

GOING AGAINST THE STREAM: A CRITICAL ANALYSIS OF SPOTIFY'S BUSINESS MODEL

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CONTENTS:

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OVERVIEW:

Although it once accounted for the majority of the revenue generated within music, the recording sector is today best described as "the engine helping to drive a much broader music industry" (O'Malley Greenburg, 2011). Nevertheless, the IFPI's Global Music Report (2017) details a recent uplift in global recorded music revenues, totalling US$15.7 billion in 2016. Prior to the current period of growth, which began again in 2015, the global music industry lost over 40% in revenues after more than a decade of steady decline (IFPI, 2017). The vast majority of this renewed growth is owed to the emergence of music streaming services. It quickly became clear that swift action would be required to supplement the dwindling number of 'traditional' (CD/Digital Download) sales caused as a result of a boom in music piracy and peer-to-peer file sharing. Spotify, launched in 2008 (Spotify, 2008), has since grown to become music streaming's market leader and has capitalised on the evolved consumption methods of today's audiences (Pullen, 2015). Initially an invitation only service, the Stockholm-based music platform now counts over 60m paid subscribers and over 140m active users (Spotify, 2017a).

This report examines three key areas of Spotify's business model and provides an in-depth critical analysis of their application. Beginning with a brief overview of its origin and development, the report then assesses both the economic and financial aspects of the business. It also scrutinises two of the streaming platform's major competitors, namely Apple Music and SoundCloud, in order to better understand the market in which Spotify operates. Lastly, this report explores the lean business methods that have been adopted by the company and outlines the short-term growth that can be expected as a result of their application. It summarises by stating that Spotify has continued to widen the gap between themselves and their competitors through the effective application of lean business strategies. Despite their present failure to become profitable during their decade in operation (Music Business Worldwide, 2015), Spotify's focus on innovative business practices gives them a sizeable advantage over their competitors.

PART 1: BRIEF HISTORY

1.1 – About Spotify

Founded in 2006 by Daniel Ek and Martin Lorentzon (Fleischer & Snickars, 2017, p. 137), the Swedish music-technology company Spotify officially launched in 2008 following the signing of "ground-breaking licensing deals" with major music catalogue holders including Universal Music Group, Sony BMG and Merlin (Spotify, 2008). In February 2009, the streaming service launched in the UK and removed its restrictions around its accessibility, becoming available for both free and paid subscribers (Spotify, 2009). Beginning as a desktop application made for use on Mac and Windows PC, Spotify has since become available for mobile devices (Cheng, 2013). This led to Spotify being named as one of the World Economic Forum's 2011 Technology Pioneers (Schonfeld, 2010); a prestigious award given to start-ups who "represent a global community of trailblazing companies […] with the potential to significantly impact business and society through the design, development and implementation of new technologies and innovations" (World Economic Forum, 2017). Yet despite its status as a forward-thinking music-tech company, Spotify has been subject to a wide range of criticism. Some of this has come as a result of its once puzzling tiered subscription model (Hamburger, 2013; Crook, 2013). Eventually, much of the restrictions were removed from its free desktop program (Murray-Morris, 2014). However, most of the more recent backlash has come from artists unhappy with the royalty payment structure. Several mainstream figures, most famously American pop singer Taylor Swift, have refused permission for their work to be made available on the streaming service until adequate remuneration is provided to artists (Linshi, 2014). It is important to note, however, that this issue is not unique to Spotify and has caused much debate since streaming became the leading form of consumption for music fans (Dredge, 2015).

1.2 – Other music streaming services

As noted earlier, music piracy and peer-to-peer file sharing decimated the traditional sales market in the music industry and although other streaming services were in existence prior to Spotify's launch, none were as successful at seizing the opportunity to capitalise in this new market. According to research carried out by Music Business Worldwide (2015), Spotify accounted for approximately 49% of new music streaming subscriptions in 2014 (see Fig. 1). Their largely unrivalled dominance led to Californian tech giant Apple deciding to launch their own service the following year (Gray, 2015). After the decline in CD sales, Apple had placed much of its focus on iTunes; a digital download store that enables consumers to purchase individual tracks or albums that can be listened to on a mobile device or PC (Apple (UK), 2017). Apple Music launched in 2015 and has gone on to challenge Spotify's global

supremacy within the music streaming market. The relationship between the two subscription-based models and those who offer free music streaming services will be explored in further detail in part 2 of this report.

