
Applied business analysis: Spotify

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A brief history

In 2005 two guys from Sweden Daniel Ek and Martin Lorentzon started developing Spotify a music streaming platform. In 2006 Spotify was officially founded, and in spring of 2007, the company had formally released its public beta and Spotify for Mac for the first time. In the winter of that year, the company launched its shared playlists, and in the summer of 2008, Spotify welcomed advertisers. In the spring, the company organised their first fundraising campaign series "A" that raised \$21.5M. October 7 marked the Spotify official European launch. In the reverse of fortune in 2009, Spotify caught up in a false accusation, potentially leaking and exposing customer personal database.

Mark Zuckerberg famously posted "Spotify is so good" on his Facebook feed In 2009 and in the summer, the company raised \$50M in the "B series" of fundraising and started to pay off licensing fees to the indie and major record label pre-licensed music catalogue. The streaming platform services were at its infant state, and only way the Spotify to get the popular artists on their platform was to pay off licensing fees. In the spring of 2009, Spotify launched its smartphone apps for Android and iOS platforms, and in 2011, the company reached 1M paid subscribers. Summer of that year, Spotify officially launched in the United States and started their Facebook user integration "playlist sharing". This feature helped to beat their biggest competitor Rdio. In 2012 in the "E Series" of fundraising campaign was organised led by Goldman Sachs, the company raised \$100M, and in the following year another \$250M in the "F Series" of fundraising. The new logo released in the spring of 2013 and 2014 was noted for their Student discount, at 50% off subscriptions and in the spring of that year company launched their family edition discount package that allowed family members subscribe through one another at 50% discounted rate. Some influential artists led by an American singer and songwriter Taylor Swift began a royalty payment debate that led the removal of her music from Spotify. A partnership was formed with the gaming platforms Playstation, enabled music streaming during gaming. And in May the company launched their video podcast support plus-activity-based playlists in New York at a tech event. That season announced another new app called Spotify Run, an exciting new exercise app that integrates with runners: by detecting the pace of the runner to match a song tempo to the runner's speed. Spotify again raised \$526M in the summer of 2015. Apple launched their Apple Music, a music streaming platform designed to compete with Spotify. In the summer of 2015, Spotify announced 20M paying users, 75M overall users and \$3B paid out in royalty payments to date. (Jordan Crook, Fitz Tepper 2015)

By July 2017 Spotify reached 60M paying subscribers and 140M total subscribers worldwide compared to 30M subscribers in March 2016. (Statista 2017)

• *Products and customer base*

Since the internet ages, the music industry has been changing rapidly. With this transformation came the most significant tweak, the fundamental ways the industry is accustomed to run. Spotify had fit into this industry gap perfectly, adapting gradually and replacing the typical ways people used to consume music, usually physical records on Vinyls and CD-s. The streaming subscription services allow listeners to choose their music wherever they are, when they want and as many times as they desire. Spotify holds a music library consists of 30M songs, from the catalogue of musicians to choose from, and the subscription comes with an unlimited music streaming without purchasing the tracks individually.

(Statista 2017)

According to (Jeffrey L. Wilson 2017), listeners can use Spotify in two different ways. The first method is by visiting the Spotify website <https://play.spotify.com>; by accessing the site player, or by the Spotify app, downloading it into the computer and use it as stand-alone mode. Smartphone apps are also made available. In the stand-alone mode, a subscriber would have an advantage to listen to their own computer's music library as well as their Spotify music. It is available on Linux, Mac and Windows operating systems and also on iOS, Android and Windows phone apps.

(Jeffrey L. Wilson 2017)

The company is rapidly developing their platform to stay compatible in this ever-changing the technological era of modern world. One of the new and exciting features Spotify added in 2015 was the "Spotify Run" app, designed to encourage and promote healthy living and exercising. The app operates by first detecting the runner's pace through the smartphone's accelerometer, then converts it into the beats per minute and matches the music tempo to the runner's pace. Running Originals are the music playlists explicitly composed for the app; these tunes adapt the runner's pace automatically as it goes on changing. The world famous DJ Tiesto is one of the first DJ-s to collaborate with the Running Originals for Spotify. The app is one of the first inventions of its kind. Some playlists curated by the computer and some by humans. (Michael Shah, 2015)

The founder of Spotify Daniel Ek introduced a new and smarter version of Spotify at the New York press conference in 2015. According to Danial Ek, this version learns user's daily routines and curates playlists accordingly.

