

A REPORT ABOUT SPOTIFY

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Abstract

Spotify is the world's leading music streaming service founded in Sweden, and they have captured the largest market share. The purpose of this paper is to critically review and analyse the micro and macro environment of said organisation and understand how they operate and what led them to where they are today, and how they continue to stay miles ahead of their competition. From not generating a single penny of profit until 2019 to blossoming into the profitable organisation amid a pandemic that we see today, this paper helps understand how Spotify achieved such popularity throughout COVID-19 and questions about where they may be in 10 years from now. A PESTLE analysis can be read on Spotify's macro environment and what Spotify can do to keep developing into a more successful business and more information on its financial side, whilst also looking at which lean business methods have been used.

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1. A brief history of Spotify

Spotify is a streaming service available for free across many devices. In 2006, Daniel Ek and Martin Lorentzon founded Spotify to halt the ongoing piracy problem threatening the music industry. Piracy was costing the music industry millions each year because nobody paid for the music they listened to (BBC News, 2018). Spotify officially launched in 2008, offering a free service for users to stream music, hoping that consumers upgraded to the premium option to get rid of any ads (BBC News, 2018). Doing so helped in the battle against piracy as people had a legal alternative to save money on buying their favourite songs. The company's revenue growth was phenomenal, from around £1.6 billion in 2015 to around £5.3 billion in 2019 (Pinkhasov, 2020). Spotify's fast growth was sure to bring competition, and so it did. The likes of Deezer, Apple Music and Tidal eventually came into play but could only dream of toppling Spotify.

Fast forward to 2021, and Spotify has grown to become the world's most popular streaming service available, with around 268 million active monthly users, 130 million of them being premium subscribers (Iqbal, 2021). Spotify's numbers are estimated to be around 208 million more than their biggest competitor, Apple Music (Iqbal, 2021). Due to the COVID-19 pandemic, streaming has been more popular than ever, including podcasting, which has seen much more significant growth since the pandemic started (Swan, 2020). Spotify got its foot in the door with podcasting by signing podcast program deals with the likes of Joe Rogan and Kim Kardashian, therefore boosting the company's value (Clifford, 2020).

2. Spotify's business economics

2.1 Products and customer base

The products that Spotify offer are the ability to stream music and podcasts on the go. It can either be used for free or for £9.99 a month for a premium subscription. The premium subscription reaps certain benefits such as ad-free listening and downloading songs for offline play. Being one of the only free streaming services available, Spotify appeals more to a younger audience who does not have the finances to pay for a subscription. Spotify is very popular amongst millennials in the United States, with 2018 numbers showing 29% of their users aged 25 to 34 and 26% of their users aged 18 to 24 (Statista Research Department, 2021). Spotify's popularity amongst millennials could be for many reasons. One of them is the free subscription for youngsters who are less inclined to spend money on it. The other one is that students can get a free month of premium, followed by a subscription fee of only £4.99 a month for up to four years (Spotify, 2021). This deal would make Spotify a much better alternative for students, as it is cheaper than Spotify's competitors. Musicians are also big customers of Spotify, mainly due to the Spotify For Artists service they provide, which gives musicians the ability to customise their artist profiles to how they see fit. This means that musicians can see data on where and when their music is being listened to. After this, Apple and Deezer also made a way for musicians to access their streaming data. However, Spotify remains the most popular amongst musicians, possibly due to Spotify being the most popular streaming platform in general.

2.2 Major competitors

Spotify may be the global leader in the streaming market, but Apple and Amazon have proven they can still catch up. Apple has quite a smart tactic. They already own half the phones in people's pockets, making it easier for them to convert the Apple phone owners into Apple Music listeners due to smartphones being the most

popular way of using music streaming services (Levy, 2018a). Third in the race for the top, Amazon has also come up with ways to cut into Spotify's customer base. With the Amazon Echo smart speaker's invention, many people are changing to Amazon Music Unlimited, which Amazon states works best with their speaker (Levy, 2018a). Whilst Apple and Amazon have come up with reasonable efforts to take the crown from Spotify, it has all been to no avail. Spotify still has the most significant advantage of all. By having more listeners, they have more data. As mentioned before, with around 268 million active users a month, the data keeps piling in for Spotify to improve their app for their consumers. With users' ability to create and share their playlists, this is practically a free advertisement for the company. It will attract more listeners to share and listen to their friend's playlists and the many playlists Spotify provide (Levy, 2018b). These are the methods that Spotify use to keep ahead of their competitors, and they have proven to work. There was a period when Spotify was offering a free 30-day trial, so their users could see the perks of being a premium member, but it did not take long for Apple to jump on board and do the same. What was Spotify's response? They extended their 30-day trial period to 90 days, giving their customers an extra two months of premium listening time for free. It is safe to say that Apple lost that pricing war (Gibbons, 2020).

