



Combat in High C: Microsoft vs. Apple

Published : October 20, 2004 in [Knowledge@Wharton](#)

Last week the opening shots were fired in the long-anticipated battle between Microsoft and Apple to gain command of the online music business. Microsoft unveiled its new beta Windows Media Player and announced the launch of a so-called built-in Digital Media Mall that offers access to online music stores such as Napster, Musicmatch, MusicNow and Wal-Mart Music Downloads. Microsoft's MSN Music service offers 500,000 songs at 99 cents each and is compatible with more than 70 music players. As such, it directly challenges Apple Computer, whose iTunes music service dominates the online music industry with a 70% market share, though songs from iTunes Music store can be played only on Apple's iPod music players (unless they are converted to formats compatible with other players).

The stakes in this battle are high. Research firm JupiterResearch estimates that digital music sales are expected to double to \$270 million in 2004 compared to 2003. By 2009, though, Jupiter projects that digital music sales will increase to \$1.7 billion, totaling 12% of consumer music spending. Whether Apple will retain its lead of this fast-growing market or be dislodged by Microsoft - or whether the online music market will be fragmented among a number of providers - will be determined by the course of this conflict over the coming years.

So which company is likely to prevail? For now, Apple, which has sold 125 million songs since it launched the Windows version of iTunes in 2003, has a huge lead over Microsoft. Moreover, Microsoft's offering is just half that of iTunes, which provides one million songs to its customers. Little wonder that Apple hasn't done much so far to respond to Microsoft's foray, though it did announce the launch of an affiliate program for iTunes on the same day that Microsoft launched its music service. Some analysts are upbeat about Apple's prospects. "The more the digital music landscape changes, the more it stays the same," notes Steve Lidberg, an analyst at Pacific Crest, a brokerage firm. "Microsoft's music launch offers nothing new to the consumer, and we believe it will do little to challenge Apple's leadership position." Over time, though, as Microsoft improves its music offering by going through more releases of its software, experts at Wharton and elsewhere believe that Apple may be vulnerable because of at least two strategic issues.

The first has to do with Apple's strategy of using its software (iTunes) to sell hardware (iPods). Wharton professors say that Apple, by not opening its iTunes format to other music players, could be repeating the mistake it made with its operating systems (OS) for Apple and Macintosh computers back in the 1970s and 1980s. The fact that Apple's OS software was a closed system that worked only with its own hardware - in contrast to Microsoft, which licensed its operating system software widely and eventually emerged as the industry standard - isolated Apple. Despite its early lead in developing personal computers, Apple's market share in personal computers today is less than 5%. "Apple chose to go with a closed system, refused to license its software and made pricing mistakes," says [Eric Clemons](#), a Wharton professor of operations and information management. Potentially, iTunes faces a similar risk of being isolated from the mainstream because of its dependence on iPod players. Although iPod is successful at present - it has a market share of 58% among music players and analysts say it will account for 15% of Apple's revenues this year, compared with 8% in 2003 - it could become a low-margin business as rivals figure out how to match its features, says Wharton marketing professor [Peter Fader](#). "This could look similar to what happened to Netscape and Apple's own history," he says. Fader sees RealNetworks recent efforts to crack the iPod code as a potential boon to Apple, which instead responded by blasting



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

RealNetworks.

Clemons agrees, up to a point. Clemons is an Apple fan and thinks the company - now led again by co-founder Steve Jobs - can hold its own; it has made a habit of "refusing to collapse." Competing with Microsoft, however, is a tough prospect for even the most resilient companies. "Microsoft picks a target area, announces a product that's not that great, says it will outspend you to death on it to freeze development, and then beats you with the third generation of software," says Clemons. This approach has worked with Internet browsers, word processors and spreadsheets. The catch? Once Microsoft takes the lead, its products don't improve dramatically. Clemons says a case in point is Microsoft's web browsing software, Internet Explorer; it dominates the market but has so many security flaws it's a "national disgrace."

