Spotify: A Strategic Analysis of its Strengths, Weaknesses, Opportunities, and Threats

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Company Description:

Spotify, a company founded by Daniel Ek and Martin Lorenzton in Stockholm, Sweden, provides an online platform where people can listen to music for free with advertising or pay a monthly subscription for ad-free access.[1] The company eventually expanded to other audio offerings such as podcasts and video content.[2]

Global Industrial Classification Model:
According to Standard and Poor's NetAdvantage Global Industry Classification, Spotify is classified as being within the Communication Services sector, the Media & Entertainment industry group, the Entertainment industry, and the Movies & Entertainment sub-industry.[3]

Spotify's biggest competitors within this industry are The Walt Disney Company, Netflix, Inc., and Vivendi SE.[4]

Business Model – Spotify:
Spotify's business model is what is commonly known as a "freemium" business model, where the company offers a base-level product for free, but then offers upgrades such as more features or eliminating advertisements if the user pays a subscription fee.[5] Using this business model, Spotify's revenue comes from two main sources: Premium Subscribers and Ad-Supported Users.[6]

According to Spotify's 2020 annual report, the company generated $9.626 billion in revenue for the calendar year (CY) of 2020.[7] There were a total of 155 million Premium Subscribers and 199 million Ad-Supported Users during this same period.[8] Premium Subscribers generated Spotify $8.76 billion in revenue (91% of the total revenue) and Ad-Supported Users generated $866 million (9% of total revenue.)[9]

Macro-Environmental Factors: Note the color key that is to be used/adjusted as necessary to represent forces that present opportunities or the forces that present a threat.

Real Gross Domestic Product (GDP) Growth – Opportunity
GDP, a sum of the monetary value of all goods and services made by a country, helps provide an outlook of how that country is performing economically.[10] Real GDP, specifically, is a measurement that adjusts for inflation to allow for easier comparison between years.[11] A report released by the Organization for Economic Cooperation and Development (OECD) shows that the COVID-19 pandemic hit the global GDP growth hard, with a decrease of 3.4% in 2020.[12] The outlook moving forward, however, looks mixed but promising, with a global GDP growth of 5.6% in 2021, 4.5% in 2022, and 3.2% in 2023.[13] In comparison, the average annual growth in GDP from 2013 to 2019 was 3.3%.[14]

This, overall, is a mixed result for Spotify, but leans toward being an opportunity. The growth in GDP increasing every year by a little over one percent is concerning, but the growth of the next few years still looks good. A recovery from the pandemic and an increase in productivity indicates people will be increasing their spending and investment. With an increase in spending and investment, Spotify has an opportunity to increase revenue, with decreasing competitive pressures between companies.

Interest Rates – Opportunity
Daily treasury yields as of December 10, 2021 are as follows: 1-year = 0.27%, 3-year = 0.98%, 5-year = 1.25%, 10-year = 1.48%, 30-year = 1.88%.[15]

As of December 13, 2021, mortgage rates are as follows: 30-year fixed = 2.87%, 15-year fixed = 2.14%.[16] The Federal Funds effective rate, as of November 2021, is at 0.08%.[17]
Interest rates have been at historic lows for a while, which provides an opportunity for Spotify. Low interest rates allow companies to acquire greater funds through loans without a high capital requirement to pay the interest. This ease of acquiring more funding would allow Spotify to invest in potential R&D projects that would increase profitability in the long run.

Inflation Rates – Threat
The annual inflation rate accelerated over the past year, going from 1.4% in January 2021 to 6.8% in November 2021, the highest rate of inflation since June 1982.[18] This trend is expected to increase to 7% by the end of Q4 2021, then start to drop each quarter for 2022, with Q1 at 6.2%, Q2 at 5%, and Q3 at 3.8%.[19] While the declining inflation rates forecasted are a promising sign, 3.8% is still well above the Fed's typical target of 2%.[20]

High levels of inflation are a threat to Spotify's profitability. As the price of goods and services increases during inflation, the purchasing power of both companies and consumers decreases. This reduction in purchasing power can lead to consumers being less willing to spend money on non-essential goods and services, such as Spotify's subscription plan, which would decrease Spotify's revenue and profitability.

