



FEATURE

SOUND INVESTMENTS: THE OPPORTUNITIES AND RISKS OF MUSIC ROYALTIES AS AN ASSET CLASS

BY CJ WEI

Due to their low correlation, consistent returns and resiliency against market fluctuations, music royalties can make for very valuable investments. CJ Wei, director of private credit at Northleaf Capital Partners, outlines how investors can make the most of this increasingly attractive asset class.



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Music royalties are emerging as an attractive asset class within specialty finance, drawing investor interest with a unique blend of low correlation and stable cash yield as part of a broader investment portfolio.

For artists, composers or other content owners, the opportunity to monetize long-lived assets and place them with sophisticated custodians can be a highly attractive proposition. Over the past several years, there have been a wide range of investment transactions surrounding the catalogs of iconic artists like Bob Dylan, Sting and Bruce Springsteen and also from newer artists like Katy Perry, Justin Bieber and Daddy Yankee. The confluence of

willing buyers and sellers is creating an active market to finance and/or acquire music royalty assets.

**ATTRACTIVE ATTRIBUTES:
OUTSIZED GROWTH WITH LOW
CORRELATION**

The global music market, encompassing music publishing, music recording and live music, is an estimated \$60 billion industry, according to a Goldman Sachs report. Today, music is more accessible than ever, driven by the proliferation of streaming services such as Spotify, Amazon and Apple Music. These platforms have experienced a tremendous increase in popularity, with a Goldman Sachs

report noting that Spotify alone experienced nearly fivefold growth in streaming hours between 2015 and 2021 while tens of thousands of new songs are added to the platform every day. Music has also expanded beyond traditional platforms and is now seamlessly integrated across channels ranging from gaming to home fitness to social media.

Investing in music royalties entails a contractual right to a portion of the income generated by a song or composition, whether stemming from streaming, physical and digital sales, live performances, or placement in film, TV or other visual mediums. The consumption of music is impervious to market volatility and broader economic cycles and therefore remarkably inelastic. This resilience ensures that music royalties can generate low correlation and consistent returns, even during periods of broader market volatility. As a result, the addition of music royalty assets can bring valuable diversification benefits to a broader investment portfolio.

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Like other forms of asset-based investing, music royalty investments are underpinned by a financial asset: music intellectual property (IP) rights that generate consistent royalty income. Music monetization is anchored on the foundation of two types of copyright: publishing rights and master rights. Publishing rights pertain to a song's composition, which may include both the melody and accompanying lyrics. Master rights pertain to a specific sound recording or reproduction of a song. As an example, Leonard Cohen composed the iconic melody and lyrics of "Hallelujah," which accounts for the publishing rights, but over the years, there have been many artist recordings (most famously by Jeff Buckley) with associated master rights.

The two types of copyrights generate revenue through three main royalty streams:

- Mechanical royalties, which are earned from the sale of the song or recording, whether physical (such as CDs or vinyl) or digital (such as downloads or streaming)
- Performance royalties, which are earned through live public performances or when a song is streamed in public venues like restaurants, bars, gyms, live concerts or through programmed music services
- Sync royalties, which are earned from licensing songs, compositions or recordings for use as background music in movies, TV shows or commercials

OTHER INVESTMENT CONSIDERATIONS: OPPORTUNITIES AND RISKS

Different structures can be utilized to invest in music royalties, including debt, structured capital, joint ventures and asset purchases. These structures all benefit from credit-like features, including predictable cash flows

collateralized by a diversified pool of assets. In addition to offering downside protection, music royalty investments may also benefit from an undercurrent of steady growth driven by enhanced monetization across different platforms and channels.

Beyond the benefits of stable yield, low correlation and portfolio diversification, there are several other key considerations for investors when it comes to music royalties:

1. Platform capabilities

Partnering with well-established platforms connected with artists, publishers, record labels and IP owners can help ensure investors benefit from exclusive sourcing of under-monetized assets, creating the ability to enhance value over time.

Music may be an art, but evaluating music IP requires a highly data-driven approach that seeks to understand song and artist performance over time, genre trends, royalty structures, channel penetration and other fundamental drivers of royalty performance. A disciplined and rigorous approach is essential to developing accurate cash flow projections and managing risk for this asset class.

In addition, effective asset management plays a pivotal role in maximizing the value of a music catalog. Strategic initiatives to maximize value may include placing content in films or TV shows (synchronization), establishing new licensing arrangements, and collaborating early with songwriters and artists. These efforts may not only increase the catalog's value but also expand its reach and influence.

2. Music catalog diversity

Song popularity typically follows a curve, peaking in the first few years after release, declining over the next two to three years, and then stabilizing after roughly five to seven years. Seasoned catalogs, with their troves of established content, enjoy the advantage of predictable and stable consumption patterns. A key advantage of seasoned content is its extensive historical data, enabling meticulous, song-by-song decay curve modeling and rigorous statistical analysis. Conversely, newer songs and current "hits" may not have such robust historical data, but they can present exciting opportunities for outsized growth.

Revenue streams originating from a diverse pool of content spanning various songs, artists, genres and vintages and disseminated through multiple delivery channels can serve as a robust defense against shifting consumer preferences and the volatility often associated with relying on single blockbusters.

3. Valuation multiples

After years of expanding multiples driven by an influx of institutional capital and headline-grabbing mega-deals, recent trends in music royalty market multiples point to a noticeable tempering, with the exception of truly iconic catalogs like those of Springsteen, Dylan or the Beatles. Catalog size and diversity are key drivers of valuation as is content maturity and the size of the listener/fan base.

But there is undoubtedly an opportunity to seek quality, under-monetized assets that will allow for greater value creation over the long term.

4. Regulatory environment

The music industry benefits from a supportive regulatory environment committed to enhancing music content rights for artists and copyright owners. One of the most notable regulatory enhancements in the U.S. was the 2018 Music Modernization Act (MMA), which streamlined the licensing and royalty collection process for digital music platforms. Other regulatory enhancements include the 2022 adjustment to mechanical royalties for streaming and digital sales, which led to an increase of 44% and 32% in each category, respectively.

5. Potential risk considerations

Lately, copyright infringement and reversion have gained prominence, particularly through high-profile cases involving artists and copyright holders. Ensuring a chain of title across prior owners, securing indemnifications where applicable, and retaining full control and administrative rights across the publisher, writer, artist and label's share of royalties are potential ways to mitigate this risk.

CONCLUSION

Music royalty assets can be attractive and diversifying additions to an investment portfolio due to low correlation and stable yield characteristics. However, the market is undoubtedly becoming more competitive. Winners in the space will leverage proprietary sourcing to seek under-monetized assets and utilize platform advantages to build scale and diversification to generate long-term value. •

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Prior to joining Northleaf in 2019, Wei was a vice president at Fundamental Advisors, where he evaluated and executed on investment opportunities across asset-based specialty finance. Previously, Wei was an investment banking analyst in the restructuring and debt advisory group at Jefferies, and he began his career as a credit investment analyst at Man Group.