Digital Music Group, Inc.
Form 10-Q
May 14, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2007

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______

Commission file number: 000-51761

Digital Music Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**20-3365526**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

2151 River Plaza Drive, Suite 200

Sacramento, CA 95833

(Address of principal executive offices, including ZIP Code)

(916) 239-6010

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes ¨ No x

As of May 14, 2007, the registrant had 9,064,941 shares of Common Stock outstanding.

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DIGITAL MUSIC GROUP, INC.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DIGITAL MUSIC GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 17,486,951	$ 20,505,674
Accounts receivable	1,651,286	1,687,492
Current portion of advance royalties	1,938,988	1,326,379
Prepaid expenses and other current assets	640,424	492,799
Total current assets	21,717,649	24,012,344
Furniture and equipment, net	952,536	803,203
Digital rights, net	3,627,629	3,033,239
Master recordings, net	1,842,398	1,777,480
Royalty advances, less current portion	5,839,143	4,230,403
Goodwill	4,428,845	4,429,782
Other assets	40,782	39,289
Total assets	$ 38,448,982	$ 38,325,740
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 104,642	$ 204,468
Accrued liabilities	306,733	496,833
Royalties payable	2,966,045	1,952,342
Accrued compensation and benefits	181,807	115,817
Current portion of capital lease obligations	44,370	50,496
Total current liabilities	3,603,597	2,819,956
Capital lease obligations, less current portion	3,636	9,335
Other long-term liabilities	91,039	92,461
Total liabilities	3,698,272	2,921,752
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value, 1,000,000 shares authorized: none issued and outstanding		
Common stock, $.01 par value, 30,000,000 shares authorized: 9,034,941 shares issued and outstanding at March 31, 2007 and December 31, 2006	90,350	90,350
Additional paid-in capital	40,221,354	40,138,284
Accumulated deficit	(5,560,994)	(4,824,646)
Total stockholders equity	34,750,710	35,403,988

Total liabilities and stockholders equity	$ 38,448,982	$ 38,325,740

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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DIGITAL MUSIC GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the Three Months Ended March 31, 2007	2006
Revenue	$ 3,392,547	$ 720,648
Cost of revenue:		
Royalties and payments to content owners	2,450,838	348,526
Amortization of digital rights and master recordings	178,517	52,035
Gross profit	763,192	320,087
Operating, general and administrative expenses	1,725,081	950,664
Loss from operations	(961,889)	(630,577)
Interest income	239,609	219,620
Interest expense	(1,777)	(2,986)
Other income (expense), net	(11,491)	
Loss before income taxes	(735,548)	(413,943)
Income taxes	(800)	
Net loss	(736,348)	(413,943)
Net loss per common share basic and diluted	$ (0.08)	$ (0.07)
Weighted average common shares outstanding basic and diluted	9,025,497	5,918,855

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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DIGITAL MUSIC GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Three Months Ended March 31, 2007	2006
Cash flows from operating activities:		
Net loss	$ (736,348)	$ (413,943)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Non-cash charges to operations:		
Depreciation of furniture and equipment	82,611	17,886
Amortization of digital rights and master recordings	178,517	52,035
Recoupment of royalty advances	282,370	68,956
Share-based compensation related to stock options, warrants and restricted shares issued	83,070	80,734
Changes in operating assets and liabilities:		
Accounts receivable	36,206	(272,310)
Prepaid expenses and other current assets	(147,625)	(471,770)
Accounts payable	(99,826)	181,486
Accrued liabilities	(190,100)	(103,823)
Royalties payable	1,013,703	208,421
Accrued compensation and benefits	65,990	(9,502)
Net cash provided by (used in) operating activities	568,568	(661,830)
Cash flows from investing activities:		
Purchases of furniture and equipment	(231,944)	(73,505)
Purchases of digital rights and master recordings	(837,825)	
Payments of advance royalties	(2,503,719)	(260,000)
Change in other assets and long-term liabilities, net	(1,978)	(17,136)
Net cash used in investing activities	(3,575,466)	(350,641)
Cash flows from financing activities:		
Proceeds from initial public offering of common stock		33,240,968
Proceeds from the exercise of Digital Musicworks International, Inc. options and warrants prior to recapitalization		43,423
Proceeds from the issuance of restricted stock		150
Payments on capital lease obligations	(11,825)	(24,887)
Net cash (used in) provided by financing activities	(11,825)	33,259,654
Net (decrease) increase in cash and cash equivalents	(3,018,723)	32,247,183
Cash and cash equivalents, beginning of period	20,505,674	468,490
Cash and cash equivalents, end of period	$ 17,486,951	$ 32,715,673
Supplemental cash flow information:		
Interest paid	$ 1,777	$ 2,986
Supplemental disclosure of non-cash investing and financing transactions:		
Purchase of furniture and equipment under capital lease obligations	$	$ 77,791

