



Inside this Issue

This MainStream Management sector report focuses on trends in the musical instruments industry, acting as a resource for owners, board members, and shareholders of musical instrument businesses. In this issue, we recap emerging industry trends as well as provide insight into the operating, capital markets, and financial challenges facing the industry.

This report encompasses a wide breadth of musical instruments, including the piano, organs, strings, wind instruments, percussion, and keyboard. While not meant to be wholly comprehensive in scope due to the absolute number of musical instruments, this report is representative of the broad-based sector. The report evaluates the trends for selected musical instruments and also presents industry forecasts.

Executive Summary

Challenges and Opportunities of the Current Environment

The following trends define the current state of the musical instruments industry:

- The industry felt the impact of the recessionary conditions of 2008/2009 in a material way. With the exception of accessories, where sales were virtually even with 2008, all categories reported in this report registered declines in sales.
- The industry experienced the decline in revenues largely due to recessionary conditions as consumers opted to curtail expenditures related to the leisure aspects of their lives. The drop in revenues in the music industry were not materially different than declines in other sectors of the leisure economy.
- Those companies that did exhibit revenue growth months have largely been smaller, more agile privately held or publicly traded companies. Larger companies that spent time “digesting” acquisitions have not grown at a pace as rapid as smaller players who are more focused on organic growth rather than growth through external means.
- M&A activity in the sector declined relative to historical levels, consistent with the general decline in M&A activity. There were certain significant M&A transactions that occurred but in the aggregate, activity was curtailed.
- Capital markets activity for publicly traded companies was non-existent over the past 12-18 months. This occurred as investors have stepped back from public capital markets activity overall, making access to public markets for growth capital or to replace debt capital difficult to obtain.
- The trend toward non-domestic manufacturing has accelerated as 2009 was the fifth year in a row where production in the U.S. declined and manufacturing abroad increased. MainStream believes that this trend will continue for the foreseeable future.
- Electronic and non-classic equipment continues to grab market share due to the attractive up-front and maintenance cost elements of these purchases. With schools and churches, for instance, facing funding pressures, the opportunity to purchase electronic equipment that will not face the ongoing maintenance costs of more traditional equipment is an attractive selling feature in today’s economy.
- Notwithstanding the decline in sales activity in 2008/2009, the industry is expected to grow at a compounded annual rate (CAGR) of 3% from 2010 through 2013.

Industry Overview

Raw Materials, Production & Technology, Product Mix, Competitive Landscape, Customers, & Recent M&As

The U.S. musical instruments manufacturing industry includes nearly 600 companies with combined annual revenue of approximately \$2 billion. There is significant market concentration at the top of the industry as the 50 largest companies control more than 80 percent of the market from a revenue standpoint. Large companies include Harman, Fender, and Steinway, the former Selmer Industries.

The industry's revenue for 2008 was approximately \$2 billion, with an estimated gross profit of 27.46%. The value of imported products within this industry was approximately 70% of U.S. production as imports were valued at \$1.4 billion from 87 countries. The industry also exported \$.8 billion worth of merchandise to 164 countries. This exhibits a high amount of trade activity, as the value of exported products within this industry into the U.S. has also been relatively high, at approximately 40% of U.S. production. Adding import value to and subtracting export value from the industry's shipment value, the total domestic demand for the industry was \$2.5 billion.

Raw Materials

Raw materials vary, depending on the instrument type and quality. Professional wind instruments are usually made using silver, gold or brass, with a normal mix of 70 percent copper and 30 percent zinc. Student versions are often made of nickel brass or silver-plated brass. High-end pianos and string instruments contain hardwoods such as maple, beech, spruce, and basswood, while lower-quality versions contain cheaper woods and plastics.

The fundamental physical construct of an instrument does not vary from one maker to another. The key differences among high-end and low-end versions of an instrument are the quality of the materials and level of craftsmanship. Because most instruments contain many intricate parts, labor content is high.

Production & Technology

Lower-cost instruments are often made on assembly lines, while higher-quality instruments are produced

at clusters of workstations. Typical tools include cutting tools, molds, sanders, lathes, presses, and drills. Production involves manufacture of components and final assembly. Components, especially electronics, are often bought from other manufacturers.