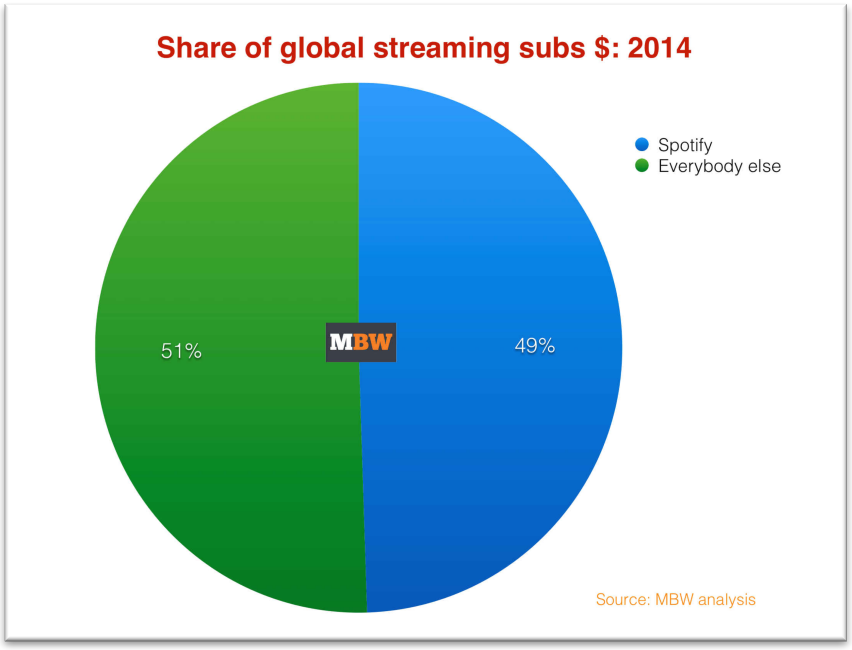


Figure 1: Share of global streaming subscription revenue (Music Business Worldwide, 2015)

PART 2: BUSINESS ECONOMICS

2.1 – Services and Customer Base

Spotify's primary aim is to act as a "digital music, podcast, and video streaming service that gives you access to millions of songs and other content from artists all over the world" (Spotify Support, 2017). It has achieved this by capitalising on a need for change in modern methods of music consumption (Pullen, 2015). As a business, they have therefore focused more on microeconomics – "the economics of the individual parts of the economy, rather than the economy as a whole" (Sloman, et al., 2012, pp. 29) – however, they have at times encouraged government intervention to protect Sweden's technology sector as it was felt current systems were "threatening to drive businesses out of the country" (Sheffield, 2016). Since its early stages, the company has made clear its aim "was to make music on-demand available to all" (Spotify, 2011). Its customer base is therefore split between two core categories; fans and artists. The mobile app (see Fig. 2) gives users access to their favourite music and enables listeners to follow or create playlists featuring these songs. In 2017, Spotify launched a separate mobile application specifically for artists to enable easier management of their profile on the streaming platform (Perez, 2017). As a result of a number of different licensing deals, it is relatively simple for artists to distribute their music on Spotify using any one of a variety of music aggregators. The app then provides both artists and/or artist managers with a detailed view of audience insights including stream counts and follower engagement (see Fig. 3).

