Evolution of Inter-organizational Relationships in Disruptive Markets
Marketing Capabilities in Music Industry

Abstract

The co-evolutionary development of music business exemplifies how inter-organizational relationships have risen in importance. Relying on the capability perspective, our study shows that changing roles in music industry are creating new capability requirements for actors in the music network. Based on previous research and wide set of interviews, we propose that actors are increasingly organized as flexible, project based networks that are driven or subscribed by aggregators that take the risk to find commercial use for the actors. Further, we identify that these hubs require adequate resources, negotiation power and market access to able to fulfill their part in the network. As such, the actors are more inter-related than ever, and actors must develop market knowledge combined with deep professional capabilities to succeed. The results show that they also require a proactive and flexible approach in utilizing and developing their commercially relevant knowledge; vertical and horizontal capabilities need to be present and balanced between actors.

Keywords: Marketing capabilities, networks, music industry, co-evolution

Introduction

According to co-evolutionary theory, change is a process where the interaction between parties, along with the changes in environment, influences the way change occurs (e.g. Henderson and Mitchell, 1997). The initiative for change is therefore multifaceted, which strengthens the impact and pace of change. This is of special interest when an industry faces considerable pressure for change, as is the case within the music industry. Technological advancements and consequential decline in record sales are pushing the whole industry to reconsider the roles of the value chain and sources of revenues. Even though many industries are experiencing never-before seen changes, only few have witnessed similar magnitude and pace of change as music industry. We see that it warrants special attention as the findings of the change, especially when analyzed from capability perspective, might serve as a platform for prediction and further analysis in other disruptive industries, such as e-commerce, television, gaming, mobile phones, travel, film, and entertainment immaterial rights industries in general (IFPI, 2008).

Music industry and its dynamics have been researched among academics (e.g. Vlachos et al., 2006; Lorenzen and Frederiksen, 2005; Lewis, Graham and Hardaker, 2005) to some extent, but the work limited, considering the impact and volume of the music industry, which had an estimated aggregate revenue of $29.8 billion in 2006 (Datamonitor, 2007). During the last three years, only 12 managerial articles have focused on music industry according to the ISI Web of Science -database. Due to radical pace of change in music as a business, it can be argued that we are missing an updated illustration of the industry, its central players and an analysis how the actors are coping with the changing business logic.

While most authors take a look at some individual element impacting the change, Huygens et al. (2001) depict the development of music industry from the invention of phonograph by Thomas Edison in 1877 onwards to year 1997 by regarding it from co-evolutionary perspective. In this paper, we build on their work by relating the industry-level analysis to co-evolutionary development as a network-level phenomenon. This level of analysis has received less attention, while it provides potential reflection for the direction where the music business is developing. We ground on the capability perspective and take a look which capabilities seem to be central on new inter-firm networks and how they influence the way firms operate and succeed. The objective of the paper is to paint a richer picture of the music industry and its challenges, and to discover capability requirements that could be generalized into disruptive markets. As such, the goal of the paper is two-folded:

1) to depict a more updated picture of music industry networks
- How the firms function as networks in disruptive markets, especially in music industry?

2) to identify lately evolved capability requirements in disruptive markets
- What kinds of capabilities are present at the network-level?

To meet these goals, we gathered data from various secondary sources and conducted 35 interviews between 2007 and 2008. The interviewees employed different roles at the music industry network, ranging from artists

and sound engineers to governmental support agents. This paper is organized as follows. Firstly, we briefly introduce the relevant concepts and methodology of this study. Secondly, we provide a review of previous research on the music industry and illustrate the evolution to its current state. Subsequently, we move to present our findings and discuss the implications and contribution of the study both at theoretical and managerial level. Finally, areas for further research are suggested.

Theoretical discussion

The theoretical foundations of this paper build on capability perspective in the networked business context. In the following, we present briefly the central concepts of previous research and key propositions that set the stage for this study.