Ek said,

"The whole notion of genres is changing. People don't look at things like Hip Hop or Country anymore, they are looking at things based on events and activities. We need to be able to deliver the right music based on who we are, how we are feeling and what we are doing, day-by-day. The new Spotify will give you the power to integrate music into your life in a way that feels kind of revolutionary but also kind of natural at the same time."

The playlists can now be consists of live radio, podcasts and even video content from a long list of partners such are ESPN, the BBC, Comedy Central, Vogue and GQ. Spotify brings video, podcasts and live radio in streaming service revamp. (Michael Shah, 2015)

• ***Major competitors***

From the recent reports, its most significant competitors are Amazon and the Apple Music. Those companies also provide streaming services like Spotify. Spotify and Pandora are the most lucrative music streaming apps on Apple's App Store grossing \$4.53M in revenues as of February 2017. 2016 was a significantly revolutionary year for the global music industry as the music streaming for the first time took over the sales in revenue, reached 51.3 percent, surpassed all the other music consumption methods such as the physical sales and the downloads combined according to Nielsen music. As of 2017 the most significant competitor of Spotify is the Apple music and according to (Dan Rys) "The big players, Spotify and Apple Music, have turned the quest for on-demand market share into a two-horse race."

"It is difficult to have more than a couple of really big, all-things-to-all-people services," says MiDia Research founder Mark Mulligan. "Amazon is trying to open up a different customer base, but for big companies like Pandora wanting to create another global player, the dice are very much loaded against them." (Dan Rys 2017)

As for the main competitor, the Apple Music have had successful run since its launch in June 2015. However, following the Universal Music group boss Lucian Grainge's ban Label-wide in August the company suffered a misfortune that significantly decreased their most lucrative inclusive album releases.

"I do not know if catching Spotify needs to be the goal, but I think making Apple Music stronger is," says Russ Crupnick, managing partner at MusicWatch. "You do not want to put yourself in a situation where you are losing ground." (Dan Rys)

"It is going to be a three-horse race among Spotify, Apple and Amazon as the dominant players," says Rich Greenfield, an analyst at BTIG Research. (Dan Rys)

• ***Pricing strategy***

With the ever demanding and changing music market, the companies are applying different survival strategies. For instance, small companies like Soundcloud and Tidal are in rumours of an acquisition, while the other streaming giants like iHeart and Pandora have already negotiated deals to offer enhanced radio at \$4.99 to the record labels, which includes offline listening and replays. Amazon is offering \$7.99 monthly streaming services through their Amazon Prime subscribers that includes Amazon Music or only \$3.99 for their highly successful voice-activated gadget Echo owners, which is much less than the industry's standard monthly subscription service value of \$9.99.

Spotify finally reached a long-term agreement deal with Warner music, the last of the licensing hurdles faced by the streaming pioneer. It was a compilation of last missing piece to their 30M songs catalogue. Although Spotify had Warner music on their streaming platform before, it was only through the short-term contracts.

“It is taken a while to get here, but it has been worth it, as we have arrived at a balanced set of future-focused deal terms,” said Ole Obermann, the chief digital officer of Warner Music.

(Anna Nicolaou 2017)