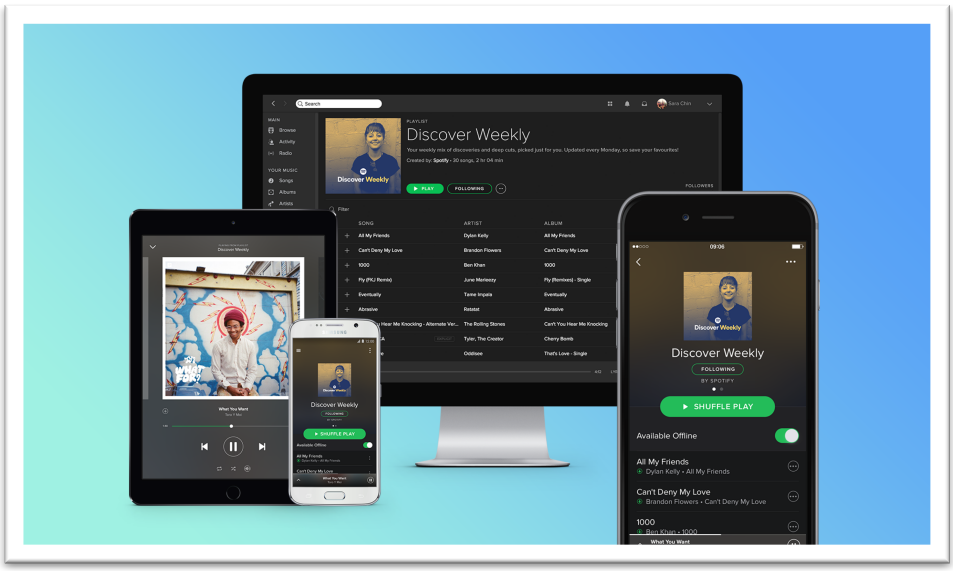


Figure 2: Spotify desktop and mobile application (Spotify, 2017c)

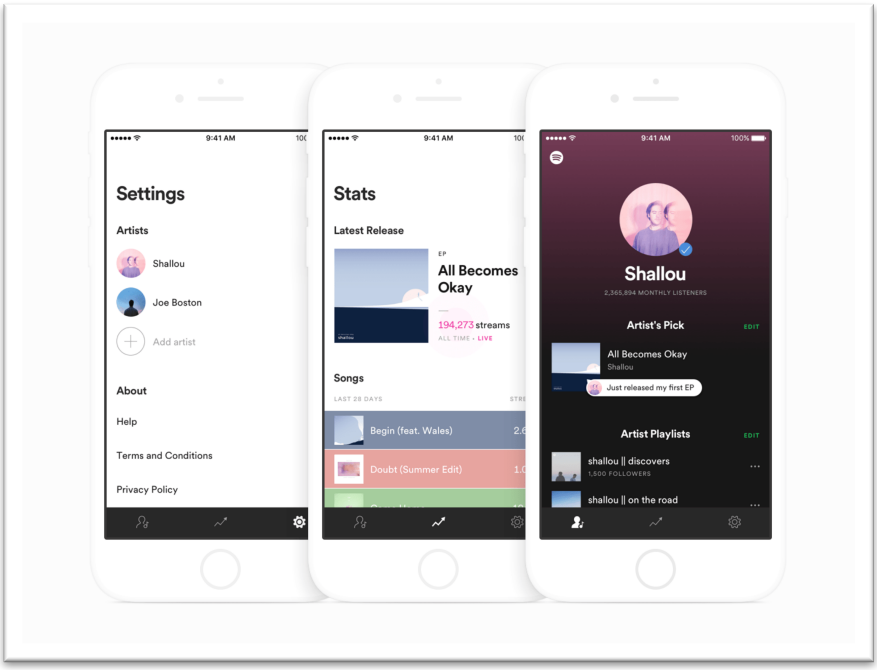


Figure 3: Spotify for Artists (Kesselaers, 2017)

2.2 – Major competitors

Berlin-based audio distribution service SoundCloud also entered the market in 2008 (Moazed, 2016). Originally designed as a tool "to help music industry types share recordings with each other" (Van Buskirk, 2009), the platform's ease of use made it suitable for evolution into something much more powerful. By giving artists a platform to showcase their talent without typical content restrictions and offering users a free place to digest that content, SoundCloud placed themselves in a strong position (Van Buskirk, 2009). Whilst this helped them to monopolise a generation of consumers, it understandably led to a number of legal issues. Threatened with cessation, SoundCloud began taking a hard-line approach to copyright infringement (Wilson, 2015). Despite some brief optimism following the signing of a licensing deal with Universal Music Group in 2016 (Lunden, 2016), SoundCloud's paid tier has been less than successful (Butler, 2017). Spotify capitalised on this by growing its subscriber base from 28 million to 50 million in just over two years (see Fig. 4). The potential for legal problems was also less than some of its competitors as it entered the market having already agreed licensing deals (Spotify, 2008). It is therefore no surprise that despite SoundCloud having 175 million unique monthly listeners (Billboard, 2014), Apple Music has now grown to become Spotify's main global competitor (see Fig. 4).