Issuance of warrant to underwriters	$	$ 620,529
Reduction in contract for digital rights	$	$ (115,320)
Merger between Digital Music Group, Inc. and Digital Musicworks International, Inc.	$	$ 73,305
Purchase of certain assets of Rio Bravo Entertainment LLC through the issuance of common stock	$	$ 243,750

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

DIGITAL MUSIC GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. ORGANIZATION AND BASIS OF PREPARATION

Digital Music Group, Inc. (the Company) was incorporated in Delaware on April 11, 2005 for the purpose of pursuing digital music opportunities. In February 2006, the Company completed its initial public offering (the IPO). Concurrent with the closing of the IPO, the Company acquired all of the outstanding common stock of Digital Musicworks International, Inc., a California corporation (DMI), and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company doing business as Psychobaby (Rio Bravo). The financial statements for Digital Music Group, Inc. prior to February 7, 2006 are the financial statements of DMI, which has been designated the Company s acquiror for accounting purposes. The historical shareholders equity of DMI has been restated for all periods prior to February 7, 2006 to give retroactive effect to the acquisition by the Company. The results of operations of the Rio Bravo assets and of the Company are included in the financial statements beginning on February 7, 2006.

On September 8, 2006, the Company entered into an Agreement and Plan of Merger with Digital Rights Agency, LLC, a California limited liability company (DRA), and DRA became a wholly-owned subsidiary of the Company. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission in accordance with the disclosure requirements for the quarterly report on Form 10-Q. In the opinion of the management of the Company, the unaudited condensed financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to fairly state the results for the interim periods presented. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of the Company included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Certain reclassifications have been made to the prior period s financial statements in order to conform to the current period s presentation.

2. ACQUISITIONS AND INITIAL PUBLIC OFFERING

On February 7, 2006, the Company completed its initial public offering of common stock, selling 3,900,000 shares at $9.75 per share and generating net cash proceeds (after fees and expenses) of approximately $33,200,000. On the same date, in connection with the closing of the IPO, the Company issued to the underwriters in the offering warrants to purchase an aggregate of 273,000 shares of the Company s common stock. Each of the warrants has an exercise price of $12.1875 per share, and are exercisable at any time from February 7, 2007 until February 6, 2011. The underwriters paid an aggregate of $100 for the warrants. The warrants had an estimated fair value at the date of issuance of $620,529 as determined in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.52%, and an expected term to exercise of 4.6 years. The fair value of the warrants was recorded as an offering cost. Accordingly, the total net proceeds from the Company s IPO were approximately $32,600,000.

Also on February 7, 2006, the Company concurrently acquired DMI and certain assets of Rio Bravo in exchange for 2,249,941 and 25,000 shares, respectively, of the Company s common stock. DMI. has been deemed the acquiror for financial reporting purposes. The Company had net liabilities and a stockholders deficit of $73,305 on the date of its acquisition of DMI. The purchase price of the Rio Bravo assets on February 7, 2006 totaled $243,750, which has been allocated to digital rights. Such rights are being amortized over 24 months, the estimated remaining life of the assets.

On September 8, 2006, the Company acquired all of the ownership interests in DRA in exchange for $3,200,000 in cash, 420,000 shares of Company common stock and a warrant issued to the former Managing Director of DRA to purchase 150,000 shares of the Company s common stock at an exercise price of $5.57 per share. The warrant had an estimated fair value at the date of issuance of $97,350 as determined in accordance with Statement of Financial Accounting Standards No. 123R, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.7%, and an expected term to exercise of 4.75 years. The fair value of the warrant was recorded as acquisition consideration. The warrant is exercisable

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in various installments beginning in September 2007, is fully exercisable by September 2009, and expires in September 2013. The shares and warrant were issued in a private placement under federal and state securities law and are subject to restrictions on resale thereunder, and a substantial majority of the shares are subject to contractual restrictions on resale, short selling and other forms of hedging for varying terms ranging from one to two years from the acquisition date.

The estimated purchase price of Digital Rights Agency, LLC consists of the following:

Cash consideration	$ 3,200,000
Common stock issued (420,000 shares at $4.14 per share)	1,738,800
Liabilities assumed	1,929,667
Acquisition costs	131,466
Estimated fair value of common stock warrant issued	97,350
	$ 7,097,283

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The total purchase price was allocated to DRA s assets and liabilities based on their estimated fair values as of the acquisition date. A summary of the preliminary purchase price allocation, which is subject to finalization, is as follows:

Cash	$ 430,646
Accounts receivable	947,312
Other current assets	399,680
Furniture and equipment	115,800
Digital rights	775,000
Goodwill	4,428,845
	$ 7,097,283

The Company is obligated to pay up to $1,155,000 in cash and 87,000 shares of common stock in additional consideration if certain financial targets are achieved through December 31, 2007. Any additional consideration obligation will be recognized when deemed probable and will be allocated to goodwill.

