

Show Time!

Just as the Mac revolutionized computing, Apple is changing the world of online music. If Steve Jobs plays his cards right this time, Apple could end up with a big chunk of the digital-entertainment market

On Jan. 6, San Francisco's Moscone convention center pulses with all the energy of a rock concert. A crowd sprinkled with hip-hop teenagers, digerati, and aging hippies streams in to hear the annual state-of-the-Mac keynote from Apple Computer Inc. Chief Executive Steven P. Jobs.

Every facet of the event bears the fingerprints of the obsessive Jobs -- right down to the music that fills the air. This year, it's the King himself, Elvis Presley. Later, Jobs rolls the tape of Apple's famous "1984" ad that ran on Super Bowl Sunday that year -- and hasn't been broadcast since. Only this version has been digitally enhanced. The ad's hammer-throwing heroine crashes a meeting of Orwellian automatons and smashes Big Brother to smithereens, just like before. But this time, she's sporting a new accessory on her hip: one of Apple's hot-selling iPod digital music players. "It's the 20th anniversary of the original Mac, and we're going to make something of it," says Jobs after the cheers subside.

The message is clear: Just as the Mac revolutionized the computer industry, Apple is once again in the business of changing the world. This time, it's the world of music. Its diminutive iPod, which can store 10,000 songs in a device smaller than a deck of cards, is the most radical change in how people listen to music since Sony Corp. introduced the Walkman in 1979. Then there's Apple's online music store, iTunes. It was established only after Jobs became the first person to persuade all the major record labels to make their music available -- legally -- on one Web site. Since late April, 30 million songs have been downloaded from Apple's store, and the trend may one day spell the end of the compact disk. "[Jobs] is a real visionary, the kind who can change industries," says Jimmy Iovine, chairman of Interscope Geffen A&M Records, a unit of Universal Music Group.

That's industries, plural. Over in Emeryville, Calif., 50 miles from Apple's Cupertino headquarters, Jobs's other company, Pixar Animation Studios, is turning the movie business on its ear. The company's latest flick, *Finding Nemo*, was the No. 1 box-office hit of 2003 and roared past Walt Disney Co.'s *The Lion King* as the highest-grossing animated hit of all time. That gives Pixar an unprecedented five blockbusters in five tries.

(Remember *Toy Story* and *Monsters, Inc.* ?) And it gives Jobs tremendous leverage as he renegotiates Pixar's contract with embattled Magic Kingdom boss Michael D. Eisner. For the past nine months, Jobs has been pressing Disney for a bigger cut of the profits from its films -- and perhaps much more. With Eisner on the hot seat, Jobs is likely to get much of what he wants.

Add it up, and this may be just the beginning of a brand new Steve Show. For years, Jobs's perfectionist approach to product development has been experienced only by Mac users. But now, massive changes are roiling the worlds of entertainment, computing, and communications, giving him a broader stage. Increasingly, content -- that magical lifeblood of movie studios, record labels, and publishers -- is being transformed into digital form. At the same time, the Internet and wireless networks are evolving to deliver those bits almost anywhere, at speeds never before possible. Couple all that with disk drives, semiconductors, and high-resolution displays that are growing ever smaller and more powerful, and technology is liberating entertainment from its past. How we watch movies, look at photos, listen to music, even read a book promises to change profoundly in the next decade.

No one may have a better chance to make order out

of this chaos -- and then profit from it -- than Jobs. He bridges the marketplace: He has a hand in the worlds of computing, music, and movies to see how they're evolving. He has the track record with consumers: His string of hits includes the original Mac, the candy-colored iMac, and the iPod. He has the pieces: Apple not only has a combination of software and hardware skills unique in the PC business, it also has strong product design and one of the world's best-known brands. And he has the silver tongue: When the record companies had dug in their heels against the Net in Napster-induced terror, it was Jobs who persuaded all the major labels to put their music on iTunes. "Steve's the right guy with the right style at the right moment," says management consultant Geoffrey A. Moore, president of Chasm Group LLC and author of the technology-marketing text *Crossing the Chasm* .

If he doesn't blow it, that is. Jobs can be so enamored of his own vision -- and so bull-headed about pursuing it -- that it has blinded him at times. In 2000, fresh off the success of the trend-setting iMac, he personally ordered up a glistening cube-shaped Mac that carried a sky-high price tag in part because of a fanless design that eliminated that annoying hum. Customers, it turned out, weren't willing to pay for noiseless good looks, and the product was pulled off the market in a matter of months. Such missteps could cost him dearly in

the battle ahead.