Spotify has managed to stay ahead of its competitors because they know how to keep their customers loyal. Spotify sees the importance of making sure that customers stay with them from the start, so they put everything into keeping new users immersed in the music streaming experience. Customers are always made to feel welcome, whether they are listening for free or a paid member. Spotify will also try to help keep the listener engaged with the artist's they love by continually recommending music by their favourite artists and even curating playlists made up of artists they love, just for that listener (Gibbons, 2020).

2.3 Pricing strategy

Spotify has five plans laid out for its customers. One of them is the free service, which is one factor of their success, generating ad revenue. The second is the premium service, where people pay £9.99 a month to receive ad-free listening and other benefits. The third is the family plan, which allows up to six users to use the same premium membership for £14.99 a month. As previously discussed, the fourth plan is the student plan (Campbell, 2018) and the final plan being the duo plan, which gives two people sharing a household a premium membership for just £12.99 a month. However, what is stopping people from getting the family plan and just splitting it with friends? Honestly, not a lot. The only measures to prevent this are members stating their address and forcing some users to share their GPS or risk losing their premium subscription (Humphries, 2018). Spotify has retained a widespread customer base with these pricing strategies and will probably get away with raising its prices.

In the third quarter of 2020, Spotify gained an extra six million subscribers, but they fell short on sales and earnings, therefore driving the stock lower. By raising their prices, Spotify hopes to increase revenue in markets where they believe their customers see the value. Spotify hopes to continue seeing their engagement and value per hour grow with the popularity of podcasts growing and the constant supply of original podcasts to their users. These are the areas where Spotify can attempt to raise its prices, but during a recession where people are losing their jobs and trying to save money, are people going to continue paying for Spotify if the prices increase (Perez, 2020)? Some might say that Spotify is relatively inelastic because streaming is more popular now than ever; surely people can afford a few more pounds to keep themselves entertained?

On the other hand, if Spotify raises its prices and is more expensive than its substitutes, what stops people from switching platforms? The answer lies in understanding how consumers engage with the changes that Spotify

makes. Demand is higher than ever for streaming right now, and it might be in Spotify's best interest to wait until inflation takes its course to raise its prices, as raising their prices now may cause their demand to drop off.

2.4 Market characteristics

Spotify holds a monopoly over other platforms in the music streaming market and how music is listened to in general. Take, for example, their 268 million monthly users over Apple's 60 million and Amazon Music's 55 million monthly users and being able to stream music on the go far outweighs the use of CD and Vinyl anymore. A monopolised Spotify does not make a difference for the consumer, but musicians are losers in this scenario (Laker, 2020). People believe that artists get paid by Spotify per stream, but there is no such thing. Instead, Spotify takes 35% of their earnings for themselves and distributes the other 65% to distributors, who then take it upon themselves to split the money across their artists, depending on the number of streams each artist has. However, should Spotify pay a higher percentage of its revenues out? Well, it is not entirely in Spotify's control in some parts of the world. For example, in the U.S., the Copyright Royalties Board sets the percentage of how much artists should get paid in streaming royalties. Either way, musicians are still going to upload their music to Spotify regardless of how much they get paid, as it is essential to have their music on Spotify nowadays for it to get famous.

Another significant characteristic of the streaming market is that everything is more or less one price. Some of the most prominent organisations in the market have very similar or identical pricing. Spotify Premium is £9.99 a month, as is Apple Music, YouTube Music, Amazon Music Unlimited and Deezer (Field, 2020). By all having the same price, if Spotify were to increase their prices now, the response would be somewhat elastic, as some people might not want to pay more when they can change to a cheaper service. Some may see this as making themselves wealthier by saving the extra money they may have spent.

