Digital Music Group, Inc.
Form S-1/A
January 04, 2006
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As filed with the Securities and Exchange Commission on January 3, 2006

Registration No. 333-128687

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 3

TO

FORM S-1

REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

Digital Music Group, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**7900**	**20-3365526**
(State or other jurisdiction of incorporation or organization)	**(Primary Standard Industrial Classification Code Number)**	**(I.R.S. Employer Identification Number)**

1545 River Park Drive, Suite 210

Sacramento, CA 95815

(916) 239-6010

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Mitchell Koulouris

Chief Executive Officer

1545 River Park Drive, Suite 210

Sacramento, CA 95815

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(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

Calculation of Registration Fee

Title of Each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price(1)(2)	Amount of Registration Fee(3)
Common Stock $0.01 par value	$ 42,550,000	$ 4,939

(1) Estimated solely for the purpose of calculating the amount of the registration fee pursuant to Rule 457(o) under the Securities Act of 1933.
(2) Calculated pursuant to Rule 457(o) based on the proposed maximum aggregate offering price and includes the offering price of shares that the underwriters have the option to purchase, assuming full exercise of the underwriters over-allotment option.
(3) 4,238 previously paid.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall hereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to Completion

Preliminary Prospectus dated January 3, 2006

PROSPECTUS

3,700,000 Shares

Common Stock

This is our initial public offering of common stock. We are selling all of the shares.

We expect the public offering price to be between $8.00 and $10.00 per share. Currently, no public market exists for the shares. After pricing the offering, we expect that the shares will be quoted on the Nasdaq National Market under the symbol DMGI.

This offering involves a high degree of risk. You should purchase shares only if you can afford a complete loss of your investment. See Risk Factors beginning on page 4.

	Per Share	Total
Public offering price	$	$
Underwriting discount[(1)]	$	$
Proceeds to Digital Music Group, Inc.	$	$

(1) Includes a non-accountable expense allowance in the amount of % of the gross proceeds, or $ per share ($ in total) payable to the representatives of the underwriters.

The underwriters may also purchase up to an additional 555,000 shares from us at the public offering price, less the underwriting discount, within 45 days from the date of this prospectus to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The shares will be ready for delivery on or about , 2006.

I-Bankers Securities, Inc. **FTN Midwest Securities Corp.**

The date of this prospectus is , 2006.

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You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus or other date stated in this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date.

Digital Music Group, Inc., DMG, Digital Musicworks International, Inc. and Digital OnRamp are our trademarks. Each trademark, trade name or service mark of any other company appearing in this prospectus belongs to its holder.

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SUMMARY

This summary highlights information contained elsewhere in this prospectus. You should read the entire prospectus carefully, including Risk Factors and our unaudited pro forma combined financial statements and related notes and the financial statements and related notes of Digital Music Group, Inc., Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC Carve Out Segment appearing elsewhere in this prospectus before you decide to invest in our common stock. References in this prospectus to we, us and our refer to Digital Music Group, Inc. on a combined basis including completion of the acquisition of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC, unless the context requires otherwise.

Background and Organization

Digital Music Group, Inc. was incorporated in April 2005 to become a leading owner of digital rights to music and other sound recordings and distributor of these recordings to online music stores. Concurrently with the completion of this offering, we have agreed to acquire Digital Musicworks International, Inc., a California corporation, and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company, doing business as Psychobaby. The assets of Rio Bravo Entertainment LLC to be acquired consist solely of agreements for digital distribution rights to music recordings and agreements with online music stores. Prior to the transactions described herein, Digital Musicworks International, Inc. was a privately held company not affiliated with us, and Rio Bravo Entertainment LLC was a privately owned entity, owned by Richard Rees, one of our founders, and another individual. The merger agreement provides that Digital Musicworks International, Inc. will be merged into Digital Music Group, Inc. in the acquisition and cease to exist as a separate entity. See Certain Relationships and Related Transactions Our Acquisition of Digital Musicworks International, Inc. and Certain Assets of Rio Bravo Entertainment LLC for further information on Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC and these acquisitions.

Our Company

We provide digital music recordings to online music stores for purchase by consumers. We have rights to sell over 200,000 music recordings in digital format, approximately one-half of which were acquired in September 2005. We purchase and license music recordings in digital format from record labels, artists and other content owners. We then process these recordings through our digital music processing system for delivery to online music stores, where they are available for purchase via downloading. We receive a negotiated fee from the online music stores based on the number of times these music recordings are downloaded or listened to by consumers.

As of September 30, 2005, the date of the most recent financial statements presented in this prospectus, we had approximately 17,000 music recordings available for sale through leading online music stores, such as Apple iTunes Music Store, RealNetworks, Napster, Wal-Mart Music, MSN Music and Yahoo! Music. This number of recordings available for sale has more than doubled to approximately 36,000 as of December 31, 2005, and we are working to obtain delivery, process the remaining music recordings and make them available for sale as quickly as practicable.

We believe the recorded music industry is undergoing significant change, with the primary means of music distribution transitioning from physical formats such as compact disc to digital formats accessed over the Internet and wireless and cable networks. We believe this is occurring as a result of the popularity and proliferation of personal computers and portable digital music players like the Apple iPod, as well as consumer acceptance and the music industry s endorsement of legitimate digital music sales. Worldwide shipments of portable digital music players are projected to grow 370% over the next five years, from 26.4 million units shipped in 2004, to 124 million units in 2009, according to a recent market research report.

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Industry sources estimate that the worldwide recorded music market was approximately $32 billion in 2004, and that the downloaded digital music segment represented approximately 1% of that total market in 2004. Industry sources reported that downloaded digital music increased to 6% of the total music market during the first half of 2005. Industry sources project that the downloaded digital music segment will represent approximately 25% of all recorded music sales in 2010.

As of September 1, 2005, more than two million music recordings were available at iTunes, the leading online music store. By comparison, Gracenote, the leading industry music database, lists approximately 54 million music recordings in its database. We believe that many owners of music recordings have yet to make their recordings available for purchase in digital format because of the time, effort and cost involved. In addition, many online music stores are reluctant to enter into relationships with holders of small numbers of music recordings.

Through online music stores, we provide consumers with access to music recordings, many of which are not readily accessible in traditional music retailers or otherwise available in digital format. In addition, we provide a means for music and other sound recording content owners to make their content available to consumers in online music stores with minimal effort on their behalf. Further, we reduce the burden for online music stores of managing individual relationships with numerous smaller content owners.

Our strategy is to rapidly acquire by purchase or license the digital rights to as many music and other sound recordings as possible. Our focus is on acquiring rights to back catalogue, out-of-print recordings, past hits and independent label recordings, including those that are not currently available for sale in traditional music retailers. Other recordings we may acquire include music and audio from live performances not previously commercially available, radio and television productions, and other sources that we identify.

Our rights generally allow us to electronically distribute, market, promote and sell our music recordings, including by digital download and by digital transmission such as streaming media and downloads to mobile phones. The Internet and mobile technology now make it economically feasible for online music stores to make virtually an unlimited number of music recordings available to consumers for purchase at any time. Sophisticated online search tools permit consumers of music and other sound recordings to identify and purchase many previously inaccessible recordings, and we believe that market demand for such recordings exists.

Our principal executive offices are located at 1545 River Park Drive, Suite 210, Sacramento, California 95815, and our telephone number at that address is (916) 239-6010. Our web site is located at *www.digitalmusicgroupinc.com* and will be fully operable upon the completion of this offering. The information contained on our web site and that of Digital Musicworks International, Inc. and Psychobaby does not constitute a part of this prospectus.

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The Offering

Common stock offered by us in this offering	3,700,000 shares
Common stock to be outstanding after this offering	8,400,000 shares
Use of proceeds	We estimate that our net proceeds from this offering will be approximately $28.8 million at an assumed initial public offering price of $9.00 per share. We intend to use the net proceeds as follows:

- approximately $1.2 million for contractual commitments currently in place and payable through September 30, 2006 in connection with acquisitions of digital rights to music recordings;
- approximately $0.8 million for acquisition of property and equipment, including processing and encoding equipment and upgrades to our royalty payment system; and
- approximately $26.8 million for general corporate purposes, including working capital, future acquisitions of digital rights to music recordings and funding operating expenses.

Risk factors	See Risk Factors and other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.
Reserved Nasdaq National Market symbol	DMGI

Unless we indicate otherwise, all information in this prospectus: (1) assumes no exercise of the over-allotment option granted to the underwriters; (2) assumes the completion of the acquisition by us of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC; (3) is based on 8,400,000 shares to be outstanding upon completion of this offering; (4) gives effect to a dividend of 1,249 shares of our common stock for each share of our common stock held as of September 8, 2005; and (5) excludes 1,200,000 shares of common stock available for future option grants under our Amended and Restated 2005 Stock Plan.

Acquisition Consideration

The total consideration to be paid by us in the acquisition of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC consists of 2,250,000 and 25,000 shares of our common stock, respectively, each of which was determined by negotiations between us and representatives of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC. For a more detailed description of these transactions, see Certain Relationships and Related Transactions Our Acquisition of Digital Musicworks International, Inc. and Certain Assets of Rio Bravo Entertainment LLC.

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RISK FACTORS

You should carefully consider the risks described below before buying shares in this offering. If any of the following risks actually occur, our business, financial condition and results of operations could be harmed. In that case, the trading price of our common stock could decline, and you could lose all or part of your investment.

Risks Related to Our Business

We have a limited operating history and have experienced net losses to date and we may not be able to become profitable or generate positive cash flow in the future.