The unaudited pro forma combined statements of operations for the three months ended March 31, 2006 presented below assume that the acquisitions of DMI, Rio Bravo and DRA were closed on January 1, 2006:

	For the three months ended March 31, 2006
Revenue	$ 2,526,085
Cost of revenue	1,959,194
Gross profit	566,891
Operating, general and administrative expenses	1,223,995
Loss from operations	(657,104)
Interest income	221,775
Interest and other income (expense)	(7,526)
Loss before income taxes	(442,855)
Income taxes	
Net loss	$ (442,855)
Net loss per common share basic and diluted	$ (0.06)
Weighted average common shares outstanding basic and diluted	7,373,299

Weighted average shares used in the calculation of the unaudited pro forma combined basic and diluted net loss per share for the three months ended March 31, 2006 include the shares issued in connection with the acquisitions of DMI and Rio Bravo on February 7, 2006 and the shares issued in connection with the acquisition of DRA on September 8, 2006, as if these acquisitions had all occurred on January 1, 2006.

The adjustments used in the preparation of this unaudited pro forma combined statement of operations are based on estimates, available information and certain assumptions which may be revised as additional information becomes available. The pro forma financial data do not purport to represent what the Company s combined results of operations would actually have been if such acquisitions had in fact occurred at the beginning of the period, and are not necessarily representative of the Company s results of operations for any future period since the companies

were not under common management or control during the period presented.

3. RECENT ACCOUNTING PRONOUCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles (GAAP). As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes

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that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on the Company.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure eligible assets and liabilities at fair value with changes in value recognized in earnings. Fair value treatment for eligible assets and liabilities may be elected either prospectively upon initial recognition, or if an event triggers a new basis of accounting for an existing asset or liability. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on the Company.

4. ACCOUNTING POLICIES

The accounting policies of the Company are set forth in Note 2 of the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2006. There have been no changes to these policies other than the adoption of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. See Note 9 below.

5. CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity or remaining maturity from date of purchase of three months or less to be cash equivalents. Based upon its investment policy, the Company may invest its cash primarily in demand deposits with major financial institutions, in highly rated commercial paper, United States treasury obligations, United States and municipal government agency securities, United States government sponsored enterprises, money market funds and highly liquid debt securities of corporations. The Company held approximately $9,000,000 and $6,500,000 in cash equivalents at March 31, 2007 and December 31, 2006, respectively.

The Company maintains its cash and cash equivalents at financial institutions. The combined account balances at several institutions exceed Federal Deposit Insurance Corporation (FDIC) insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. The Company has not incurred losses on these deposits to date and does not expect to incur any losses based on the credit ratings of the financial institutions.

6. DIGITAL RIGHTS

Digital rights comprise the following at:

	March 31, 2007	**December 31, 2006**
Digital rights	$ 4,132,184	$ 3,405,605
Less accumulated amortization	(504,555)	(372,366)
	$ 3,627,629	$ 3,033,239

Amortization expense was $132,189 and $52,035 for the three months ended March 31, 2007 and 2006, respectively.

7. MASTER RECORDINGS

Master recordings comprise the following at:

	March 31, 2007	December 31, 2006
Master recordings	$ 1,964,407	$ 1,853,161
Less accumulated amortization	(122,009)	(75,681)
	$ 1,842,398	$ 1,777,480

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Amortization expense was $46,328 and $0 for the three months ended March 31, 2007 and 2006, respectively

8. ROYALTY ADVANCES

Royalty advances comprise the following at:

	March 31, 2007	December 31, 2006
Total royalty advances	$ 9,161,657	$ 6,657,938
Less cumulative recoupment of royalty advances	(1,383,526)	(1,101,156)
	7,778,131	5,556,782
Current portion of royalty advances	(1,938,988)	(1,326,379)
	$ 5,839,143	$ 4,230,403

9. INCOME TAXES

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), on January 1, 2007. FIN 48 provides a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. There was no impact on the Company s consolidated financial statements as a result of the adoption of FIN 48.

