PROGRESSIVE CAPITAL PARTNERS LTD

THE MUSIC NEVER STOPS PLAYING

MUSIC ROYALTIES AS A POWERFUL NICHE ALTERNATIVES INVESTMENT PROPOSITION IN TIMES OF COVID-19

PROVIDERS OF REMOTE WORKING TOOLS, ONLINE SHOPPING, AND HOME ENTERTAINMENT SAW SIGNIFICANT INCREASES IN DEMAND.

The market swings around COVID-19 have reiterated a common observation associated with previous market turbulences: Seemingly stable and uncorrelated assets get caught up in the storm. They sometimes take significant hits to their market valuation.

This phenomenon, which occurred indiscriminately across the board in February and March of this year, was at least partially liquidity-driven. It took a hefty intervention by central banks, which reminded us of the quantitative easing measures in the wake of the Great Financial Crisis in 2008, to get various asset classes and sectors to calm down and start behaving independently again.

THE SURGE OF HOME-EVERYTHING

As countries across the globe went into various flavours of lock-down, and both private and business activities were confined to homes, providers of remote working tools, online shopping, and home entertainment saw significant increases in demand. Not unexpectedly, the so-called FAANGs (an acronym referring to the five big US technology companies Facebook, Amazon, Apple, Netflix, and Alphabet, formerly known as Google) soared.

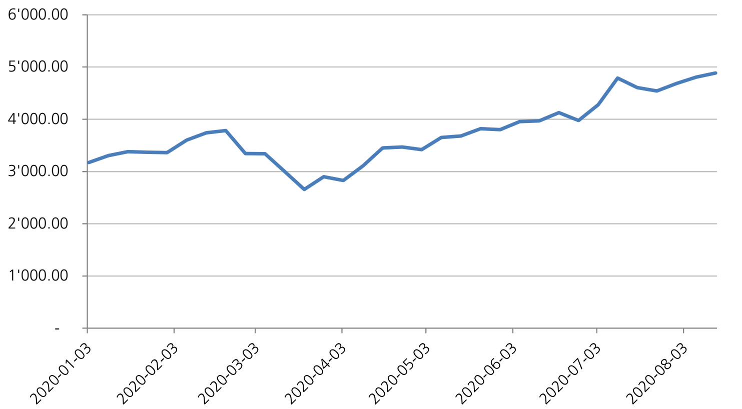
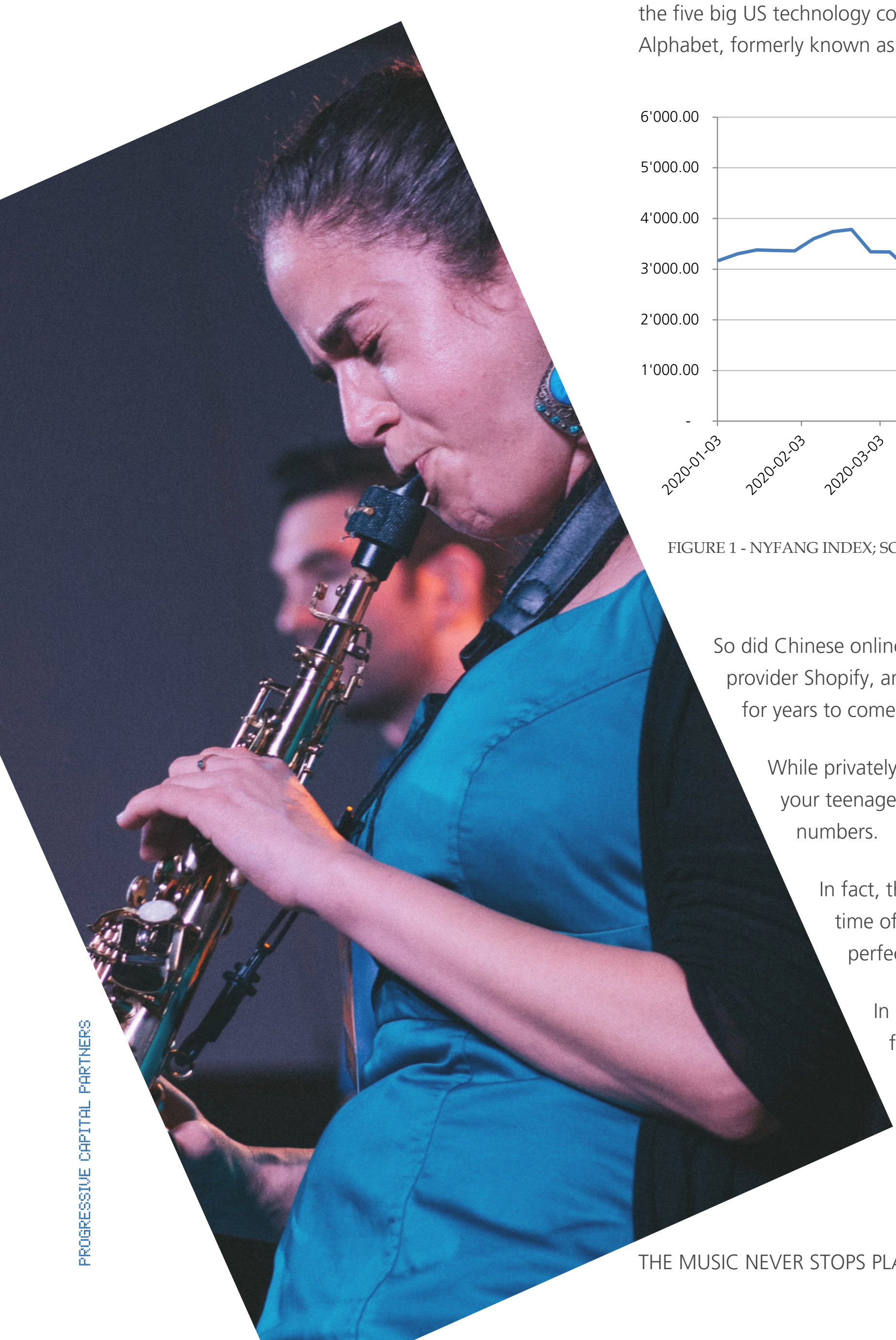