Due to COVID-19, people who have been out of work have less money to spend, and others who have been working but with nowhere to spend their money have more money to spend. People with more money to spend will feel more inclined to pay for streaming services such as Spotify, mainly because there is not much else to do whilst everything is closed. People with less money to spend are also more inclined to use Spotify over any other streaming service because of their free membership and popularity. This shows that the economy has a minimal effect on Spotify. With the halt of live music, streaming has more demand than ever, and musicians also supply more music due to being stuck inside with more time to write. It is a win-win for musicians and music lovers alike, as there is more music uploaded for them to stream and more royalties for the musician to get paid, regardless of how little the amount is.

As mentioned before, Apple and Spotify had a minimal price war, an application of game theory, which resulted in Spotify raising their 30-day free trial period, as matched by Apple, to 90 days (Gibbons, 2020). Apple loses out on this price war fast, and Spotify subscribers relished in the invisible hand serving them a free package usually priced at £29.97. This helped Spotify establish a better relationship with their consumers and create a trust barrier between them. With people experiencing 90 days of premium membership, indeed, they would feel like they almost needed it after it expired, as they would have got used to it after having it for so long.

2.5 Macro-environment

2.5.1 Political factors

In 2018, Donald Trump signed the Music Modernization Act, making it easier for rightsholders to get paid when their music has been streamed online. These unclaimed royalties would have previously stayed with platforms like Spotify (Deahl, 2018). Spotify's Cost of Revenue which consisted of many unclaimed royalties took up to 74.6% of its total revenues. This new law could threaten industry giants like Spotify, reducing their profitability (Team Pitchspot, 2020). At the start of 2020, Spotify announced that they would not run any political ads amid the 2020 presidential race. Some people commend Spotify for such actions, considering that its revenue stems from advertising on their free membership service (Heater, 2019). However, there are indeed other ads that would happily fill the void.

2.5.2 Economic factors

With the U.K. being Spotify's biggest market and unemployment rates in the U.K. rising to 5% in November 2020 (Leaker, 2021), this could impose a threat to Spotify's growth and profits as unemployment may result in more cancelled subscriptions. Regardless of this, Spotify has still seen a massive rise in subscriptions in the recent year and will surely only grow more significant as the impact of COVID-19 starts to wear thin, and jobs begin to open up again. If there was another reason for unemployment other than the pandemic, Spotify might have been in trouble. However, because everybody is isolating or working from home, Spotify has been to their aid. The music industry is expected to boom as restrictions are decreased (Murphy, 2021). Venues and festivals may have been closed off from the world, but regardless of this, royalty streams are increasing, fanbases are growing, and labels still release lots of new music. It can only be assumed that once the vaccine is fully rolled out, everything will be bigger and better than ever (Murphy, 2021). With festivals and large events returning on the 21st of June in England, One of Spotify's biggest markets, it will be interesting to see how this affects Spotify's use. One could say that Spotify's use will slowly start to decline as people are listening to more music live, and it could be imagined that concerts will be like never before.

On the other hand, it would be believable for Spotify's popularity to stay the same, if not more extensive. People will be listening to more music live and want to hear the same music after and before the concerts. It is pretty common for people to want to stream music online before going to a concert and stream it afterwards as they get the 'festival blues'.

2.5.3 Social factors

Spotify is a company driven by values, and it has been known to use music to drive social changes. The business has an assortment of powerful tools that can be used to solve problems within the social sector (McPherson, 2017), and they strongly believe in using these tools to create a better world to live in. Such tools would be their workers' skills, the massive number of people they can reach, their distribution channels, and their relationships with governments (McPherson, 2017). Due to social distancing, Spotify has seen the way people listen to music and podcasts change in many ways. An example of this is fewer people streaming music from their cars when commuting to work, to instead streaming more on their computers and phones whilst at home. Many positive things are coming from Spotify, such as specific podcasts and playlists helping keep people fit and healthy whilst stuck at home, as well as user playlist collaboration and social sharing are also helping to bring people together. A perfect example of the impact COVID has had can be seen in The Police's "Don't Stand So Close to Me", which has seen a 135% spike in streams since lockdown started. (Spotify, 2020).