You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development in a rapidly evolving industry. Digital Music Group, Inc. was formed in April 2005 and has had no operations to date other than with respect to the acquisitions and this offering. We have entered into agreements to acquire Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC concurrently with, and as a condition to, the sale of shares of our common stock in this offering. Digital Musicworks International, Inc. has had limited operations. As a pro forma combined entity, we have experienced net losses of approximately $2.0 million from inception through September 30, 2005, and we have not yet been able to generate positive cash flow from operations. We cannot be certain that we will be able to generate net income and positive cash flow from operations in the future.

As a result of our limited operating history, we may fail to meet our forecasts or the expectations of securities analysts or investors, which could cause our stock price to decline.

Our limited operating history and the rapidly evolving nature of our industry make forecasting quarterly operating results difficult. We may not be able to quickly reduce spending if our revenue is lower than we project. Any significant increase in our expenses or shortfall in our revenue would be detrimental to our business, operating results and financial condition and could cause our results of operation to fall below the expectations of public market analysts and investors. As a result, you should not rely on our historical results as an indicator of our future performance.

If we are unable to successfully integrate the operations of Digital Musicworks International, Inc. and the acquired assets of Rio Bravo Entertainment LLC, our revenue and results of operations could be adversely effected.

Our costs of operations will increase if we are unable to successfully combine the acquired operations of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC or integrate the systems and procedures, including accounting, financial reporting and information technology of the combined entity. Our pro forma combined financial results cover periods during which we were not under common control or management and, therefore, may not be indicative of our future financial or operating results. Our failure to integrate Digital Musicworks International, Inc. and the acquired assets of Rio Bravo Entertainment LLC and obtain all the benefit of the content license agreements and employee and business relationships of Digital Musicworks International and Rio Bravo Entertainment LLC could impair our future revenue and results of operations.

Our business depends on our ability to identify and locate the holders of digital rights to additional music recordings, and failure to do so will limit our revenue growth.

Our goal is to continue to acquire digital rights to music recordings in order to substantially increase our revenue. Ownership of music recordings is highly fragmented and not organized in a common marketplace. There is no registry or directory of the holders of digital rights to music recordings that we may wish to acquire. Finding the owners of music recordings and associated digital rights can be difficult and time-consuming. We currently rely on our network of relationships and market research to locate content owners. In the future, our ability to continue to identify and locate such content owners will have a significant impact on the amount of content we are able to acquire.

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Our inability to enter into agreements to acquire additional digital rights to music recordings on commercially favorable terms could impede our growth and increase our expenses.

Our business is dependent on our ability to acquire digital rights to additional music recordings. Even if we are able to locate additional content owners, they may not be willing to sell or license the digital rights to their music recordings or we may not be able to negotiate terms that are commercially favorable to us. While we believe that our experience and knowledge in the music industry and our operating history allows us to determine commercially reasonable prices, we may be unable to objectively determine fair market value for the digital rights to music recordings that we acquire because of unknown consumer demand for such recordings, unknown number of additional owners of digital rights to such recordings in certain cases and absence of independent valuations for these music recordings. If these content owners are unwilling to sell or license their rights on terms that we have determined are commercially favorable to us, we will not be able to substantially increase our revenue.

We face competition from companies seeking to acquire the digital rights to music recordings, which could negatively impact our ability to acquire additional digital rights to music recordings.

The market for acquiring digital rights from content owners is competitive, although the majority of our known current competitors are focused on short-term distribution arrangements, whereas our focus is on acquiring digital rights under long-term license or purchase agreements. The number of commercialized music recordings available for acquisition is large, but limited. We expect to face competition in our pursuit to acquire additional music recordings, which may limit the number of available music recordings for sale or license and may lead to higher acquisition prices. Our competitors may from time to time offer better terms of acquisition to content owners. Several of our competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, marketing and other resources than we do. Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to acquiring digital rights to music recordings. In addition, our competitors may form strategic alliances with record labels and online music stores that could result in increased competition for the acquisition of music recordings, service offerings or favorable terms with the online music stores. Increased competition for the acquisition of digital rights to music recordings may result in a reduction in our operating margins, market share and brand.

We may acquire record labels or other companies that own rights to music recordings, and if we are unable to successfully acquire or integrate these companies, we may not be able to acquire additional recordings or grow our revenue.

We may attempt to acquire record labels or other companies that own rights to music recordings for purposes of acquiring their digital rights. If we are not able to successfully acquire such companies, we may not be able to acquire additional recordings or grow our revenue. In the event we are able to acquire other companies, we may be subject to a number of risks related to the integration and management of such companies, including failure to obtain valid consents to assignment of contracts, including contracts granting rights to music recordings, failure of the business of the acquired company to achieve expected results, diversion of management s attention, and failure to retain key personnel of the acquired company. In addition, if we undertake an acquisition of a company that owns digital and other rights to music recordings, we may attempt to sell the non-digital rights to another person or entity, and we may not be able to do so on terms favorable to us.

If the music recordings that we provide to the online music stores do not appeal to consumers tastes and preferences, our revenue will decrease.

Our success depends on our ability to acquire and offer for purchase music recordings that appeal to consumers tastes and preferences. Consumers tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our music recordings. We do not own rights to current popular hits and may never acquire rights to these music recordings. Our historical sales are based on a limited library of music recordings available for purchase at the online music stores. In the

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future, our current music recordings and the additional music recordings we make available for purchase may not experience similar demand. Any reduction in the number of downloads of our music recordings by consumers will cause a reduction in our revenue.

The digital music industry is in its infancy and we are vulnerable to discounting, price-reductions and pricing structure changes in the industry. Any reduction in the price paid to us by the online music stores per download of our music recordings could cause a reduction in our revenue.

We receive revenue based on the wholesale prices determined by the online music stores based, to a large extent, on the price charged to consumers by the online music stores. Currently, the largest online music store, iTunes, charges consumers $0.99 per music recording download. We believe two of the four major record labels in the music industry are attempting to change the online pricing model so that the price for current popular hits will be over $1.00, while older or less current music recordings will be sold for less. Because we are focused on acquiring or licensing the digital rights to independent label, back catalogue and out-of-print music recordings, we have not acquired rights to any current popular hits and are subject to any such pricing changes. We have limited ability to influence the pricing models of the online music stores. If the online music stores adopt a lower pricing model for our music recordings or if there is a pricing structure change to a flat-fee subscription or other similar pricing models, we may receive substantially less per download for our music recordings, which could cause a material reduction in our revenue, unless it is offset by a corresponding increase in the number of downloads.

We are substantially dependent on a limited number of online music stores, in particular Apple iTunes Music Store, for the sale of our music recordings.

We derive our revenue from a small number of leading online music stores that sell to consumers the digital music recordings that we acquire or control through licenses. For the nine months ended September 30, 2005, we received 88% of our revenue from iTunes, compared to 93% of our revenue from iTunes for the year ended December 31, 2004. Our agreements with Apple iTunes have terms of three years ending in April 2007. Under the terms of the agreements, Apple is required to pay us an agreed upon wholesale price for each recording sold by Apple. If we are not able to renew our relationship with iTunes and other online music stores that offer our music recordings for sale on similar economic terms, our ability to generate revenue will be significantly reduced.

Our accounts receivable are concentrated with a limited number of online music stores, particularly Apple iTunes, which subjects us to substantial payment risk.

We rely on reports from the online music stores detailing download activity to determine our revenue, and such reports are typically provided to us within 30 days following the end of the month. We receive payment at approximately the same time as we receive these reports of download activity. Our accounts receivable therefore consists of approximately one month s revenue. We currently have music recordings for sale at 10 online music stores, and as of September 30, 2005, accounts receivable from Apple iTunes Music Store represented 81% of our total accounts receivable, compared to 76% of our total accounts receivable as of December 31, 2004. This concentration of accounts receivable among a small number of online music stores is likely to continue and we expect our accounts receivable to become larger as we grow. If any of these online music stores are unable to pay us as due each month, it could disrupt our business and cause us to report a bad debt loss.

Other parties may have digital rights, or claim to have such rights, to our music recordings, which may result in duplicates of the music recordings we sell to be available for purchase at the online music stores and cause a reduction in our revenue.

We generally acquire all of the digital rights that the content owner of music recordings has available to grant; however, the holders of such rights may not possess exclusive rights to those music recordings. We are unable to determine the number of additional holders of rights to our music recordings. Aside from copyright law, the rights to music recordings are contractual in nature. There is no central registry that evidences the chain of title to the rights of music recordings other than copyright registration, which is voluntary. Given the age of

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many of the music recordings we have or may acquire, there is often a lack of documentation to evidence the chain of title of rights we acquire. In addition, there is a common practice in the music industry of licensing rights in various formats or in certain compilations and to grant the same rights to different parties for the same or different geographic regions. Our content acquisition agreements contain representations, warranties and indemnities only with respect to the digital rights granted to us and not with respect to the rights held by other parties. Because more than one party may have the right to sell the same music recording, we have acquired, and we expect in the future to acquire, rights to multiple copies of the same music recording. In such instances, we become entitled to payment for download activity for both copies, to the extent they are both purchased by consumers at the online music stores. Additionally, we are aware of numerous instances where other parties have digital rights to the same music recordings to which we have digital rights. If copies of our music recordings are available at the online music stores from alternative sources, our revenue will be reduced to the extent these copies are purchased instead of ours.

We may not receive legal title to the digital rights of music recordings that we have paid to acquire, and any determination that we don t hold such rights may subject us to damages for revenue received.

Our agreements contain representations, warranties and indemnities with respect to the digital rights granted to us. In at least one instance, we purchased digital rights that were determined not to be held by the holder from whom we acquired those rights, and we are awaiting a refund of the purchase price we paid for those rights. If we were to acquire and make available for purchase music recordings from a person who did not actually own such rights, our business would be adversely affected. We would lose the rights to sell such music and might be subject to copyright infringement lawsuits for selling such music recordings without the right to do so. Finally, it could materially impact our reputation with content owners and our relationships with online music stores, which could adversely affect our business.

