Digital Music Group, Inc.
Form 424B4
February 02, 2006
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Filed Pursuant to Rule 424(b)(4)
Registration Statement No. 333-128687

PROSPECTUS

3,900,000 Shares

Common Stock

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

Prior to this offering, no public market existed for the shares. The common stock has been approved for quotation 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	$ 9.75	$ 38,025,000
Underwriting discount(1)	$ 0.78	$ 3,042,000
Proceeds to Digital Music Group, Inc.	$ 8.97	$ 34,983,000

(1) Includes a non-accountable expense allowance in the amount of 1% of the gross proceeds, or $0.0975 per share ($380,250 in total) payable to the representatives of the underwriters.

The underwriters may also purchase up to an additional 585,000 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 February 7, 2006.

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

The date of this prospectus is February 2, 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 56 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*. 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	3,900,000 shares
Common stock to be outstanding after this offering	8,600,000 shares
Use of proceeds	We estimate that our net proceeds from this offering will be approximately $33.4 million. 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 $31.4 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.
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 28.9% of our outstanding common stock. Mitchell Koulouris, our President, Chief Executive Officer and one of our director nominees, will beneficially own approximately 6.6% 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 3.8% 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 4.9% 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 $5.53 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 $5.53 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

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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 8,600,000 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, including 440,800 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 1,736,298 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 2,160,302 shares, of which 258,400 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 3,900,000 shares being offered by us at an initial public offering price of $9.75 per share, after deducting estimated underwriting discounts and commissions and estimated offering expenses, are estimated to be approximately $33.4 million, or approximately $38.7 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 $31.4 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 3,900,000 shares of our common stock at the initial public offering price of $9.75 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	$ 1,187,165	$ 34,570,165
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 (actual); 30,000,000 shares authorized (pro forma combined and pro forma combined as adjusted); 2,425,000 shares issued and outstanding (actual); 4,700,000 shares issued and outstanding (pro forma combined) and 8,600,000 shares issued and outstanding (pro forma combined as adjusted)	24,250	47,000	86,000
Additional paid-in capital		4,834,727	38,178,727
Accumulated deficit	(44,261)	(1,977,251)	(1,977,251)
Total stockholders equity (deficit)	(20,011)	2,904,476	36,287,476
Total capitalization	$ 479,989	$ 3,460,623	$ 36,343,623

The shares of common stock to be outstanding in the pro forma combined as adjusted column excludes up to 585,000 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 3,900,000 shares of common stock in this offering at the initial public offering price of $9.75 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 $36.3 million, or approximately $4.22 per share. This represents an immediate increase in pro forma combined net tangible book value of $3.60 per share to existing stockholders and an immediate dilution in pro forma combined net tangible book value of $5.53 per share to new investors purchasing our common stock in this offering.

The following table illustrates the per share dilution:

Public offering price per share		$ 9.75
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	$ 3.60	
Pro forma combined net tangible book value per share as adjusted after this offering		$ 4.22