FIGURE 1 - NYFANG INDEX; SOURCE: BLOOMBERG



So did Chinese online entertainment giant Tencent, online commerce provider Shopify, and the one many of us will associate with COVID-19 for years to come, namely Zoom Video Communications Inc.

While privately held, Chinese media company Bytedance (ask your teenage kids about TikTok) must have seen equally stellar numbers.

In fact, these companies have done so well that, at the time of writing, a majority of them look almost priced to perfection.

In contrast to the painful and often catastrophic fate of traditional providers of travel, hospitality, entertainment and commerce that depend on us leaving our own four walls.

When a piece of music is created, two copyrights come into existence:

The sound recording copyright is traditionally owned by record labels which represent performing artists, and increasingly by artists themselves as new distribution and royalties collection models emerge.

Musical composition copyrights are held by songwriters either through music publishers with traditional 50/50 splits, or directly, as the latter are disintermediated over time through technological disruption.

SOME PARTS OF THE MUSIC BUSINESS APPEAR TO WEATHER COVID-19 REMARKABLY WELL

It did not take long for the pandemic to impact, e.g., live music events through postponement or cancellation.

Even more painful were the knock-on effects that left tour musicians, support staff, and many dependent businesses without income for the foreseeable future.

Music royalties revenues, however, have remained robust and even increased throughout the crisis, proving to be an uncorrelated and thus diversifying source of income in the overall portfolio context.

While tour revenues consist mainly of ticket sales, sponsorship and merchandise sales, music royalties are primarily composed of streaming and digital, physical/mechanical, performance, and synchronisation fees.

Of all ways in which performance royalties income is generated, live performance revenues are a rather negligible factor, accounting for only about 3% of total revenues, according to our estimates. In contrast, video streaming, TV/film, and radio account for just shy of 60% of all performance royalties (Source: IFPI).

Early signs indicate that streaming services such as Spotify or Apple Music are gaining importance caused by social distancing. Additionally, social media platforms, such as YouTube, Facebook, Instagram, and rising star TikTok have become serious contenders in terms of music streaming, and this development is far from exhausted.

MUSIC CAN PROVIDE NORMALITY IN UNUSUAL TIMES

For many, listening to music provided a much-needed feeling of positivity and normality as compensation for social isolation.

INTERESTING FACT:

During the initial phase of COVID-19, 62% streamed music they hadn't heard in a long time. This has resulted in almost forgotten songs being catapulted back into the list of songs that were most listened to, which means that they generate unexpected additional revenue for its rights holders. Examples are "Don't Stop Believing" by Journey, "Something Just Like This" by The Chainsmokers featuring Coldplay or "Thinking of You" by Sister Sledge[1].

According to MRC/Billboard, streaming initially declined during the first hit of COVID-19 in March of 2020, presumably as many users stopped listening to music on their way to and from work. As commuters settled into their home offices, streaming service registrations started to recover strongly beginning in April 2020. Spotify, for example, saw a 5% increase in paying users and an increase in user engagement of 6%, in the first quarter of 2020.