The Company has incurred net losses since its inception and has fully offset the deferred income tax benefit of such losses by a valuation allowance due to the uncertainty of the ultimate realization of such tax benefits. The Company has substantial net operating losses available for carryforward to reduce future taxable income for federal and state income tax reporting purposes. The federal net operating loss carryforwards begin to expire in 2024 and the state net operating loss carryforwards begin to expire in 2014. In addition to potential expiration, there are other factors that could limit the Company s ability to use these federal and state tax loss carryforwards. Under Section 382 of the Internal Revenue Code of 1986 (Section 382), as amended, use of prior net operating loss carryforwards can be limited after an ownership change. The Company s ability to fully utilize DMI s net operating loss carryforward will be subject to limitation under Section 382 as a result of its merger with the Company and other transactions, and may be subject to further limitations as a result of future sales of securities, if any. Accordingly, it is not certain how much of the existing net operating loss carryforward will be available for use by the Company and the Company s future tax benefits as of March 31, 2007 and 2006 have been fully offset by a valuation allowance due to the uncertainty of their ultimate realization. If the Company generates taxable income in the future the use of net operating loss carryfowards that have not expired would have the effect of reducing the Company s tax liability and increasing after-tax net income.

10. CONCENTRATION OF CREDIT RISK

Accounts receivable from the Company s largest digital entertainment service comprised approximately 47% and 85% of the Company s consolidated accounts receivable at March 31, 2007 and 2006, respectively. Based on its previous cash collection experience and knowledge of the digital entertainment service, the Company does not believe there is significant collection risk associated with this account.

11. COMMITMENTS AND CONTINGENCIES

At March 31, 2007, the Company is contractually obligated to pay up to $4.7 million over the next twelve months in additional advance royalties and digital rights and master recordings purchase consideration. These payments are due under various digital rights agreements as music and video recordings and related metadata and artwork are received from the content owners for processing by the Company. The Company is also obligated to pay a total of $360,000 in equal quarterly installments through February 2016 as additional advances against future royalties under one long-term agreement. In addition, in connection with the acquisition of DRA, the Company is obligated to pay up to $1,155,000 in cash and

to issue up to 87,000 shares of stock if certain financial targets are achieved through December 31, 2007.

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12. SHARE-BASED COMPENSATION

The Company recorded non-cash charges of $83,070 and $80,734 as a component of operating, general and administrative expense related to share-based arrangements for the three months ended March 31, 2007 and 2006, respectively. The share-based compensation charge for the three months ended March 31, 2006 included $38,834 associated with the accelerated vesting of DMI stock options due to the merger of DMI with the Company.

The Company has an Amended and Restated 2005 Stock Plan (the Plan) under which 1,219,500 shares of its common stock have been reserved for issuance at March 31, 2007. All options granted to employees since inception of the Plan have a four-year vesting period. Annual option grants to non-employee directors are automatic pursuant to a formula within the Plan which establishes the number and terms of such grants.

In accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, the Company utilizes the Trinomial Lattice Model to measure the fair value of stock option grants. The following weighted-average assumptions were used in estimating the fair value per share of the options granted under the Plan for the three months ended March 31, 2006. There were no stock options granted for the three months ended March 31, 2007.

Risk-free rate of return	4.64%
Expected volatility	35.0%
Expected life (in years)	5.3
Suboptimal exercise factor	2
Exit rate post-vesting	22.8%
Exit rate pre-vesting	19.0%

The Company calculates the expected volatility for stock-based awards using the historical volatility for its peer group public companies because sufficient historical trading data does not yet exist for the Company s common stock. The Company estimates the forfeiture rate for stock-based awards based on historical data. The risk-free rate for stock options granted is determined by using a zero-coupon U.S. Treasury rate for the period that coincides with the expected option terms. It is further assumed that there are no dividend payments.

Stock option activity for the three months ended March 31, 2007 is summarized as follows:

	Number of Shares	Exercise Price	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2006	366,500	$ 4.02 -$ 9.75			
Granted					
Exercised					
Forfeited	(1,000)	$ 4.13			
Outstanding at March 31, 2007	365,500	$ 4.02 - $ 9.75	$ 8.28	7.30	$ 60,155
Exercisable at March 31, 2007	110,500	$ 6.38 - $ 9.75	$ 9.57	8.19	$

The aggregate intrinsic value shown in the table above was calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company s common stock for the 65,500 options that were in-the-money at March 31, 2007. The weighted average estimated grant-date fair value per share for the 1,000 unvested options forfeited during the three months ended March 31, 2007 was $0.80.

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Restricted stock activity is summarized as follows:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Nonvested at December 31, 2006	143,334	$ 0.68
Issued		
Vested	(96,669)	$ 0.50
Nonvested at March 31, 2007	46,665	$ 1.04

During the three months ended March 31, 2007, 41,665 restricted shares became vested upon the resignation and termination of the employment of a former executive as required under the restricted stock agreement with such executive.