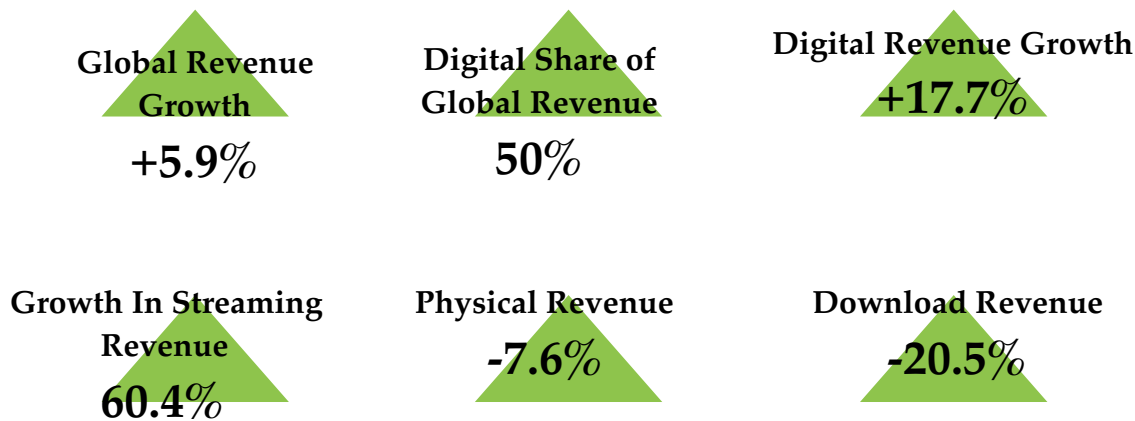
The new long-term contracts are going to help Spotify to develop a strong case with investors before a public listing. Last year Spotify revenue doubled, reached 50% higher compared to the previous year to €2.9b and surpassed the main competitors Apple music and Amazon by paying subscribers, reaching to 60M. However, the company is still yet to profit, as the net loss has more than doubled due to the royalty payments and distribution fees. Spotify has been negotiating firmly with the music giants Universal Music and Sony Music to stroke a better deal and finally got some rewarding results. With every dollar, Spotify would pay 52 cents instead of 55 cents, 3 cents less than previous years. In the trade-off, Spotify agreed to restrict for few weeks some newly released albums to its platform, which presented a resolution to the royalty war between the artists led by Taylor Swift and the streaming giant Spotify. Steve Cooper, chief executive of Warner Music, this month said: “We only agree to terms that are net-positive for our recording artists and songwriters.” (Anna Nicolaou 2017) The company is going to list their shares directly at the New York stock exchange right after familiarising their fourth quarter/people with the plan. Direct listing allows the company's privately owned stock to be traded publicly and allow investors to buy shares from existing owners. Even though the streaming has taken over the music industry, and the revenue has significantly increased, this new system of distribution have grappled to find profitable business model. For instance, Hedge funds helped Soundcloud to stay in business this month, and Pandora got a \$480m investment from SiriusXM to keep the streaming company in operation.

(Anna Nicolaou 2017)

• *The market characteristics*

In the USA the recorded music streaming sales increased for two years in a row, at the beginning of 2016. By the financial review it is recorded the music industry revenue through streaming was the only most significant revenue source for the country, bringing in \$1.61 billion to its economy. Moreover, the three major labels Universal, Warner and Sony have increased their income to double-digit percents in the streaming revenue. It predicted that by 2019 the global streaming revenue would increase to \$5.4 billion in revenue, as the US Department of Commerce reports and a study revealed by IHS Markit, on-demand streaming subscribers will triple by the year 2020 in the USA alone. (Dan Rys)

Global Music Market



Global Music Report 2017 (IFPI, 2017)

Global Market Overview.

The world recorded music market grew by 5.9% in 2016, the most significant growth since IFPI started tracking the global music market from 1997. This growth reflected continuous two-year growth for the global recorded music market and increased revenue for almost all sectors. However, considering the historical tale, the global recorded music industry as an entity had suffered depreciation, 40% loss of revenue in the previous 15 years. The streaming was a forefront of this growth, reaching 60.4% increase in revenue. Now reaching more than 100M paid streaming subscribers globally, it marked a significant milestone. The digital music revenue mostly benefiting from the streaming and now it covers 50% of the total global recorded music revenue.

Modern indie record labels and major companies played a driving force in this thriving modern music industry, pushed through the previous 15 years of market decline.

The digital music market has now become a significant part of the music industry, especially with the streaming services reaching worldwide paying subscribers. New and bespoke lean business methods used in developing local markets thanks to the record company and music industry professionals. As the music licensing spread, more music is reaching music lovers through out the world thanks to the streaming platforms like Spotify more than ever before. With the technological advance and the digital music popularity, music industry celebrates a new chapter for

the recorded music world, the importance of investing and developing new talent and many possible ways to reach the fans more than ever before; the industry is pushing on. It is vital to nurture this growth and develop it into a sustainable revenue is an essential infrastructure for the future of the industry. The "Value Gap" otherwise the downfall of the industry must be fixed, and the music makers and investors should get rewarded rightfully. (IFPI, 2017)

2016 Global Recorded Music Industry Figures by Format

PHYSICAL FORMAT: Revenue reduced by 7.6% even further decreased compared to the previous year, which was 3.9%. Even though, the physical format is still a significant player in global music economy, covering 34%, especially in the countries like Japan and Germany.

DIGITAL REVENUES: The most prominent growth, digital music sector has grown by 17.7% compared to the year before reaching to \$7.8 billion and 60.4% growth overall, the greatest growth in eight years. Although the streaming sector had grown significantly by reaching 59% of all digital revenue, download format has declined by 20.5%. The digital music revenue has never been so prominent; it made up 50% of the total global recorded music industry revenue for the first time. It recorded, digital revenue made up more than 50% of the recorded music in 25 different markets and five more countries passed the threshold in 2016.