Additionally, there is a strong indication that synchronisation royalties also got a boost as people started spending more time at home watching YouTube, playing digital games, or participating in home fitness programs.

As we will see later on, the short-term surge in streaming, digital, and synchronisation fee related income forms part of a secular trend that has been developing for years.

GETTING UP TO SPEED ON THE VARIOUS TYPES OF MUSICAL COMPOSITION ROYALTIES

Music royalties are payments that go, for example, to artists, songwriters, composers, and publishers who have the intellectual property right. Copyright laws grant the right holders exclusivity for their works.

In general, music royalties can be divided into several types:

PERFORMANCE
These royalties refer to music that is performed publicly, including over the radio, in a restaurant or bar, or at a live venue, such as a concert.

STREAMING AND DIGITAL
Refers to music streamed by individuals via services such as Spotify or Apple Music, and digital download services. A key difference to radio (performance) royalties is that the consumer has influence over the music that is being streamed.

PHYSICAL/MECHANICAL
These are royalties derived from selling physical copies of CDs, DVDs, vinyl records etc.

SYNCHRONISATION
Royalties referring to music that is used in advertisements, movies, TV features, computer games, apps, etc.

OTHER
As the name suggests, these are royalties that do not fall under the above categories. One notable example is print royalties such as sheet music, i.e., transcribed music.

THE INVESTMENT CASE FOR MUSIC ROYALTIES

Investing in music royalties involves receiving a share of the respective music license fees. Of course, the more successful a song is, the more money it earns - for years to come!

ICONIC SONG CLASSICS ARE BOTH AN IRREPLACEABLE PART OF OUR CULTURAL HERITAGE AND AN ECONOMIC DRIVER

Music royalties not only enjoy a very stable and less cyclical demand. They can be a source of substantial cash-flows as well: Until his death in December 2016, George Michael, for example, earned USD 9.7 million annually for the Wham classic "Last Christmas".

Since the copyright on musical works is valid for 70 years after the death of the last composer involved[2], George Michael's estate is expected to receive significant income for decades to come.

Another, even more striking, example for the longevity of music royalties cash-flows in the case of Charles Dumont, the composer of the Edith Piaf hit "Non, je ne regrette rien". He wrote the song in 1960, and with Mr. Dumont being alive at the time of writing, the copyright associated with it has not only generated a constant income for the last 60 years but will do so for at least another 70 years!

If this is not enough to convince the reader of the strong potential of royalties cash-flows, take the example of the legendary song "Yesterday" by the Beatles, which alone has been covered by musicians 2,200 times. The songwriters receive royalties on each version, currently resulting in total revenues of USD 30 million per year.

WHEN RIGHTS HOLDERS SELL THEIR LICENSING RIGHTS, INVESTORS CAN PARTICIPATE IN THE REVENUE POTENTIAL

Composers can sell their rights, which has already happened for some of the Beatles songs, for example. An investment in 50% of the royalties of a song offers the right to receive 50% of all revenues from these songs in the future.

THERE ARE VALID REASONS FOR ARTISTS TO SELL PROFITABLE RIGHTS

Why would anyone agree to sell parts of their copyright and forfeit future income potential? One might immediately think of a glitzy pop star with the urgent need for a multi-million dollar mansion or a shiny new business jet.

The reality can be much more business-oriented: Many artists require high levels of financial liquidity to stay abreast in terms of new music or recording equipment and software.

While sounding counter-intuitive at first, Merck Mercuriadis, the Founder and CEO of Hipgnosis Songs Fund Limited[3] advises artists who negotiate with him not to sell. He makes it clear to potential rights sellers that he is only buying because he believes the value of the rights will more than double within the next decade.

"The only reason they should sell to Hipgnosis is if they are certain that a one-time, instant check for several million dollars will make such a difference in their career that it is worth giving up this potential increase in the value of the rights", Merck stated at the 2019 Progressive Capital Niche Alternatives Conference.

The cost of touring with a band, producing competitive music videos, or getting involved in any project that could advance their career should not be underestimated.

Selling the rights to their works aims to finance new projects through a more flexible arrangement than a traditional publishing or label contract[4].

This aspect is not unlike a company in a late-stage startup or growth scenario that sells equity to venture, private equity, or debt investors in return for fresh capital to finance an expansion.