If there are long delays in the time it takes to receive the music recordings that we acquire rights to, our revenue growth will be negatively impacted and our cash flow will be affected adversely.

Implementation of our business plan and growth strategy depends on increasing the number of music recordings we have available for purchase by consumers at the online music stores. Our purchase and long-term license agreements typically require the content owners of the music recordings to deliver to us their music recordings. Under our short-term license agreements, there are no delivery terms. Certain of the music recordings we acquire may be in older physical formats such as audio tape or vinyl records that require processing onto compact disc prior to being delivered to us. In addition, our agreements require that certain descriptive information required by the online music stores for each music recording be delivered with the music recordings, such as recording title, album title, artist name, genre, copyright information, label name, unique product identifier, artwork, biographical information, sales information and date of release. Historically, it has at times taken several months or longer after we have entered into an agreement before we have received delivery of all of the music recordings acquired. Although we generally specify delivery dates and make certain cash payments by us conditional upon delivery, we do not have control over the timing for receipt of the music recordings acquired. If there are long delays in the time it takes for the content owners to deliver to us the music recordings in physical format and the related descriptive information, it will delay our ability to begin the process of converting the music recordings into the digital formats required by the online music stores. It could also cause inefficiencies in the utilization of our operations personnel who process these recordings. Any delay in making our music recordings available for purchase at the online music stores will delay our revenue growth, and inefficiencies caused by such delays could cause a reduction in our cash flow in the interim.

We have entered into multi-year agreements for digital rights to music recordings and if we are unable to renew these agreements on commercially favorable terms once they expire, our revenue could materially decrease.

Our long-term success depends upon, among other things, our ability to renew our non-perpetual rights to music recordings once they expire. If any of our competitors offer better terms, it will cause us to spend more

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money or grant better terms, or both, to renew the rights we currently hold. If we are unable to renew the non-perpetual rights to our music recordings on commercially favorable terms, our revenue could materially decrease.

If we are not able to scale our reporting and payment processes, we may experience delays providing reports to the content owners and paying required royalties that could have a negative effect on our brand identity.

We receive regular sales reports from online music stores that contain sales information for each of our music recordings. Based on these reports, we provide summary reports to the content owners. When we acquire the perpetual digital rights to music recordings and in certain of our license agreements, we may assume the obligations of the content owner to pay any required royalty payments to the artists according to the terms of the existing agreements. In addition, we may be required to pay statutory publishing royalties on behalf of the content owner according to the terms of our agreements. We have not fully implemented the systems required to process these royalties. We have accrued for future payment of royalties based on our calculations of such amounts due, but have not paid any of these amounts. As we acquire digital rights to additional music recordings, we may experience difficulties in preparing and distributing sales reports for the content owners or processing and paying artist and publishing royalties in a timely fashion. If we are not able to successfully expand our processing capability or introduce technology to allow us to determine and pay royalty amounts due and automate these tasks, we may experience delays as we increase the number of our music recordings, which could have a negative effect on our relationships with content owners and brand identity.

The loss of one or more of our key personnel, or our failure to attract, assimilate and retain other highly qualified personnel in the future, could cause a disruption in our relationships with the online music stores and content owners.

We depend on the continued services and performance of our key personnel, including Mitchell Koulouris, our Chief Executive Officer and President. Although we have employment agreements with our executive officers, they may decide to terminate their employment or otherwise cease to be employed by us. For example, Cliff Haigler, who is one of our founding stockholders, agreed to serve in the position of Chief Financial Officer in an interim capacity while we were focused on the acquisitions and preparation for this offering, and it is likely that we will hire a permanent Chief Financial Officer following completion of this offering. We do not have key person life insurance for any of our personnel. As we grow, our business will be dependent on our ability to recruit, employ and retain additional management and other skilled personnel. The loss of the services of any of our key personnel or the failure to attract other key personnel could disrupt and limit our ability to grow our business.

Piracy is likely to continue to negatively impact our potential revenue.

Our revenue comes from the sale of our digital music recordings over the Internet and wireless and cable networks, which is subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. Global piracy is a significant threat to the music industry generally and to us. Unauthorized copies and piracy have contributed to the decrease in the volume of legitimate sales of recorded music and have put pressure on the price of legitimate sales.

We face a potential loss of music recordings if it is determined that recording artists have a right to recapture rights in their recordings under the U.S. Copyright Act.

The U.S. Copyright Act provides authors and their heirs a right to terminate licenses or assignments of rights in their copyrighted works that were not works made for hire . If any of our music recordings were determined not to be works made for hire , then the recording artists or their heirs could have the right to terminate the rights we hold. These residual author rights generally survive for five years after the end of the 35-year period from the date of a post-1977 license or assignment, and in the case of a pre-1978 grant in a pre-1978

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recording, five years after the end of the 56-year period from the date of creation or January 1, 1978, whichever is later. Any termination of our rights to our music recordings could have a material reduction in our revenue.

We may need to raise additional capital to accomplish our objectives of acquiring the digital rights to music recordings, and if we are unable to raise such money as needed our growth would be limited.

We intend to use our common stock and cash for the consideration for future acquisitions of digital rights to additional music recordings. If our common stock does not maintain a sufficient market value or content owners are unwilling to accept common stock as part of the consideration for the sale of the digital rights to their music recordings or of their businesses or as consideration for licensed rights to their music recordings, we may be required to utilize more of our cash resources, if available. If we do not have sufficient cash resources, our ability to acquire additional rights to music recordings could be limited unless we are able to obtain additional capital through future debt or equity financings. Using cash to finance acquisitions could substantially limit our financial flexibility, using debt could result in financial covenants that limit our operations and financial flexibility, and using equity may result in dilution of the ownership interests of our then existing stockholders. We may not be able to obtain financing if and when it is needed or that, if available, it will be available on terms that we deem acceptable. As a result, once the net cash proceeds of this offering are fully utilized, we may be unable to continue to pursue our acquisition strategy, which would limit the number of music recordings we could acquire in the future and would significantly limit our growth.

If the Internet and portable digital music players cease to be the medium accepted by the mass market for digital music, our business could be affected adversely.

Our success depends to a substantial extent on the willingness of consumers to increase their use of online services as a method of purchasing music. Of all music recordings sold worldwide in 2004, approximately 1% was purchased by digital download, according to the International Federation of the Phonographic Industry. The use of the Internet to select and download purchased music is growing rapidly but is still evolving, and it is uncertain whether this market will achieve and sustain high levels of demand and market acceptance. If the use of the Internet to select and purchase music recordings does not gain in popularity and market acceptance, our business could be affected adversely. Much of our revenue is tied to the popularity of portable digital music players like the iPod by Apple Computer and other digital music listening devices. If the market penetration by these devices does not continue, the number of consumers purchasing digital music may decrease or not grow, which could result in a reduction in our revenue.

Risks Related to this Offering

Our officers and directors and their affiliates will exercise significant voting control over us as stockholders.

After the completion of this offering, our officers and directors and their immediate family members will beneficially own, in the aggregate, approximately 29.1% of our outstanding common stock. Mitchell Koulouris, our President, Chief Executive Officer and one of our director nominees, will beneficially own approximately 6.5% of our outstanding common stock, Anders Brown, our Chief Operating Officer, will beneficially own approximately 2.9% of our outstanding common stock, Cliff Haigler, our Chief Financial Officer, will beneficially own approximately 3.9% of our outstanding common stock, Peter Koulouris, our Vice President of Business Development, will beneficially own approximately 5.1% of our outstanding common stock, Richard Rees, our Vice President of Business Development and Secretary, will beneficially own approximately 5.0% of our outstanding common stock, and Clayton Trier, our Chairman of the Board and one of our directors, will beneficially own approximately 1.2% of our outstanding common stock. These significant stockholders may have interests that are different from yours. As a result of their shareholdings, these individuals will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions.

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New investors in our common stock will experience immediate and substantial dilution of approximately $5.23 per share.

The initial public offering price is substantially higher than the net tangible book value per share of our common stock. Investors purchasing common stock in this offering will, therefore, incur immediate dilution of $5.23 in net tangible book value per share of common stock. This dilution figure deducts the estimated underwriting discounts and commissions and estimated acquisition and offering expenses payable from the initial public offering price. See Dilution.

Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

Following this offering, our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

- authorize our board of directors, without stockholder approval, to issue up to 1,000,000 shares of undesignated preferred stock; and
- establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings.

As a Delaware corporation, we are also subject to the Delaware anti-takeover provisions contained in Section 203 of the Delaware General Corporation Law. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on this provision to prevent or delay an acquisition of us. For a description of our capital stock, see Description of Capital Stock.

Our stock price could be volatile and could decline following this offering.

Prior to this offering, there has been no public market for shares of our common stock. An active market may not develop following completion of this offering, or if developed, may not be maintained.

The market prices of the securities of development stage companies, and in particular those companies with no significant history of profits, have been extremely volatile. The price at which our common stock will trade after this offering could fluctuate substantially due to the following factors, some of which are beyond our control:

- variations in our operating results;
- variations between our actual operating results and the expectations of securities analysts, investors and the financial community;

announcements of developments affecting our business, systems or expansion plans by us or others; and

conditions and trends in online commerce industries, particularly in the online digital music market.

As a result of these and other factors, investors in our common stock may not be able to resell their shares at or above the initial offering price.

In the past, securities class action litigation often has been instituted against companies following periods of volatility in the market price of their securities. This type of litigation, if directed at us, could result in substantial costs and a diversion of management s attention and resources.

Future sales of our common stock, including those purchased in this offering, may depress our stock price.

Sales of substantial amounts of our common stock in the public market following this offering by our existing stockholders may adversely affect the market price of our common stock. Shares issued upon the exercise of outstanding options also may be sold in the public market. Such sales could create the perception to the public of difficulties or problems with our business. As a result, these sales might make it more difficult for us to sell securities in the future at a time and price that we deem necessary or appropriate.