PERFORMANCE RIGHTS and SYNCHRONISATION: Music broadcasting and public venue usage generated 7.0% more revenue which grossed US\$2.2 billion in 2016. Even though the performance rights revenue increased and made up 14% of the market, it continues to undervalue performers in royalty revenue from the broadcast platforms, especially global radio broadcasting industry, that pays only about 2% of this industry's revenue proves how insufficiently this sector continues to operate. As it believed by the IFPI, there are some countries; the statutory regulations not followed and therefore a fair synchronisation right's royalty negotiation is not made with the music right holders with broadcasters. France, the US and the UK were the leading territories for the performance right's and synchronisation revenue compared to the shortfall markets of Japan and Germany. The industry is looking to improve in this sector. (IFPI, 2017)

- ***Major short-term financing***

A financial statement is crucial for investors, financial analysts and creditors to obtain reliable information about a corporation's finances as it shows a snapshot of the company's assets and liabilities periodically.

Tencent and Spotify buy minority stakes in each other

One of the most recent major financial advancement by Spotify was the deal between Chinese giant Tencent and global streaming number one Spotify. Both companies bought minor stakes in each other under series of deals. Two companies buying stakes of one another, Spotify in Tencent's music unit and Tencent in Swedish streaming giant. One of the significant moves made by the Chinese internet giant for their global outreach policy to intersect the global music industry with Chinese music scene. (Anna Nicolaou 2017)

According to the word to mouth by some people familiar with the deal, two companies bought equity shares only under 10% by liquid asset before the initial public offerings reported to go ahead next year. Agreement proceeded the Tencent will make further stake buying by their parent group Tencent Holdings from Spotify to make up the difference between the two music service companies after the valuations posted. From the reports, Spotify valued at \$8.5b in their fundraising in 2015, but the analysts predict the company will be valued at \$20b in the public offering, by their rapid growth and the recovering industry from depreciation. Last year Tencent Music valued at \$6b and is predicted to be valued at 10b in public offering. Tencent, the Chinese giant, inventors of the most popular local platform WeChat, has long been trying to expand outside of their home territory in both acquisitions and investments. S&P Global reported, \$2b business stake hold of Tencent group in Snap, the parent company of social media platform Snapchat, is the fifth biggest investment by a Chinese company in a US tech group. Tencent recently also invested in eco-friendly electric carmaker Tesla, 5% stake hold and bought the majority of stake in Supercell, the hit game Clash and Clans inventor start-up from Finland. Tencent rumoured to have made an offer to buy Spotify before, but according to the sources, Daniel Ek the Spotify founder had denied the offer. Spotify now reached 140M users, 60M paying subscribers, covering 61 countries and have significantly contributed in turning the failing global music market economy that declined for 15 years. Only two years ago the revenue started to pick up again, and Spotify played prominent role in reducing the internet piracy substantially. IFPI reported Chinese music market grown by 20%, substantial growth compared to the global music market at 6%. Smartphone streaming is the most popular in China that could be a critical factor in this rapid growth. Tencent music apps are dominating in China today. QQ Music, Kugou music apps provide services to 500M active users and 15M paying subscribers.

(Anna Nicolaou 2017) reported "Daniel Ek, Spotify's founder and the chief said the deal would allow both companies to benefit from the global growth of music streaming". Although the

global music experts predicted, it would be harder to penetrate Chinese music market where local talents are appreciated more.

Tencent deal would add more financial assurance for Spotify ahead of the planned public offering, as viewed by the Spotify officials. The company is planned to go public on the New York Stock Exchange in 2018. (Anna Nicolaou 2017)

The deal of the two companies will help the both companies leverage in negotiating better deals with the major record labels and artists. Streaming has taken over the music industry and is excepted by the industry at large as the main music revenue format, music label executives are looking for a way to leverage better royalty deals in this sector. Tencent and Spotify both sealed better licensing deals with majors, Universal Music, Sony Music and Warner Music.

(Anna Nicolaou 2017) reported "Cussion Pang, Tencent Music's chief executive said the companies would work together to explore collaboration opportunities".

(Anna Nicolaou 2017)

From the below Financial Statement: Total asset of the company is £95368808

And the total liabilities are: £78200520

From this calculation of Spotify UK sector Equity is: £17168288

Company's Equity is worked out by total asset subtract the total liabilities.

$$£ 95368808 - £78200520 = £17168288$$

Debt-Equity Ratio

The debt-equity ratio is a common ratio used to assess a firm's leverage

The debt-to-equity ratio shows the percentage of financing that comes from banks or stockholders.