PRICING MUSIC ROYALTIES IS REMARKABLY SIMILAR TO VALUING EQUITY AND FIXED INCOME INVESTMENTS

Remaining in the terminology of private markets, investors could, for example, use the discounted cash flow (DCF) method to value songs to calculate their internal rate of return (IRR) and net present value (NPV). The cash flows can be derived, e.g., through a song by song analysis, which helps to understand the earnings profile of the song portfolio. Then the types of earnings (mechanical, downloads, performance, streaming, and synchronisation) can be determined using forecasts from external data sources (IFPI, PRO organisations, and others).

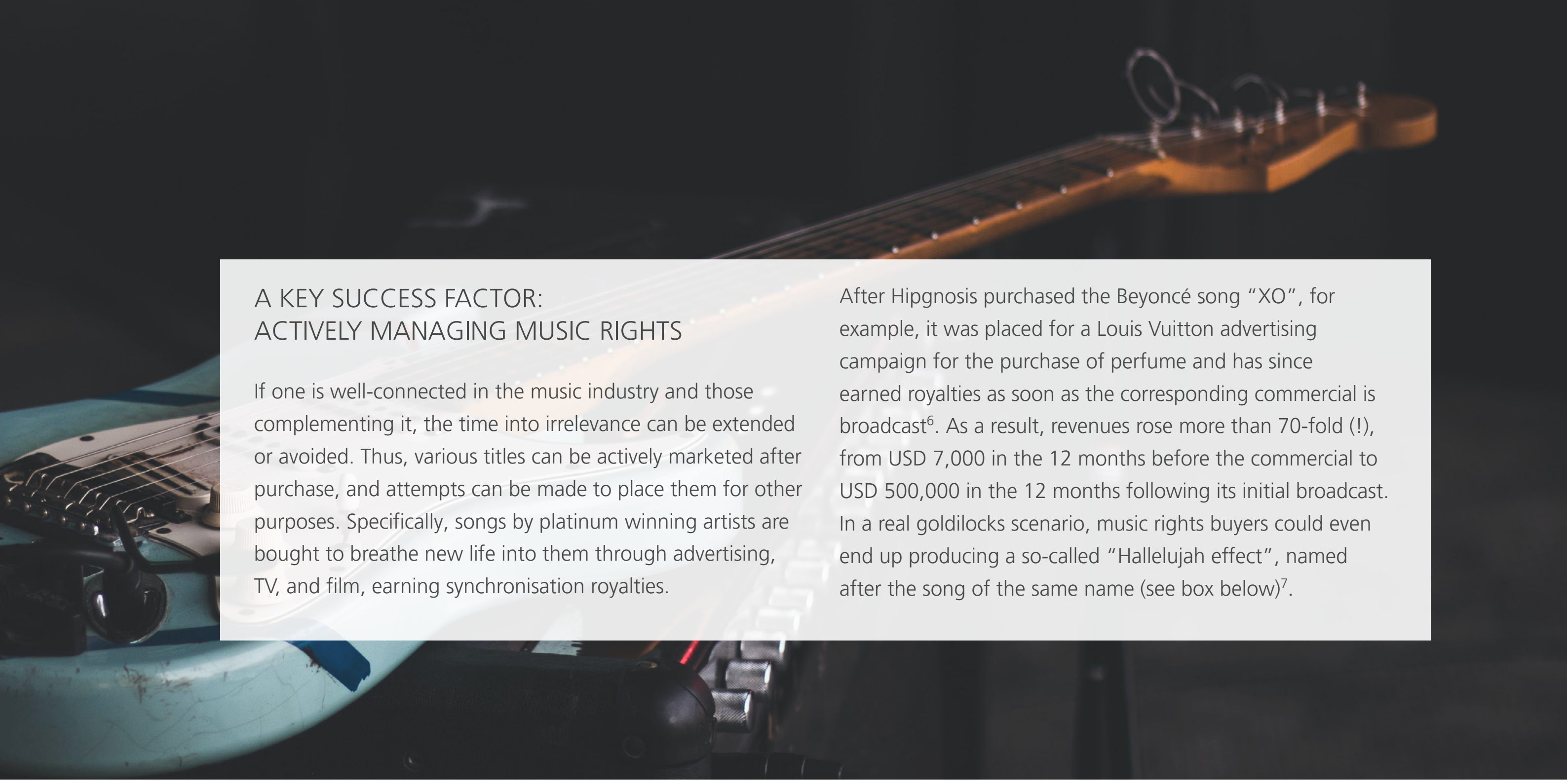
The traditional challenge in gathering such data in the past was that it had to be collected manually, making the process cumbersome, error-prone, and costly. This has started to change:

A Swedish/Swiss tech company, Utopia, for example, screens thousands of radio stations and internet streams in real-time, thus being in a position to provide in-depth data insights that ultimately enable their clients to better price such content.