As of March 31, 2007, the future pre-tax share-based compensation expense for stock options grants is $396,544 to be recognized in the remainder of 2007 through 2011. Future pre-tax share-based compensation expense for restricted stock is $44,413 to be recognized in the remainder of 2007 through 2008.

In April 2007, the Compensation Committee of the Board of Directors, which administers the Plan, approved grants to 15 employees which comprised an aggregate of 30,000 shares of restricted common stock vesting over 18 months and 79,000 options vesting over four years to purchase the Company s common stock at the fair market value as of the date of grant.

13. NET LOSS PER SHARE

Basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding for the three months ended March 31, 2007 and 2006 of 9,025,497 and 5,918,855, respectively. As of March 31, 2007, common stock equivalents included outstanding stock options, warrants and non-vested restricted stock totaling 365,500, 423,000 and 5,000 shares, respectively, all of which were issued during 2006. Common stock equivalents have been excluded from the calculation of the weighted-average number of shares outstanding in all periods presented due to their antidilutive effect. Restricted stock vesting over two years which was issued to three executives in August 2005, of which 41,665 shares were non-vested at March 31, 2007, were nominal issuances and all such shares are included in basic and diluted weighted-average shares outstanding for the three months ended March 31, 2007 and 2006.

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Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Forward-Looking Statements

This Quarterly Report on Form 10-Q contains statements that are considered to be forward-looking statements within the meaning of federal securities law. These statements contain forward-looking information relating to the financial condition, results of operations, plans, objectives, future performance and business of Digital Music Group, Inc. (DMGI). These statements (often using words such as believes , expects , likely , intends , estimates , plans , appear , should and similar words) involve risks and uncertainties that could cause actual results to differ materially from those projected by us. You should not place undue reliance on these forward-looking statements, which are based on our current views and assumptions. Actual results could differ materially from those anticipated in such forward-looking statements as a result of many reasons, including risks, uncertainties and factors which include, but are not limited to:

revenue and earnings expectations which are difficult to predict because of our limited operating history and emerging nature of the digital media industry;

our limited operating history in the acquisition, processing and sale of digital video content;

acceptance and adoption of the digital format by consumers and potential changes in consumers tastes and preferences in music and video, and the extent to which our content will appeal to consumers;

our ability to successfully identify, acquire for a commercially reasonable valuation, and process additional catalogs of music and video content;

competitive and economic conditions in our industry;

our ability to renew multi-year agreements for digital rights to music and video content as they expire;

our limited ability to influence the pricing models of digital entertainment services;

we may not have proper legal title to the digital rights associated with music and video content that we purchase or license, or others may claim to have such rights;

potentially long delays in receiving the master music and video recordings that we acquire rights to;

our dependence on digital entertainment services to review, process and make all of our digital offerings available on a comprehensive and timely basis for purchase by consumers;

music and video piracy;

availability, terms and use of capital to continue to grow our business;

our ability to successfully integrate acquisitions, including the acquisition of DRA;

our dependence on Apple iTunes Store for the majority of our revenue;

our ability to successfully enter into new sales channel relationships;

the differing interpretations of and potential ambiguities in U.S. copyright laws; and

maintaining adequate internal operating and financial controls over our business and financial reporting.

The following discussion of our financial condition and results of operations should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006 and our unaudited condensed consolidated financial statements and related notes included in this Quarterly Report on Form 10-Q.

Overview

Our Business

Digital Music Group, Inc. is a content owner and global leader in the digital distribution of independently owned music and video content, including music recordings and music, television, film and other video content. At March 31, 2007, we had approximately 341,000 individual music recordings and more than 4,000 hours of video content under management that we expect to make available for sale. We acquire or license the digital rights to music and video content from record labels, artists, television and film production companies, and other content owners. We digitally encode the content into multiple formats for distribution to digital entertainment services operating over the Internet and wireless, cable and mobile networks. Consumers can then listen, view and/or purchase the content for use on their personal computers, digital music and video players, and music and video-enabled mobile phones.

During the first quarter of 2007, we acquired digital rights to approximately 16,000 additional music recordings. Also during the quarter, we made a net reduction of 10,000 to the total number of music recordings under management due to 1) a reduction of 23,000 music recordings as a result of one content owner s inability to deliver approximately 13,000 out of the 75,000 music recordings under contract, plus certain other adjustments related to the contract; and 2) a net increase of approximately 13,000 music recordings under management due to deliveries by content owners in excess of contracted amounts and other adjustments. Under our contract terms, we are not required to pay for the music recordings that are not delivered to us and typically are not required to pay additional consideration or make additional royalty advances for deliveries in excess of contracted amounts. As a result of these transactions, our total music recordings under management increased from approximately 335,000 at December 31, 2006 to approximately 341,000 at March 31, 2007. As of that date, we had approximately 243,000 music recordings available through digital entertainment services. In addition, approximately 49,000 music recordings had been processed and transmitted to one or more services where they were awaiting review and processing by the service before being made available to consumers, approximately 14,000 music recordings were in various stages of our digitization processes, and approximately 35,000 music recordings had not yet been delivered to us by the content owners. We are also a party to short-term distribution agreements (generally for two to three years) for additional recordings that we do not consider to be under management until we receive delivery. Also as of that date, we were in the early stages of processing and delivering our video content to digital entertainment services.