Total debt/ Total Equity = Firm's Leverage

And so Spotify UK sector's leverage is:

$$£78200520 / £17168288 = 4.5549399\%$$

Spotify Limited (Company House, 2017)

• *The recent major financing and investment activities*

PETER ATRILL, (2016). "We can further distinguish between long-term and short-term sources of finance. There is not agreed definition concerning each of these terms but, for the purpose of this chapter, long-term sources are defined as those that provide finance for at least one year. Short-term finance are therefore defined as those that provide finance for up to one year."

(Accounting and Finance for Non-Specialists, 2016)

Note 16. Financial risk management objectives and policies

The Company's financial assets and liabilities are as outlined below:

	2016	2015
	€	€
Financial assets		
Other non-current assets	870 338	3 631 074
Accrued income	6 206 247	8 113 584
Trade Receivables	16 517 768	16 426 577
Amounts owed by group undertakings (note 19)	77 274 455	89 630 033
Total	95 368 808	115 801 540
Financial liabilities		
Trade payables	1 742 009	2 996 128
Amounts owed to group undertakings (note 19)	43 697 961	31 285 190
Social security and other taxes	4 077 161	6 015 308
Accrued salaries	574 293	713 930
Accrued expenses	24 572 532	19 912 651
Finance lease liability	2 936 765	5 396 348
	78 200 520	66 229 540

In 2016 Spotify has raised \$1 billion in convertible debt from investors. As the money is in convertible debt, it comes with restrictive conditions. Private-equity firm TPG, Hedge fund Dragoneer Investment Group and clients of Goldman Sachs Group Inc were the investors that sealed the deal. One of the conditions of this debt is the debt can be exchanged into stocks, but considering today's volatile stock market; investors are looking for a better evaluation, for lucrative returns. Spotify turning into investment rather than the stock market means the company has kept their market value intact. Spotify valued at \$8.5 billion in June 2015. In the negotiations of the debt, Spotify offered strict guarantees tied to an IPO to the investors. It means when Spotify takes their company for IPO (initial public offering), if it happens within a year of the debt, the investment giants TPG and Dragoneer can convert their loans into a 20% discounted rate equity share of the public offering. Moreover, if the IPO prolonged more than a year, 2.5% discount would be added every six months on the initial discount rate. Spotify agreed to pay 5% interest rate on loan, and 1% will be added every six months until it reaches 10% or until company goes public. This method of interest deal is also known as the "coupon" an increase in debt percentage not in cash value and is mostly negotiated in private equity deals and not in venture funding. On top of that, TPG and Dragoneer are allowed to sell their share after only 90 days of the public offering and not the usual 180 days, where the company's employees and the other shareholders are restricted to sell their shares. TPG and Dragoneer are appointed to buy \$750 million worth share, and the rest is

contracted to get purchased by the clients of Goldman Sachs Group Inc. Spotify stated to go public within the next two years.

(Douglas MacMillan 2016)

Although the debt is not going to affect the company's stock market value, Fidelity Investments, one of Spotify's mutual investor had lowered their stock shares. It reported at \$1643 in January 2016, 27% lower than the rate from August of 2015. As it reported on the regulatory filings, compared to Vanguard International Growth, paid \$2,229 the same share for a stake, as of December of the previous year. A source close to the company reportedly noted according to (Douglas Macmillan) the company had left over \$600 million on their balance sheet after EBITDA before the convertible debt deal was sealed. The company raised over 1 billion dollars in 2015 from investors including Founders Fund, Accel Partners, Technology Crossover Ventures and Kleiner Perkins Caufield & Byers. In 2014 Spotify reported having the net loss of €162 million. However, in 2015 the revenue has risen by 45% to €1.08 billion from 2013 reported at €747 million. Pandora was valued less than the three times of the Spotify value as Pandora lost one-third of its market share value within 2016. (Douglas MacMillan 2016)

Spotify has been negotiating to lower its royalty payment percentage with labels, as it working towards having a profitable company. It is unclear what kind of deal Spotify has negotiated with Universal Music group and Merlin. It will be visible when company's 2017 financial results released in 2018. According to some press release, Spotify would hope to get evaluated at \$13 billion. Wall Street contemplated if Spotify proceeds with a public offering it may help with the valuation based on its latest financial reports. As the financial report released in 2016, it used a revenue multiple of 2.5 in 201 compared to 4.5 times in 2015. When revenue was €1.928 billion, its stock valuation ranged between €4.4 billion (\$5.06 billion) to €8.7 billion (\$9.17 billion). However, in 2016, Spotify produced better results by lowering the multiples to 2-3.5 times revenue, in 2016 revenue of €2.933 billion, which the valuation could range at €5.9 billion (\$6.22 billion) to €10.3 billion (\$10.85 billion). So expected \$13 billion was a little over cited.