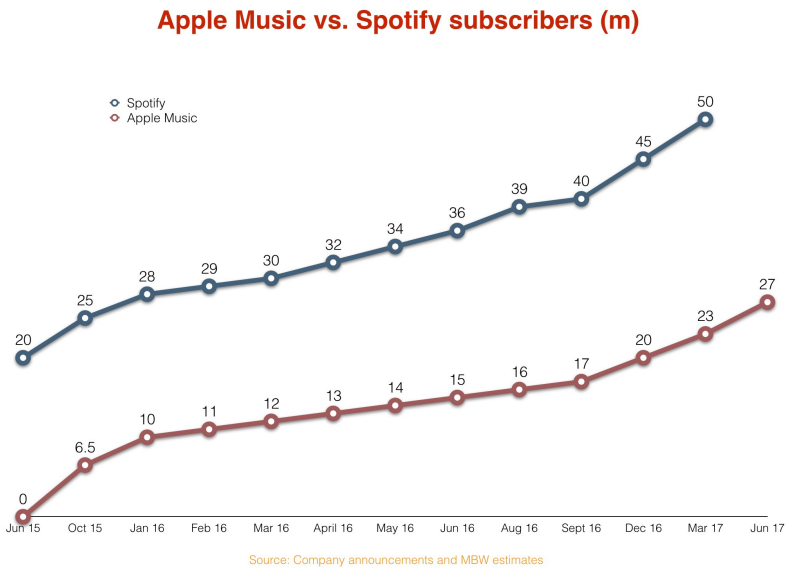


Figure 4: Apple Music v Spotify subscribers (m) (Music Business Worldwide, 2017)

Since launching in 2015, Apple Music has successfully converted a large chunk of its iTunes customer base in to paid subscribers following three months of free use for all new users (Gray, 2015). Spotify, however, have taken a different approach to their pricing strategy.

2.3 – Pricing Strategy

Spotify offers a range of introductory offers to persuade users to sign up for its service – at the time of writing, the streaming platform was offering a free month of its Premium service before entering into a monthly rolling plan (Spotify, 2017b). This is known as a "freemium" model – a service which seeks to gain customers by offering a free service but charging extra for additional features (Rayna & Striukova, 2016, pp. 23). Establishing itself in an era in which many other services offered free streaming (such as SoundCloud, for example) was always going to be difficult. Spotify therefore set its focus on avoiding the hassle that came with the illegal downloading of music and peer-to-peer file sharing. The service now offers four tiers to its payment structure in the UK (see Fig. 5):

1. Spotify Free
2. Spotify Premium
3. Premium for Family (£14.99 for up to six users who reside at the same address)
4. Student (£4.99 for registered Unidays users in the UK)

NB: The PlayStation® Music service is available on both the Spotify Free and Premium tiers for Sony PlayStation® users.