Euro/USD Foreign Exchange Rate – Opportunity
The exchange value of the euro has been steadily decreasing over the past year, with an exchange rate high of 1.231 on January 06, 2021.[21] As of December 12, 2021, the Euro/USD exchange value is 1.132.[22] This trend is expected to continue, with the Euro/USD projected to trade at 1.11 in 12-month's time.[23] This trend and projection results in a major opportunity for Spotify, with its large presence in the US. Because Spotify's principal office is in Sweden, US investors purchase shares in the company through "American Depository Receipts" (ADRs).[24] A declining Euro/USD exchange rate means that the US dollar increases in value, allowing for ADR companies to do more business in the US. One example of this is Airbus, which could see a $1 billion increase in profits for every 0.10 decline in the euro.[25]

Analysis of the Collective Economic Data
Overall, the economic forces for Spotify look promising in the next few years. A high level of GDP growth means there will be a higher level of spending available for consumers, which gives Spotify an opportunity to increase its revenue. Similarly, historically low interest rates allows Spotify to acquire more funding for its R&D for cheap, which can result in higher profitability later. The declining value of the euro compared to the USD is another opportunity for Spotify if it focuses on increasing its presence in the US market. The one force that Spotify needs to be careful about is the currently high inflation rates. If the rates happen to be transitory, this could end up being only a minor threat, but inflation regardless can have an impact on Spotify's profitability.

Social Forces:
As part of its "Life at Spotify" website that aims at introducing potential employees to the company's culture and inner workings, Spotify has a section dedicated to "Diversity, Equity & Impact". Within this section, it discusses different social actions that Spotify is undertaking to fulfill its values, addressing

issues such as climate change, racial equity, and diversity, inclusion & belonging.[26] The two issues that this section will focus on are its actions to address racial equity and diversity.

Racial Equity - Opportunity

Spotify has been transparent about its current performance on progressing toward equity, and what it plans to do next to continue that progress. Currently, 7.1% of Spotify's US employees are black, which the company is aiming to increase to 14% by the end of 2023, focusing on higher-level positions.[27] Spotify implemented several initiatives and programs to provide black employees with the tools necessary to grow and succeed in the company.[28] On top of this, Spotify is matching donations up to $10 million made by its employees to organization focused on addressing racism, injustice and equality, as well as "providing relevant organizations and artists with pro bono advertising and $1 million in advertisement credit."[29]

This kind of public stance addressing racial injustices and working toward racial equity can be a profitable stance to take. One example of this is Nike, with its Kapernick campaign in 2018. After the release of that ad campaign, Nike's online sales increased by 31% over the Labor Day Holiday.[30] If Spotify handles its branding properly and makes meaningful progress in its actions, this social force could result in an opportunity to boost to the company's profitability.

Diversity, Inclusion & Belonging - Opportunity

Much like Spotify's aim of being transparent about its efforts and success with addressing racial equity, the company is boosting its transparency over its progress on addressing diversity, inclusion & belonging. In 2020, 44% of Spotify's total workforce was female, 55% was male, and 0.2% was non-binary.[31] In terms of Spotify's leadership for 2020, 38% was female, 61% was male, and 0.1% was non-binary.[32] Spotify also acknowledged that the ethnicity within the workforce could be improved, with 57% of its employees being white, 19% Asian, 8% black or African American, 7.7% Hispanic or LatinX, and 0.3% Native American.[33] Their statement says that although they're moving in the right direction, they know there's more work to be done.

Having a diverse workforce can be very beneficial to a company's profitability. According to a report from McKinsey & Company, gender diversity in management positions is 21% more likely to have above-average profits.[34] With ethnic diversity, that increase in likelihood is even higher at 33%.[35] If Spotify is successful in its efforts to drive diversity, inclusion & belonging, it could be a real opportunity for it to increase its profitability.