2.5.4 Technological factors

Technology is constantly evolving. Spotify needs to keep up to date with any technological advancements to keep their consumers supplied with the goods and products they require. Spotify is planning to manufacture its smart speakers after seeing an increase in smart speakers being purchased, some even from their website, which links directly to their competitors. This could be an opportunity for Spotify to increase its subscribers by encouraging consumers to listen to music on their speakers with Spotify, generating higher revenue (Team Pitchspot, 2020). The days of focusing on traditional promo for new releases such as billboards and interviewing are slowly declining, as artists such as Drake and Ed Sheeran turn to Instagram and Spotify to do their promotion (Cole, 2019). Perhaps Spotify could find a way to monetise this promotion for artists, therefore boosting their revenues. This could be seen as quite a lean business method as they will be improving their value stream without necessarily putting too much workload on themselves, as artists will be paying Spotify to promote themselves on their platform. This sort of deal could be of great value to many customers.

2.5.5 Legal factors

Some states in the U.S., such as Virginia, have proposed a 5% tax on streaming services to increase tax revenues. If this tax gets approved, it may result in Spotify having to increase their premium subscription cost in that area for them to maintain profitability after taxes. Thus, Spotify needs to be aware of any legal issues that may arise around this to prevent them from changing their prices, leading customers away to a cheaper alternative (Team Pitchspot, 2020). Spotify also needs to be aware of the copyright laws for each territory they operate within and ensure that all royalties are paid. Spotify has previously got into trouble with royalties not being paid properly and ended up paying more than £30 million to settle a case back in 2017 (Perez, 2018). They had allegedly failed to pay royalties for a selection of songs available to their customers. This was followed by a £1.1 billion lawsuit filed by Wixen Music Publishing in late 2017, in which both parties agreed on a final dismissal of the lawsuit (Perez, 2018).

2.5.6 Environmental factors

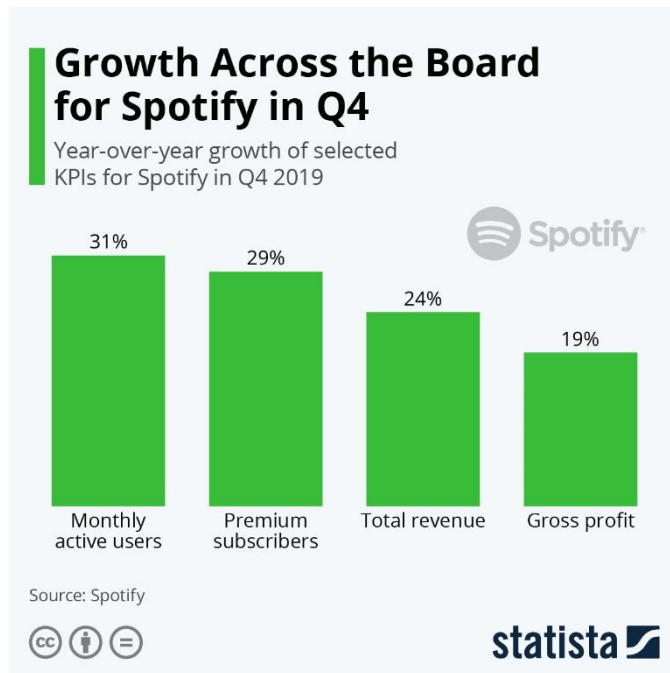
Some speculate on the relationship between Spotify and the environment. One thing that is proven is the increase in plastic generated to create CDs due to the increase in streaming. CD production peaked in the year 2000, which had the U.S. industry using 61000 tonnes of plastic. By 2016, this had dropped significantly to around 8000 tonnes of plastic as the music streaming market grew exponentially (Campbell, 2020). The University of Glasgow found the price that consumers are willing to pay for music has never been lower, whilst the environmental impact of listening to music has never been higher due to streaming. The downloading and use of energy to store and stream music have a massive impact on the environment (University of Glasgow, 2019). To reduce its carbon footprint, Spotify has adopted Google's servers, known for being one of the world's highly sustainable companies, promising to use 100% renewable energy (Team Pitchspot, 2020). This seems like a step in the right direction for Spotify in tackling rising carbon emissions. Hopefully, with the steps that Spotify has made, they can help create a more environmentally friendly world for everyone to live in.

