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Strategic Audit of Spotify

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Abstract

Spotify is a music streaming platform that originated in Sweden in 2006. Since inception, it has found immense success in the music streaming industry. It has the largest market share compared to other major competitors, Apple and Amazon. In 2018, Spotify was able to turn a profit for the first time. Royalties on music content has prevented the company from reducing their cost of goods sold. In order to make a sustainable business model, Spotify has to adjust their business model to attract consumers to more profitable products.

Background

In 2006, Daniel Ek and Martin Lorentzon founded Spotify in Stockholm, Sweden. It launched its music streaming service in 2008 with hopes of reducing piracy in the music industry. The platform provides customers the ability to search music based on title, artist, genre, and record label. Users can also create playlists, listen to radio stations, and share tracks on social media.

Seen in the table below are several fast facts about Spotify:

Number of Songs:	40 million
Monthly Active Users:	207 million
Number of Subscribers:	96 million
Revenue paid to rights holders:	$11.2 billion
Number of Markets:	79

Since its inception, Spotify failed to turn a profit until the fourth quarter of 2018, where it earned $107 million in profit (Mercuri, 2019). This positive margin is partially due to Spotify going public in the spring of 2018 with a valuation of $26.5 billion (Iqbal, 2019).

Spotify operates a freemium business model where customers get basic services for free and can pay for better features. Spotify pays royalties to artists based on number of artist streams in proportion to total songs streamed. This usually equates to $0.006 to $0.0084 paid to an artist per stream. It pays approximately 70% of its revenue to rights holders.

External Analysis: Porter's Five Forces

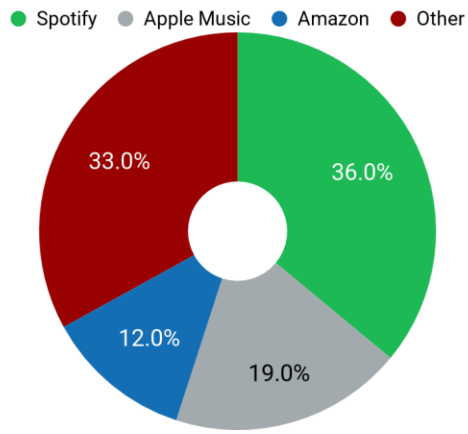
Competitive Rivalry

The main competitors in the music streaming industry are Apple Music, Pandora, and Amazon Music. Although Spotify still is the largest music streaming service, these platforms all provide value to their distinct customer base. Spotify is at high risk in this industry competing with these companies.

Despite Spotify's current advantage as the leader in the industry, its competitors are backed by major cash and name brand advantages. Apple has a loyal customer base and has quickly caught up to Spotify's success in the music streaming industry. Apple showed it is capable of turning its current customers into users of its music service. It was able to convert customer because it owns half of American phones (Levy, 2018).

Amazon is the third largest player in the industry. It has leveraged its smart speaker products to enhance its music streaming service. This smart speaker industry combined with music streaming is currently untouched by Spotify. Figure 1 below shows the current market share for the music streaming industry. Spotify leads with a 36 percent market share followed by Apple with 19 percent.

Figure 1: Music Streaming Market Share



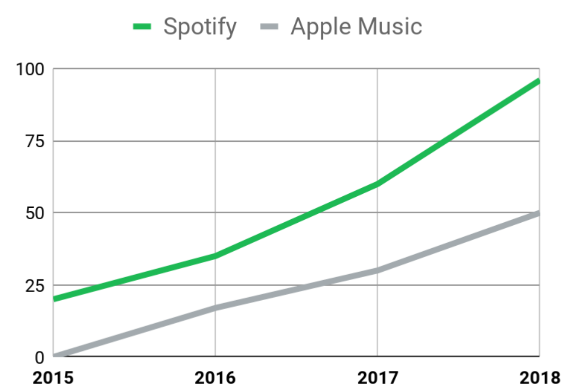
Power of Suppliers
Record labels, artists, and rights owners are the main suppliers to Spotify. This business model is very fragile because it is only dependent on the music industry and nothing else. This power of suppliers has been the main catalyst for Spotify's inability to turn a profit until the final quarter of 2018. As seen in Table 1 in the appendix, the main operating expense is the "cost of revenue" which is primarily composed of payments to rights holders for content. This expense increased 21 percent from 2017 to 2018 indicating Spotify has yet to get control of its expenses. Without managing this, it will continue to fail to create an operating gain for the company.