Capability perspective

The capability perspective argues that competitive advantage and business performance of companies is primarily driven by its unique processes and skills. Capabilities define the way of utilizing resources (e.g. Grant, 1996), such as physical property or know-how, Thus, the capability perspective recognizes the interdependent nature of resources and capabilities, but asserts that the ways of utilizing resources are the primary drivers of performance. The implementation of market-driven strategy, for example, requires skills in designing, developing, managing, and controlling strategic alliances, while keeping them all focused on the customer (Webster 1992). Furthermore, the new vulnerability of record labels and other industry players is making adoption of new strategies mandatory (Bockstedt, Kauffman and Riggins 2006). As such, capabilities should be researched in order to better understand the determinants of success. This view is supported also by a recent review on empirical research comparing resource-based research with capability-based studies, which reports that capabilities seem to have better explanatory power over performance than resource-based research (Newbert, 2007).

Capabilities are defined in many ways, but are generally viewed as complex bundles of skills and collective learning, exercised through organizational processes (Day, 1994). Capabilities essentially enable activities in business processes and help them to be carried out efficiently and effectively. So far, previous research has identified many different aspects to capabilities but it seems that the generalizability is questionable in many cases. Therefore, only few typologies have gained acceptance and the theoretical discussion falls short on different categorizations of capabilities. One typology that has gained acceptance is presented by Day (1994). He proposes three distinct capability concepts, namely: 1) outside-in capabilities, 2) inside-out capabilities, and 3) spanning capabilities. In this study, we are especially interested in outside-in capabilities, which connect the processes defining other organizational capabilities to the external environment. These are considered important as they enable the business to compete by anticipating market requirements ahead of competitors (see e.g. Day, 1994). Outside-in capabilities contain four components: 1) market sensing, 2) customer linking, 3) channel bonding, and 4) technology monitoring (Day, 1994). These kinds of process-based capabilities are built from tacit elements of process knowledge (Srivastava et al., 2001), but come identifiable when an industry is under disruptive change as actors have to change the logic of operation and accommodate to industrial and situation-specific challenges.

Together with the other focus area, business networks, capabilities provide a coherent basis to this study, as both internal resources and new inter-organizational context are taken into consideration. In fact, concept of networking capabilities that help companies to effectively manage relationships with suppliers and other strategic partners have also achieved rather wide acceptance among scholars (e.g. Greenley, Hooley and Rudd 2005; Gulati, Nohria and Zaheer 2000). Specifically, the focus is to study situation-specific capabilities that are present in music business networks.

Business networks and their management

Networks are important aspects of industrial reality (e.g. Baraldi et al., 2007), especially when service is created in a network of activities involving a host of stakeholders (Gummesson, 2008), as is the case within music industry. Immaterial rights embodied in music are defined by different roles, starting from composers and continuing all the way to the artist, who actually present the music. For example, although current digital recording and distribution technologies present new opportunities for artists, record labels are still able to

provide services, such as promotion and marketing management, that artists cannot provide for themselves. Regarding the money flows, therefore, music business is a network of actors that come together to contribute into an outcome which is then commercialized and utilized in exchange for compensation. This view of looking business and its operations as networks has a long tradition among business researchers. One of the seminal proceedings in the field by Grandori and Soda (1995) defines the role of networks as "… modes of organizing economic activities through inter-firm coordination cooperation". This definition presents why networks are an interesting subject of the study and, by building an understanding of their logic, it can be further figured out how they should be managed. Even though the research on networks has been extensive, the different approaches employed have created a fragmented field of study that has not been able to capture the chain of effect and influence to performance. Further, the different aspects and ontological assumptions employed have created a fragmented picture of this complex and multifaceted phenomenon and, consequently, no concise theory of network management yet exists (Järvensivu and Möller, 2008).