3. Spotify's business finance

3.1 Short and long term financing

Spotify made their stock market debut in 2018, although they had never made a profit, making it harder for potential investors to value them. Something that differs Spotify from other business is that they were not

issuing any new stock. Instead, they were selling shares currently held by their private investors to save the company money rather than using investment bankers. This opportunity would help fund the business's expansion, although it would also increase the management's pressure (Monaghan, 2018). Institutional investors hold most of Spotify's shares at around 55-57%. The top three are Daniel G. Ek, Sven Hans Martin Lorentzon and Baillie Gifford & Co. Each of them holding a combined 41.3% of the total shares outstanding (Johnston, 2021). After 13 years and 96 million subscribers later, Spotify finally reported its first profit in February 2019 (Hollister 2019). By the end of 2019, Spotify's gross profit was 19%, with its total revenue sitting at 24% (Armstrong, 2020).



Graph 1: Growth Across the Board for Spotify in Q4

Spotify releases financial information to its investors quarterly. Their most recent financial results for the fourth quarter of 2020 show substantial growth in MAUs (Monthly Active Users), an improvement in ARPU trends (Average Revenue Per User), a massive increase of users engaging with podcasts, better than their expected gross margin, and Free Cash Flow of around €74 million (£64 million) (Spotify, 2021b). This is shown in the table below.

SUMMARY USER AND FINANCIAL METRICS					
	Q4 2019	Q3 2020	Q4 2020	% Change	
USERS (M)					
Total Monthly Active Users ("MAUs")	271	320	345	27%	8%
Premium Subscribers	124	144	155	24%	7%
Ad-Supported MAUs	153	185	199	30%	8%
FINANCIALS (€M)					
Premium	1,638	1,790	1,887	15%	5%
Ad-Supported	217	185	281	29%	52%
Total Revenue	1,855	1,975	2,168	17%	10%
Gross Profit	474	489	575	21%	18%
Gross Margin	25.6%	24.8%	26.5%	--	--
Operating Income/(Loss)	(77)	(40)	(69)	--	--
Operating Margin	(4.1%)	(2.0%)	(3.2%)	--	--
Net cash flows from operating activities	203	122	107	(47%)	(12%)
Free Cash Flow ¹	169	103	74	(56%)	(28%)

With the way that Spotify is growing, it seems like a brilliant idea for investors to get shares in the company now, as Spotify is heading to generate massive amounts of revenue in years to come. In 10 years from now, Spotify's total user base could at least triple its current size, and profitability should drastically improve due to high-margin podcast ads as well as the leveraging of its fixed costs. The company may even negotiate better music royalties for Spotify in the future, as they will be even more significant and crucial for music labels and artists to get their music on (Tseng, 2020).

Spotify's advertising technology has far more financial benefits than the revenue generated from streaming music alone, so there is no doubt they would use their best efforts to exploit this system. As noted in Vonderau's article (2017), Spotify sells its services to advertisers with the promise of targeting a selected audience for the best outcome for their customers. By using advertising, Spotify also prompts users using their service for free to pay for premium. This seems to balance out quite nicely for Spotify, with money being generated from ad revenue for the free users and premium subscription payments being paid from premium users.

3.2 Recent financing and investment activities

Since 2019, Spotify has invested hundreds of millions of pounds in podcasts. They have signed top-ranking podcaster Joe Rogan on an exclusive deal, along with the likes of Michelle Obama and DC Comics. It has been rather tricky to measure the return of an investment in podcast advertising. Podcasters cannot tell how long listeners listened for and if they listened to any ads. With the integration of Spotify's "Streaming Ad Insertion" tool, Spotify can insert audio ads into podcast streams being listened to on its platform, creating better targeting and measurement. Information such as this is precious to advertisers, as they can target precisely where and when they want their ads to play (Bursztynsky, 2020). Podcasts present Spotify with an opportunity to use its fixed costs to generate more revenue from advertising. This way, unlike with the royalties made from music streaming, when Spotify generate money directly from consumers steaming podcasts, they keep all of it. With Spotify's acquisition of Anchor (an operating system for creating podcasts) and advertising and publishing company Megaphone (Henderson, 2021), Spotify now has more opportunity to generate revenue directly from podcast listening. By directly monetising podcasts, Spotify could see a considerable boost to its financials (Levy, 2021).