Upon completion of this offering, we will have outstanding 8,400,000 shares of common stock, assuming no exercise of the underwriters over-allotment option. Of these shares, only shares sold in this offering to persons not subject to a lock-up agreement with our underwriters are freely tradable without restriction immediately following this offering. Beginning 180 days after the date of this prospectus, 298,000 shares of our common stock held by non-affiliates that are subject to lockup agreements expiring 180 days from the date of this prospectus, will become salable under Rule 144, subject to the satisfaction of the holding period and other requirements thereunder. An additional 505,400 shares held by our current affiliates are subject to lock-up agreements expiring 365 days from the date of this prospectus and will become salable under Rule 144 at such time. An additional 1,765,291 shares, a portion of which are held by our affiliates, will become salable approximately 370 days after the date of this prospectus, one year after the closing of the acquisitions of Digital Musicworks International and Rio Bravo Entertainment concurrent with the closing of this offering. Further, an additional 2,131,309 shares, of which 242,250 shares are held by non-affiliates, are subject to lockup agreements expiring 540 days from the date of this prospectus and will become salable at such time subject to the satisfaction by the holders thereof of the holding period and other requirements under Rule 144. I-Bankers Securities, Inc. may also, in its sole discretion, permit our officers, directors and current stockholders to sell shares prior to the expiration of the lock-up agreements. See Shares Eligible for Future Sale for more information regarding shares of our common stock that may be sold by existing stockholders after the completion of this offering.

We do not intend to pay dividends. You will not receive funds without selling shares, and you may lose the entire amount of your investment.

We have never declared or paid any cash dividends on our capital stock and do not intend to pay dividends in the foreseeable future. We intend to invest our future earnings, if any, to fund our growth. We cannot assure you that you will receive a return on your investment when you sell your shares or that you will not lose the entire amount of your investment.

Our internal controls over financial reporting may not be adequate and our independent auditors may not be able to certify as to their adequacy, which could have a significant and adverse effect on our business and reputation.

We are in the process of documenting and evaluating our internal controls over financial reporting in order to allow management to report on, and our independent auditors to attest to, such controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and rules and regulations of the Securities Exchange Commission thereunder, which we refer to as Section 404. Section 404 requires a reporting company to, among other things, annually review and disclose its internal controls over financial reporting, and evaluate and disclose changes in its internal controls over financial reporting quarterly. We will be required to comply with Section 404 for our fiscal year ending December 2007. We are currently performing the systems and process documentation, evaluation and testing required (and any necessary remediation) in an effort to comply with management certification and auditor attestation requirements of Section 404. In the course of our ongoing evaluation, we may identify areas of our internal controls requiring improvement, and plan to design enhanced processes and controls to address issues that might be identified through this review. As a result, we expect to incur additional expenses and diversion of management s time. We cannot be certain as to the timing of completion of our documentation, evaluation, testing and remediation actions or the impact of the same on our operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors may not be able to certify as to the effectiveness of our internal control over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such actions could adversely affect our results.

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FORWARD-LOOKING STATEMENTS

You should not place undue reliance on forward-looking statements in this prospectus. This prospectus contains forward-looking statements that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. We use words such as anticipates, believes, plans, expects, future, estimates, intends and similar expressions to identify such forward-looking statements. Forward-looking statements include statements regarding our acquisition of Digital Musicworks International, Inc. and certain of the assets of Rio Bravo Entertainment LLC, our business strategy, future operating performance, the size of the market for our music recordings and our prospects. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described in Risk Factors starting on page 4 and elsewhere in this prospectus. We caution you not to rely on these statements without also considering the risks and uncertainties associated with these statements and our business that are addressed in this prospectus.

This prospectus contains various estimates related to the recorded music industry and digital music sales within the recorded music industry. These estimates have been produced by industry analysts and research firms based on trends to date, their knowledge of technologies and markets, and customer research, but these are forecasts only and are subject to inherent uncertainty.

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USE OF PROCEEDS

The net proceeds to us from the sale of 3,700,000 shares being offered by us at an assumed initial public offering price of $9.00 per share, after deducting estimated underwriting discounts and commissions and estimated offering expenses, are estimated to be approximately $28.8 million, or approximately $33.4 million if the underwriters over-allotment option is exercised in full.

We expect to use the net proceeds from this offering as follows:

- $1.2 million for contractual commitments currently in place and payable through September 30, 2006 in connection with acquisitions of digital rights to music recordings;

- an estimated $0.8 million for acquisition of property and equipment, including processing and encoding equipment and upgrades to our royalty payment system; and

- an estimated $26.8 million will be used for general corporate purposes, including working capital, future acquisitions of digital rights to music recordings and funding operating expenses.

In addition, we may use a portion of the net proceeds to acquire companies that own digital rights to music recordings or companies with complementary technologies or businesses. However, we currently have no commitments or agreements and are not involved in any negotiations with respect to any such transactions.

Other than the contractual commitments, the amounts set forth above are estimates, and the amounts that we will spend for these uses cannot be exactly determined. For example, the net proceeds we actually expend for fixed assets may be greater or less than the amount shown above depending on our rate of growth. The amount actually expended for general corporate purposes, including working capital, could vary significantly depending on a number of factors, including future revenue growth, profitability and cash flows. The actual amount expended for future content acquisition is even more difficult to predict as we have no commitments or agreements in place, other than those disclosed herein. As these negotiations will take place subsequent to this offering, the amount of the net proceeds to be used to acquire additional digital rights could vary significantly depending on a number of factors, including our ability to locate content, enter into binding acquisition agreements on favorable terms, the structure of future transactions as perpetual or long-term license agreements, and the negotiated purchase price and payment terms. As a result, we will retain broad discretion over the allocation of the net proceeds from this offering. Pending use of the net proceeds from this offering, we intend to invest the excess funds in short-term, investment-grade securities. We cannot predict whether the proceeds invested will yield a favorable return.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our capital stock. We currently intend to retain our future earnings, if any, for future growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board or directors and will depend on our results of operations, financial conditions, contractual and legal restrictions and other factors the board deems relevant.

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CAPITALIZATION

The following table sets forth our cash and cash equivalents and capitalization as of September 30, 2005:

- on an actual basis for Digital Music Group, Inc.;
- on a pro forma combined basis assuming:
  - collection of subscriptions receivable and completion of the issuance of Series B preferred stock by Digital Musicworks International, Inc. and receipt of proceeds in the amount of $621,000;
  - completion of the acquisition of Digital Musicworks International, Inc. and the conversion of all of the shares of Digital Musicworks International, Inc. capital stock into 2,250,000 shares of our common stock;
  - completion of the acquisition of certain assets of Rio Bravo Entertainment LLC and the issuance of 25,000 shares of our common stock to Rio Bravo Entertainment LLC; and
  - Digital Musicworks International, Inc. is designated as the acquiror for accounting purposes.
- on a pro forma combined as adjusted basis to reflect the sale of 3,700,000 shares of our common stock at the assumed initial public offering price of $9.00 per share, less the underwriting discounts and commissions and estimated offering expenses.

You should read this information in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our unaudited pro forma combined financial statements and related notes and the financial statements and related notes of Digital Music Group, Inc., Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC Carve Out Segment appearing elsewhere in this prospectus.

	Actual	Pro Forma Combined	Pro Forma Combined As Adjusted
Cash and cash equivalents	$ 254,209	$ 1,186,165	$ 29,989,165
Capitalization:			
Note payable to related party	$ 500,000	$ 500,000	$ 0
Capital lease		56,147	56,147
Total indebtedness	$ 500,000	$ 556,147	$ 56,147
Stockholders equity (deficit):			
Preferred stock; $0.01 par value: 1,000,000 shares authorized; no shares issued and outstanding	$	$	

Common stock, $0.01 par value: 20,000,000 shares authorized; 2,425,000 shares issued and outstanding (actual); 4,700,000 shares issued and outstanding (pro forma combined) and 8,400,000 shares issued and outstanding (pro forma combined as adjusted)	24,250	47,000	84,000
Additional paid-in capital		4,815,977	33,581,977
Accumulated deficit	(44,261)	(1,970,220)	(1,970,220)
Total stockholders equity (deficit)	(20,011)	2,892,757	31,695,757
Total capitalization	$ 479,989	$ 3,448,904	$ 31,751,904

The shares of common stock to be outstanding in the pro forma combined as adjusted column excludes up to 555,000 shares of common stock that could be sold upon exercise of the underwriters option to purchase additional shares to cover over-allotments.

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DILUTION

If you invest in our stock, your interest will be diluted to the extent of the difference between the public offering price per share of our common stock and the pro forma combined net tangible book value per share of our common stock after this offering.

The pro forma combined net tangible book value of our common stock on September 30, 2005 was approximately $2.9 million or $0.62 per share of common stock. Pro forma combined net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of common stock outstanding, after giving effect to the completion of the acquisition of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC.

Dilution in net tangible book value per share represents the difference between the amount per share paid by purchasers of shares of our common stock in this offering and the net tangible book value per share of our common stock immediately afterwards. After giving effect to our sale of 3,700,000 shares of common stock in this offering at an assumed initial public offering price of $9.00 per share, and after deducting the underwriting discounts, commissions and estimated offering and acquisition expenses payable by us, our pro forma combined as adjusted net tangible book value would be approximately $31.7 million, or approximately $3.77 per share. This represents an immediate increase in pro forma combined net tangible book value of $3.15 per share to existing stockholders and an immediate dilution in pro forma combined net tangible book value of $5.23 per share to new investors purchasing our common stock in this offering.