Our digital entertainment service partners make our content available to consumers through two primary business models permanent copies of entire albums, individual recordings or ringtones on a pay-per-download basis, or broad access to a substantial quantity of content on a subscription basis. We receive revenue from the digital entertainment services based on the number of times our content is downloaded or streamed by consumers. For music recordings for which we are the owner of the digital rights or master recordings, we pay a royalty from our revenue to the artist and the publisher of the music recording. For each licensed or distributed music recording, we pay a negotiated portion of the revenue to the content owner and, if applicable under our contract with the content owner, we may also pay the royalty owed to the artist and/or the publisher of the music recording. For licensed video content, we pay a negotiated portion of the revenue to the content owner. Beginning in 2007, we are delivering portions of our video content to certain advertising-supported Internet sites which are currently in a test-marketing environment. Video content will be available on these sites without charge to consumers, and we will share in a percentage of the advertising revenue generated by these digital entertainment services based on the number of times our video content is viewed by consumers

Over the past three years, the recorded music industry has experienced increasing demand for the digital distribution of music in digital format, driven by the proliferation of personal music players and music-enabled mobile phones and the ability to offer large selections of music recordings available for consumption at any time. Like the music industry in 2003, we believe the television and film industries have recently begun a migration from sales and rental of content in physical formats such as digital video discs to digital distribution. However, only a relatively small percentage of known music and video content is currently available for purchase in digital format. We believe that many content owners have yet to make their content available in digital format because of the time, effort and cost involved. In addition, we believe many digital entertainment services are reluctant to enter into relationships with smaller content owners because of the administrative costs involved.

We actively seek out the owners of music and video content to acquire their digital rights through purchase, long-term license or short-term distribution agreements. Such acquisitions are pursued based upon the quality and commercial marketability of the content, our ability to negotiate appropriate consideration and terms, and our available financial resources. We have acquired digital rights to music and video content that represents a wide variety and mix of genres and time periods to appeal to many different interest groups. The music recordings that we own or control under long-term agreements are generally not current mainstream and popular hits, but consist primarily of back catalog, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may not be readily available from traditional music retailers. The music recordings that we distribute under short-term arrangements consist primarily of more contemporary recordings by independent record label artists. The video content we have acquired consists of classic episodic television shows no longer in wide syndication, vintage feature and short films, cartoons and other animated features, music videos, live music and stand-up comedy performances, action shorts, reality programming, sports events, and programs focused on children or special-interest groups.

Our strategy is to fulfill the basic needs of each of our market participants in the rapidly growing and evolving digital media industry. We provide consumers with access to music and video content, music of which is not readily accessible in traditional brick-and-mortar retailers or otherwise available in digital format. In addition, we provide a means for content owners to make their content available to consumers at digital entertainment services with minimal effort on their behalf. Further, we reduce the burden for digital entertainment services of managing individual relationships with many smaller content owners.

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Key Business Metrics

Since our inception through March 31, 2007, our revenue has been derived almost entirely from the sale or distribution of digital music content. Apple iTunes, the most popular digital music retailer accounted for approximately 70%, 77% and 87% of our revenue during the three months ended March 31, 2007 and for the years ended December 31, 2006 and 2005, respectively. Our digital music revenue is derived from the following sources:

Permanent downloads. Our permanent download revenue is driven by the number of music recordings we have available for downloading at digital music retailers, times the average number of times our music recordings are downloaded, multiplied by the download rate paid to us by each retailer. The download rates for our music recordings are driven primarily by popularity and demand for the recordings, the number and nature of the digital entertainment services through which we make the recordings available to consumers, and the territorial distribution rights we have. The amount we receive per download is negotiated in advance at the time we enter into an agreement with a digital music retailer. Under our agreements with Apple iTunes, we currently receive $0.70 per download for distribution in the United States and up to approximately $0.85 (at current translation rates) per download for distribution outside the United States. For permanent downloads sold through subscription-based services, we receive a percentage of each retailer s total revenue based on the number of times our music recordings are downloaded as a percentage of each retailer s total downloads. The overall average download rate paid to us by all digital music retailers was approximately $.58, $.64 and $.68 for the three months ended March 31, 2007 and for the years ended December 31, 2006 and 2005, respectively. Revenue from permanent downloads comprised approximately 82%, 87% and 97% of our total revenue for the same periods, respectively.