<u>**Political/Legal Forces:**</u>

Copyright Law - Threat

Spotify, comparatively, is a newcomer to the business world. This makes it difficult for it to navigate the complexity that copyright law can be, particularly with its primary business involving music. The slightest misstep in the copyright world can result in a significant damage to its profitability. Unfortunately, there is an example of this occurring already for Spotify, when it was sued by Wixen Music Publishing Inc. for allegedly using thousands of songs without a license and compensation to the publisher.[36] This lawsuit was supposedly because Spotify had not sent physical letters to songwriters to obtain license for use on the platform, which was a requirement until the Music Modernization Act took place in 2018.[37] The original lawsuit was for $1.6 billion, but was later settled for an undisclosed amount.[38]

Mistakes over minor issues such as the letters not being on paper can result in significant financial damage, which makes the complexities of copyright law a threat to Spotify's ability to increase its profitability.

Political Ads - Threat

There has been a point of contention with social media and political ads, particularly in the last two election cycles of 2016 and 2020.[39] During this time, misinformation drastically increased, and social media companies have struggled to find a balancing point between the ad revenue that political ads provide and the potential fallout those ads can have. In 2020, Spotify decided to avoid this issue altogether by suspending the selling of political advertising until it had the capability to "responsibly validate and review this content."[40]

While Spotify was potentially able to avoid any of the political fallout other social media platforms faced by suspending political ads, removing revenue streams reduces Spotify's ability to increase its profitability, making this force a threat.

<u>Global Forces</u>

Untapped Global Markets - Opportunity

Globally, Spotify already has a significant presence in several major markets. In 2021, however, Spotify announced that it is pushing that presence even further, launching the platform in 85 new markets and adding support for 36 new languages.[41] These markets are in Asia, Africa, the Caribbean, Europe, and several other countries, reaching "more than a billion" new users.[42] Spotify particularly noted the expansion into Bangladesh, Pakistan and Nigeria, which the company claims has the "fastest growing internet populations in the world."[43] Although its expansion has continued to enter new markets, there is still no news about when China will be added to the list.[44]

Increasing its market reach by as much as Spotify is claiming is possible would provide significant new sources of revenue, giving Spotify a strong opportunity to increase its profitability.

COVID-19 - Opportunity

Overall, the COVID-19 pandemic has been painful for the global economy. Spotify found significant opportunities to increase its profitability from it, however. When the pandemic first began, Spotify lowered its revenue outlook for 2020, as well as slowing its hiring due to the economic uncertainty the pandemic brought.[45] The first quarter of 2020, however, beat expectations, with a net of 6 million new Premium Subscribers, and a growth of monthly active users of 31%.[46] This increase of usership allowed Spotify to report a net profit of €1 million, compared to the €142 million loss Spotify reported for Q1 a year earlier.[47] Overall, Spotify has been cautious about its economic state during the pandemic, offering conservative projections for each quarter.[48]

On top of the increase of subscribership, the pandemic led Spotify to provide more flexibility for its employees in where they want to work, adopting what they called a "Work from Anywhere" model.[49] Spotify is continuing to pay at the same rates it would pay residents of San Francisco or New York.[50] This change is overall an opportunity for Spotify to increase its profitability because it gives the company more flexibility on what talent they recruit and hire without having to worry about relocation or travel expenses.

Life Cycle Analysis – Movies & Entertainment:

The three-year Compound Annual Growth Rate for the Movies & Entertainment industry was 10.0% in 2018, 13.3% in 2019, and 0.8% in 2020.5[1] The drop in revenue growth of 12.4% was primarily due to the COVID-19 pandemic, and the industry is projected to recover by 19.8% in 2021.5[2] The lack of explosive growth, however, even ignoring the outlier of 2020, indicates the market is saturated, which is a sign of an industry in the Mature stage of the life cycle.

This saturation is consistent with the industry's competitive structure, where the competition for consumers is intense and there is a consistent presence of price wars between companies vying for subscribers to their streaming services. For example, ViacomCBS is offering for consumers to subscribe to the platform for a year with a deal of 50% off the normal price, Discovery+ reduced the prices for two of its ad-free plans by 30%, and HBO Max is offering a promotion to reduce the cost of a consumer's subscription by 20%.[53] On top of this, there are only a few massive corporations at the top of the market (after extensive consolidation) which control most of the profits of this sub-industry. In the 12 months leading up to August 2021, Disney, Vivendi, and Netflix held a combined total of 63.4% of the sub-industry's revenue.[54]