Technology is used in automation of assembly lines and through the use of computer-controlled machine tools. Computer systems are used in distribution to dealers and to manage inventory. Large retail chains require manufacturers to use business-to-business electronic ordering and purchasing systems.

Product Mix

Many companies offer a low, medium, and high-end version of an instrument type. This wide range of quality and craftsmanship results in high variation in pricing for consumers. Domestically produced pianos can cost as little as \$2,000 for a basic upright to \$150,000 for a limited edition grand piano. Band instruments can range from \$200 for student versions to \$25,000 for specialized instruments for professional artists.

Competitive Landscape

Though California is the largest domestic producer of musical instruments, the industry is also concentrated in New York, Pennsylvania, and Ohio. Imported instruments are a major source of competition, accounting for about 50 percent of the U.S. market. China is the largest source of imports. Many domestic manufacturers now source products in Asia or have plants overseas. Exports amount to 25 percent of U.S. production, largely to Japan and Canada.

Customers

Major customers are music distributors, music retailers, schools, churches, and professional artists. Depending on the customer, sales are handled by independent dealers, retail showrooms, an internal sales force, or telemarketing.

Recent Mergers & Acquisitions

Jam Industries Acquires U.S. Music Corp

On August 25, 2009 MMR magazine has reported

acquisition of U.S. Music Corp by Jam Industries. Rudy Schlacher is stepping down from his position as CEO of the company, which he founded four decades ago. U.S. Music's family of brands includes: Washburn, Randall, Eden, Parker, Soundtech, Oscar Schmidt, Vinci, and GWL. UK distribution of these brands will not be affected. Jam Industries is a Quebec-based company that has been distributing musical instruments and related gear for over 30 years.

LOUD Technologies Inc Goes Private

In a letter to its shareholders, dated Nov. 3, 2008, LOUD Technologies (under the name Sun Mackie) issued a request to purchase the remaining 23.8 per cent of the

firm's shares that were still in the public domain.

LOUD Technologies Inc. is one of the world's largest dedicated pro audio and music products companies. As the corporate parent for world-recognized brands Alvarez®, Ampeg, Blackheart, Crate, EAW, Mackie and Martin Audio, LOUD engineers, markets and distributes a wide range of professional audio and musical instrument products worldwide.

Sun Mackie which at that point was holding 76.2% of the outstanding common stock of the company offered \$1.45 in cash per share of common stock. Loud's shares were trading at \$1.35 at that point.

Industry Trends

Business Trends & Sales Trends of Musical Instruments by Type

Business Trends

1. Domestic Production has Decreased Sharply, Production being Shifted Abroad

U.S. musical instrument manufacturing has decreased in the past five years. Unit production has been down an estimated average of 4 percent per year. Production has been down most sharply for traditional pianos. Many U.S. manufacturers have moved production abroad.

2. Consolidation

U.S. musical instrument manufacturers have consolidated operations and merged manufacturing facilities with distribution networks. In the past several years, eight of the largest music companies – the so-called Global 225 – have merged or consolidated with other music manufacturers.

3. Manufacturers Rely Increasingly on New Marketing & Sales Techniques

Musical instrument manufacturers increasingly struggle with a lack of consumer interest in learning an instrument – particularly band and classical instruments. To boost sales, manufacturers are experimenting with new marketing and sales techniques, including price breaks if schools promise to use their products exclusively, direct-to consumer Internet sales, and endorsements from famous musicians.

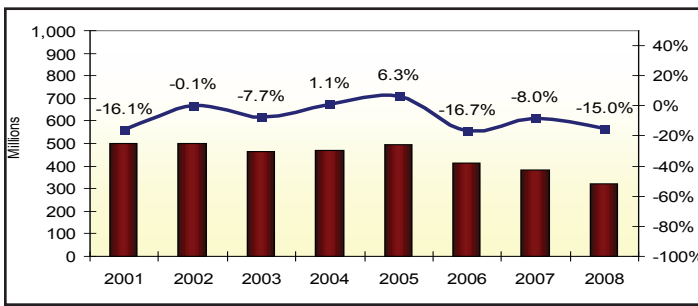
Sales Trends of Musical Instruments by Type