SUCCESSFUL INVESTMENTS IN MUSIC LICENSES REQUIRE SPECIALISED KNOW-HOW OR A PARTNER WITH THE NECESSARY EXPERTISE IN THE RESPECTIVE SEGMENT.

IN ROYALTIES INVESTING, TOO, THERE IS NO FREE LUNCH

Experience is essential when it comes to surviving in the music rights business. Successful investments in music licenses require specialised know-how or a partner with the necessary expertise in the respective segment. This is because royalties on these assets often spike early in their life (usually around the release date of the commercially most successful catalogue hit[5]) before they face a steady decline to the point of irrelevance.



A KEY SUCCESS FACTOR: ACTIVELY MANAGING MUSIC RIGHTS

If one is well-connected in the music industry and those complementing it, the time into irrelevance can be extended or avoided. Thus, various titles can be actively marketed after purchase, and attempts can be made to place them for other purposes. Specifically, songs by platinum winning artists are bought to breathe new life into them through advertising, TV, and film, earning synchronisation royalties.

After Hipgnosis purchased the Beyoncé song "XO", for example, it was placed for a Louis Vuitton advertising campaign for the purchase of perfume and has since earned royalties as soon as the corresponding commercial is broadcast[6]. As a result, revenues rose more than 70-fold (!), from USD 7,000 in the 12 months before the commercial to USD 500,000 in the 12 months following its initial broadcast. In a real goldilocks scenario, music rights buyers could even end up producing a so-called "Hallelujah effect", named after the song of the same name (see box below)[7].

AN EXAMPLE OF SYNCHRONISATION ROYALTIES REVIVING OTHER TYPES OF ROYALTIES INCOME:

The song "Hallelujah" earned a modest USD 20,000 in the first eight years of its existence. Then it was used in "Shrek", one of the biggest film hits at the turn of the millennium. Children and parents all over the world fell in love with it. Twenty years on, "Hallelujah" has earned a few million dollars, and is played all over the world. And it is still regularly used to accompany emotional moments in other films and even at talent contests.

POTENTIALLY A USD 100 BILLION MARKET WITHIN TEN YEARS

In the past, there was a belief that there is little potential in combining the music business and the financial world. Artistic creativity and asset management's need for constant returns were thought challenging to reconcile.

With the advent of actively managed music royalties, supported by emerging technology and changing ways to consume and employ music, this has changed rapidly. Increasingly, specialised financial players have emerged to promote independent and emerging artists as the next lucrative asset class.

TAKING ADVANTAGE OF THE SECOND DIGITAL MUSIC REVOLUTION

The first digital music revolution, when music became available online in the form of so-called MP3 files, may have been disruptive, but for most industry incumbents not precisely in a positive way. There were few winners in a world marred by music piracy through illegal downloads.

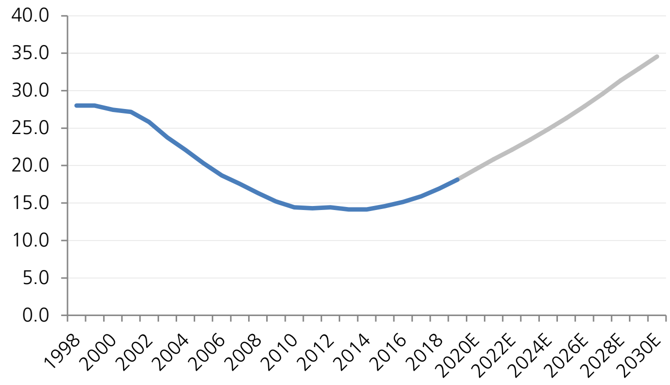


FIGURE 2 - MUSIC MARKET REVENUES IN USD BN; SOURCE: IFPI, GOLDMAN SACHS, PROGRESSIVE CAPITAL PARTNERS

PHYSICAL MUSIC SALES PEAKED AT USD 28 BILLION IN 1999 BEFORE BEING HAMMERED BY ONE AND A HALF DECADES OF DISRUPTION

Today's second digital music revolution, while inherently disruptive, strengthens music rights owners. It also propelled the music market back to positive growth rates after a decline that lasted 16 years. It diverts income streams away from structurally declining markets such as traditional physical purchases and downloads into significantly larger new pools of income consisting of advertising revenue and streaming subscription income.