The following table illustrates the per share dilution:

Estimated public offering price per share		$ 9.00
Pro forma combined net tangible book value per share as of September 30, 2005	$ 0.62	
Increase in pro forma combined net tangible book value per share attributable to this offering	$ 3.15	
Pro forma combined net tangible book value per share as adjusted after this offering		$ 3.77
Dilution per share to new investors		$ 5.23

If the underwriters over-allotment option is exercised in full, there will be an increase in pro forma combined as adjusted net tangible book value to $4.06 per share to existing stockholders and an immediate dilution in pro forma combined as adjusted net tangible book value of $4.94 per share to new investors in this offering.

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The following table sets forth, on a pro forma combined basis as of September 30, 2005, giving effect to the acquisition of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC at September 30, 2005, the differences between the number of shares of common stock purchased from us, the total price and average price per share paid by our existing stockholders, shareholders of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC and by the new investors, before deducting estimated offering and acquisition expenses payable by us, using the estimated public offering price of $9.00 per share.

	Shares Purchased		Total Consideration		Average Price
	Number	Percentage	Amount	Percentage	Per Share
Our existing stockholders and shareholders of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC[(1)]	4,700,000	56.0%	$ 4,862,977	12.7%	$ 1.04
New investors	3,700,000	44.0%	$ 33,300,000	87.3%	$ 9.00
Total	8,400,000	100.0%	$ 38,162,977	100.0%	

(1) See Certain Relationships and Related Transactions Our Formation and Organization for a discussion of the issuance of common stock to our stockholders and the shares of common stock issuable to the shareholders of Digital Musicworks International, Inc. and to Rio Bravo Entertainment LLC upon completion of the acquisitions.

If the underwriters over-allotment option is exercised in full, our existing stockholders and shareholders of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC would own 52.5% and our new investors would own 47.5% of the total number of shares of our common stock outstanding after the completion of the acquisitions and this offering.

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SELECTED FINANCIAL DATA

We will acquire Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC concurrently with, and as a condition to, the completion of this offering. Digital Music Group, Inc. has had no operations other than in connection with the acquisitions and this offering and, therefore, selected financial data for Digital Music Group, Inc. is not presented. The following selected financial data for Digital Musicworks International, Inc. as of and for the period from February 26, 2004 (inception) to December 31, 2004 and as of and for the nine months ended September 30, 2005, and for Rio Bravo Entertainment LLC Carve Out Segment as of and for the year ended December 31, 2004, have been derived from the audited financial statements of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC Carve Out Segment included elsewhere in this prospectus. The following selected financial data for Digital Musicworks International, Inc. as of and for the period from February 26, 2004 (inception) to September 30, 2004, and for Rio Bravo Entertainment LLC Carve Out Segment as of and for the nine months ended September 30, 2004 and 2005, have been derived from the unaudited financial statements of Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC Carve Out Segment included elsewhere in this prospectus and, in the opinion of management, contain all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the financial position and results of operations for such periods. The historical results are not necessarily indicative of results to be expected for any future period. The following selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, and are qualified by reference to the financial statements and related notes included elsewhere in this prospectus.

Digital Musicworks International, Inc.

	From February 26, 2004 (Inception) to December 31, 2004	From February 26, 2004 (Inception) to September 30, 2004	For the Nine Months Ended September 30, 2005
Statement of Operations Data:			
Revenue	$ 37,268	$ 11,703	$ 225,535
Cost of revenue	13,744	3,692	157,465
Gross profit	23,524	8,011	68,070
Operating expenses	666,831	216,428	1,128,577
Interest, taxes and other expenses, net	1,291	419	133,979
Net loss	$ (644,598)	$ (208,836)	$ (1,194,486)
Balance Sheet Data:			
Cash and cash equivalents	$ 735,837	$ 64,126	$ 311,956
Working capital (deficit)	657,121	19,113	578,243
Total assets	1,206,280	201,639	2,372,378
Capital lease obligations	88,553		56,147
Shareholders equity	1,033,658	144,364	2,151,143

Rio Bravo Entertainment LLC Carve Out Segment

	For the Year Ended	For the Nine Months Ended	
		September 30,	September 30,

	December 31, 2004	2004	2005
Statement of Operations Data:			
Revenue	$ 35,752	$ 12,411	$ 233,553
Cost of revenue	29,301	9,892	179,465
Gross profit	6,451	2,519	54,088
Operating expenses	7,064	2,652	11,471
Net income (loss)	$ (613)	$ (133)	$ 42,617
Balance Sheet Data:			
Cash and cash equivalents	$ 12,212	$	$ 96,197
Working capital (deficit)	(613)	(133)	42,004
Total assets	19,588	6,100	125,942
Retained earnings (accumulated deficit)	(613)	(133)	42,004

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MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and related notes of Digital Music Group, Inc., Digital Musicworks International, Inc. and Rio Bravo Entertainment LLC Carve Out Segment contained elsewhere in this prospectus. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described in Risk Factors starting on page 4 and elsewhere in this prospectus.

Overview

Background and Basis of Presentation

Digital Music Group, Inc. was organized as a Delaware corporation in April 2005 to become a leading owner of digital rights to music and other sound recordings and distributor of these recordings to online music stores. In September 2005, we entered into a merger agreement to acquire Digital Musicworks International, Inc. and an asset purchase agreement to acquire certain assets of Rio Bravo Entertainment LLC. The assets of Rio Bravo Entertainment LLC to be acquired consist solely of agreements for digital distribution rights to music recordings and its agreements with online music stores. Both of these acquisitions will be completed concurrently with, and as a condition to, the completion of this offering.

Digital Music Group, Inc. does not have an operating history separate from the operations of Digital Musicworks International, Inc. and the digital music distribution operations of Rio Bravo Entertainment LLC. Accordingly, this discussion consists of an analysis of the key trends and seasonality, future revenues and operating expenses, critical accounting policies and estimates, recent accounting pronouncements and other factors affecting us, followed by a specific discussion of the business, results of operations and liquidity and capital resources of Digital Musicworks International, Inc. and the digital music distribution operations and results of operations of Rio Bravo Entertainment LLC Carve Out Segment.

Key Trends Affecting Demand for Digital Music Recordings

We believe that the recorded music industry is presently undergoing a significant change, with the primary means of music distribution transitioning from physical formats (compact discs) to digital formats accessed over the Internet and wireless and cable networks. The recorded music industry has undergone two previous format transitions over the last 35 years. The first transition was from vinyl records to cassette tapes from the early-1970s to the mid-1980s, and the second transition was from cassette tapes to compact discs from the mid-1980s through the 1990s. In both cases, the format transition was dramatic and completed within about a decade, and in both cases the recorded music market at the end of the transition was larger than at the beginning.

Today, we believe that we are in the early stages of the transition from physical formats to digital formats. We believe this is a direct result of the popularity and proliferation of personal computers and portable digital music players like the Apple iPod, and consumer acceptance and the music industry s endorsement of legitimate digital music sales. We believe this transition is just beginning and the market share of digital music will increase and digital formats will ultimately become the preferred way consumers purchase and listen to music.

Seasonality

Our limited operating history has not allowed us to identify seasonality in our business.

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Future Revenues and Operating Expenses

We expect our revenue to increase substantially over future periods. We presently have the digital rights to over 200,000 music recordings, approximately one-half of which were acquired in September 2005. We had only approximately 17,000 of these recordings available for sale at online music stores at September 30, 2005. This number of recordings available for sale has more than doubled to approximately 36,000 at December 31, 2005, and a significant focus of management is presently on obtaining delivery of and processing the remaining tracks to make them available for sale as quickly as practicable. There is no assurance that the added tracks will be as popular with consumers and generate revenue at the same rate as those currently available for purchase. In addition, there is no assurance that our tracks currently available will generate the same rate of downloads and revenue in the future.

We also expect our operating expenses to increase substantially following completion of the offering for the following reasons:

Business Development. We expect to hire additional business development and musicologist personnel and incur added travel and legal costs as we focus on aggressively evaluating and acquiring additional catalogs of music recordings.

Digital Music Processing. In order to expeditiously process the music catalogs we have recently acquired, as well as catalogs we anticipate acquiring in the future, we will continue to invest in expanding and enhancing our digital music processing operations. We expect to incur expenses for additional data entry, graphics and information technology personnel, as well as depreciation associated with the purchase of additional processing equipment and software.

Accounting and Reporting. We expect to increase the number of our accounting personnel upon completion of this offering to comply with the obligations of being a public company. In addition, we will continue to expand our accounting operations to accommodate increasing numbers of music recordings under management and to improve our royalty payment processing and reporting systems.

Public Company. Our general and administrative expenses will increase due to being a public company, including the cost of periodic public reporting, investor relations, fees to independent directors, insurance, and legal and accounting fees.

Critical Accounting Policies and Estimates

The financial statements presented in this prospectus were prepared in accordance with accounting principles generally accepted in the United States of America. In preparing these financial statements, it was necessary for us to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, we will evaluate our estimates and judgments, including those related to customer revenue, accounts receivable, capitalized digital music rights, advance royalties, income taxes, contingencies and litigation. We base our estimates and judgments on our experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies, among others, affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition and Accounts Receivable

We derive our revenue from leading online music stores that sell to consumers the digital music recordings that we have acquired or control through licenses with record labels, artists, publishers or other content owners. We receive revenue from online music stores that charge consumers on a per download basis for each download of a music recording. In addition, we receive revenue from subscription-based online music stores calculated as a percentage of the subscription price paid by the consumer based on the percentage of times our digital music

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recordings are listened to or downloaded as compared to the total for all available music recordings during the relevant time period. Our revenue is directly related to the number of times our digital music recordings are listened to or downloaded from the online music stores. Each online music store provides detailed reports of our revenue, generally on a monthly basis within 30 days following the end of the month, pursuant to the terms of our agreement with such online music store, and we recognize revenue in the month the transaction occurs. We receive payment at approximately the same time as we receive these reports of download activity. Our accounts receivable therefore consists of approximately one month s revenue. We have never experienced a bad debt and have never recorded a bad debt allowance.