Subscription fees. Certain digital music retailers distribute our music recordings on a subscription basis. Our subscription revenue is a percentage of each retailer s total subscription revenue based on the number of times our music recordings are listened to by subscribers as compared to the total for all music recordings listened to during the relevant time period. Following the termination of their subscription, consumers are not able to play our music recordings. Subscription-based revenue comprised approximately 7%, 6% and 2% of our total revenue for the three months ended March 31, 2007 and for the years ended December 31, 2006 and 2005, respectively.

Mobile services. With the acquisition of DRA in September 2006, we gained relationships with numerous mobile distribution services. Over 15% of DRA s stand-alone revenue was derived from mobile services for the year ended December 31, 2006. On a consolidated basis, approximately 6% of our revenue for 2006 was derived from mobile services. During the three months ended March 31, 2007, approximately 10% of our revenue was derived from mobile services and we expect the sale of our music recordings through mobile services to become a more significant portion of our revenue in the future. Our revenue from mobile services is derived primarily from downloads of full-length music recordings and ringtones. During the three months ended March 31, 2007, we received an average of $.76 per full-length download and $.82 per ringtone from our mobile service partners. Most mobile ringtone services generally make available to consumers a limited selection of ringtones due to the limited space on mobile handset screens and higher per track processing costs related to the many formats that are required for various mobile handset makes and models.

Other. Our other revenue is comprised mainly from the licensing of physical distribution rights to our master recordings to third parties.

We believe, as the digital entertainment marketplace continues to mature and as we begin to realize meaningful revenue from our video content, the composition of our revenue will shift from being predominantly driven by permanent downloads of music content from digital music retailers to a more diversified revenue mix consisting of music and video downloads, subscription fees, mobile-sourced revenue and advertising revenue. Due to the disparate nature of these distribution models and the revenue and gross profit results they produce, we believe that appropriate key metrics to measure our results will continue to evolve.

Cost of revenue consists of:

- royalties to artists and publishers;
- revenue sharing payments based on long-term or short-term distribution agreements with content owners of music and video content;
- amortization of costs to acquire master recordings or digital rights to music and video content; and
- reserves or write-downs of capitalized digital rights, master recordings or royalty advances that may be deemed necessary from time-to-time.

Our cost of revenue and corresponding gross profit is determined by the revenue earned on our music and video content and the manner in which we own or distribute the content. When we purchase or license the digital rights to recorded music or music videos we have no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. Our experience is that these artist royalty obligations for music recordings have historically been between 0% and 15% of the revenue attributable to a specific track or album. The publisher royalties for music recordings are a statutory rate in the United States, which was $0.085 per music recording sold during 2005, which increased to $0.091 in January 2006. The royalties for music video recordings, or synchronization rights, are negotiated by contract with the artist or publisher and typically range between $0.10 and $0.15 per video download. When we acquire the master recordings or digital rights to music or music video content, we usually pay certain or all of these artist, publisher and synchronization royalties. We capitalize the acquisition costs, including the purchase price and direct ancillary costs, of our perpetual and long-term digital rights and our master recordings. We amortize these amounts over the shorter of seven years or the length of the contract for digital rights and ten years for master recordings, which we believe reasonably relates the amount of amortization to the revenue expected to be generated. When we have acquired our digital rights through long-term license agreements with music and video content owners, our cost of revenue typically includes a revenue sharing arrangement whereby the content owner receives 25% to 57% of the gross or net revenue, as defined, over the term of the agreement. As an inducement to enter into the long-term license agreement, we will make a royalty advance against the content owner s share of future royalties under this revenue sharing arrangement. All such advance royalties are capitalized as a prepaid asset that is amortized as cost of revenue as the related revenue is earned and the cash advances are recouped. In short-term distribution agreements, which typically have terms of two to three years, we are not responsible for any artists, publisher or synchronization royalties and we generally make no upfront or fixed payments to the content owner at the time we enter into the agreement. The revenue sharing percentage retained by the content owner (generally 80% to 85% for music recordings and 70% for video recordings) is substantially higher than under long-term license agreements. Accordingly, higher gross profit margins are achieved from revenue generated from owned content and content controlled under perpetual and long-term license agreements and lower gross profit margins are achieved through short-term distribution agreements.

Operating, general and administrative expenses include all costs associated with processing music and video content and operating the business. These expenses increased substantially during 2006, primarily because of salary costs associated with additional personnel dedicated to business development, accounting and operations, cost incurred as a result of becoming a public-reporting company in February 2006, and from the addition of our DRA subsidiary on September 8, 2006. On a sequential quarter-over-quarter basis, our operating general and administrative expenses have leveled off and totaled $1,743,905 and $1,725,081 for the three months ended December 31, 2006 and March 31, 2007, respectively.