Piano

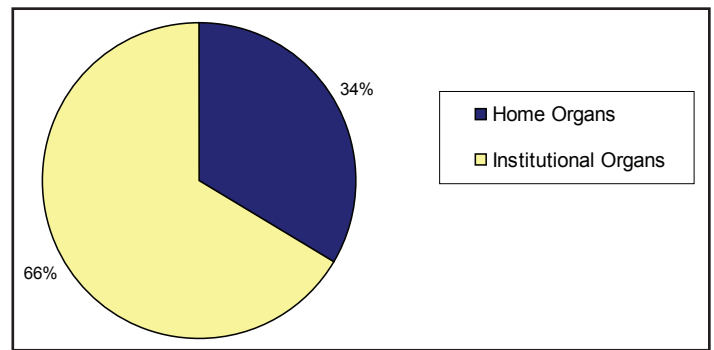
Economic forces combined to severely depress piano sales from 2006 to present. In fact, it would be hard to imagine a worse market scenario for selling high-ticket keyboard instruments. Plummeting housing values prompted consumers to sharply curtail all house-related purchases, from lawn mowers to linens, not to mention furniture, televisions, and appliances. This trend took a heavy toll on piano sales as well. The credit crisis further aggravated matters, making it more costly and difficult for consumers to finance any high-ticket discretionary purchase. The prevailing consumer uncertainty also made life difficult for the piano sales, making it drop by 15% in 2008. The total wholesale value of piano sales in 2008 totalled \$323 million.

Unit sales of digital pianos edged up 1.8% in 2008. However, a flood of low-cost instruments resulted in a 1.3% decline in retail value. Given that digital pianos tend to be visually similar, manufacturers are faced with the challenge of differentiating high-end products from lower-cost alternatives. On the positive side, the resilience of this market segment reflects the ongoing interest in keyboard music.

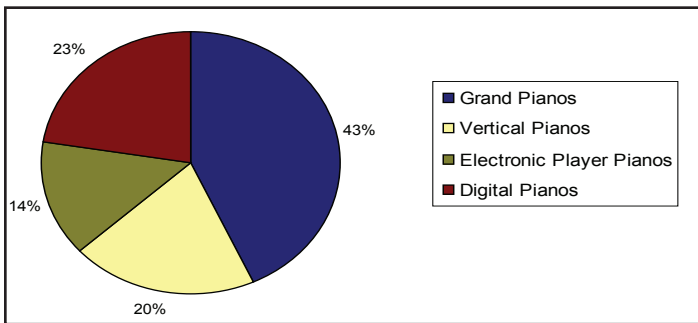
Piano - Wholesale Value Trend



Organ - Wholesale Value by Type (2008)



Piano - Wholesale Value by Type (2008)



Strings

Strings include fretted strings, acoustic and electric guitars, and other string instruments. This category posted its largest sales decline in over a decade as the total wholesale value of string instrument sales slipped 7.2% to \$825 million in 2008. The declines were fairly evenly spread out with acoustic guitar sales off 8.2% and electrics off 5.9%.

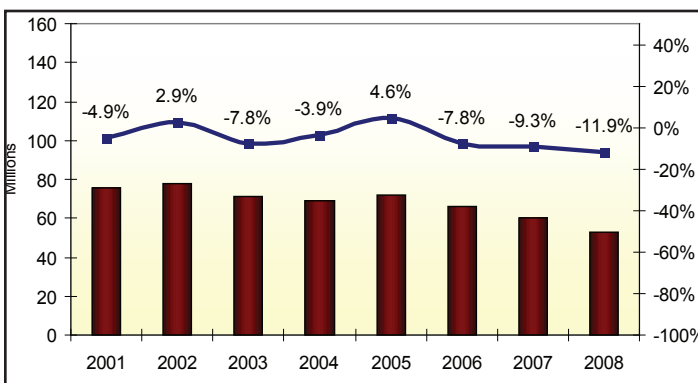
Although the decline has caused consternation throughout the industry, a closer look at the numbers reveals a still vibrant fretted instrument market. Despite what has been described as the most challenging economy since the Great Depression, entry-level guitar sales actually advanced slightly for the year. Acoustic guitars retailing for under \$200 increased 2%, while electric guitars in the same price point declined a modest 0.6%. The strength of the entry-level price point reflects a continued fascination with the guitar and suggests the industry is in the process of creating another generation of committed guitar players, who, as the economy improves, will trade up to more expensive instruments.