Acquisition Costs for Digital Music Rights

We capitalize the costs of acquiring or licensing the digital rights to music recordings, which are amortized using the straight-line method over the shorter of the term of the related agreement or seven years, which we believe reasonably relates the amount of amortization to the revenue expected to be generated. Legitimate music downloading through online music stores has only recently become available. Accordingly, we have limited data upon which to base amortization assumptions. Because our music recordings are primarily past hits, live performances, previously unreleased studio tracks and other vintage recordings, primarily from the 1950s through the 1970s, spanning a broad array of genres and artists, they are not subject to initial high demand and subsequent drop-off in sales typically experienced by new releases of current mainstream music. Our limited experience has shown that download activity in our music recordings generally tends to be steady from month-to-month. As a result, we believe that our amortization method and term are reasonable in the circumstances. Management will continue to monitor download trends of our music and may adjust amortization methodology, periods and resulting rates in the future if the number of downloads and resulting cash flow trends are substantially different than anticipated. This could result from changes in consumer demand for our library of music recordings or general industry conditions. Our amortization expense would increase by approximately 15% for each year that the period of amortization used by us was shortened. The impact of any such change would be insignificant to historically reported financial information contained in this prospectus, but could have a material effect in the future as we seek to expand our music library and are likely to spend increasing amounts to acquire additional digital music rights. See Use of Proceeds.

Royalty Advances

Royalty advances are cash amounts paid to content owners in connection with our contractual agreements for the right to sell digital music recordings for a specific period of time, usually seven to ten years. These advances are recorded as prepaid assets. On a monthly basis, as each online music store reports the number of downloads of each music recording and pays to us the gross revenue attributable to such downloads, the portion of such revenue due to each content owner under our long-term license agreement is charged to cost of revenue and the royalty advance account is reduced until it is fully recouped.

Valuation of Capitalized Digital Music Rights and Royalty Advances

Total capitalized digital music rights and royalty advances amounted to approximately $1.8 million as of September 30, 2005. We periodically, but at least on an annual basis, review these assets for evidence of impairment by comparing the expected future cash flows to be generated from these assets to the carrying value of the assets. Future adverse changes in market conditions or poor demand for our music recording assets could result in losses or an inability to recover the carrying value of the asset, thereby possibly requiring an impairment charge in the future.

Share-Based Compensation

We elected early adoption of Statement No. 123 (revised 2004) of the Financial Accounting Standards Board. See Recent Accounting Pronouncements below. As a result, we recognize compensation expense in an amount equal to the estimated fair value of share-based awards and issuances, such as stock options and

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warrants granted to employees and non-employees. Such expense is recognized over the period during which the recipient is required to provide services in exchange for the award or issuance (usually the vesting period). The computation of share-based compensation cost involves numerous assumptions by management. We utilize the fair value method, whereby the compensatory element of each share-based grant or issuance is estimated on the date of grant using the Black-Scholes fair value model. Assumptions used in this model include, among others, expected life (turnover), risk-free interest rate, dividend yield and volatility of the underlying equity security. In addition, as a private company prior to this offering, the fair market value of the underlying equity security at date of grant was determined by the board of directors after considering information available to the directors at that time, as opposed to an independent market valuation. The use of different assumptions by management in the Black-Scholes model can produce substantially different results. During the nine months ended September 30, 2005, the total share-based compensation cost recognized by us on a pro forma combined basis was approximately $31,000. However, that amount could increase significantly and reduce reported results of operations in the future to the extent that share-based awards and issuances are made under our Amended and Restated 2005 Stock Plan. See Management Compensation Plans Digital Music Group, Inc. Amended and Restated 2005 Stock Plan for a description of the terms of this plan.

Accounting for Income Taxes

Deferred income taxes result primarily from temporary differences between financial and tax reporting. Deferred tax assets and liabilities are determined based on the difference between the financial statement basis and tax basis of assets and liabilities using enacted tax rates. Future tax benefits are subject to a valuation allowance when management is unable to conclude that its deferred tax assets will more likely than not be realized from the results of operation. At December 31, 2004 and September 30, 2005, because of its limited operating history and net losses recorded since inception, Digital Musicworks International, Inc. recorded a full valuation allowance against deferred income taxes.

The federal and state unused net operating loss carryforwards generated in 2004 by Digital Musicworks International, Inc. expire in 2019 and 2014, respectively. It is anticipated that additional net operating loss carryforwards will be generated for federal and state income tax purposes in 2005, which would expire in 2020 and 2015, respectively. In addition to potential expiration, there are several factors that could limit or eliminate our ability to use these federal and state tax loss carryforwards. For example, under section 382 of the Internal Revenue Code of 1986, as amended, use of prior net operating loss carryforwards is limited after an ownership change. Digital Musicworks International, Inc. may be subject to limitations on the use of its net operating loss carryforwards as provided under section 382 because of prior or future sales of securities or the sale or issuance of the shares offered hereby. Accordingly, it is not certain how much of the existing net operating loss carryforwards will be available for our use. If we generate taxable income in the future, which may not happen, the use of net operating loss carryforwards that have not expired would have the effect of reducing our tax liability and increasing our net income and available cash resources in the future.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Compensation* (SFAS No. 123R). SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is to be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. We chose early adoption of SFAS No. 123R in 2004.

Qualitative and Quantitative Disclosures About Market Risk

The primary objective of our investment activities is to preserve principal. Our funds are currently held in checking accounts and money market funds which do not subject us to risk of a loss of principal due to changes

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in prevailing interest rates. Following this offering, we intend to maintain our excess cash funds in a portfolio of cash and cash equivalents and which may include investments in a variety of investment-grade securities, including commercial paper, money market funds, government and non-government debt securities and certificates of deposit with maturities of less than thirteen months. Some of these securities may be subject to market risk due to changes in prevailing interest rates, which may cause fluctuations in market value.

Digital Musicworks International, Inc. Background and Overview

Digital Musicworks International, Inc. was founded in February 2004 to explore opportunities in the digital music industry. Its early business model involved signing artists to its own record label, funding the cost of producing original studio music recordings for these artists, promoting these artists and their recordings, and distributing their recordings through both physical and digital channels. Digital Musicworks International, Inc. began receiving revenue from these activities in June 2004 and currently represents six artists. While it still recognizes minimal revenue from the sales of these existing recordings, the company is not seeking any new artists for this purpose as its focus has evolved to predominately involve acquiring digital rights to music recordings by purchase or long-term license and processing these recordings through its digital music processing system for delivery to online music stores for sale.

Digital Musicworks International, Inc. entered into the company s first catalog acquisition agreement in July 2004. Since then it has executed four other acquisition agreements with owners of large catalogs of music recordings, which provide the company with long-term or perpetual digital rights to the music recordings. In addition to its efforts to acquire music tracks under perpetual and long-term license agreements, Digital Musicworks International, Inc. also obtains short-term distribution rights to digital music. Currently, the company has under contract 35,000 tracks that it has purchased outright, 158,000 tracks under long-term (seven to ten years) licenses and 2,000 tracks under short-term distribution agreements of one to two years. See Business Content Acquisition and Business Our Content for a further discussion of the way that digital rights to music recordings have been acquired.

Digital Musicworks International, Inc. processes these recordings through its digital music processing system for delivery to online music stores, and the cost of such processing is reported in operating expenses. This involves several steps of processing and encoding the music recordings into the specific digital formats required for submission to individual online music stores. The company then distributes the digital music recordings to online music stores, including Apple iTunes Music Store, RealNetworks, Napster, Wal-Mart Music, Yahoo! Music and MSN Music to make them available for purchase by consumers.

Digital Musicworks International, Inc. s revenue is derived primarily from online music stores that offer its music recordings on a pay-per-download or subscription basis. Apple iTunes, the most popular online music store, accounted for approximately 87% and 83% of its revenue during the period from inception to December 31, 2004 and the nine months ended September 30, 2005, respectively. The company also distributes its music recordings through nine other online music stores. The amount paid to Digital Musicworks International, Inc. per download is negotiated in advance at the time it enters into an agreement with an online music store. Although the company negotiates with each store separately, its experience is that the percentage of the retail price paid to rights holders does not vary significantly across music stores.

Cost of revenue consists of (i) royalties to artists and publishers, (ii) revenue sharing payments based on long-term license or short-term distribution agreements with content owners, and (iii) amortization of costs to acquire digital rights to music recordings. Digital Musicworks International, Inc. purchases or licenses the digital rights to previously recorded music and has no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. The company s experience is that these artist royalty obligations have historically been between 0% and 15% of the revenue attributable to a specific track or album. The publisher royalties are a statutory rate in the United States of America, which was $0.085 per music recording sold during 2005, increasing to $0.091 in January 2006. As part of the company s negotiations to acquire the digital rights to music recordings, the content owner from whom it licenses the recordings will often pay certain or all of

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these artist and publisher royalties. Digital Musicworks International, Inc. enters into long-term license agreements with content owners that also typically include a revenue sharing arrangement whereby the the content owner receives 25 to 50% of the revenue earned (after certain deductions) over the term of the agreement. In most cases, as an inducement to enter into the long-term license agreement, Digital Musicworks International, Inc. 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 expensed as cost of revenue as the related revenue is earned and the cash advances are recouped. Digital Musicworks International, Inc. also capitalizes the acquisition costs of its perpetual and long-term digital rights and amortizes these amounts over the shorter of seven years or the length of the contract, which it believes reasonably relates the amount of amortization to the revenue expected to be generated.

Digital Musicworks International, Inc. has incurred losses since its inception. As of September 30, 2005, these losses totaled approximately $1.8 million. Although the company expects an increase in its revenue, it may continue to incur losses as a result of higher operating expenses. These increased operating expenses will be caused primarily by adding personnel dedicated to business development, accounting and operations and for other reasons described above under Overview Future Revenues and Operating Expenses.

