion dollars, but he could be a small-business owner who sells music in a London shop, as did his father, Cecil. On earnings calls, Grainge can sound more like a London taxi dispatcher than a chief executive. But woe to those who mistake his European civility for a lack of competitive fire”*.

¹UMG ‘An open letter to the artist and songwriter community’

²Inside the Music Industry's High-Stakes A.I Experiments. Lucian Grainge, the chairman of UMG, has helped record labels rake in billions of dollars from streaming. Can he do the same with generative artificial intelligence? February 5, 2024 edition of The New Yorker Magazine



IMPORTANT INFORMATION

This article is provided for general information only and should not be construed as investment advice or a recommendation. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

STOCK EXAMPLES

The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

Registered in Scotland 93685. Registered Office as above. Authorised and regulated by the Financial Conduct Authority.
FCA Head Office: 12 Endeavour Square, London E20 1JN · www.fca.org.uk