Artists and record labels hold all of the power over the music streaming industry. Popular artists, such as Taylor Swift, have openly discussed how music streaming platforms do not fairly compensate artists which has led to even less of an opportunity for Spotify to create a profitable business model. Spotify has commented saying, "The music industry has a high level of concentration, which means that one or a small number of entities may, on its own, take actions that adversely affect our business" (Nicolaou, 2018).

Power of Buyers
Consumers in the music streaming industry can easily switch which platform they choose to use, making the power of the buyers strong. With many options available for around the same price, customers can easily change their mind on product and turn to another.

The largest competitors to Spotify provide value outside of their music streaming platform such as a free trial or access to Prime features in the case of Amazon. These features, however, have not deterred users from preferring Spotify over other services. The growth in user base can be seen in Figure 2 below.

Figure 2: Number of Paid Subscribers (in millions)



Threat of New Entrants
The threat of new entrants is low in the music streaming industry. Considering the market has yet to find a decisive plan to turn a profit on the business model, it is not the most alluring market.
Alongside profitability issues, Amazon and Apple have both been able to succeed in the market because of their business

outside of music streaming. They have plenty of capital to sustain a music streaming business.

Spotify had first mover advantage which has allowed them to succeed, but other companies with capital advantages have been able to penetrate the market. It would be difficult for another company to enter this market without serious cash and capital to back its entry.

With Spotify's financial instability, other companies that do not have outside sources of revenue would probably avoid the music streaming business. Entering in this market would most likely lead to failure due to the high cost of goods sold.

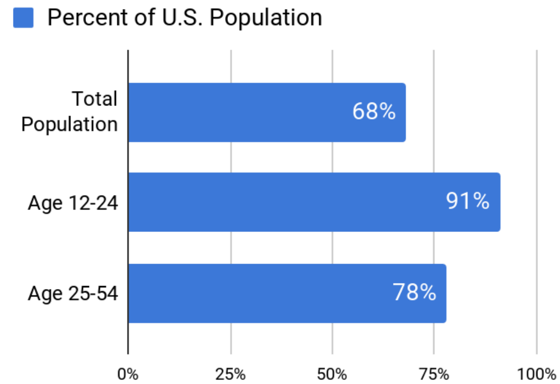
Threat of Substitutes

Music streaming became a substitute for older methods of consuming music such as downloads, physical copies, and radio. Because it easily replaced the need the consumers needed, the threat of substitutes is high in this industry.

The biggest substitute threat is Youtube. The service currently drives 149 million users to the service every month (Statista, 2018). Many customers already use the service to meet their music needs with the added feature of video. Figure 3 shows the percentage of U.S. consumers that have used Youtube to watch music videos or listen to music. This data was collected up until February 2017.

Youtube could easily meet the music needs of consumers and be profitable. All content on Youtube is uploaded by the users allowing the cost of goods sold to be significantly lower than Spotify.

Figure 3: % of U.S. Population That Uses Youtube for Music



External Analysis: PEST

Political

The music streaming industry is heavily influenced by politics. Many countries have laws pertaining to copyright and music rights holders.

In the fall of 2018, President Trump signed the Music Modernization Act which created provisions to properly compensate artists. The law accomplished three main objectives:

- Streamlining the process of payment to artists and producers from streaming services
- Includes producers in payment from satellite and internet radio
- Allows payments of royalties to songs written before 1976 to both producers and artists

Spotify is highly affected by laws like this. Ultimately its bottom line is affected when legislation enforced higher royalties to content creators.

Economic

The economy mildly affects Spotify. If the economy is down, consumers will have less expendable income to spend on luxuries such as music streaming. However, with the freemium model, Spotify can still earn revenue off of advertisements.

Consumers are highly sensitive to price changes in the music streaming market. Nearly every music streaming platform is priced around $10 per month. Any fluctuations in this pricing strategy would alter consumer behavior.

