

The E-Reader (R)evolution

Here to stay or a path to digital process?



Time is critical as the universe of e-readers advances at a blistering pace. New devices are launching regularly (the Apple iPad), with some percentage of consumers testing them out, and financial analysts raising their estimates of the e-book market's size almost weekly. Price forecasts are just as volatile with CNN forecasting that the price for the Amazon Kindle could fall to \$100 by December 2010. The e-reader market is a dynamic one that will progress quickly and could become obsolete sooner rather than later. Although no one can predict exactly what will happen in the future, successful companies will be ready for any scenario, flexible to different formats and trends—acknowledging that only time will paint a full picture.

As the 2009 winter holiday season came to an end, the shift in Americans' use of technology was on display in airports, as travelers proudly sported their new Amazon Kindle 2s. A combination of smart marketing tactics by Amazon.com, a little help from Oprah, low prices and positive buzz surrounding its electronic-paper display helped the Kindle become one of the hottest gifts for a second consecutive holiday season. The first-generation model sold out of its 500,000 inventory by mid-November 2008, despite the recession. Sales on the second version reached an estimated 2 million in 2009, according to Citigroup, almost doubling prior-year expectations. Analysts today

forecast \$2 billion in 2010 sales for Kindle devices and digital books.

With optimistic projections suggesting that Kindle growth rates could surpass that of Apple's iPod—and market statistics to support the hype—why wouldn't every content creator and content distributor jump on the e-reader bandwagon?

As financial analysts and sociologists alike anticipate a drastic change in how content is created, distributed and digested, the landscape of companies in the digital content arena is splitting into two categories: content distributors and content creators. In the e-reader market, the devices (Kindle, Apple's iPad and the Sony Reader)

distribute the content and publishers (Amazon, MacMillan, Simon & Schuster) create the content. While both sides provide unique contributions to the evolution of the digital marketplace, the quest for balance could lead to a power struggle.

Distributors: Chasing the Kindle

The market for distributing digital books is flooded with new devices and software trying to ride the wave of Kindle's success (*see figure 1*). As distributors fight to stay relevant amid the next generation of devices, leading companies will focus on the following:

Market dynamics. Credit Suisse analysts estimate that Amazon's market share will drop from 90 percent to 35 percent in the next five years as new players enter the e-reader market. The number of new competitors is not the only factor at play—the market is dynamic and changing. To gain market share, device manufacturers must appeal to consumers by aggressively promoting

the benefits and advances of the device—its usability and functionality—while also guaranteeing that consumers have access to desired content. This requires significant investment in research and development (R&D) to ensure cutting-edge gadgetry and technical platforms compatible with multiple publishing formats, which are being updated constantly as providers combine print and digital content and streamline their internal workflows.

Technical platform. With every e-reader iteration, new hardware and software platforms are being introduced, adding complexity to how publishers prepare digital content for distribution. The more formatting options there are, the greater the difficulty of sharing content across platforms. There are three main formats:

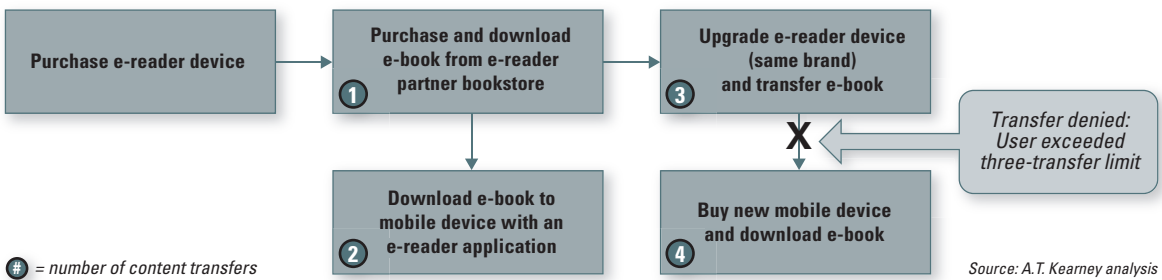
Proprietary format. The Kindle is built on a proprietary format: Books purchased on a Kindle cannot be stored for future reading on another device, or even a future version of the Kindle.