Retail Payoff

While consumer-electronics giants develop scores of products at once and endure a few flops, Jobs's hands-on approach means Apple can focus on only one or two brand-new projects at a time. "Apple's problem is that it's just a blip by consumer-electronics measures," says consultant Paul Saffo, research director at Institute for the Future. "It's too big to play the Bang & Olufsen angle, but it's just a blip next to Sony or Samsung. That's a really awkward place to be."

One advantage Apple has over rivals is its retail stores, which give customers first-hand experience with the company's new products. In 2001, when the entire PC industry was bent on boosting online sales to reduce costs, Jobs went the opposite way. He started opening swanky retail stores, now numbering 74, in high-rent locations such as Chicago's Magnificent Mile and the Ginza district in Tokyo. Products are displayed on uncluttered maple tables, so shoppers can comfortably try things they may have never done on a computer before, like create a home movie. Mac-savvy salespeople wait at a "Genius Bar" to answer questions, but don't hover. The stores, which turned profitable in 2003's third quarter, also offer hundreds of classes in filmmaking, graphic design,

and more. "I love the store," says Tanika Goudeu, a 26-year-old documentary filmmaker visiting the location in New York's SoHo on a recent January afternoon.

What new fare will shoppers find in those stores in the years to come? Near term, an iPod for viewing digital photos would need nothing more than a color screen. Then, with its design skills, Apple could create a compact entertainment hub for the living room. That could eliminate the usual mess of DVD players, stereos, music CDs, and remote controls, and loaded with Apple's successful iLife software suite, the hub could be used for managing digital photos or watching home movies. A musician could even use it, loaded with Apple's new GarageBand music software, to create a backup band while playing lead on the family piano. Such a device might appeal to youngsters who've grown up digital -- interacting with technology rather than just watching it. Jobs won't comment on such opportunities, except to warn of the difficulty of creating products people really want to use. "I'm not saying we're not going to do these things. I'm just saying they are a lot more complicated than they look."

Imaginary Key

That goes for watching movies, too. If Jobs and his movie pals one day adopt online distribution of

films, it's easy to imagine an iTunes-like store for downloading them. Asked if such talks are in the works, he smiles and turns an imaginary key in front of his mouth. Still, he doesn't deny Apple has many paths to explore. "There's no company in the world that's better at making complex technology simple," he says. "That's Apple's primary skill, and it's a skill that has never been more valuable."

All this may be causing Jobs to rethink Apple in fundamental ways. For years, his growth plan was to gain a percentage point of PC market share each year. Now, the iPod shows there may be a better way: milk those loyal Mac fans for profits, and pioneer new markets to bring in new customers. "If our [PC] market share grows, we're thrilled," says Jobs. But with the iPod, "we're finally getting to compete without our 5% market-share ceiling, and look what's happening: We're winning." Merrill Lynch & Co. estimates that the company's revenues will rise 23% in fiscal 2004, to \$7.6 billion, as net income more than doubles, to \$185 million. Half of that revenue growth is expected to come from music as iPod sales nearly triple, to \$931 million, and iTunes's sales boom tenfold, to \$220 million. "They're better positioned today than they've been in a long time," says Merrill analyst Steven Milunovich. "Despite its up-and-down track record, we're confident Apple can stay at the leading edge of innovation."

Still, a stampede of competitors will be trying to elbow their way past Apple. Sony, though struggling of late, still dwarfs Apple with an expected \$66 billion in revenues this year. Korea's Samsung Electronics Co., a fast-rising force in everything from cell phones to high-definition TVs, says it will spend more on capital investment this year than Apple's revenues. Even networking giant Cisco Systems Inc., not known for its consumer savvy, has gotten into the market with sophisticated wireless products for zapping video and music around the home. The giants are dismissive of Jobs and Apple. "They're a one-trick pony," says Hideki "Dick" Komiyama, president of Sony Electronics Inc.

There are many who think Jobs won't even be able to hold on to his lead in music. Skeptics note that he's up against the same crew of companies that trounced Apple in PCs, as well as an army of newcomers, including Wal-Mart Stores and Virgin Entertainment Group. Microsoft Corp. is providing the software for more than 60 digital music players, and Dell, Samsung, and others are building the hardware. "It doesn't take a genius to see what comes next: lower prices for consumers and lower market share for Apple," says Chris Gorog, CEO of Roxio Inc., which operates a rival music service under the Napster brand name.

"Steve Jobs is right back to the Mac model."

That is a serious risk. Some 20 years ago, Apple leaped ahead in PCs and then blew its lead because it insisted on too much control over its products. While other PC makers used Microsoft software and only made hardware, Apple opted to make the Macintosh operating system itself -- and refused to license the software to cloners who might have helped it hold share against a united front. Forced to maintain high prices to pay for its marketing and research, Apple managed its way into a tiny niche.