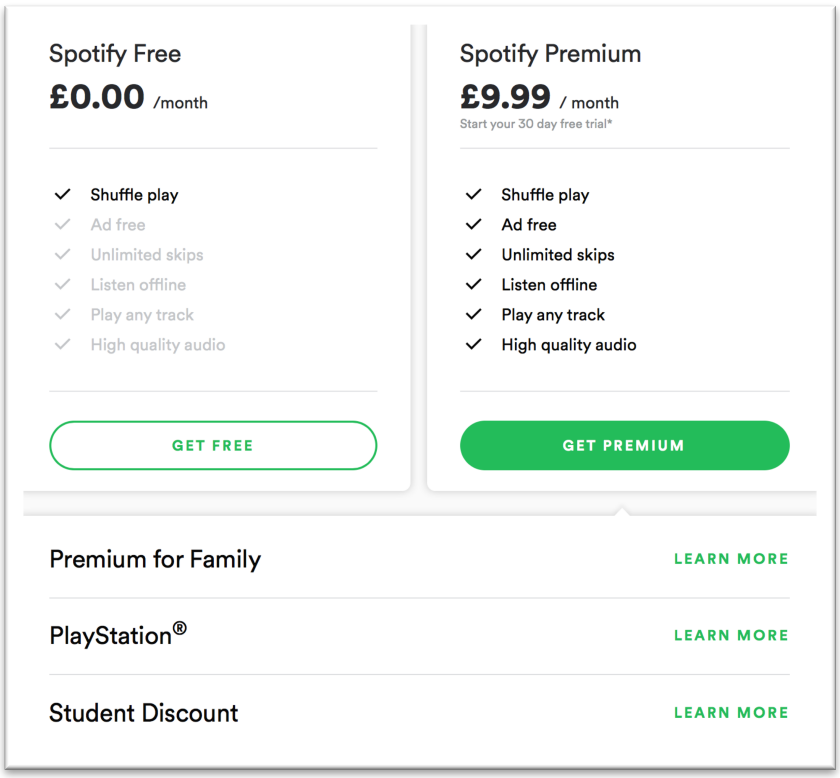


Figure 5: Spotify UK payment tiers (Spotify, 2017b)

2.4 – Market characteristics

As earlier noted, the changes in music consumption methods meant that the market needed to quickly adapt. Although Spotify has moved quickest to dominate, some have argued that this was never their intention. Fleischer and Snickars (2017) assert that "it was certainly not an attempt to disrupt the music industry to save it from piracy"; instead, Spotify's aims were "purely technological: to create a platform for media distribution based on a peer-to-peer network." Spotify's classification of their music streaming service as purely technological, Fleischer and Snickars (2017, p. 134) contend, ignores the fact that "a core part of its business has been to provide content to audiences and selling those audiences to advertisers". It is perhaps this that has amplified the disconnect between the platform and the artists who feel that they are not being fairly compensated by the service for the exploitation of their work. Spotify currently operates with a business model of paying royalties based on market share as opposed to individual streams (Holmes, 2013). It is therefore put forward that a change in focus to macroeconomic core business plan that aims to fairly compensate creativity whilst simultaneously providing the end user with access to licensed works would help to improve Spotify's reputation. The global recorded music industry is heavily reliant upon the success of the service, as will be outlined in further detail when examining the business' financial position.

PART 3: BUSINESS FINANCE

3.1 – Short-term v Long-term Financing

Spotify has yet to post a global profit in any year since it became operational in 2008 (Music Business Worldwide, 2015). This is largely due to the streaming service launching in emerging markets such as Latin America and Asia; costly and risky business practices but made with a view towards long-term benefit. Despite this, its UK arm has been steadily growing and has now reached a stage of profitability (see Appendix 1). Nevertheless, when examining the balance sheet (see Appendix 2), it can be seen that Spotify had a negative net working capital of £-23,782,399 in 2016 with a current liquidity ratio of 0.8. This is a slight improvement on 2015, which saw a net working capital of £-26,891,180 with a current liquidity ratio of 0.82. This is a worrying assessment as it means Spotify does not have enough assets to meet their short-term liabilities. However, the company's focus is seemingly geared towards medium to long-term finance.

By way of comparison, Apple (UK) (see Appendix 3) posted a 2015 net working capital of £91,234,000, up from £63,480,000 in 2014. It must be noted that Apple does not separate its music streaming arm from its overall company, making the two difficult to compare financially. However, some commenters believe that the idea behind the service was not to generate large profits but to re-establish Apple as a market leader; a journey on which they have substantial ground to make up (Music Industry Blog, 2016). SoundCloud, on the other hand, (see Appendix 4) is the only one of the three companies that saw their net working capital fall, from £8,184,000 in 2014 to £6,465,000 in 2015.