3.2 Pros and cons of alternative ways of financing

An alternative way for Spotify to generate revenue could be from attempting to jump onto the video-streaming bandwagon. Of course, they would have tough competition against YouTube. However, they could make it a premium membership feature for members to share their videos to the platform or fanmade music videos. These videos could then be monetised by strategically placing ads throughout said videos. An issue with this would be how popular the content would be on the get-go, considering almost 100% of the content streamed on Spotify requires listening only, aside from the odd lyric videos on certain songs. Most videos on YouTube already have ads, so consumers most likely would not feel discouraged to use the feature due to the advertisements. One strategy might be to interject adds that target the music community.

The pros of this feature would be that artists could use Spotify as more of a social media platform to promote themselves and their upcoming releases, rather than the likes of Instagram or Twitter. The thought of having

everything in one place sounds very promising; it just depends on whether Spotify would be able to adapt to make this happen. Another negative side to this could be that it would not be considered a very lean business method. It would require a lot of spending and many human resources to make something like this possible, without any promise of a profitable outcome, which many investors may not trust.

If this feature was to go ahead, and Spotify could generate even more ad revenue from video streaming and potentially revenue from paid promotions on their platform, one would see it as a rather promising direction for the business to head towards. Nevertheless, as said before, the risks of everything not going to plan may far outweigh the promises of large profits. Perhaps they could also sell and create small marketing packages for artists that use their services, just as some distributors do. Indeed some artists would feel more comfortable going directly to Spotify for marketing services, as Spotify is the central hub for their music stream. During a pandemic where everyone is isolating, some musicians primary income source is through streaming, depending on their popularity.

Spotify may also find a way to generate revenue from musical events' potential return just before the summer in England. Promotional campaigns could be run through Spotify, and playlists could be created to get people ready for the summer festivals. These are potential ideas that Spotify could build on to maximise its profits.

4. Lean Business Methods

Aghnia and Larso (2018) indicate that a lean startup's idea is to create a minimum viable product (MVP), a new product with limited features to generate customer feedback. The MVP must be kept at a low cost but still viable to the customer, hence the name. As explained by Ries (2011, pp. 200-201), short surveys and tests can be done on customers to receive insight that may affect the product's development. It may continue in the same direction or change completely. Doing this will avoid costly mistakes early on and help create a product that will succeed.

One of the biggest reasons for Spotify's success is 'The Spotify Model'. By using lean principles and agile tools and practices, Spotify has built the best working environment possible, establishing transparent processes and objectives. Agile helps keep the structure together, whilst lean makes the structure stronger and steadier (Castelli, 2020a). In lean management, Gemba Walk is essential. Gemba commonly refers to the shop floor, or in Spotify's scenario, their offices. It is ideal to be able to engage and build relationships with the people working in the Gemba. Gemba Walk helps in seeing how processes work and help in resolving issues and identifying their causes. It differentiates massively from just reading results on a piece of paper (Castelli, 2020b). Spotify utilises Gemba everywhere to help shrink hierarchy and to establish a better connection between teams. All employees are given a voice that can provide constructive criticism or even give suggestions or ideas. The decision-making process is close to where value is produced, so politics and waste are usually lower (Castelli, 2020a). Also included in 'The Spotify Model' is that Spotify does endless experiments. This is one of the lean ideas: experiments and tests with small groups before releasing to a larger audience (Castelli, 2020a). By endlessly experimenting with new developments, it ensures that everything is of the best quality and working as designed before being released.

The 'Business Model Canvas', as invented by Alex Osterwalder et al, helps businesses to analyse, create and develop business models. The 'Spotify Canvas' can be seen below, detailing their values and statistics (Lumos Business, 2020). This canvas, in particular, does an excellent job of displaying necessary information relevant

to the values and structure of Spotify. However, it does fail to capture certain aspects of financing, competition and certain market factors.