Digital Musicworks International, Inc. Recent Accounting Pronouncements

Digital Musicworks International, Inc. elected early adoption of SFAS No. 123R as disclosed in Notes 1 and 9 to its financial statements as of September 30, 2005, included in this prospectus. Subsequent to September 30, 2005, options to purchase a total of 195,000 shares of Digital Musicworks International, Inc. were granted. As Digital Musicworks International, Inc. is a private company and no market exists for its common shares, the board of directors of the company set the exercise price for these options at $0.21 per share, which it estimated to be equal to the fair value of a company common share on the date of grant. The estimated fair value was not determined using contemporaneous valuation by a valuation specialist since Digital Musicworks International, Inc. completed a third party equity financing at approximately the same time as these options were granted. The board of directors considered all available facts and circumstances to determine fair value of the common shares. Specifically, significant weight was given to the $0.262 price per share paid by third parties for recent purchases of Series B convertible preferred shares of Digital Musicworks International, Inc. and the preferential rights of such convertible preferred shares. For these 195,000 options, the fair value of each option was estimated using the Black-Scholes fair value model with the following assumptions: (a) expected life of approximately six years; (b) risk-free interest rate of 4.5%; (c) 0% dividend yield; (d) volatility of 75%; and (e) a stock price of $0.21 per share. The estimated compensation expense of $0.14 per option share, or approximately $28,000 in the aggregate, will be recognized as the options vest ($1,750 per quarter) beginning in the fourth quarter of 2005. If the proposed offering price for shares of common stock being sold by Digital Music Group, Inc. in this offering had been used to value the options, the stock price of Digital Musicworks International, Inc. used in this calculation would have been $0.61 per share based on the merger exchange ratio, and the estimated compensation expense would have been $78,000 in the aggregate ($4,875 per quarter), which does not represent a material difference. Digital Musicworks International, Inc. is an independent private company not controlled by Digital Music Group, Inc. and the closing of the proposed acquisition of Digital Musicworks International, Inc. is subject to a number of conditions, including the completion of this offering.

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Digital Musicworks International, Inc. Results of Operations

The following table sets forth Digital Musicworks International, Inc. s results of operations expressed as a percentage of revenue for the periods presented:

	Period from February 26, 2004 (Inception) to December 31, 2004		Period from February 26, 2004 (Inception) to September 30, 2004 (unaudited)		For the Nine Months Ended September 30, 2005	
	Amount	Percentage of Total	Amount	Percentage of Total	Amount	Percentage of Total
Revenue	$ 37,268	100.0%	$ 11,703	100.0%	$ 225,535	100.0%
Cost of revenue	13,744	36.9	3,692	31.5	157,465	69.8
Gross profit	23,524	63.1	8,011	68.5	68,070	30.2
Operating expenses	666,831	1689.3	216,428	1749.3	1,128,577	500.4
Interest, taxes and other expense, net	1,291	3.5	419	3.6	133,979	59.4
Net loss	$ (644,598)	(1,629.6)%	$ (208,836)	(1,684.5)%	$ (1,194,486)	(529.6)%

Comparison of Period from February 26, 2004 (Inception) to September 30, 2004 and Nine Months ended September 30, 2005

Revenue. Revenue grew from $11,703 for the period from February 26, 2004 (inception) to September 30, 2004, to $225,535 for the nine months ended September 30, 2005. From inception to September 30, 2004, Digital Musicworks International, Inc. s revenue was insignificant because it was beginning its operations and focused on acquiring its initial digital rights to music recordings, establishing relationships with online music stores and identifying artists to sign to its record label. Digital Musicworks International, Inc. had only approximately 400 music recordings available for purchase as of September 30, 2004, compared to 12,200 available for purchase at online music stores as of September 30, 2005.

Cost of revenue. Cost of revenue increased from $3,692, or 31.5% of revenue, for the period from February 26, 2004 (inception) to September 30, 2004, to $157,465, or 69.8% of revenue, for the nine months ended September 30, 2005. The cost of revenue for the nine months ended September 30, 2005 was negatively impacted by a write-down of $73,442 related to a contract with an artist under its record label, which was entered into in January 2005 and cancelled in July 2005. Excluding this item, the company s cost of revenue would have been $82,282, or 36.5% of revenue, for the nine months ended September 30, 2005.

Operating expenses. The following table sets forth the individual components of operating expenses for the period from February 26, 2004 (inception) to September 30, 2004 and for the nine months ended September 30, 2005:

	Period from February 26, 2004 (Inception) to September 30, 2004 (unaudited)		For the Nine Months Ended September 30, 2005	
	Amount	Percentage of Total	Amount	Percentage of Total
Personnel-related expenses	$ 99,256	45.9%	$ 617,834	54.7%
Professional fees	54,919	25.4	129,652	11.5
Travel-related expenses	16,598	7.7	82,490	7.3
Other	45,655	21.1	298,601	26.5
Total	$ 216,428	100.0%	$ 1,128,577	100.0%

Operating expenses increased from $216,428 for the period from inception to September 30, 2004, to $1,128,577 for the nine months ended September 30, 2005. Operating expenses increased in the first nine months of 2005 because of a substantial increase in employees and resulting payroll costs, professional fees, travel related costs and other expenses as Digital Musicworks International, Inc. began to more aggressively identify and acquire rights to music recordings and process an increasing number of tracks for sale. Digital Musicworks International, Inc. expects its operating expenses to increase substantially as it expands business development, operations and accounting activities following the offering, as explained in more detail above under Overview Future Revenues and Operating Expenses.

Interest, taxes and other expense, net. Interest, taxes and other expense increased from $419 for the period from February 26, 2004 (inception) to September 30, 2004, to $133,979 for the nine months ended September 30, 2005. In September 2005, in connection with the issuance of Digital Musicworks International, Inc. s Series B convertible preferred stock, $230,000 of subordinated convertible notes issued in June 2005 were converted into Series B shares at a discount to the noteholders, and this discount of $125,034 was charged to interest expense.

Period from February 26, 2004 (Inception) to December 31, 2004

Revenue. Revenue was $37,268 for the period from February 26, 2004 (inception) to December 31, 2004. The company was in a start-up mode and refining its business model. As of December 31, 2004, Digital Musicworks International, Inc. had approximately 700 music recordings available for purchase at online music stores.

Cost of revenue. Cost of revenue was $13,744 for the period from February 26, 2004 (inception) to December 31, 2004, or 36.9% of revenue.

Operating expenses. Operating expenses were $666,831 for the period from February 26, 2004 (inception) to December 31, 2004, or 1,629.6% of revenue. Operating expenses consisted primarily of salaries and benefits for management, business development, operations and administrative personnel, travel, professional fees, consulting and other costs. These operating expenses related primarily to identifying and negotiating with potential sellers and licensors of digital rights to music recordings, processing of music recordings acquired and making them available for purchase at the online music stores and identifying artists to sign to its record label.

Digital Musicworks International, Inc. Selected Quarterly Results of Operations

The following table sets forth unaudited quarterly statement of operations data for each of the seven quarters through September 30, 2005:

	For the Quarters Ended (unaudited)						
	3/31/04[1]	6/30/04	9/30/04	12/31/04	3/31/05	6/30/05	9/30/05
Statement of Operations Data:							
Revenue	$	$ 852	$ 10,851	$ 25,565	$ 41,480	$ 53,560	$ 130,495
Cost of revenue		567	3,125	10,052	18,334	96,992 [2]	42,139
Gross profit		285	7,726	15,513	23,146	(43,432)[2]	88,356
Operating expenses	64	8,629	207,735	450,403	537,745	333,782	257,050

Interest, taxes and other expense, net		800	381	(872)	3,095	(7,056)	(128,418)
Income (loss) before income taxes	(64)	(8,344)	(199,628)	(435,762)	(512,304)	(384,270)	(297,112)
Net loss	$ (64)	$ (9,144)	$ (199,628)	$ (435,762)	$ (513,104)	$ (384,270)	$ (297,112)
As a percentage of revenue:							
Cost of revenue	0.0%	66.5%	28.8%	39.3%	44.2%	181.1%	32.3%
Gross profit margin	0.0%	33.5%	71.2%	60.7%	55.8%	(81.1)%	67.7%
Operating Data:							
Number of tracks for sale at end of Quarter			400	700	2,300	8,000	12,200
Number of paid downloads during Quarter[3]			19,900	37,900	56,400	75,100	191,400

(1) For the period from February 26, 2004 (inception) to March 31, 2004.

(2) Cost of revenue in the quarter ended June 30, 2005 includes a charge of $73,442 related to write-off of a contract entered into in January 2005 with an artist under the company s record label that was terminated in July 2005. Without this charge, cost of revenue in the quarter ended June 30, 2005 would have been $23,550, or 44.0% of revenue, and gross profit would have been $30,010, or 56.0% of revenue.

(3) Does not include the number of times our music recordings were streamed or played on subscription-based online music stores.

Digital Musicworks International, Inc. s revenue increased in every quarter on a year-over-year basis and on a sequential quarter-over-quarter basis. This increase in revenue is due to continued acquisition of rights to music recordings and processing of such recordings to make them available for purchase at the online music stores. During each quarter, the company has added music recordings available for sale at the online music stores. Approximately 84% of its revenue since inception was derived from iTunes.

Gross profit margin varies depending on the mix of revenue received from the music recordings licensed by Digital Musicworks International, Inc. Higher margins are achieved from revenue generated under perpetual and long-term license agreements and lower margins are achieved through short-term distribution agreements. During the nine months ended September 30, 2005, during which Digital Musicworks International, Inc. has increased tracks available for sale from 400 to 12,200, gross profit margin has fluctuated on a quarter-by-quarter basis from 55.8% to 67.7% (excluding the writedown in the quarter ended June 30, 2005), with the gross profit margin during that nine-month period being 62.7% (excluding the write-down in the quarter ended June 30, 2005).