3.2 – Investment Activities

Private companies within the music and entertainment sector such as Spotify and SoundCloud keep much of their financial activity private and, therefore, difficult to analyse. However, major financing and investment activity is often reported as it influences future investors before the companies begin publicly trading. According to Crunchbase (2017), Spotify received US$21.64m in its first round of funding from 5 investors. However, it has also been stated that at this time Spotify also received investment from major record labels in exchange for a fifth of the shares in the company (The Swedish Wire, 2008). Spotify has since gone on to receive over US$2.6b in funding (Crunchbase, 2017) and is rumoured to begin trading publicly in 2018 (Sisario, 2018). Sisario (2018) also goes on to state that the company's current estimated value sits at US$19b.

Although Billboard (2014) indicated that SoundCloud received over US$100m in funding since launching, the company has been in steady decline ever since. The Berlin-based audio service has been

closing offices and making staff redundant (Butler, 2017). This is therefore evidence of Spotify's dominance having a negative impact on its competitors and their ability to remain sustainable in the current climate.

3.3 – Alternative Methods

Spotify has primarily sought external private funding to power its business up until now. The mooted public offering (Sisario, 2018) would likely prove the best method for raising revenue and increasing the lifespan of a company in an industry in which most companies barely survive five years. The investment from the record labels and rights holders (The Swedish Wire, 2008) has given the streaming service an advantage over its competitors as the industry has become more reliant upon its success. Forbes (Bertoni, 2012) expressed their belief that Spotify co-founder Daniel Ek was the most important man in music today and possessed a platform "that could save the recording industry from piracy—and iTunes." It is statements such as these from major economic influencers that have helped to position the company as the global market leader in the streaming market and accrue such vast amounts of funding despite the fact they have yet to post a profit. The financial future is therefore bright for Spotify if current trends continue.

PART 4: LEAN BUSINESS

4.1 – Techniques

Developed from the Toyota Production System (TPS), "lean" is Japanese business model that seeks to eliminate waste and instead focus on customer wants (Maurya, 2012, pp. XXIII). The Customer Development method, pioneered by Steve Blank, creates a four-step process designed to generate a "continuous feedback loop with customers throughout the product development cycle" (Maurya, 2012, pp. XXIII). The four-step process can be simplified as follows:

1. Find
    a. Find a group of early adopters within a core group as opposed to a mass audience
    b. Test whether they have this problem that you think they have
    c. Determine whether the problem exists and is worth solving
2. Confirm
    a. Confirm whether the solution you're providing solves the problem
3. Scale
    a. Understand whether this is a wider problem that relates to multiple audiences
4. Invest
    a. Seek the investment of money and resources towards building the wider business

In order to better understand this process, it should be examined how Spotify has applied these four steps to their own business model.

4.2 – Application

The lean business model is most effective when the company applying it understands the problem inherently before attempting to create a solution. Spotify's origins as a technology company aimed at enabling "a platform for media distribution based on a peer-to-peer network" (Fleischer & Snickars, 2017) has been central to its success as a lean business platform. Spotify was able to find a core group of early adopters through its original invitation only service and determine whether the problem they were trying to solve really existed. Following this, they confirmed their platform as the solution to that problem. By opening up the service to wider audiences across Scandinavia before launching in the UK and the US, Spotify was able to better understand the scale of the problem. Finally, the streaming service sought investment of money and resources to expand their business and has since gone on to great success as a result of their original methods. Having outgrown start-up status, the company has now lessened its influence in those areas and has instead moved its focus on to acquisitions of smaller

companies who have taken a similar approach: the most recent of these acquisitions being a "cloud-based platform [that] allows musicians to record and edit tracks across multiple devices, and invite other collaborators to work on projects" (Music Business Worldwide, 2017).