Network management can be defined as "improving the ability of the network to operate towards accomplishing varying objectives, or as the means by which network members influence each other and/or other network as a whole in order to improve network cooperation" (Järvensivu and Möller, 2008). However, the manageability of networks is not clearly agreed upon. Some researchers even argue that networks cannot be managed by any single actor as they are in fact adaptive and emergent systems, where *individual* actors simultaneously and continuously pursue *individual* goals (see e.g. Ford and Håkansson, 2006). As a shortcoming, this does not fully take into consideration the reciprocal nature of many business relationships, the learning that takes place between parties or the potential benefit of organizing actors independently to provide platform for capability focus and possibilities to leverage on that focus. Another approach to networks takes a view where the differing power of actors is taken into consideration, and proposes that networks can have influential hubs or focal firms that exercise considerable coordination over a network, or "strategic net" as often coined by the researchers underlining this perspective (e.g. Parolini, 1999; Möller and Rajala, 2007).

In this study, we approach the logic of network operations and consider the differing roles that are present. As such, we consider the manageability of networks, or the "best practices" that exist among the actors and networks that we take a look at. We primarily focus on the logic of why and how inter-firm relationships are beneficial, and also how capability-level analysis explains the logic of networks in music business.

Research methodology

The present study is both conceptual and empirical in nature. Its literature review builds on the fields of marketing and strategic management. Research in highly disruptive music industry forms the empirical part of the analysis. The case companies represent four multinational companies, which were interviewed in Finland. The companies own rights to music and represent bands and their business logic relies on the commercialization and utilization of immaterial rights. In this context, the potential of business success is based on expected value of music where value communication becomes critical. Music business was chosen into our analysis as it demonstrates a rapidly changing industry where the role of market interaction is considerable and increasing.

Semi-structured in-depth interviews were used in data gathering. During 2007 and 2008, 35 interviews were conducted in business-to-business environment. Eight of the interviewees were CEOs or equivalent managers of four international music companies that concentrate on recording, production and event promotion. The companies own rights to music and represent bands, but also import and export licenses that enable the use of immaterial rights. As such, the business logic of these companies relies on the commercialization and utilization of immaterial rights. Therefore, both products and services are represented on their dimensions of business, service-orientation probably being the dominating one. Also customers of these firms and representatives of governmental support agencies were interviewed to capture comprehensive perspective to markets and sales in the industry. On average, interviews lasted for one hour. During the interviews, we deliberately brought into discussion the value-creation logic of music industry and asked the interviewees to provide a list of necessary capabilities, as well as their change over time.

Case study: Music industry

New tunes in music industry

Music industry is an old but vibrant industry that is generally characterised to compile of songwriters, producers, sound engineers, record companies, artists and resellers. The list is not meant to be exhaustive, but depicts the plethora of different roles involved in the process of making and commercializing music. Even though these roles have reshaped among years, the whole music industry is currently experiencing stronger wave of change than perhaps ever before. Huge technological advancements have enabled music to be distributed to end-customers in extended number of channels and formats, both legally and illegally. Music used to be available only as concrete recording, such as compact disc, while today one might download music in digital format from internet, order ringtones to his or her mobile phone or listen to music for free through web-based music communities, such as MySpace. The development goes in parallel with customers, as consumer tastes are also polarizing. While people who do not buy music actively are satisfied with increased availability of free music, the people who buy music have developed more fragmented tastes, also reflecting the more dispersed spectrum of new possibilities. Vlachos et al. (2006) even argue that "business as usual" in the music industry is over, as the traditional music industry value chain is being rapidly re-engineered to a more complex direction.

Recorded music industry has a long history, dating back to Thomas Edison who invented phonograph in 1877. Since then, the development of music business has been a long process, where a network of different actors and roles has come to existence. The industry has been driven primarily by technological advancements and consequential evolutionary changes, or sequences of "competitive regimes", many of which have been identified and described in Huygens et al. (2001). They also looked the co-evolution of capabilities between network actors and competition within music industry and its competitive environment, arguing that the development of firm capabilities impacts the development of capabilities at the industry level (and vice versa) because they co-exist in ecology of competition (Huygens et al., 2001; Carrillat, Jamarillo and Locander, 2004).