Social

The music streaming industry is highly impacted by social factors. Tastes and trends in music can change rapidly which could alter the success of Spotify. Consumers enjoy visuals while they listen to music. Spotify has noticed this trend and has added “playlist videos” into its product line. These videos play in the background with the song, but it does not yet provide a full music video experience that can be found on Youtube or similar platforms.

Technology

Just as music streaming technology replaced smart phone download music, new technology will disrupt Spotify and the music streaming industry. Recently, there has been an emergence in making music a physical experience in the form of virtual reality. The emergence of VR in music could turn users away from Spotify.

Internal Analysis: SWOT

Strengths

Spotify’s greatest strength is its largest user base. Although it has had trouble turning a profit, it has the user base to make appropriate moves to ensure financial stability. Because Spotify was one of the first companies to the market, it has garnered a positive reputation from users.

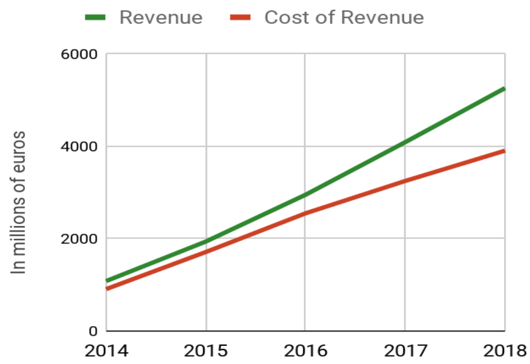
Spotify’s platform and user experience is the best in the industry. It places heavy emphasis on ensuring that its UI and UX are at the forefront of what customers want. It releases new features regularly to please users and make the experience more enjoyable.

By staying very in sync with trends and customer needs, Spotify is always looking into the next big thing to add to its platform. For example, Spotify has started added music recorded by artists in its studio and labeled them “Spotify Singles”. It has added radio features, personalized playlists, new podcasts, and more. By always adding new content to keep users excited, Spotify keep users returning to the platform.

Weaknesses

One of Spotify’s largest weaknesses is there reliance on content from artists and content creators. The business model is pushed and pulled by many stakeholders. As mentioned earlier, and shown in Table 1 in the appendix, Spotify spends around 70% of its revenue on the rights to content. This high percentage prevents it from becoming profitable without a serious business model change. The revenue compared to cost of revenue through time is seen in Figure 4 below.

Figure 4: Spotify Revenue vs Cost of Revenue



Although the difference between revenue and COGS slightly grew apart in 2018, that discrepancy is still not wide enough to create a sustainable business model. The production of goods in the music streaming industry does not have economies of scale. Royalties will never diminish regardless of how many listens a certain song receives.

With current technology, consumers can easily get any music they want for free through torrenting. With the subscription model, Spotify struggles to turn free users into paid subscribers becauses customers can meet that need elsewhere. To combat this, Spotify has to keep throwing money into research and development to create more features that customers would be willing to pay for.

Opportunities

As the current leader in the music consumption industry and a big name in music, Spotify has a huge opportunity to breach into other music areas. This includes live events and music recordings. Spotify can leverage its existing relationships with artists and producers to create Spotify albums and songs. It can also put on live events and create a personally branded music festival.

Because Spotify has been compliant with artists and producer demands, it has forged a decent relationship with the music production industry. It can further these existing relationships to potentially get exclusive deals with influencers.

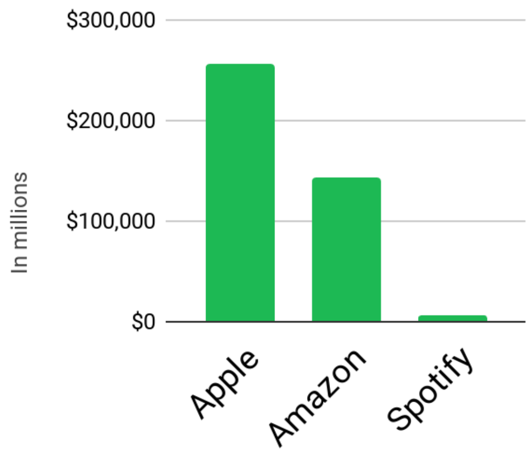
Threats

Due to the reliance on artists and content creators, Spotify is constantly threatened by politics and reputational risk. At any moment, a popular artist could remove its music from a platform concurrently leading to a smaller user base and less engagement. Because of this volatility, Spotify has to constantly make its user experience positive for both consumers and creators.