Figure 1
Emerging e-reader devices, 2010



Source: A.T. Kearney analysis

Figure 2
Digital rights management can be a roadblock for readers



Some critics complain that employing a proprietary file format is anti-progress—similar to Sony’s now-defunct ATRAC format for music players—and could lead to Kindle’s fast extinction as competing devices offer open file formats and software.

Open format. Sony has learned from its prior mistakes by applying an open format to the Sony Reader, allowing books to be shared across devices—not just e-readers but also other electronics. Open file formats benefit consumers and content providers by allowing interchangeable files that can be produced and shared quickly, reducing the need for publishers to customize device-specific content. The drawback of an open format is that it makes it more difficult to manage digital rights.

Alternatives. Even better for consumers than a device that hosts an open format is software that can make any format open. Blio, the new free software introduced at the 2010 Consumer Electronics Show, converts partner content sold in its virtual bookstore into color-rich PDF formats readable on any device. The catch behind this free software (there always is one) is that the speed of adoption and acceptance is related to technical limitations such as platform constraints and reader experience.

Digital rights management. File conversion and file sharing brings us to the elephant in the room: digital rights management (DRM). Many e-readers employ DRM technology to limit file sharing and copying to other devices or users. While this protects e-reader manufacturers from the unlawful sharing of purchased content, it also generates considerable controversy.

For example, the number of times a file can be transferred to new devices—even e-reader-approved applications—is often limited. When upgrading to the latest generation of an e-reader, attempting to transfer e-books may prove impossible because you’ve exceeded the maximum number of approved devices to display the content (see figure 2). This number is often unpublished—sometimes at the behest of the device manufacturer, sometimes the content publisher. This begs the question: What is the purpose of a digital library if the books are “rented” not “owned”? From another angle, it is like requiring readers who want a copy of a physical reference manual at home and the office to buy two copies. The next question: What premium will readers pay for universal access to content?

Industry attempts to answer these questions are still in the nascent stages. For example, Apple

recently offered tiered iTunes pricing for universal access to songs, versus the typical limited access, at a 30 percent premium. Determining the right premium and willingness to pay for different types of content will require calibration, consumer testing and some trial and error. Magazines have long claimed that on a rate base of 1 million readers, readership is actually four to eight times higher due to pass-along readers, those who read it without having purchased it. Will the number of pass-along readers decrease as e-reader magazine subscriptions increase? If not, can providers better track pass-along readers through premium subscriptions that allow access from multiple devices—and likely unique readers?

Another DRM obstacle is obsolescence, which happens when delivery formats change and old content is no longer usable. Several instances of this have popped up since digital music and video proliferated in the early 2000s. In 2007, according to *The Washington Post*, Major League Baseball fans who had downloaded paid footage from MLB.com were told that the website could no longer support the video format because the DRM provider had changed, rendering the videos unwatchable. After a bout of negative publicity, the league offered replacements for old downloads. Similar cases have occurred with online music downloads from Microsoft, Yahoo!, Sony and Wal-Mart. Thus the irony: As long as record players exist, you can play your old LPs. But in many cases, digital music upgrades are the equivalent of destroying the last record player on earth.

Creators: The Reign of Content

In terms of content, publishers and consumers appear to have eagerly accepted the e-reader as a viable, innovative option for distributing and digesting content. The possibilities seem endless:

the morning news instantly delivered daily to your e-reader; a library-sized collection of books, newspapers and magazines fitting easily in your bag; a university education's worth of information weighing less than a paperback beach read. Beyond these dreams, however, two main factors underscore provider and consumer desires:

- Pricing, in terms of affordability for consumers and profitability for publishers
- Accessibility, in terms of content for consumers and broad distribution for publishers

For any new product, price is a challenge. Amazon initially imposed a flat rate of \$9.99 for Kindle books, a move that actually netted a roughly \$3 per-book loss for Amazon, paid for by the price of the device (currently \$259 for the smaller version and \$489 for the larger) and its 90 percent market share in the estimated \$125 million e-reader market.¹ Amazon pays publishers about the same for e-books as it does for hardcover copies, yielding publisher profits of approximately \$2.20 for digital books versus \$1.30 for the hardcover edition of the same book. Despite the higher profits, Amazon's per-book losses and the Kindle's near-monopoly had some publishing industry observers worried that they could lose control of pricing and distribution. In a position of power, Amazon could enforce book price reductions, or reduce their payments to publishers.