The most notable changes that influence music business today can be traced to the mid-1980s, when the revenues streams of music business started to expand from the physical manufacturing and distribution of music products to the exploitation of copyrights attached to recordings. This was caused by the rise of music videos presented in Music Television and other channels, introduction of digital music (CD format) and the rise of ICT and computers, which started the still continuing expansion of rights and market value involved in music. Revenues could not only be generated through sales of music releases on a particular format, but could also be collected by exploiting the rights connected to that piece of music. This, however, is only now becoming apparent to companies in music business. Despite many radical shifts in the industry, it was not until the revenues started to run down that the industry realized that the models of business used then could not respond to the market changes. One could argue that the business logic has been essentially reactive, as it has been driven by the decreasing revenue streams of music distribution, supported by active inertia (Sull, 2005). As a matter of fact, one of the key findings in our study was that practically all interviewees brought up that the distribution-driven way of thinking, or "old" logic, has dominated the way industry operated until very recently.

Today, record companies aim to reinvent themselves as to diversify their revenue streams across a much broader range of products and platforms than recordings. Companies are now taking hold on a larger part of rights and tasks related to music and bands. For example, merchandise licenses and concert bookings are being integrated to the operating portfolio of former record companies, now widely coined as "music companies." This reflects the co-evolution of the whole industry networks, as besides consumers and traditional distributors the mobile network operators, computer software and hardware companies, media companies and internet service providers, among others, are beginning to work with music and music companies. Music industry can now be considered as an industry that is organized in projects, which are predominantly organized on the market (Lorenzen and Frederiksen, 2005). Several players are building their presence and have started to experiment on finding viable business models for delivering music via electronic channels (Vlachos et al., 2006), and digital music's role as a strategic necessity has been recognized. The shift is apparent, as in 2007 already 15 % of revenues in the music industry came from digital distribution (IFPI, 2008). In fact, digital market share of music is higher than in any other entertainment business except games. It is anticipated that this development will take full effect in near future as one fundamental barrier in digital distribution, the lack of contracts concerning the digital rights of old, classic recordings, is to be removed.

Along with the rise of digital distribution, the business logic and commercialization process of a record has clearly become more complex. The amount of different activities, their complementary role and the chain of cause-and-effect has risen in importance. At the same time, the timeframe of the whole process has become shorter. Figure 1 depicts this change and relates the situation of mid-90s with the way current recordings can be promoted. It illustrates the increased complexity that a record company faces when promoting an artist. Figure 1 essentially shows how a linear process has become a dynamic and iterative loop of influencing different audiences sequentially and repeatedly.