A host of other data points confirm the guitar's centrality in popular music around the globe. Ultimate-guitar.com, a website that hosts a large and free library of guitar tab music, attracts hundreds of thousands of visitors every day and ranks as the world's most highly-trafficked music-related website. The huge and unexpected success of the Guitar Hero and Rock Band video games are further evidence of the guitar's tremendous popularity. Better yet, a recent consumer survey conducted by Fender Musical Instruments provides compelling evidence that these musical video

Organ

Organ sales in both the home and institutional market were punished by a challenging economy in 2008. Tight credit, shrinking home values, and stock market decline all adversely affected the purchasing power of the senior citizen demographic, the industry's primary customer base. As a result, sales dropped 11.9%. The total wholesale value of organ sales totalled \$52.92 million in 2008.

Organ - Wholesale Value Trend

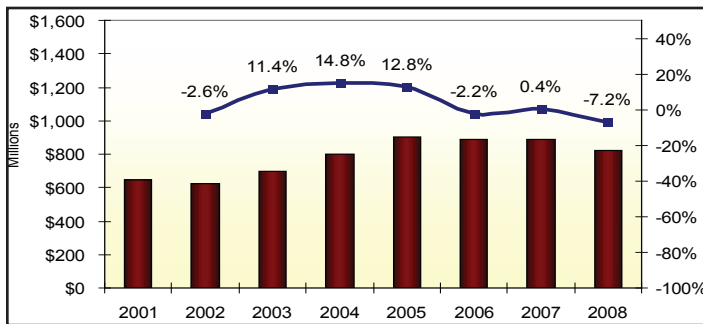


games actually prompt kids to learn to play a real guitar.

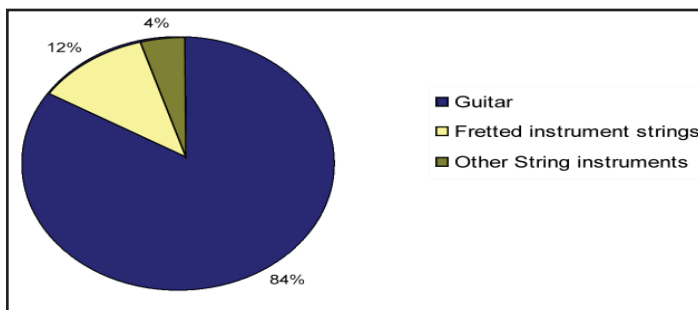
Over the past decade, price points in the guitar market have expanded in both directions. Low-cost Asian manufacturers pushed down the price of entry-level products, providing unprecedented values. At the same time, inspired by the soaring prices of vintage instruments, U.S. manufacturers have expanded the high end with ever more elaborate and exclusive models. This “super high-end” market took the biggest hit in 2008 as a sizable number of cautious consumers put their dream guitar purchases on hold. Acoustic guitars selling for over \$1,500 dropped 8% in units, while electric guitars in the same price point were off by 6.8%.

While makers of toothpaste, shampoo, and other staples tie their sales projections to population growth, in much the same way sales of guitar strings are dependent on the size of the guitar playing population. Over the past eight years, the industry has sold close to 20 million guitars, which has created a larger market for strings.

Strings - Wholesale Value Trend



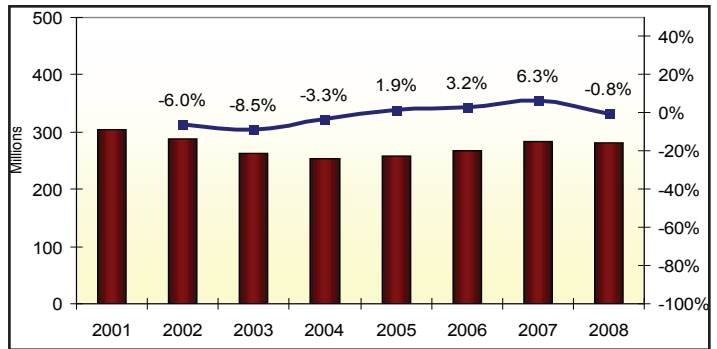
Strings - Wholesale Value by Type (2008)