In contrast, Clemons says, a closed system isn't so bad. For one thing, Apple can argue it is more secure. Clemons says the music industry should be wary of Microsoft. If security and anti-piracy are big issues for the industry, why should it trust Microsoft with its security track record in Windows XP and Internet Explorer, he asks.

Downloads vs. Streaming

The second factor that could make Apple vulnerable, according to Fader, is that as part of its iTunes and iPod business model, the company has been steadfast in its belief that downloads are the future. Apple believes that consumers want to own their music, not rent it. However, many online music services - including the popular Rhapsody from RealNetworks - rely on streaming music. Customers pay a monthly fee and then get rights to the music library. Fader believes Microsoft ultimately will succeed because its music store is just the first step toward piping songs through its MSN Internet service. "The key is what's down the road," says Fader.

The main technology Microsoft has included in its latest Media Player is called Windows Media Digital Rights Management 10, code-protection software that would give portable music players access to all-you-can-eat subscription music services. If Microsoft and other services can convince consumers that monthly subscription services are better than downloading songs a la carte, Apple could face problems since it apparently has no plan to offer a streaming music service. Napster plans to offer a portable subscription service for \$14.95 a month. "Apple is trying to disparage streaming, but customers will ultimately speak for themselves," says Fader. "Once streaming services are accepted, Apple could be in trouble." Clemons agrees that subscription services have a future. Indeed, he listens to XM Satellite Radio, which is a form of renting music.

Fader argues it would be prudent for Apple to offer a streaming service for iTunes, especially given its large database of one million songs. "It makes no sense [for Apple not to do that]," he says, adding that he expects music services to bill customers in the same way that cell phone or cable services are charged. "Saying subscription services don't work is just wrong." Fader suggests that Apple should investigate other ways to monetize iTunes, such as charging a monthly fee for usage. Apple's affiliate program to drive traffic to iTunes and boost song sales is not enough at a time when the industry, and especially big purchasers of online music, seem to be gravitating toward subscription services. "I can't believe Apple is not developing a subscription service. It is leaving money on the table," says Fader, adding that even a \$2 monthly charge for iTunes could make an impact. "Apple customers are so loyal that if Jobs said the only way to listen to music was to stand on your head, they would all be upside down."

Battle for the Living Room

Whether Microsoft is able to put a dent in Apple's music lead remains to be seen. It is possible that neither company will eventually dominate. Virgin, Viacom's MTV unit and Yahoo! are all expected to launch music services, in addition to the companies currently selling songs online.

The real battle, however, may be for the living room. The company that offers the operating system for home entertainment could benefit for years to come. It will be a long, hard battle, and Microsoft and Apple have different approaches. Microsoft's vision is driven by its software strategy; Apple sees software and hardware as symbiotic, but has a greater focus on hardware because that is where its profit margins are fatter. "Microsoft's real goal is the proliferation of its Windows Media technology," says Piper Jaffray analyst Gene Munster. Apple has a different take. "Apple's view is colored by hardware," adds Fader. "It can sell iPods, but it's a finite market. Someone else like Sony will ultimately figure it out."

Some analysts who are upbeat about Apple don't share Fader's view. Lidberg notes that iPod and iTunes could turn into a "multibillion-dollar category for Apple over the next two to three years." Meanwhile, Munster estimates 85% to 90% of iTunes traffic is driven by iPod users. These analysts argue that iPod and similar devices in new markets could propel the company's entry into car entertainment systems, digital media players and portable video players. Indeed, Apple is already branching out, as is evident from its recent deal to make iPod compatible with certain BMW models.

The battle ahead will be a long one. Munster doesn't expect Microsoft-powered devices to become a major factor until the second half of 2005. Once those devices become attractive to consumers, Microsoft will become a force with which Apple will have to reckon. "Microsoft will ultimately be cheaper because it's not out to sell hardware," says Clemons. "It usually starts out badly in a new market, but then it either gets better or it terrifies the competition." Usually it does both.

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.