

Hyperion Asset Management

Company Profile

Spotify Technology SA

Main Business Activities

Spotify Technology (Spotify) was founded in 2006 and has grown to become world's dominant audio content platform, operating in over 178 markets globally. The Spotify application was launched in 2008 and the company listed on the New York Stock Exchange in 2018. Daniel Ek, a co-founder, took over the CEO and Chairman roles from Martin Lorentzon, other co-founder, in 2013 and 2016 respectively. Daniel Ek currently owns approximately 17% of the company and while Lorentzon left Spotify to pursue politics, he still owns 11% of the business and holds a seat on the board.

Users access the company's service through either a monthly subscription-based payment or by accepting advertisements in between listening, with Spotify generating roughly 90% of its revenue through subscription payments. Although only 10% of revenue is generated from ad supported subscribers, the primary role of the free offering is to attract potential future paid subscribers. It provides Spotify with the opportunity to convert listeners into paying users. Over 60% of subscriber gross additions have come through the advertising funnel historically.

Key Value Proposition to Customers

Spotify's platform allows people to enjoy audio content, primarily music and podcasts, whenever and wherever they want. Spotify offers a large library comprised of both music and podcasts. The company has played a large part in transforming the music industry by allowing users to move from the transaction-based experience of buying and owning music to an access-based model, which allows users to stream music on demand. In contrast, traditional radio relies on a linear distribution model in which stations and channels are programmed to deliver limited song selection with little freedom of choice.

Spotify's mission is to unlock the potential of human creativity by giving a million creative artists the opportunity to live off their art and billions of fans the opportunity to enjoy and be inspired by these creators. In this way, its value proposition is centred on the availability of audio content and also regular innovation relating to engagement, experience and discovery.

Spotify believes it is in the discovery business and every day, fans from around the world trust its brand to guide them to music and entertainment that they would never have found on their own. It provides personalisation that drives a unique and tailored experience to each user and the tools for artists to reach the widest fan base. Given the amount of music content available in the world, there is a real need for a service that helps you discover new music and search for music you want to hear. With the advent of the internet and more recently machine learning, Spotify is able to use search and discovery tools to generate a unique user experience for each listener. This is a far superior customer value proposition to radio and/or the purchasing of music in the past. Personalisation of content, not exclusivity is the key to success for Spotify. With every swipe, search, skip and shuffle Spotify learns more about you and is able to better curate the offering, which is fuelling the increase in engagement.

Spotify offers a premium service for a monthly subscription fee that provides unlimited online and offline high-quality streaming access to its catalogue of music and podcasts. In addition to accessing its catalogue on computers, tablets, and mobile devices, users can connect through speakers, receivers, televisions, cars, game consoles, and smart watches.

It also offers an ad-supported ('free') service which has no subscription fees and generally provides users with limited on-demand online access to its catalogue of music and unlimited online access to its catalogue of podcasts on their computers, tablets, and compatible mobile devices.

Sustainable Competitive Advantages and Outlook

Spotify's competitive advantage is not only strong but increasing as the company continues to scale its user base and improve its product offering.

Product leadership:

Spotify's audio services provide users with deep, personalised content and a platform for discovery, which results in high customer retention rates and engagement. With every swipe, search, skip and shuffle Spotify learns more about the user and is able to better curate the offering, this is a key driver of improving user metrics. Spotify programmed or recommended a meaningful portion of listening which is growing over time, and over half of listening time on Spotify is through playlists, which are either Spotify or user created. Although industry pricing is essentially identical and peers like Amazon and Apple continue to build out their bundled offerings, it is important to note that this has not resulted in Spotify having to compete on price, while the company continues to maintain low customer churn and gain market share. Spotify has in fact more recently been increasing prices in markets where they have strong adoption and user satisfaction. This suggests a non-trivial amount of product differentiation and competitors have so far failed to subvert Spotify despite significant attention and investment into their audio streaming services.

Scale and Brand Recognition:

Spotify's offering is primarily supported by its scale in terms of subscriptions and ad revenue, which allow it to negotiate better licencing deals, as well as invest in Research and Development, thereby reinforcing its value proposition. The company has a leading industry position and boasts impressive user engagement metrics that have improved over time. With its leading data position in audio streaming, Spotify is able to best match supply and demand, which actually drives higher demand. Over time, it is likely Spotify will be able to leverage its position to focus on creating original content, similar to Netflix. Spotify remains the only large player purely focused on audio streaming and has a strong, globally recognised brand.

Overall Company Growth Options

Today, consumers spend five to eight times more money on other forms of entertainment such as video and video games than they do on recorded music. According to a 2018 Nielsen survey on media consumption in the United States, consumers spend approximately 14 hours a week listening to music (streaming and radio) versus 36 hours a week combined on video games consoles or watching TV and video streaming. While there are clear differences between these forms of entertainment and their respective distribution models, the disparity between time spent consuming music content versus paying for it as compared to other entertainment is stark.

Between the industry peak in 1999 (the year Napster launched) and the bottom in 2014, the dollar value of spending on music fell by nearly half, from over US\$30 billion down to US\$14 billion. Since then, the growing adoption of paid subscription services has reversed the industry decline and driven high to mid-single digit overall industry growth and, high double digit audio streaming revenue growth. Today, the market has largely recovered which strongly supports the notion that consumers are willing to pay for recorded music content, provided it is delivered with a positive user experience and is reasonably priced. The previous decline was largely due to web-enabled piracy, which remains significant, however should continue to decline over time.

By being the only large competitor focussed solely on audio and the streaming market leader with a strong brand as well as a demonstrated willingness to reinvest back into product and price to improve the customer value proposition, Spotify is in a powerful position to leverage ongoing industry growth. Management have stated they believe Spotify's revenue will grow at over 20% per year into the foreseeable future which will be driven by geographic expansion, a growing user base, increased engagement, and new products. The company has a long-term multi-billion user target. As of 2020 there were 3 billion weekly radio listeners and over 2.5 billion people (excluding China) using smartphones. While weekly radio listeners are likely to decline, and transition to streaming sources such as Spotify, global smartphone users are likely to grow meaningfully into the foreseeable future.

Lastly, secular advertising trends will also support Spotify's growth, with spending to reach consumers migrating from offline to online content. The relative size difference between online radio advertising spend versus offline and the relatively small share of online as a percent of total radio ad spend compared with digital suggests strong and ongoing advertising revenue growth is likely for Spotify.

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