The iPad (which sold 300,000 units on its first day, April 3) has shaken this pricing structure and tipped the balance back toward the publishers. In early 2010, with Apple's backing, MacMillan demanded its own pricing terms from Amazon. Other major U.S. publishers, including Hachette, HarperCollins, Penguin and Simon & Schuster, soon followed suit. Within weeks of Apple's iPad announcement in January, Amazon announced new pricing arrangements starting at

¹ In its original Kindle model, Amazon typically bought books from publishers at 50 percent of their cover price. For a Kindle e-book that costs \$26 in hardcover, Amazon would buy it for \$13 and sell it for \$9.99, a net loss of \$3.01.

\$12.99 per e-book, including a 30 percent commission for retailers. This shifted the balance of power back to the publishers, increasing their profits and possibly even Amazon's (see figure 3). While the consumer may take the initial price hit, in the long run, free-market forces should reach an equilibrium in which prices match supply and demand—driving some prices back below the \$9 mark. In the end, the old industry model may prevail: Producers will once again be responsible for pricing their content, and distributors will be responsible for pricing their devices.

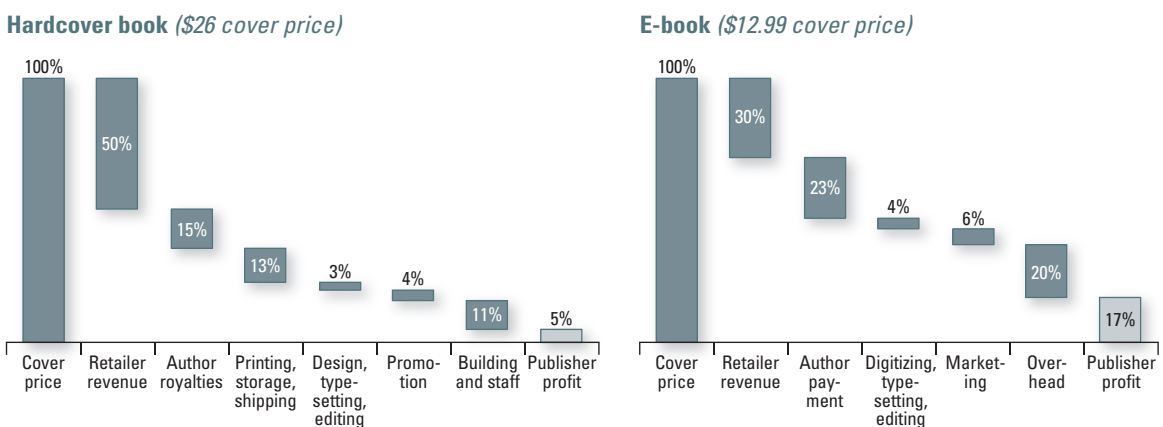
New online publishing sites such as Scribd, which gives 80 percent of book sales to publishers while relying on ad revenues for free content, could reinforce the content-producer-sets-the-price model. This leads to a final point on pricing: e-books will never, and should never, be free. Printing expenses may disappear, but marketing, overhead and royalties costs will not, nor will the price of creating content in multiple formats. Publishers have taken to heart past lessons about

content value and will work hard to avoid past mistakes. Quality content will always have value that can be translated into revenue.

The Suddenly Ubiquitous E-Reader

What if print products disappeared entirely and all books came in digital format? Simple. Publishers would develop strategies to maximize their distribution and reach. These strategies are already evolving. Outside the realm of traditional publishing, online publishers such as Scribd are bridging the divide between content creator and distributor. A “social publishing company,” Scribd serves as a digital storefront for mainstream publishers such as Simon & Schuster, Random House and *The New York Times*, while at the same time allowing amateur writers to upload and sell their stories. An open format allows files to be sent to mobile devices and some e-readers, including the Kindle and Barnes & Noble's Nook. The ability to share documents online and read them on multiple devices strikes a sweet spot for readers and

Figure 3
Book profit structure



Sources: Industry analysis; A.T. Kearney analysis

publishers, at the price of advertisements framing the Scribd website's content. As connectivity and social networking increase inexorably, ubiquitous access to content is essential. Championing ubiquity is the role of the content provider. Ensuring that content flows across platforms, devices and versions is the emerging role of the distributor.