(Ed Christman 2017)

- ***Pros and cons:***

Pros:

The company is still growing:

2016: €1.93 billion (\$2.1 billion) total revenue

2017: €2.93 billion (\$3.09 billion) total revenue

Grown by: €1 billion (\$1.054 billion) in revenue

Paying Subscribers:

By March 2017: 50 million

September 2016: 40 million

Increased by 10 million paying subscribers and a 140 million active users.

Operating loss:

2016: €349.4 million (\$368 million), 11.9% of revenue

2015: €236.3 million (\$238.2 million), or 12.3% of revenue

2014: €191.1 million (\$201.3 million), or 17.6% of revenue

Decreased by 6.3% of revenue within 2 years.

EBITDA:

2016: €161.2 million (\$169.2 million)

2015: €170.7 million (\$180 million) by Billboard calculation

Product development costs:

2016: €206.85 million (\$217.9 million), or 7.1 percent of revenue, 2015: 7.1 percent of revenue

Concerning the percentage of the revenue did not increase or decrease.

After the convertible debt:

€1.6 billion (\$1.713 billion) in the fund (€796 million/ \$838.6 million)

In cash and short-term investments: €830 million (\$874.5 million)

Above funds give the company much-needed relief to run its business into a steady growth for four years without obliged to go public while keeping their stock value intact. Though, keep the company away from big acquisitions and keep the loss under €200 million per year.

Cons:

Slower growth rate:

2016: 52.1% growth

2015: 77.8% growth

Net loss:

2016: €539.2 million (\$568 million)

2015: €231.8 million (\$244 million)

more than doubled.

General and administrative revenue:

2016: €175.2 million (\$184.6 million), 6 percent of revenue,
2015: €105.9 million (\$111.6 million), 5.5 percent of revenue;

Sales and marketing costs:

2016: €417.9 million (\$440.3 million), 14.3 percent of revenue, 2015: €258.7 million (\$272.6 million), 13.4 percent of revenue

Cost of goods:

2016: €2.48 billion (\$2.61 billion), or 84.6 percent of revenue compared to on-demand digital service model usually rated a cost of 70 percent of revenue for royalty payments, which consists of 60 percent of revenue pay for licensing master recording and 10.5 percent of revenue for publishing royalties.

€1 billion in notes (due in 2021, as Spotify failed to do the public offering within one year by April 2016),

The adjusted net loss: €294.2 million (\$310 million) a 27.1 percent increase in debt,
2015: \$231.4 million net loss. (Ed Christman 2017)

- ***Lean business methods and techniques are applied and/or could be applied.***

What is lean business technique?

- The lean business technique is a way to maximise value for customers and eliminate waste.
- The value is referred to the process or product that customers are willing to pay.
- The waste is referred to any part, process, material and efforts that do not add value to the product. (Steve Blank 2014)

Throughout this case study, we learned that Spotify as a business thinks, adapts and applies the lean business methods to meet their customer demands better in this ever-changing technological era of the music industry. Spotify has designed new custom-made apps and features to further pinpoint their subscriber's musical tastes and daily routines. Some of these apps and features include:

- "Spotify run" an app that changes the music tempo to the runner's pace
- Automatic curation of the playlist according to the Subscriber's taste
- Connecting friends and their playlists through Facebook interaction app
- Uber interactive service

-
- Turn Spotify desktop app into a Karaoke machine
 - Recover deleted Playlists and many more...

The lean business method could be applied to the following areas to reduce depreciation and waste further. Even though the revenue increased, the net loss doubled in 2016 €539.2 million (\$568 million) from 2015 €231.8 million (\$244 million). By reducing the general administrative costs, costs of goods and securing better negotiation deals for the artist royalty percentages will reduce the net loss further. The company paid out 84.6% of revenue for royalty and distribution fees instead of the industry's custom 70 percent, for licensing master recordings and publishing royalty deals which could be reduced in the future.

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