STREAMING LEADS THE WAY IN THE SECOND DIGITAL REVOLUTION

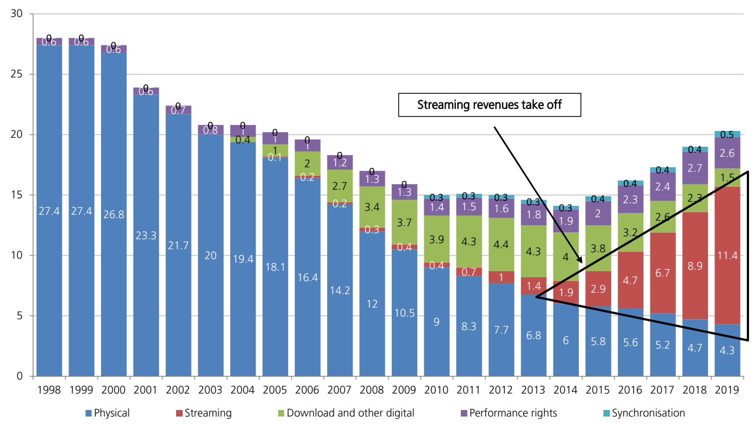


FIGURE 3 - GLOBAL RECORDED MUSIC REVENUES; SOURCE: IFPI

While streaming revenues only accounted for 4% of overall recorded music revenues in 2011, as at the end of 2019, they claimed 56% in terms of fees of all the music sold. This number is even more impressive if one considers that since 2015 streaming grew by 42% annually in an industry that, on average, across all types of royalties, already enjoyed a healthy 9% compound annual growth rate.

While there are dozens, if not hundreds, of music streaming services, the top platforms Spotify, Apple Music, Amazon, and Chinese Tencent control around 75% of the market, according to a recent study by JP Morgan.

Thanks to digitalisation, including rights management, these have unbundled music ownership and consumption, making it possible for music to be sent around the world at lightning speed. In a typical fee-sharing split, those platforms keep 30% of revenue while the remaining 70% are distributed to the rights holders.

By enjoying lower consumer pricing, more convenient access, and a highly personalised experience when consuming music, users today are more willing to turn away from illegally distributed pirated music.

With the advent of streaming content providers like Netflix, Amazon, and YouTube and the current massive growth in their user base, even obscure songs can enjoy a boost in revenue, as self-produced shows and films on these streaming platforms require legally sourced soundtracks.

According to a proprietary study, Goldman Sachs expects music royalties revenue to grow to anything between USD 50 billion to USD 100 billion by 2030. In addition to the technological disruptions already mentioned, these five factors are expected to drive this massive growth:

1. Smartphone use (especially in developing countries)
2. Technological disruption through digitalisation
3. Expansion of social media
4. Integration of streaming apps in various products
5. Regulatory change resulting in a significant income boost for rights holders

INCREASED SMARTPHONE USE IS DRIVING THE GROWTH OF THE STREAMING MARKET…

According to studies by Goldman Sachs[8] and JP Morgan[9], the development of the streaming market is primarily dependent on global smartphone use. In fact, only the introduction of the smartphone made the impressive growth of streaming services possible.

IFPI estimates that in 2019 there were 341 million streaming subscribers, which is only 11% of global smartphone owners.

In 2015, however, only about 2% of all global smartphones could be reached by streaming services.

In contrast to further developed streaming markets such as Sweden with a paid streaming penetration of 57%, or the US and Germany with 32 and 20%, respectively. Once brought into context with the penetration of traditional pay-TV usage of 85% in the US, it is easy to appreciate the enormous growth potential.

> An example of the enormous growth potential that has not yet been exhausted:
>
> Even though the artist Eminem had not released an new album for five years, at the time, 18 million Spotify users listened to his music every month, flushing approx. USD 5 million annually into the pockets of the rights holders. The turnover of the offered song catalogue nevertheless showed a positive growth rate - partly due to the developments described here[10,11].

… PARTICULARLY IN (FORMER) DEVELOPING COUNTRIES WITH CURRENTLY HIGH PIRACY RATES

In absolute terms, immense growth can also be expected from the developing countries and the high smartphone usage rates prevailing there. In addition to the high smartphone usage rates, countries such as China, India, Mexico, and Brazil also have high piracy rates of around 90%, which should now fall massively as a result of the new, not only legal but much more convenient, consumer experience.

Overall, we expect the number of users of streaming services to increase to 1.8 billion people worldwide by 2030.

Free streaming for the user leads, among other things, to advertising revenues for the respective provider. Furthermore, historically about 60% of all non-paying users have become paying customers.