Operating expenses increased on a sequential quarter-over-quarter basis from inception to the quarter ended March 31, 2005, due to the expansion of Digital Musicworks International, Inc. s operations. In the second and third quarters of 2005, operating expenses declined as a result of a reduction in the company s personnel associated with the management and promotion of artists signed to its record label. Total full-time employees of Digital Musicworks International, Inc. were 14 at March 31, 2005, and declined to eight at September 30, 2005.

Digital Musicworks International, Inc. Recent Results

For the two months ended November 30, 2005, Digital Musicworks International, Inc. had 330,800 paid downloads and recorded revenue of approximately $222,000. As of December 31, 2005, it had approximately 30,600 music recordings available for sale at online music stores, and management is continuing to work to obtain delivery, process the remaining music recordings it has under contract and make them available for sale as quickly as practicable.

Digital Musicworks International, Inc. Liquidity and Capital Resources

Digital Musicworks International, Inc. has funded its operations from February 26, 2004 (inception) to September 30, 2005 primarily through private sales of convertible preferred shares and promissory notes totaling $3,972,281.

The company s operating activities resulted in net cash outflows of $895,718 for the nine months ended September 30, 2005 and $590,237 for the period from inception to December 31, 2004, primarily as a result of net losses from operations.

The company s investing activities resulted in net cash outflows of $1,666,986 for the nine months ended September 30, 2005 and $322,757 for the period from inception to December 31, 2004, to purchase fixed assets, acquire digital rights to music recordings and pay cash advances for license rights.

Financing activities provided cash of $2,138,823 during the nine months ended September 30, 2005, primarily from the issuance of Series B convertible preferred stock. Financing activities provided cash of $1,648,831 during the period from inception to December 31, 2004, primarily from the issuance of Series A convertible preferred stock.

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As of September 30, 2005, Digital Musicworks International, Inc. had cash and cash equivalents of $311,956 and a working capital surplus of $578,243.

The following table summarizes Digital Musicworks International, Inc. s contractual obligations as of September 30, 2005, and the effect such obligations are expected to have on its liquidity and cash flows in future periods:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**After 5 years**
Capital lease obligations	$ 56,147	$ 49,045	$ 7,102	$	$
Operating lease obligations	97,457	77,789	19,668		
Digital rights purchase obligations	566,521	566,521			
Royalty advances	1,300,000	895,000	90,000	90,000	225,000
Total	$ 2,020,125	$ 1,588,355	$ 116,770	$ 90,000	$ 225,000

From October 1, 2005 through December 7, 2005, Digital Musicworks International, Inc. received $621,000 in cash as a result of the collection of subscriptions receivable and the issuance of shares in connection with the closing of its Series B convertible preferred stock offering. Approximately $250,000 of such proceeds was used in December 2005 to pay a contractual obligation for the purchase of digital rights to a music catalog, as included in the above table. Management of Digital Musicworks International, Inc. believes that its available cash balances are sufficient to allow the company to fund its operations and meet its contractual obligations as they come due through the closing of this offering. We intend to utilize approximately $1.2 million of the net proceeds of this offering to pay the remaining royalty advances and digital rights purchase obligations due through September 30, 2006 under contractual commitments currently in place, less any such obligations that may be funded in the interim by Digital Musicworks International, Inc. out of its available cash reserves.

Off-Balance Sheet Arrangements

As of September 30, 2005, Digital Musicworks International, Inc. had no off-balance sheet arrangements.

Rio Bravo Entertainment LLC Carve Out Segment Background and Overview

Rio Bravo Entertainment LLC, doing business as Psychobaby, was organized as a Delaware limited liability company in June 1998. The company began operations as an entertainment production company and in 2001 began record label recording and music promoting operations. In March 2004, the company commenced operations as a distributor of digital music recordings through online music stores.

Digital Music Group, Inc. is acquiring from Rio Bravo Entertainment LLC its contracts to distribute music recordings in digital format and its contracts with the online music stores. This Management s Discussion and Analysis of Financial Condition and Results of Operations of Rio Bravo Entertainment LLC Carve Out Segment focuses only on these assets being acquired by Digital Music Group, Inc. and the results of these operations.

As of September 30, 2005, Rio Bravo Entertainment LLC has rights to sell approximately 4,700 music recordings in digital format on behalf of record labels, artists and other content owners pursuant to short-term (generally one to two years) exclusive digital distribution agreements where it typically pays no up-front amounts. The company processes these music recordings through its digital music processing system and offers them for sale through leading online music stores, including Apple iTunes Music Store, Napster, MSN Music Store and Real Networks.

Revenue is derived primarily from online music stores that offer Rio Bravo Entertainment LLC s music recordings on a pay-per-download or subscription basis. The company retains a distribution fee and pays the

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remainder of the revenue it receives from the online music stores to the content owner, in accordance with the terms of its agreement with the content owner. iTunes accounted for 99% and 92% of Rio Bravo Entertainment LLC Carve Out Segment s revenue during the year ended December 31, 2004 and the nine months ended September 30, 2005, respectively. During 2005, Rio Bravo Entertainment LLC began entering into agreements with other online music stores and expects that the percentage contribution from iTunes will decrease in future periods, although it is likely to remain a significant amount as iTunes is the largest and most popular online music store. The amount paid to Rio Bravo Entertainment LLC per download is negotiated in advance at the time the company enters into an agreement with an online music store. For subscription-based online music stores, Rio Bravo Entertainment LLC typically receives a percentage of the subscription revenue realized by the online music stores based on the number of times its music recordings are listened to or downloaded as compared to the total for all available music recordings during the relevant time period.

Cost of revenue consists of the content owner s percentage of the revenue the company receives from the online music stores in accordance with the revenue sharing terms of Rio Bravo Entertainment LLC s agreement with the content owner. During the three quarters ended September 30, 2005, cost of revenue, as a percentage of revenue, remained relatively constant, fluctuating from 75% to 78%, as Rio Bravo Entertainment LLC s agreements with content owners contain generally standard terms.

Rio Bravo Entertainment LLC Carve Out Segment Results of Operations

The following table sets forth the results of operations expressed as a percentage of revenue for the periods presented:

	For the Year Ended December 31, 2004		For the Nine Months Ended September 30, 2004 (unaudited)		For the Nine Months Ended September 30, 2005 (unaudited)	
	Amount	Percentage of Total	Amount	Percentage of Total	Amount	Percentage of Total
Revenue	$ 35,752	100.0%	$ 12,411	100.0%	$ 233,553	100.0%
Cost of revenue	29,301	82.0	9,892	79.7	179,465	76.8
Gross profit	6,451	18.0	2,519	20.3	54,088	23.2
Operating expenses	7,064	19.7	2,652	21.4	11,471	4.9
Net income (loss)	$ (613)	(1.7)%	$ (133)	(1.1)%	$ 42,617	18.3%

Comparison of Nine Months Ended September 30, 2004 and Nine Months Ended September 30, 2005

Revenue. Revenue grew from $12,411 for the nine months ended September 30, 2004, to $233,553 for the nine months ended September 30, 2005. For the nine months ended September 30, 2004, Rio Bravo Entertainment LLC Carve Out Segment s revenue was insignificant because it was beginning digital music acquisition and distribution operations. Approximately 99% of the company s revenue for the nine months ended September 30, 2004 was from iTunes, compared to 92% for the nine months ended September 30, 2005. Rio Bravo Entertainment LLC had only approximately 300 music recordings available for purchase at online music stores as of September 30, 2004, compared to approximately 4,700 music recordings available as of September 30, 2005.

Cost of revenue. Cost of revenue increased from $9,892, or 79.7% of revenue, for the nine months ended September 30, 2004, to $179,465, or 76.8% of revenue, for the nine months ended September 30, 2005. Gross profit margins for both periods were similar as a result of generally standard contract terms with the record labels, artists and other content owners and the online music stores.

Operating expenses. Operating expenses increased from $2,652, or 21.4% of revenue, for the nine months ended September 30, 2004, to $11,471, or 4.9% of revenue for the nine months ended September 30, 2005.

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Operating expenses as a percentage of revenue decreased significantly in the nine months ended September 2005 because of the company s low fixed operating costs.

For the Year Ended December 31, 2004

Revenue. Revenue was $35,752 for the year ended December 31, 2004. Rio Bravo Entertainment LLC s digital distribution business was just beginning during this period, and a total of approximately 900 music recordings were available for purchase as of December 31, 2004. Approximately 99% of the company s revenue for the year ended December 31, 2004 was from iTunes.

Cost of revenue. Cost of revenue was $29,301 for the year ended December 31, 2004, or 82% of revenue.

Operating expenses. Operating expenses were $7,064 for the year ended December 31, 2004, or 19.7% of revenue.

Rio Bravo Entertainment LLC Carve Out Segment Selected Quarterly Results of Operations

The following table sets forth unaudited quarterly statement of operations data for each of the seven quarters through September 30, 2005:

	For the Quarters Ended (unaudited)						
	3/31/04	**6/30/04**	**9/30/04**	**12/31/04**	**3/31/05**	**6/30/05**	**9/30/05**
Statement of Operations Data:							
Revenue		$ 874	$ 11,537	$ 23,341	$ 58,932	$ 69,700	$ 104,921
Cost of revenue		700	9,192	19,409	45,251	52,180	82,034
Gross profit		174	2,345	3,932	13,681	17,520	22,887
Operating expenses		1,803	849	4,412	3,090	2,064	6,317
Net income (loss)		$ (1,629)	$ 1,496	$ (480)	$ 10,591	$ 15,456	$ 16,570
As a percentage of revenue:							