This time, Jobs has changed his tactics -- but only partially. He made the iPod and iTunes work with Windows PCs and cut a deal for Hewlett-Packard Co. to resell the music player under the HP brand. Still, he continues to use proprietary software in his music products to insulate Apple from direct competition. That means the iPod won't work with any download site other than iTunes, and iTunes won't work with any music player other than iPod. "Apple's world is a good world, but it's a closed world. Choice is important," says Dave Fester, general manager of Microsoft's Windows digital-media unit. Jeff Hastings, president of rival portable-player maker Rio Audio, is even more critical: "At the end of the day, it's about how big your ego is. If you believe you're going to own the

category, you can try to have the complete solution."

Some have argued that Jobs should license the software inside the iPod or its design so that it can become the Microsoft of music players, but that probably won't work. The little-known truth is that Apple doesn't own much of the technology inside the iPod. A small company called PortalPlayer Inc., for example, makes the key chip and some of the underlying software. Apple did plenty of innovation, including the industrial design, the wheel interface, and the synchronization with iTunes. But it would be difficult to license these contributions on their own, and they probably wouldn't command very high royalties.

Jobs insists Apple is better off keeping its technology to itself. "We can invent a complete solution that works and take responsibility for it," he says. "It will be very interesting when one of these other portable-music players starts to leak music [so it can be shared freely with others]. The music companies will get upset and point their fingers at Microsoft, and Microsoft will point their fingers at the hardware company. Apple can take responsibility for the entire solution."

The challenge for Apple, then, comes down to innovation and design. Can it make products that

are so much better than rivals' that it can command a premium and keep its market-share lead? Jobs seems capable of pulling it off. Despite the onslaught of competition, Apple's share of the portable music-player market rose last year, from 24% to 25%, says market researcher IDC. Apple's iPod mini, a \$249 player introduced on Jan. 6, is a lower-priced version of its current hit. And its deal with HP signals a more aggressive approach to grabbing control of the music market. While Apple may lose some share over the next few years, it should remain the market leader. "The iPod is on the verge of becoming a verb, like TiVo," says market researcher Mike McGuire of GartnerG2. "It's really hard to unseat that."

Apple's success in the music biz began with an oversight. In the late '90s, when students were starting to burn CDs of their favorite tunes, Macs didn't have CD burners. Realizing the mistake, Jobs ordered Apple's developers to create the iTunes program to help customers manage their growing PC music collections. That led to the concept of the iPod. If people were going to maintain the bulk of their music on their PCs, they'd want a portable device to take it with them. Such devices already existed, but most could hold only a few dozen songs.

Pulling the Pieces Together

That's when Apple's creative DNA kicked in. Scouring the market for the necessary components, Apple found that PortalPlayer had technology that could serve as the guts of the device. It also learned that Toshiba Corp. was building a tiny, 1.8-inch disk drive that could hold thousands of songs. Other manufacturers had balked at the high price, but not Apple. Instead, it quickly cut an exclusive deal for the drives, giving itself an 18-month head start on the competition in high-capacity music players. Meanwhile, Apple's engineers poured their time into designing the user interface, the elegant exterior, and on making it simple to synch up song libraries from the Mac.

When it was unveiled in October, 2001, the iPod drew mixed reviews. The price was so high, \$399, that critics joked the product's name stood for "idiots price our devices." But iPods flew off the shelves. Brisk sales pushed Jobs to make a wrenching decision. After years of doing battle with Windows PCs, he decided that Apple should make the iPod work with enemy machines. The call paid off. Sales surged after the Windows-compatible iPod came out in mid-2002.

That's when Jobs set his mind to tackling an even bigger problem: persuading the major music companies to make their music available for legal downloads. For years, the record labels focused

more on squelching song-swapping on free sites such as Napster than on building a legal download business. But Jobs argued that 80% of consumers would pay for music downloads if there were a simple, affordable way to do so. By mid-2002, Apple was moving ahead with a prototype to do just that.

A key meeting occurred in the fall, when Warner Music Group Chairman Roger Ames traveled to Cupertino to interest Jobs in a super-secure new kind of CD. After a few minutes of discussion about the CD, Jobs gave Ames an early demo of the iTunes store. Jobs laid out his 99 cents-per-song pricing scheme and said that all the labels would have to be involved for it to work. While Ames wasn't ready to sign on, he and Jobs continued to meet in New York and Cupertino. One important step, Ames says, came when the two debated why radio developed so much more extensively in the U.S. than in Britain. Jobs said it was because there are no fees attached to U.S. radio. The argument resonated with Ames, convincing him that fewer restrictions on downloaded music would help sales. He also began to build trust in Jobs. As head of Pixar, "here [was] a guy who obviously knows a great deal about what it means to artists to protect their works from being ripped off," says Ames. "This was the right person for us to be in business with."