The company has typically favoured convenience and ease of use over flashy features. This can be exhibited through their integration into and partnerships with services ranging from mobile networks (Peoples, 2013) to online gaming platforms (Brown, 2015). Their forward-thinking nature in an industry build on short-sightedness is indicative of their position as a tech company. Spotify has also led innovation in the field with the introduction of features such as Spotify Codes; a unique waveform that can be scanned using a smartphone to connect with artists' profiles (Kraft, 2017). This has also been taken advantage of by artists who have weaved the Spotify Codes into their merchandise (Harding, 2017). Surprisingly, these innovations are in stark contrast to many of Spotify's competitors. Considering the gap between Spotify and the rest of the market, it is somewhat unexpected that none of its major rivals are implementing new technology or marketing strategies at the same rate as Spotify. The streaming platform has recently moved to further strengthen its position through the introduction of live concerts in both the UK and the US (Spotify, 2017d). This new venture into experiential marketing conveniently comes at a time shortly after Apple discontinued its iTunes Festival (Ingham, 2017) and seeks to go direct to fan, bypassing the 'middle-man' (the concert promotors) in the process. Lastly, Spotify has closed 2017 with its most influential advertising campaign to date. The "Wrapped" feature, Tech Crunch (2017) describes, "tells you the amount of time you spent streaming music in 2016 and how many songs and artists you listened to." Following this, listeners are then quizzed on their listening habits before being presented with a personalised 30 track playlist (Shu, 2017).

Across the board, from its marketing strategies to its business model and down to its Internships and company transparency, Spotify has separated itself from its competitors. Whilst it is surprising that other technology focused companies such as Apple have had less of an influence over the streaming market, Spotify's success is not without reason. Despite creating a product that some believed "looked as if it might be the killer of the music industry" (Lynskey, 2013), Daniel Ek's service has gone on to provide renewed hope for the global recorded music sector largely as a result of its application of lean business methods.

PART 5: SUMMARY

This report has analysed the Swedish music streaming service Spotify from an economic, financial and lean business standpoint. Despite not being the first streaming platform to enter the market, Spotify has grown to become the most dominant globally and looks to expand its reach in the coming years. If rumours of an initial public offering are proved to be true, this would likely serve to increase the value of a company already worth an estimated US$19b without having posted a profit.

Spotify has continued to grow and evolve at a rate in excess of its competitors and has continually applied new and innovative business methods to ensure its status as the dominant force in the music streaming marketplace. It is therefore put forward that the service has displayed all the characteristics of a flexible, lean business with a customer centric view. The platform provides ease of use and convenience to its over 140m active users and shows no signs of changing for the worse.

The onus now lies upon its competitors to close the gap in the streaming market. All studies of the sector indicate that it will continue to provide the global recorded music industry with the lion share of its income in the coming years, making the next steps more crucial than ever before for these services.

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APPENDICES

Statement of comprehensive income
For the year to 31 December 2016

	Note	2016 £	2015 £
Continuing operations			
Revenue	3	237 810 275	187 186 838
Cost of sales		(166 711 512)	(149 186 739)
Gross profit		**71 098 763**	**38 000 099**
Distribution costs		(7 746 068)	(3 221 827)
Administrative expenses		(38 335 263)	(28 546 058)
Other operating income		-	(143 260)
Other operating expenses		(849)	-
Operating profit	6	**25 016 583**	**6 088 954**
Finance income	4	125 839	415 267
Finance costs	4	(22 375 401)	(4 487 460)
Finance costs - net		**(22 249 562)**	**(4 072 193)**
Profit before tax from continuing operations		**2 767 021**	**2 016 761**
Income tax charge	7	(840 199)	(832 489)
Profit for the year		**1 926 822**	**1 184 272**

	Note	2016 £	2015 £
Statement of comprehensive income			
Profit for the year		1 926 822	1 184 272
Other comprehensive income: Items that will not be reclassified to profit and loss			
Movement on deferred tax related to share options	7	-	62 132
Other comprehensive income for the year, net of tax		**-**	**62 132**
Total comprehensive income for the year		**1 926 822**	**1 246 404**

The accompanying notes are an integral part of this statement of comprehensive income. The profit for the year is attributable to owners of the Company.

There are no recognised gains or losses in the year other than those items recorded in the statement of comprehensive income above.