Illegal downloading is a prevalent issue that threatens the use of Spotify. Consumers can feed their music needs through free methods. It must always combat this issue by creating a platform that is more enticing than torrenting.

The biggest threat to Spotify is its competitors' cash, brand, and financial advantages. Apple and Amazon are two of the biggest companies in the world. Each of them have various business sectors with different strategies. With their diversified business models, Apple and Amazon can easily absorb the cost of revenue associated with streaming music. Below in Figure 5 is a graph showing how small Spotify is in relationship to the biggest players in the music streaming industry. Apple earns an impressive $256 billion in revenue a year and Amazon earns $141 billion. Both of these figures make Spotify's revenue inconsequential.

Figure 5: 2018 Revenue



Internal Analysis: Competitive Advantage

Comparative Advantage

Spotify's comparative advantages are twofold:

- First mover advantage
- Stockholm headquarters

Spotify was the first company to make a dent in the music streaming industry, therefore allowing them a first mover advantage. This position has allowed them to make connections, hire the best talent, and market themselves as a reputable name in the industry. Other companies that are just now entering the market have to overcome the hurdle of comparison to existing companies.

In terms of geography, Spotify has an advantage on the world market. Both Amazon and Apple are headquartered in the United States while Spotify has its headquarters in Stockholm, Sweden and London, England. By not being an American brand, it released the platform into 79 distinct markets.

Distinct Advantages

Spotify has three distinct advantages compared to competitors:

Spotify has a unique and intuitive *platform design*. The user interface design of Spotify's mobile and web applications is unparalleled. It is sleek, easy to use, and sophisticated enough to keep customers coming back to the platform. It has put heavy emphasis on creating an experience for users when using the application rather than just connecting users to music. The layout and navigation allow the user to do so much more than listen to a song.

Spotify has a distinct advantage with *playlists*. Spotify has personalized playlists, curated content, and user generated playlists. User created playlists compose 36 percent of total listening on the platform (Levy, 2018). In total, two thirds of all listening on the platform comes from playlists. With the volume of traffic that this feature drives, other competitors are trying to mimic the model on their own platforms.

Finally, Spotify is *platform agnostic*. Compared to its competitors, Spotify is not tied to a physical product. Amazon has a line of smart speakers and Apple obviously has a large suite of hardware. Because it remains platform agnostic, Spotify's music will stream to users equally with no preference to a specific medium.

Internal Analysis: Leadership Structure

Spotify's CEO and founder is Daniel Ek. As an introvert he does not go to the media often, but when he does he is humble and directs all praise to the entire Spotify team. As a leader and strategist for the company, Daniel prioritizes the relationships forged with artists, producers, record labels, etc. He wants to enable artists to be able to live off of their craft, therefore, he finds Spotify as a way to create a mini economy for artists (Safian, 2018).

Ek likes to decentralize decision making while simultaneously keeping his hands in many pots. He acts as a caretaker of the business by allowing others to take risks and backs them up through the process. He trusts the team to create great products for consumers and lets his team fail and learn from mistakes. Under his leadership, Spotify has been able to grow from inception into a $30 billion company.

Strategy Goals

Spotify needs to focus its attention on creating meaningful profit for the company. Without the ability to lower the proportion of costs to sales, Spotify will not be able to continue. It should also continue placing emphasis on growing and maintaining a large user base.

Evaluation Criteria:

Strategy alternatives should be assessed based on:

Feasibility: Is this able to be accomplished? Is the funding available to implement?

Sustainability: Would this create value for a long time horizon?

User retention and growth: Will users still continue to use the platform? Will the strategy attract more people to Spotify?

Strategy Alternatives

First Alternative: Prioritize First Party Content

Royalties are what is currently killing Spotify's opportunity to profit off of its business model. If it was able to create more first party content, it would automatically eradicate the royalty cost altogether. This content could manifest in the form of exclusive albums, Spotify created music videos, Spotify podcasts, etc.