So Ames urged rivals such as Universal Music's Iovine to take a look. Iovine says he was "blown away. This guy had been doing serious thinking while we were all batting our heads against a wall." Jobs also met with 20 top artists, including Bono, Sheryl Crow, and Mick Jagger. "So many artists were on the fence about the digital world," says Island Def Jam Music Group's Lyor Cohen. "It really showed his determination to make this happen."

Within days of iTunes's unveiling last April, it was clear that Jobs had a hit on his hands. A million songs were sold the first week. "We've shown there's a way out of this mess, that there's a legal alternative consumers can use that's better than stealing online," says Jobs.

Apple is going to get major help in keeping its lead in music over the next few months. The deal with HP will put iTunes software on 9 million PCs a year and put the marketing muscle of HP behind iPod sales. America Online Inc. just made iTunes the exclusive music store for its 26 million subscribers. And on Feb. 1, Pepsi-Cola North America will run a Super Bowl ad publicizing a 100-million-song iTunes giveaway.

Are Movies Next?

Jobs bristles at the notion that Apple's lead is in

danger. "It's kind of insulting, actually," he says. "The suggestion is that we stumbled into this thing. When are we going to get some credit?" He notes that the Mac's peak in the U.S. was about 16% market share. That's far less than the iPod and miles less than iTunes, which has 70% of music downloads. What's more, Apple's rivals are fighting among themselves, so it's not *mano a mano* with mighty Microsoft. Microsoft is pushing one standard, RealNetworks is pushing another, and Sony is supporting a third. That's giving Jobs the opportunity to expand his market and make his technology the standard for digital music. "Over half the iPods we sell are being used with Windows PCs, and it has been that way for a while," Jobs says.

There's more Apple can do. It could cut wholesale deals for its iPods, similar to the one with HP, with other companies. That would put more marketing oomph behind the iPod while taking potential rivals out of the market. Jobs won't comment on the possibility. What if rivals begin taking share? Apple could field a much cheaper model by introducing a player based on flash memory, which costs less and has a lower capacity than a hard drive. A more radical step would be to load Microsoft's software onto the iPod in addition to Apple's so it could play music from sites other than iTunes. That would give comfort to people who like

the iPod but want to buy music from, say, the 88 cents-a-song Wal-Mart site, which uses Microsoft's software.

The bigger challenge is what comes after the iPod. That's where Pixar may come in. Though Jobs dismisses talk of synergies between Apple and Pixar, it's a safe bet that he is thinking about them as he negotiates Pixar's new deal with Disney. The main debate is over more obvious topics: Pixar wants to boost the roughly 37% of profits it now clears on its films after Disney has taken its 50% share plus a distribution fee. But Jobs could be pushing for more unusual terms. What if Pixar asked for exclusive rights to offer digital downloads of its films? If Apple ever created an iMovie site, such flicks would be a powerful draw. Jobs has another advantage: Apple already has the most popular site for watching movie trailers on the Web.

Setting up a movie-download site would be no easy feat, as Jobs readily concedes. For starters, five major studios -- Universal Pictures, MGM, Warner Bros., Sony, and Paramount Pictures -- opened their own site, Movielink, in 2002. And Movielink, which charges \$4.99 for its newest releases, hasn't caught on. That's because downloading an entire movie is slow and there are plenty of other ways to see movies now, from rentals to pay-per-view.

"Hollywood is much more mature than the music business in terms of distribution," says Jobs.

Could Jobs work his way around such obstacles? Maybe. Before he founded iTunes, the major record companies had their own music-download sites, with a hodgepodge of copy-protection technology. What Jobs did was cut deals with all the majors so customers could go to one place for all their music -- with standardized, reasonable copy protection. It's possible he could work out a similar deal for movies. "You never want to say never when it comes to Steve Jobs," says a top Hollywood exec. "He could come to us tomorrow and say: 'I've got it all figured out.'"

Jobs's resurgence is, in some ways, like a Pixar script -- full of lessons and redemption. A dozen years ago, he was the washed-up former CEO of Apple, the *enfant terrible* of tech with little hope of doing anything of consequence again. Now, he's hailed for changing the world of music -- and has the opportunity to do much more. For this drama to have a happy ending, Jobs will have to play his role perfectly.

By Peter Burrows

With Ronald Grover in Los Angeles, Tom Lowry in New York, and bureau reports