They were signed on its behalf by:

Barry McCarthy
Director

Appendix 1: Spotify Income Statement (2016)

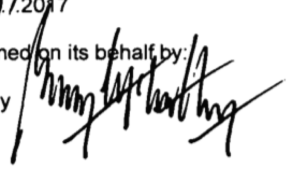
Statement of financial position
For the year to 31 December 2016

	Note	2016 £	2015 £
ASSETS			
Non-current assets			
Property, plant and equipment	11	16 002 859	15 414 560
Investments	12	376 576	376 576
Other non-current assets	13	970 339	3 631 074
		17 349 774	**19 422 210**
Current assets			
Trade and other receivables	10	96 041 810	116 327 461
Deferred Tax	7	1 351 722	2 530 264
		97 393 532	**118 857 725**
Total assets		**114 743 306**	**138 279 935**
LIABILITIES			
Non-current liabilities			
Finance leases liabilities	18	(415 465)	(2 818 132)
		(415 465)	**(2 818 132)**
Current liabilities			
Cash overdraft	9	(37 770 043)	(66 108 899)
Trade and other payables	14	(76 650 644)	(71 893 356)
Other current liabilities		(698 068)	(773 311)
Income tax payable	7	(3 535 856)	(4 425 122)
Finance leases liabilities	18	(2 521 320)	(2 548 217)
		(121 175 931)	**(145 748 905)**
Net liabilities		**(6 848 090)**	**(10 287 102)**
EQUITY			
Share capital	15	1 000	1 000
Shareholder contributions		14 544 300	14 544 300
Retained earnings		(21 393 390)	(24 832 402)
Total equity		**(6 848 090)**	**(10 287 102)**

The accompanying notes are an integral part of this Statement of financial position. The financial statements of Spotify Limited, on pages 7 to 33 were approved by the Board of Directors and authorised for issue on.....28/9/2017

They were signed on its behalf by:

Barry McCarthy
Director



Appendix 2: Spotify Financial Statement (2016)

Apple (UK) Limited

Balance Sheet
at 26 September 2015

	Note	2015 £'000	2014 £'000
Fixed assets			
Tangible assets	11	**5,421**	3,593
Investments	12	**3,715**	3,715
		9,136	7,308
Current assets			
Debtors	13	**95,663**	73,937
Cash at bank and in hand		**2,232**	1,282
		97,895	75,219
Creditors: amounts falling due within one year	14	**(15,797)**	(19,047)
Net current assets		**82,098**	56,172
Total assets less current liabilities		**91,234**	63,480
Provisions for liabilities	15	**(5,339)**	(4,816)
Net assets		**85,895**	58,664
Capital and reserves			
Called up share capital	16	**1,000**	1,000
Profit and loss account	17	**84,895**	57,664
Capital contribution reserve	18	**-**	-
Shareholder's funds	19	**85,895**	58,664

These financial statements were approved by the board of directors on .....
and were signed on its behalf by:

Director

Print..... GENE LEVOFF

Dated 14 JUNE 2016

100 New Bridge Street
London EC4V 6JA

Appendix 3: Apple (UK) Financial Statement (2015)

Company Balance Sheet
at 31 December 2015

	Note	2015 €000	2015 €000	2014 €000	2014 €000
Fixed assets					
Intangible assets	9		198		27
Tangible assets	10		5,920		6,284
Investment .	11		2,732		1,823
			8,850		8,134
Current assets					
Debtors	12	24,105		7,564	
Cash at bank and in hand		12,449		12,519	
		36,554		20,083	
Creditors: amounts falling due within one year	13	(38,939)		(20,033)	
Net current liabilities)/assets			(2,385)		50
Total assets less current liabilities			6,465		8,184
Creditors: amounts falling due after more than one year	14		(41,443)		-
Net (liabilities)/assets			(34,978)		8,184
Capital and reserves					
Allotted and issued share capital	15		45		43
Share premium account	16		82,339		82,040
Share based payment reserve	16		13,689		7,138
Profit and loss account	16		(131,051)		(81,037)
			(34,978)		8,184

The financial statements were approved by the board of directors on December 20, 2016 and were signed on their behalf by:



A Ljung
Director

Company number: 06343600

Appendix 4: Soundcloud Financial Statement (2015)