By housing the content under a single roof, Spotify can focus its energy on the content itself rather than the costs associated with buying content from artists. With this alternative, the artists would be compensated along with Spotify.

Second Alternative: Negotiate Better Rates for Content

Spotify could attempt to negotiate the cost of royalties down. By reducing the amount it has to pay to content creators, the more profitable it will be in the future.

Third Alternative: Enter Physical Music Arena

Spotify could enter the concert hosting and festival hosting market. With existing connections and brand recognition, it could host concerts and festivals throughout the year. This is a proven business model that derives profits for the host.

Fourth Alternative: Continue Podcast Expansion

Spotify has recently purchased Gimlet and Parcast to enhance the existing podcast platform. It could continue this effort by challenging Apple podcasts' dominance in the market. If Spotify were to gain hold of this market, it could focus its attention on converting Apple consumers into Spotify subscribers.

Strategy Recommendation

Spotify should use a combination of alternative one and four to meet the strategy goal of creating long standing profit for the company. By synthesizing creating first party content while continuing to expand its podcasting endeavors, it will open up more doors to revenue and lower costs.

Roughly 73 million Americans listen to podcasts every month (Smith, 2019). In 2019, Spotify plans to spend around $500 million on podcasting deals. By trying to get a better hold on the podcasting market, Spotify should leverage the large population that is engaged with podcasts and turn them into paid customers. About 50 to 70 percent of current podcast listening is done through Apple podcasts (Smith, 2019). As its main competitor, Spotify can leverage new podcasting knowledge to turn users away from competition and into subscribers.

Along with podcasting, Spotify should continue to create first party content such as “Spotify singles”, Spotify created podcasts, videos with songs, and more. This content will cost the company less money in royalties and ultimately lead to a more engaging user experience.

Implementation Plan

May 2019: A division should be created to focus solely on Spotify created content with emphasis on cost reduction and user experience.

May - December 2019: Heavy research and development to better understand users pain points, wants, and needs related to content on the platform. Continue acquisition of podcasting talent similar to Gimlet and Parcast.

January 2020: Begin collaboration with artists and podcasters to bring content directly to consumers.

February 2020: Soft launch to a small group of test users with intentions of finding bugs and using telemetry data to better the experience.

March 2020: Heavy emphasis on testing with users to understand how they are responding to Spotify content. After this testing, the creative team and software developers should perfect a platform for a hard launch to the public.

May 2020: Hard launch to the public with Spotify content.

Contingency Plan

If the curated content were to flop with users, Spotify would be have sunk costs of approximately $800 million. This cost is predicted by combining acquisition costs, labor costs, and research costs. As a contingency plan, Spotify should revert the software changes on the platform. Users will quickly return to an experience they are familiar with.

For all of the content that was created, Spotify should remove it from the platform and continue to reengineer its creative strategy. The content would flop with users if there was not proper research and testing done. The team would have to regroup and get a better pulse on consumers.

Conclusion

Spotify has grown immensely since its inception in Sweden. As a current $30 billion company and leader in the music streaming industry, Spotify seemingly has all of the pieces in place for a booming business model. However, it has failed to consistently turn a profit due to the high cost of royalties paid to artists and record labels.

Given this lack of profit, Spotify should turn its sights to content that costs less to the company. This comes in the form of first party content and podcasts. By removing the need for royalties, Spotify can stay in the lead in the industry while also creating a sustainable business model.

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Appendix

Table 1: Income Statement - Year ended December 31					
In Millions of Euros	2018	2017	2016	2015	2014
Revenue	$5,259	$4,090	$2,952	$1,940	$1,085
Cost of Revenue	$3,906	$3,241	$2,551	$1,714	$911
	21%	27%	49%	88%	
Gross Profit	$1,353	$849	$401	$226	$174
Research and Development	$493	$396	$207	$136	$114
Sales and Marketing	$620	$567	$268	$219	$184
G&A	$283	$264	$175	$106	$67
	$1,396	$1,227	$650	$461	$365
Operating loss	-$43	-$378	-$249	-$235	-$191