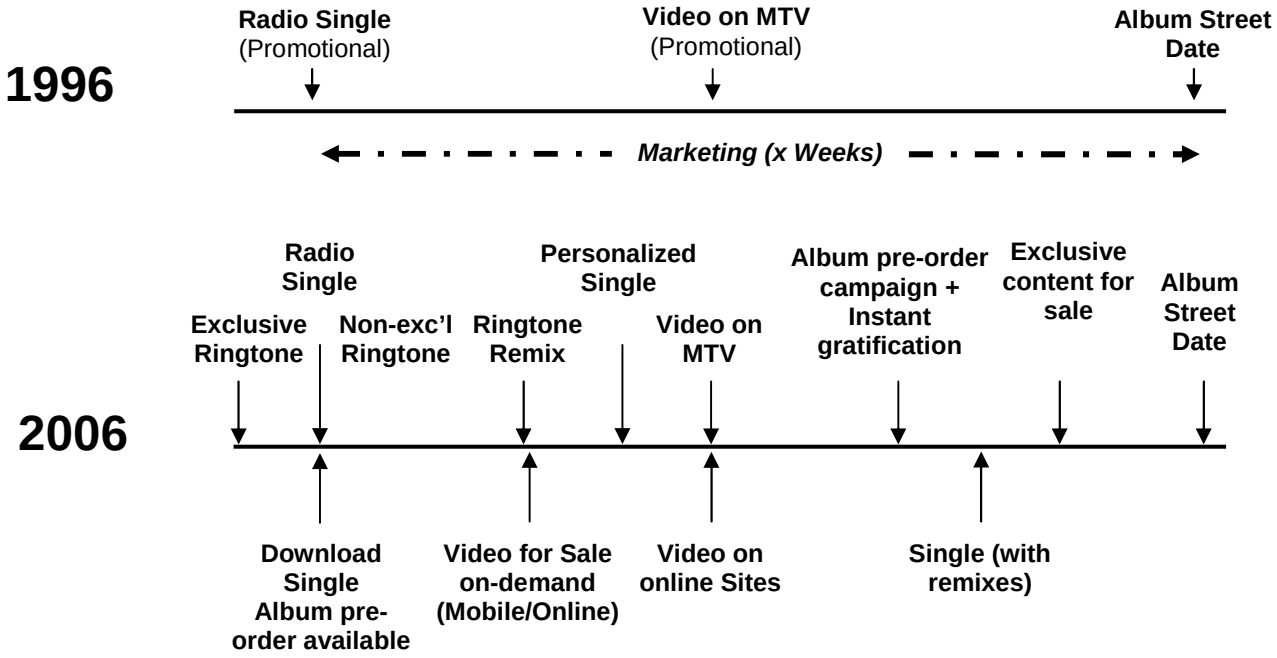

Figure 1 Towards a multi-product, multi-channel process in the music industry

Composing the tunes - network as a logic of operation in music business

Bockstedt, Kauffman and Riggins (2006) describe the recent changes in music business as dramatic, and see that the industry structure will consequently be heavily transformed. As digital formats are more strongly present, a new distribution channel is available and physical retailers are being increasingly replaced by digital music retailers. Artists are in ever stronger position, and supply and demand are thus brought closer to each other. In terms of value added, immaterial property rights, enforcement and piracy protection, and digital distribution and sales have increased their value contribution, whereas for manufacturing and distribution, and traditional inventory and sales, the contribution has decreased. (Bockstedt, Kauffman and Riggins 2006) Furthermore, according to our interviews, the market structure within music industry is becoming more complex and fragmented: besides the direct link to consumers, there is a growing market of third party customers, who use music to promote their own products and services (e.g. advertising agencies and consumer product companies). Accordingly, while the operating model used to be artist-driven, now it can also be music company -driven as those are able to use their networks to find new uses and applications for immaterial rights (e.g. ringtones, exclusive use in third party context, commercial co-operation). This broad new market is only emerging, but has considerable potential.

To counterbalance the increased complexity and fragmentation, our findings indicate that music business is primarily organized as a network of operators that form project-based value networks for certain periods. It further seems that, the network roles of individual actors have become smaller and specialized, enabling the actors to better focus on their core competences. At the same time, the record company – or artist itself – is becoming even more like an integrator, builder of concepts and commercialization agent. As artistic knowledge and potential is the cornerstone in music business, the role of understanding musical potential has expanded into a capability to understand how musical potential can be engineered, packaged and commercialized in a proactive manner. A *vertical* capability, ability to integrate several *horizontal* capabilities, was brought up into discussion in several interview sessions. It appears that, as artistic and other useful skills and knowledge, or horizontal capabilities need to be specialized into, also the skill to combine

them as a commercializable package is a distinctive, necessary capability. This logic, where an aggregator coordinates individual actors so that their objectives are consistently in providing value to the end customer, is illustrated in Figure 2. We want to emphasize the distinctive nature of the actors with broad understanding of production issues (e.g. composers, producers, sound engineers), and aggregators that might be music companies or artists that aim to commercialize the immaterial rights related to music and artist. Aggregator might also govern distribution and media relations. According to the interviewees, proactive approach of the aggregator towards distribution, media and third party customers seem to have a significant impact on business performance.