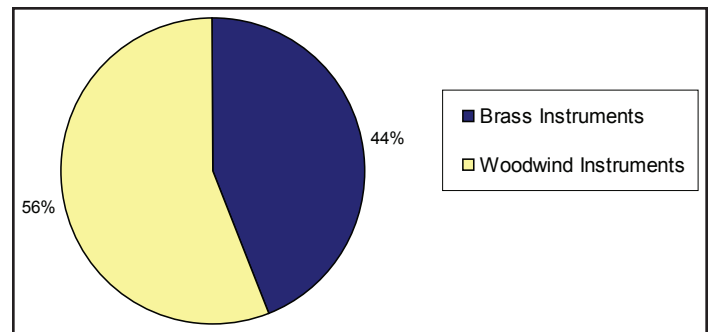
Wind Instruments

Mirroring a 2.2% increase in the school-age population, woodwind sales advanced 4.7% in units while brass wind units were off 0.4%. This is not to say that the market was unaffected by current economic woes. Average selling prices of woodwinds and brass winds both declined. The cause of this is that cautious parents and students cut back on the purchase of higher-priced “step-up” horns. Several Music Trades retail polls indicated that while instrument rentals were strong in 2008, retail sales of higher-priced instruments declined between 5% and 8%. The total wholesale value of wind instrument sales totalled \$ 281.8 million declining 0.8% in 2008.

Wind Instruments - Wholesale Value Trend



Wind Instruments - Wholesale Value by Type (2008)

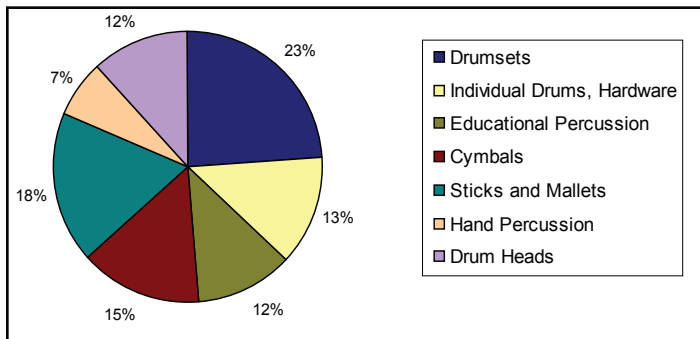


Percussion Instruments

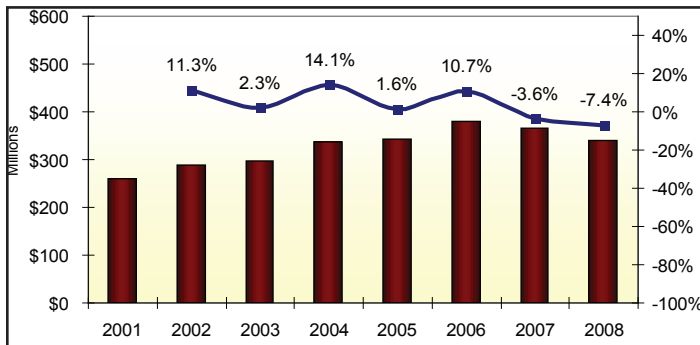
Plummeting drum kit prices over the past decade sent sales soaring. Parents who once bought their aspiring drummer a snare kit were prompted by sub-\$500 prices to buy an entire kit instead. Shifting economic realities reversed this trend last year, resulting in a 10.2% decline in drum kit unit sales. How sales were affected by the widespread availability of used drum kits is difficult to ascertain with precision, but there were close to 8,000 used drum kits listed on eBay and an even larger supply on craigslist.com. Clearly, they have had some impact.

With the exception of drumsticks, the rest of the percussion market also was adversely affected by larger economic problems. Drum and hardware sales were off 6%, cymbal sales dropped 6%, and even educational percussion sales were off. The one bright spot was stick and mallet sales, which advanced 1.1%. Sticks and mallets break, they are inexpensive, and percussionists can't live without them. Taken together, it makes for an almost recession-proof business. Overall, the total wholesale value of percussion instrument sales slipped 7.4% in 2008 to \$ 339.3 million.