For the Movies & Entertainment industry, the barriers to entry are high, overall. There is a high level of capital requirements necessary to get started with the industry which, when combined with the power the major established companies hold, makes it difficult for new entrants to break into the industry.[55] Meanwhile, access to key technology such as machine learning and consumer prediction algorithms is becoming necessary in the streaming market in the ever-continuing effort to reduce consumer churn, a side-effect of the low switching costs for consumers.[56] According to consumer research from Netflix, a subscriber typically loses interest after 60-90 seconds of browsing.[7] If they haven't found anything interesting to them during that time, they choose to do something else. In order to avoid that risk, algorithms with machine learning to understand a consumer's interests and make recommendations based off that information is necessary to keep that viewer's interest, which will in turn help reduce consumer churn.[57] One good sign about competition over consumers is that the number of streaming services the typical consumer subscribes to has increased since the onset of the pandemic from 3 services to 5.[58] With this, however, also means that companies have to fight even harder for the consumer's attention, leading to a greater need for competent algorithms.

All these combined indicate that the Movies & Entertainment sub-industry is in the Mature stage of the life cycle analysis. This stage is a threat to companies aiming to increase profitability within this sub-industry, including Spotify, due to the inability to raise prices to increase profitability without risking losing customers to other companies. The threat to profitability is especially true for Spotify, who does not have as established a financial backing as some of its competitors such as Disney or Vivendi. Instead of increasing market capture through prices, Spotify is focusing heavily on developing its AI to maximize the experience of the end-user.[59]

Risk of Entry by Potential Competitors = Weak = Opportunity

Overall, as mentioned earlier in the life cycle analysis, the risk of entry of new competitors is low due to high barriers of entry. There are three primary things resulting in this high barrier to entry: a high capital investment required to break into the industry, established, well-known brand names, and a high level of technology requirements in the streaming industry.

Barriers to Entry:
Distribution channels & capital requirements – High barrier to entry
Distribution companies are responsible for marketing and distributing films to the public and, as such, are essential points of contact within the Movies & Entertainment industry.[60] The well-established channels already laid in place by companies within the industry make it difficult for a new competitor to begin that relationship as it is, but then the actual capital requirement of distribution amplifies that difficulty ten-fold. The typical rule of thumb for marketing budgets for distribution is to match the film's production budget up to $35 million dollars, a very high upfront cost to budget for when it's for a single movie.[61] Other factors to keep in mind when it comes to capital requirements are the price of theater prints, production, equipment rental, wages of workers and actors, union fees… All this adds up very quickly, with an average budget to produce a movie being over $100 million.[62] That is a significant amount of money to invest, when most movies typically end up losing money in their domestic theatrical run, with large commercial successes typically being very rare.[63]

Well-known, established companies – High barrier to entry
Putting the issue of making deals with distribution companies and having the capital backing to break into the industry aside, there is one colossal elephant in the room when it comes to the idea of breaking into the Movies & Entertainment sub-industry: the top of the industry is already very well-established, and its roots are deep. Only a few companies overall control major Hollywood film studios: Disney, Warner Media, Viacom, Comcast, and Sony.[64] These companies, with a few independent exceptions, such as Lions Gate Entertainment, account for more than 90% market share of the typical annual US box office revenue and most of the revenue of television production studios.[65] With that small of a number of powerhouses controlling almost the entire market, it is extremely difficult for new competitors to enter the market with any hope of succeeding.

Technology requirements – High barrier to entry
There is one major technology requirement that serves as a barrier to entry in the streaming service part of the Movies & Entertainment sub-industry: a company's content recommendation algorithm. This algorithm is essential for keeping consumer retention and reducing churn.[66] To give an example of the importance of the algorithms, Netflix estimates its algorithm saves the company nearly $1 billion every year.[67] When the average consumer only holds 3-5 streaming service subscriptions, it is essential that the content recommendations a company's program gives is successful, or else it risks losing revenue.[68]

Risk of Entry summary
All in all, the distribution channels of the Movies & Entertainment industry are well established for the currently existing competitors, and it would require significant capital funding up front in order to be able to break into the industry. The industry itself has a few companies control the majority of the industry's revenue, and the technology requirement to have a successful content recommendation algorithm is essential to do well in the streaming market. All these combined make for a low risk of entry of new competitors, which provides an opportunity for Spotify to increase its profitability by being able to focus more on capturing market share from its current competitors.