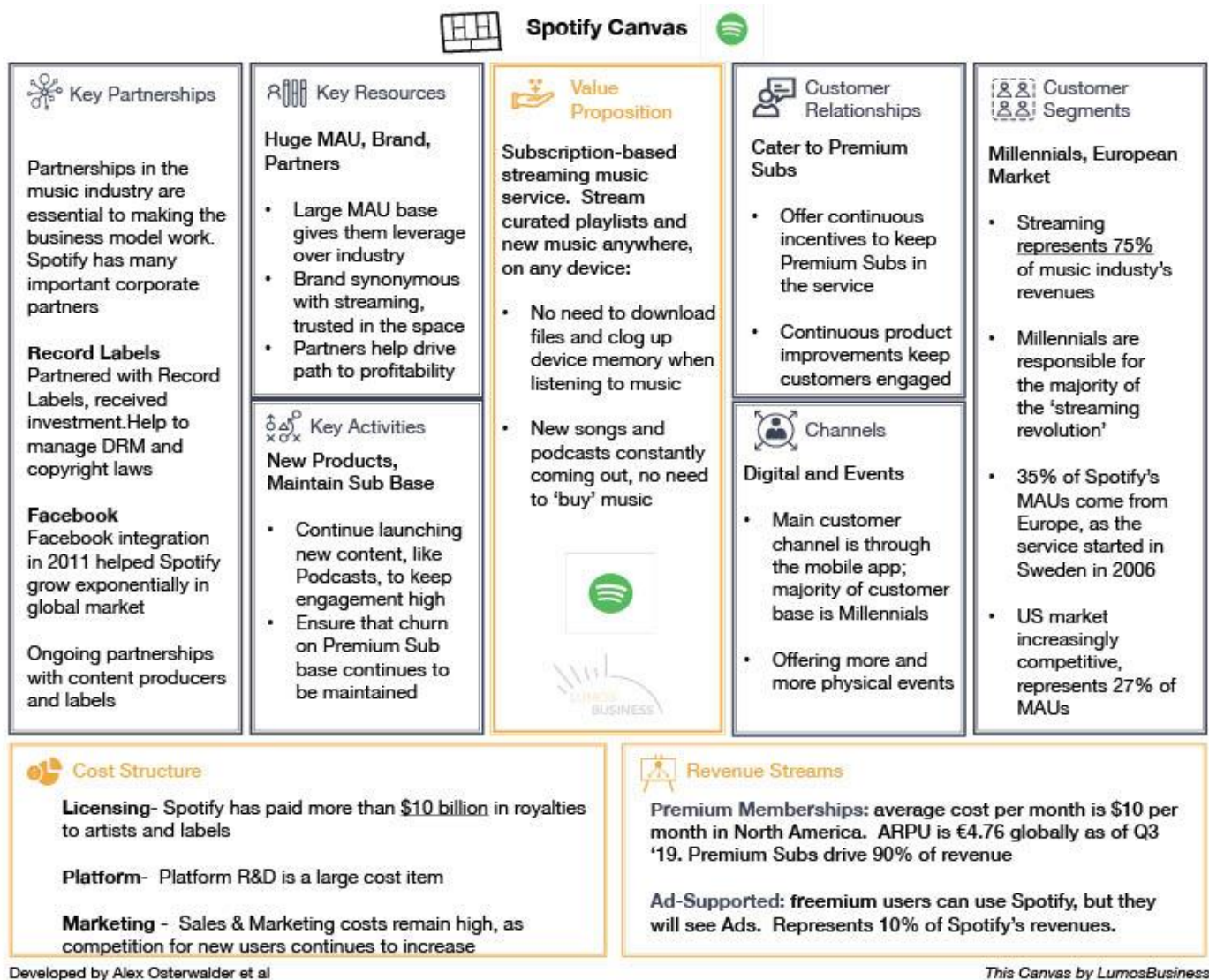


Chart 1: Spotify Canvas

5. Conclusion

As seen in the sections above, Spotify has used lean business methods to create a relaxing and motivating workplace for its workers. Although Spotify has not always been profitable, they finally managed to see some profit, which hopefully continues to grow as they get more popular as time goes on. Some uncertainties remain, such as how Spotify will adapt to stay on top of their competitors or how their business model might change as the market's popularity increases, but only time will tell.

Word Count: 4643

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7. Appendix

Chart 1: Spotify Canvas

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Graph 1: Growth Across the Board for Spotify in Q4

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Table 1: SUMMARY USER AND FINANCIAL METRICS

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