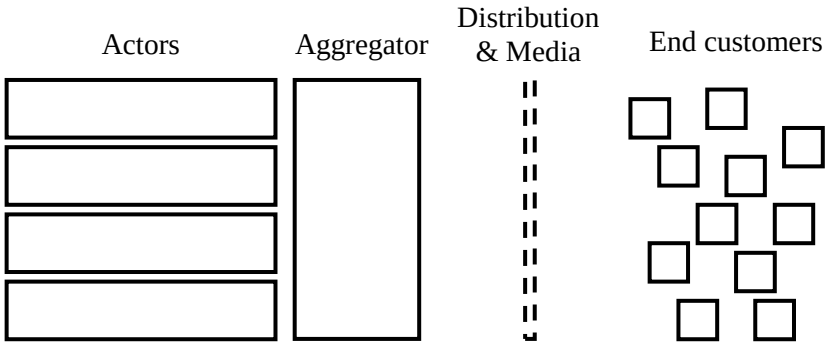

Figure 2 The new aggregator-driven structure of music industry

Our interviews reveal that development of network hubs with necessary resources and capabilities to commercialize immaterial rights seems to be all the time more common within the contemporary music industry. Furthermore, the interviews suggest that network management is becoming increasingly important. This is also proposed by Lorenzen and Frederiksen (2005) who argue that one of the most important issues of organization in the music industry is how the skill holders, who can provide commercializable content, are coordinated with those who possess skills in manufacturing, marketing, and distributing products. The primary role of the hub company seems to be of no importance, but we identify three prerequisites for becoming a hub: 1) access to decision makers within the industry, 2) sufficient negotiation power, 3) adequate resources to buy necessary capabilities and human capital from open markets.

Instruments of contemporary music industry – building blocks of business success

As suggested above, changing industry dynamics in music business seems to drive the focus of actor roles in network. While the fragmentation of end users becomes more diverse, they create independent “markets” that require deep understanding of the symbols and artefacts that these markets employ to evaluate the originality and appeal of different products. On one hand, this may be the reason for higher specialization, but on the other hand, these capability-based businesses concurrently require complementing and packaging by resource-rich and networked actors so that they could be compiled and commercialized for both organizational and individual customers. There is a distinction in the way organization sets to emphasize its use and development of, among others, marketing activities. Considering the results of this research, we propose that this distinction can be understood by referring to the two ends of the continuum as depth and width of the understanding.

While individual actors that specialize on certain value-adding activities could find deep understanding on customer dynamics and their value-logic valuable, we argue that aggregators would benefit more from wide understanding of the value-creating logic on network and business level. Interviews in the music industry revealed a selection of capabilities that can be identified from the companies in the music industry. The identified capabilities are presented in relation to the categorization by Day (1994), which was presented earlier. The outside-in capabilities were the focus of our analysis and we found that, in the music industry, it can be presented as a background to how actors in the network stress the development of their capability portfolio. In Table 1, we have listed some of the key findings of this paper: the distinction of two capability profiles, the vertical and horizontal, description of them and theoretical stance for each sub-dimension.

On general level, most of the capabilities refer to knowledge and the process of developing understanding of actors in the market and their business logic. They rather well fit into the categorization of (Day 1994) for market-driven organizations. We argue that the both capability dimensions and their more detailed

descriptions illustrated in Table 1 should be approached with sufficient level of proactiveness. Although not presented in the table, proactive approach to capability development was generally considered as the single most important issue in music industry by the interviewees. To be more specific, problem-solving, networking, participating and questioning were the issues frequently brought into discussion. In terms of prerequisites for developing different capabilities, access to decision makers within the industry, sufficient negotiation power and adequate financial resources were emphasized.