As companies build strategies to succeed in the digital world, successful distributors and content providers should be prepared for three likely scenarios.

The rise and fall of the e-reader. e-readers will go down in history as the enablers in content's journey from print to digital. The e-reader is changing consumer behavior, and the next generation of colorful, interactive devices is expected to convert glossy magazines to digital formats. But what is the lifespan for e-reader technology? As more creative content enters the digital cloud, and consumers continue to favor lighter, faster and fewer devices, the e-reader as a delivery mechanism may in fact become obsolete.

Consumers will focus on the speed and accessibility of information, and most will be device-agnostic as long as they get the content they want. It is certainly no stretch to imagine that in the next decade the game-changing Kindle, futuristic Skiff (incubated as a separate company by Hearst) and visionary iPad will be relics of a bygone era, their functionality and digital-ink attributes morphed into flexible, featherweight, all-in-one devices that meld mobile phones, books, entertainment and computers together. Savvy distributors and content creators will seek paths improved by technology but not constrained by it. e-readers are a necessary stage of digital evolution, yet to remain relevant, those in the e-reader market must continue to innovate and improve the consumer experience beyond these current devices.

² ABC stands for Audit Bureau of Circulations, a nonprofit organization of magazine and newspaper publishers, advertisers and advertising agencies that audits circulation, readership and website activity.

Print lives on. In March 2010, magazine behemoths Time Inc., Hearst, Condé Nast, Wenner Media and Meredith announced a multimillion-dollar joint advertising campaign to promote the power of print. One tagline says, "We surf the Internet. We swim in magazines," while another says, "(P)eople aren't giving up swimming just because they also enjoy surfing." Hand-in-hand with Next Issue Media, the digital consortium formed in mid-2009, the publishers' message is clear: Print and digital will coexist into the future. This notion may bring comfort to traditionalists and technocrats alike, but can cause angst for publishers.

Classic print outlets have moved away from single or dual versions of printed products (such as newsstand and subscription versions of magazines, and hard-cover and paperback versions of books) to more than a half-dozen variations that include some combination of print, digital, website, e-reader and social networking. Managing these different adaptations strains already-strapped resources. Editorial teams must make quick decisions about which content to reuse across platforms and which to adjust. IT groups must determine how to format content for distribution and monitor technology standards. Legal and publishing departments must remain vigilant about managing digital rights and distribution agreements. Sales groups must define an organizational structure and selling strategy that maximizes cross-selling. Circulation and planning departments must design holistic rate-base and customer management strategies that capture emerging revenue streams and ABC-verified customers versus unverified customers.²

Publishing executives, meanwhile, must maintain brand consistency and voice across all of the moving pieces of the organization. This is

no small task, and requires significant strategic guidance and collaboration among groups that traditionally sit in organizational silos.

Content is in the driver's seat, but.... Will the magazine of the future be a static document of articles and pictures, much the way television began with static pictures of people reading radio copy? The answer is no, of course not. Up to this point we have promoted the hierarchy of content over device, but what attributes of digital devices in general will influence content?

Will digital magazines—now appearing on the iPad—be an “editorial package” that includes the benefits of search, clip and send, or more like Web magazines that continually refresh content? Will the iconic magazine cover become obsolete? Will blogs replace newspapers? Will newspapers become hybrid audio-visual products?

E-Reading the Tea Leaves

The degree to which content providers move to new platforms rather than develop new concepts will determine whether or not they succeed and how quickly. Rather than catering to a particular device, the leaders will foster an environment in which creative power is unleashed on a limitless tableau—expandable photos, videos, interactive reader dialogue boxes and much more than perhaps we can imagine today. Discussion of this future rages across literary and technical circles. While we cannot predict exactly what will happen, the most successful companies will be ready for any scenario—for a (R)evolution of sorts, flexible to different formats and trends, and vigilant to the integrity of their content and devices.

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