TECHNOLOGICAL DISRUPTION THROUGH DIGITALISATION

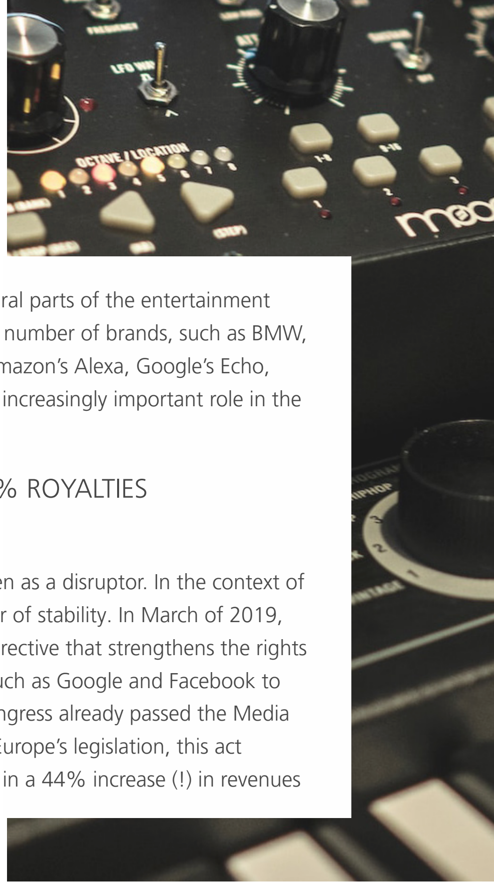
Digitalisation also led to greater stability in royalties income. Improved technology has made tracking, transparency, and royalties collection more efficient, which in turn improves the return on music rights investment.

THE EMERGENCE OF SOCIAL MEDIA AS A POWERFUL PLATFORM FOR MUSIC STREAMING

Social media platforms also support the expansion of streaming services. Facebook, with its two billion users, also announced that videos with song content can now be legally uploaded, therefore generating royalties for the rights holders in the future. YouTube already has a system in place that allows rights holders to monetise even privately created videos that contain their works.

INTEGRATION OF STREAMING APPS IN VARIOUS PRODUCTS

Services such as Spotify, Apple Music, or YouTube Music have become an indispensable part of a consumer's everyday life. Spotify, for example, is already pre-installed on the Xbox and PlayStation at the time of purchase.



Spotify or Apple Music CarPlay are already integral parts of the entertainment system in various car models from an increasing number of brands, such as BMW, Volvo, and Ford. Not only since the advent of Amazon's Alexa, Google's Echo, and Apple's Siri, streaming offers are playing an increasingly important role in the development of the smart home offering.

REGULATION TAILWIND LEADS TO 44% ROYALTIES REVENUE INCREASE

IN THE CONTEXT OF MUSIC ROYALTIES, REGULATION HAS BEEN A KEY DRIVER OF STABILITY.

In the financial industry, regulation is usually seen as a disruptor. In the context of music royalties, however, it has been a key driver of stability. In March of 2019, the European Parliament adopted a copyright directive that strengthens the rights of music licensees and forces major platforms such as Google and Facebook to upload only licensed media content. The US Congress already passed the Media Modernisation Act in October 2018. Similar to Europe's legislation, this act strengthens music rights holders, and will result in a 44% increase (!) in revenues paid out to artists from 2018-2023.

CONCLUSION

An investment in music royalties can be an exciting building block for a Niche Alternatives portfolio.

The music industry has suffered for almost two decades. It saw the demise of the compact disc and witnessed the rise of illegally distributed music. Revenues, and with it, the prices of royalties suffered greatly during that time.

Most recently, however, technological developments have already started to change how we consume music fundamentally. We expect legal streaming to reduce the recent ubiquitous music piracy and illegal distribution to the level of other criminal activities.

System reforms and legislation will make the collection of royalties easier and more transparent. This, in turn, should lead to growth rates that, we believe, are not nearly reflected in today's prices.

Music royalties today have a current implied run yield of 8% p.a., but will be subject to regulation-related income uplifts highlighted above of 10% p.a. over the next two years. Additionally, they are expected to benefit from the projected 15% p.a. growth in streaming. Finally, they exhibit a low correlation to other alternative and traditional investments.

While the lock-downs associated with COVID-19 have hit live music events and dependent areas hard, music royalties revenues, however, have remained robust and even increased throughout the crisis.

One way investors can benefit from this development is by allocating to funds[12] or special purpose vehicles (SPVs), each of which can be diversified across catalogues of various artists and genres. Today, there is also the possibility of trading individual song rights directly on stock exchanges. The liquidity of a music investment varies according to the corresponding investment vehicle. Investment initiators can demand lock-ups over several years or offer funds with daily liquidity, for example.