Table 1 Capabilities in the music industry business networks

Capability dimension	Description	Theoretical Stance
Vertical capability	Understanding of the artistic potential and success factors	Channel bonding
	Understanding of market dynamics and evolution	Market sensing, technology monitoring
	Network/hub management	Customer linking
	Offering development and commercialization	Customer linking, technology monitoring
Horizontal capability	Understanding of the end-customer	Customer linking
	Highly specialized know-how	Market sensing

Discussion and implications

Previous literature and interviews conducted illustrate the latest development in the music industry. Organizational capabilities have shaped the competitive environment, and vice versa, as an interactive two way process (Henderson and Mitchell, 1997; Carrillat, Jamarillo and Locander, 2004). In this paper, we identify central capabilities and supporting resources that depict latest development in the music industry during this new competitive regime. Our findings support the results of Huygens et al. (2001) who proposed that co-evolution of firm capabilities and industry competition manifests itself in a reciprocal process between the emergence of new organizational forms at firm level and new business models at industry level. Based on our results, it seems that the actors of music business are increasingly organized as networks, where hubs with critical resources and *vertical* capabilities bound themselves to a set of providers with special *horizontal* capabilities (e.g. music video directors, sound engineers, managers). The hubs can be centered by the artists themselves, music companies or other actors that possess access to retail front and media, have negotiation power and credibility, and have enough physical resources and human resources to pull the process through. In this role, widely understanding how specific market works and what promotional mechanisms can be used seems to be critical for success, especially so in the future. Understanding the seemingly unrelated events in popular culture and other fields might also prove as influential when addressing the entity. On the other hand, the results suggest that specific actors in the network seem to be motivated by the possibility to focus on their area of expertise and aim to provide a deep understanding of this area in relation to the targeted audience. It seems that they provide the link to the end customer and focus on the production of the commercialized concept.

Our findings indicate that the relevant capabilities in the music industry fall into the “outside-in” division of Day (1994), suggesting that firms should aim at being considerably market-driven. The results centrally show that marketing sensing and customer linking capabilities are the most important and relevant capabilities for companies in the music industry, emphasized in both vertical and horizontal capability dimensions. Also channel bonding capabilities and technology monitoring are focused on, as has been important especially in business-to-business markets (Day, 2000). But should firms try to be market-driven or to drive market? Jaworski, Kohli and Sahay (2000) argue that the approaches are complementary so that a given organization can both drive markets and be market driven. Nevertheless, we suggest companies to adopt more proactive mindset to promote the value-creation for customers and other network players (cf. Narver, Slater and MacLachlan, 2004). Active search of synergetic relationships within company’s network could also pay off if the company is able to concentrate on its core competence (Hamel and Prahalad, 1994). We further argue that, of the four types of marketing assets identified by Hooley et al. (1998), especially supply chain assets and alliance-based assets are increasing in importance.

Conclusions and further research

We see that this paper has potential to prove valuable both academically and managerially as there is a limited amount of studies on music industry and other disruptive industries. Academically, we discuss capabilities from the network perspective, while managerially we present a way the business logic is changing in a disruptive industry and how actors are reacting to this changing business environment.

According to Schumpeter (1934), industrial growth and development is a product of the competitive process. We see that companies operating in highly dynamic music industry are developing capability pools that help them to take market dynamics into consideration proactively, and not reactively. It seems that proactiveness is bedrock that serves as a trigger for the use of other capabilities, especially market sensing, customer linking and channel bonding. Network management skills are needed more than ever, and vertical business understanding is becoming a success factor. Market-relating capabilities are especially difficult to understand as they span several functions and organizational levels and incorporate numerous connective links between the buyer and the seller (Day, 2000) and they may provide a sustainable competitive advantage for firms in music industry. However, in absence of adequate resource pool, companies are not able to operate effectively.

The results of this study can potentially be generalized into other disruptive industries, discussed earlier. The consistency of the results could be tested by examining such industries (e.g. e-commerce and gaming). Suggested already by Huygens et al. (2001), an additional interesting topic for future research would be to explore why certain new capabilities and organizational changes have an impact on the industry, while others do not. Also process of joint value creation through network collaboration could be a fruitful topic for research.

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