Percussion - Wholesale Value Trend



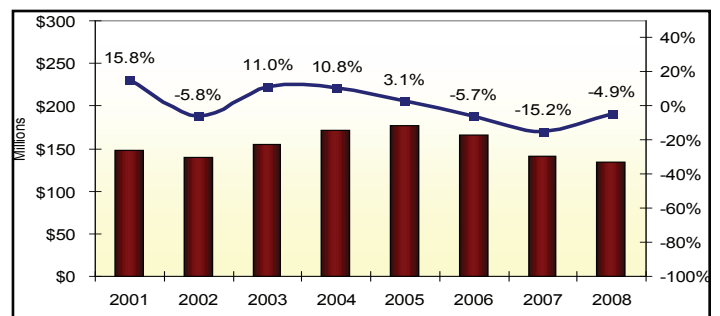
Percussion - Wholesale Value by Type (2008)



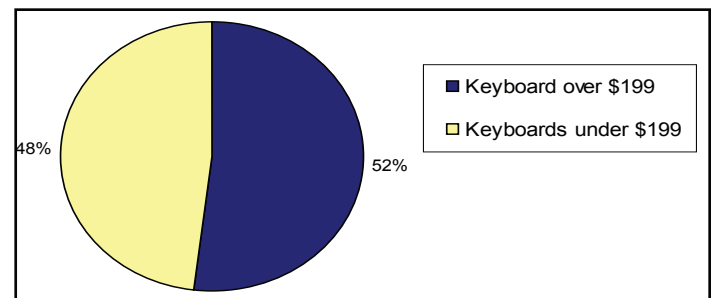
Keyboard

The keyboard market is actually two distinct markets. Instruments under \$200 retail are almost exclusively sold through mass merchants, running the gamut from Wal-Mart to Costco. Keyboards over \$200 are primarily the preserve of specialized retailers. Not surprisingly, performance of the two markets varied significantly in 2008. The mass market segment, i.e. keyboards of the business experienced a 12% decline in both units and dollars. Manufacturers attribute the drop to the economy and reduced emphasis on keyboards among major retailers. Higher-priced products edged up 8.5% in units and 3.2% in dollar value. Portable sales seem to have been enhanced by a sizable number of cautious buyers who traded down from a digital piano or acoustic piano.

Keyboard - Wholesale Value Trend



Keyboard - Wholesale Value by Type (2008)



Industry Forecast & Opportunities

Forecast (2010 -2013) & Opportunities

Forecast (2010 -2013)

The industry is expected to grow at a compounded annual rate (CAGR) of 3% through 2013. Industry revenue for 2009 decreased marginally due to the impact of recessionary conditions domestically, a slight decline that industry experts considered a strong indicator of the relative position of musical instruments in the consumer purchasing world. In addition, industry revenue is projected to again decline slightly in 2010. The reasons for these slight declines relate to the demographics of the purchasing community and the continued recessionary conditions. However, significant growth from 2011 through 2013 is forecasted, with experts predicting annual increases at the rate of 6% for 2011, 8% for 2012 and 6% for 2013, respectively.

Opportunities

Electronic Pianos and Organs Are Increasingly Replacing Traditional Ones

While sales of traditional pianos have declined steadily over the past two decades, sales of electronic player pianos have increased rapidly. The renewed popularity of amateur singing has boosted demand for musical

accompaniment. Self-playing pianos now hold the same market share as traditional pianos, a significant industry trend.

Once considered pale imitations of “the real thing,” electronic pianos and organs are replacing pianos as popular instruments. Many contemporary churches have replaced traditional pianos and organs with electronic pianos because of lower maintenance costs. Traditional pianos and organs need periodic, expensive tuning, and while the music quality may be better than newer electric pianos, the cost impact of lower operating costs is a significant factor in buying decisions.

High Quality Instruments Finding Markets Outside United States

U.S. producers see opportunities to sell high-quality instruments in Asia, Russia, South America, and eastern Europe. Interest in music is strong in many of these markets, but local instrument production is often limited to low-end products. While the current U.S. exports to these markets are still small, volume has grown rapidly to Mexico, Brazil, and China.

Industry Forecast (2010 - 2013)