We at Progressive Capital Partners would be delighted to partner with you on your journey into investing in Niche Alternatives in general, and in music royalties in particular.

FOOTNOTES

[1] Hipgnosis Songs Fund Limited Q1 2020 Annual Report. Hipgnosis Songs Fund Limited is an investment company that invests in music royalties. In his 35-year music career, its founder, Merck Mercuriadis, has managed, among others, Nile Rodgers, Beyoncé, Elton John, Guns N' Roses, Iron Maiden, Morrissey, Pet Shop Boys, Macy Gray, Mary J. Blige, Joss Stone, Jane's Addiction, and Catherine Wheel.

[2] Here, the Berne Convention applies to all countries, which states that works are protected for at least 50 years after the death of a songwriter. In addition, there are country-specific regulations, e.g., in the USA, England, and Australia, where works are protected 70 years after the death of the last living co-songwriter.

[3,7] Quote: Merck Mercuriadis at the Progressive Capital Niche Alternatives Conference 2019.

[4] Publishing or label contracts differ in terms of duration and license fees. As a rule, however, an agreement often includes an advance payment that is offset against license fees. Further information on the types of publishing or label agreements can be found, for example, at https://www.songstuff.com/music-business/article/record_contract_basics/ or https://www.songstuff.com/music-business/article/music_publishing_contracts/.

[5] In the music industry, a collection of musical compositions is catalogued in a music catalogue. The owner owns the copyrights of the catalogued compositions.

[6] Louis Vuitton commercial on youtube: https://www.youtube.com/watch?v=43OdAWtyjLI.

[8] Goldman Sachs Equity Research, October 4th, 2016.

[9] JP Morgan Equity Research, June 29th, 2020.

[10] The music and lyrics of a song are protected by music royalties as soon as they are recorded in any way - even if it is only a rough recording on a mobile phone.

[11] Most music companies have their own data science teams that analyse various royalties to detect any anomalies. Music publishers also have extensive tracking and analysis teams to ensure that streams from digital service providers are correctly taken into account. The royalties statements show the streaming units, which can be compared with the previous period's statements and streaming statistics.

[12] Here, the songs within the portfolio are evaluated at least every six months by an independent expert. External data sets are also used to support growth assumptions.

THE AUTHORS

Flurin Grond is Deputy CIO and Head Niche Alternatives at Progressive Capital Partners Ltd. Before joining Progressive, he spent five years as Portfolio Manager at the Abu Dhabi sovereign wealth fund ADIA, where he focused on alternative equity strategies in the hedge fund group. Prior to that, Flurin worked ten years at Man Group (RMF) in the Equity Hedge and Global Macro section and in equity trading for various Swiss banks. Flurin holds an MBA (with distinction) from the Strathclyde University Glasgow. He is also a Certified International Investment Analyst (CIIA), and a Chartered Alternative Investment Analyst (CAIA).

Dr. Thomas Kochanek is the Chief Risk Officer and the Chief Operating Officer at Progressive Capital Partners Ltd. Before joining Progressive, Thomas was a Director of a Malta-based Alternative Investment platform and Co-CEO of a Zurich-based quantitative hedge fund. Before that, he worked for a Spanish investment bank, where he serviced institutional clients in Alternative Investments and Structured Products. During his career, he served high net worth individuals, professional and institutional clients with regards to portfolio optimisation and developing investment strategies. Thomas holds a PhD from the University of St.Gallen, a MBA from Western Illinois University, a business diploma (Diplom-Kaufmann) from University of Mannheim, and he is a Research Professor for Financial Services at Hankou University in Wuhan, China.

Werner Brönnimann is an Investment Analyst at Progressive Capital Partners Ltd. Before joining Progressive, Werner worked four years at PWC Switzerland as the Head of banking, trading and finance in the Data Analytics and Modelling team. He was responsible for a number of forensic investigations where he led teams of data scientists. Prior to that, he worked for eight years at JP Morgan in London and Singapore. Werner has in-depth experience across all asset classes. He is experienced with different accounting standards and their respective strengths and weaknesses. Werner holds an MA in financial economics from the University of Zurich, and the Certificate in Quantitative Finance (CQF) from Fitch Learning.

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Progressive Capital Partners Ltd
Haldenstrasse 3
CH-6340 Baar
Switzerland

www.progressivecapital.com
info@progressivecapital.com
+41 41 561 40 80 phone
+41 41 561 40 88 fax