Seasonality

The early-stage nature of the entire digital distribution industry and our limited operating history have not allowed us to identify seasonality in our business, although we suspect that the first and fourth quarters of the calendar year may have seasonally higher sales, just as this is the peak time for sales of music and video content in physical format. Based on our brief history, our music content that is represented by older, back-catalog and out-of-print recordings has not experienced the same degree of seasonality as our more contemporary content from current artists.

Significant Customer

Revenue from Apple iTunes accounted for approximately 70% and 89% of our revenue for the three months ended March 31, 2007 and 2006, respectively.

Critical Accounting Policies

There have been no significant changes in or additions to our critical accounting policies during the three months ended March 31, 2007, as compared to the previous disclosures in Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 30, 2007.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles (GAAP). As a result of SFAS No. 157 there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure eligible assets and liabilities at fair value with changes in value recognized in earnings. Fair value treatment for eligible assets and liabilities may be elected either prospectively upon initial recognition, or if an event triggers a new basis of accounting for an existing asset or liability. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our consolidated financial statements.

Results of Operations

The following table sets forth items in our Condensed Consolidated Statements of Operations as a percentage of revenue, as well as certain additional revenue and operating data regarding our sources of revenue; music recordings available for sale and paid downloads data for the periods indicated. The data for the three months ended March 31, 2006 includes the results of operations for Digital Musicworks International, Inc., the acquiror for accounting purposes, for the period from January 1, 2006 through February 6, 2006, and the combined operations of Digital Musicworks International, Inc., certain assets of Rio Bravo Entertainment LLC, and Digital Music Group, Inc. for the period from February 7, 2006 through March 31, 2006.

	For the Three Months Ended March 31,			
	2007		2006	
	Amount	Percentage of Total	Amount	Percentage of Total
Revenue	$ 3,392,547	100.0%	$ 720,648	100.0%
Cost of revenue:				
Royalties and payments to content owners	2,450,838	72.2%	348,526	48.4%
Amortization of digital rights and master recordings	178,517	5.3%	52,035	7.2%
Gross profit	763,192	22.5%	320,087	44.4%
Operating, general and administrative expenses	(1,725,081)	(50.80)%	(950,664)	(131.9)%
Interest, taxes and other expense, net	225,541	6.6%	216,634	30.1%
Net loss	$ (736,348)	(21.7)%	$ (413,943)	(57.4)%
Key Revenue and Operating Data:				
Digital music revenue by source:				
Downloads	$ 2,794,174	82.4%	$ 693,923	96.3%
Mobile services	346,925	10.2%		%
Subscriptions	236,218	7.0%	26,426	3.7%
Other	14,271	0.4%	299	%
Total digital music revenue	3,391,588	100.0%	720,648	100.0%
Digital video and other revenue	959	%		
Total revenue	$ 3,392,547	100.0%	$ 720,648	100.0%
Digital music revenue from:				
Owned and controlled music recordings	$ 1,003,980	29.6%	$ 587,414	81.5%
Music recordings under short-term distribution agreements	2,387,608	70.4%	133,234	18.5%
Total digital music revenue	3,391,588	100.0%	720,648	100.0%
Digital video and other revenue	959	%		
Total revenue	$ 3,392,547	100.0%	$ 720,648	100.0%
Average number of music recordings available for sale during the period	232,300		44,000	
Number of music recordings available for sale at the end of the period	243,100		65,000	
Number of paid downloads (1)	4,782,200		1,010,000	

(1) Does not include the number of times our music recordings were streamed or played on subscription-based digital music retailers or downloaded through mobile services.

Comparison of Three Months Ended March 31, 2007 to 2006

Revenue. Revenue increased to $3,392,547 for the three months ended March 31, 2007, from $720,648 for the three months ended March 31, 2006. Total paid downloads increased to 4,782,200 from 1,010,000 for the same periods, respectively. The increase in the number of paid downloads was driven by the increase in music recordings made available for sale, partially offset by a decline in the average monthly download rate to 6.9 times during the first three months of 2007 from 7.7 times during the first three months of 2006. The average number of music recordings available for sale was approximately 232,300 during the first three months of 2007 and 44,000 during the first three months of 2006. The increase in the average number of music recordings available reflects the increase in music recordings under contract which have been delivered to and processed by us and made available for sale by our digital entertainment service partners; the acquisition of DRA which added approximately 53,000 music recordings on September 8, 2006; and the acquisition on February 7, 2006 of certain assets o