Competitor Rivalry = Strong = Threat
As mentioned previously, the Movies & Entertainment industry is heavily saturated, and the streaming market is a significant example of that saturation. There are over three hundred different streaming services, with each attempting to draw market share through the company's original content.[69] This saturation, combined with the low switching costs for consumers, is leading to intense competition between companies, particularly when the average consumer household only subscribes to 3-5

streaming services.[70] This intense competition can result in price wars, or a greater demand for investment in original content.

This all indicates that the Competitor Rivalry force is strong, indicating a threat to the ability for companies in the Movies & Entertainment industry (such as Spotify) to increase profitability through raising prices. To succeed on increasing profitability, Spotify must instead capture a greater share of the market through higher quality content or successful consumer prediction algorithms.

Bargaining Power of Buyers = Moderate = Opportunity and Threat

The overall bargaining power of buyers is mixed, with both opportunities and threats to Spotify's ability to increase profitability. The two main buyer groups for Spotify are advertisers and subscribers.

Bargaining Power of Buyers – Advertisers = Weak = Opportunity

Advertisers, in the Movies & Entertainment sub-industry, are buyers through the purchase of ad space. This space could be through product placement, movie trailers, commercials on television, etc. As commercial-free streaming services keep gaining popularity, however, advertisers have fewer options, with their opportunities to get their message in front of viewers fading.[71] As the opportunities for ad space get more limited, the bargaining power of advertisers continues to decrease. As Amobi and Salbiah wrote, premium ad spaces are limited, and demand is typically more than supply.[72] This weak force provides an opportunity for Spotify to negotiate higher prices for ad space, improving the company's profitability.

Bargaining Power of Buyers – Subscribers = Strong = Threat

On the other side of the coin is the bargaining power of the subscribers buyer group. When determining how much bargaining power a subscriber has, one only needs to look at two indicators: how easily a consumer can drop one service in favor of another and the level of brand loyalty subscribers have for a company. Neither of these indicators look good for the Movies & Entertainment industry, as mentioned earlier in the Competitor Rivalry force. Outside of streaming services such as Netflix and Disney+ that recently increased their monthly cost, other streaming services are fighting tooth and nail for consumers to choose their service over other companies, with massive price bargains, and free trials.[73] In early 2021, ViacomCBS offered 50% off their regular cost for $30 a year or $2.50 a month for its streaming service with ads, and $50 a year/$5 a month for its ad-free service, while Hulu offered as low as $2 per month with a one-year subscription.

With low switching costs between competitors and a consumer household typically only subscribing to four or five services at most, companies have no wiggle room to increase prices without risking losing those customers.[74] This indicates that the bargaining power of buyers for subscribers is strong, and therefore a threat to Spotify's ability to increase profitability through increasing price. To handle this issue, Spotify needs to instead focus on increasing brand loyalty to reduce the risk of consumer churn.

Bargaining Power of Suppliers = Strong = Threat

Suppliers, according to Hill, Schilling, and Jones, are the organizations that provide inputs into the industry, which can include materials, services, and labor.[75] The bargaining power of suppliers refers to the ability for these organizations to raise the cost of doing business for the industry, such as through higher input prices, poor-quality inputs, or poor service.[76] In Spotify's case, there are two main suppliers to be concerned about: music industry suppliers and podcast creators.

Bargaining Power of Suppliers – Music Suppliers = Very Strong = Threat

The music industry, as one of Spotify's major suppliers, is a massive obstacle in the way of Spotify's hopes of increasing profitability. Spotify's biggest draw is its ability to stream music. In order for Spotify to legally do that, however, Spotify must pay royalties to the rights holders of that music.[77] Royalties, being regulated by IP laws, vary in their requirements from country to country. There are two main types of royalties Spotify had to pay, either songwriting royalties (which were split 50/50 between the credit songwriters and the publisher) or recording royalties (which is much more complex in scope and coverage than songwriting royalties).[78] In 2017, Spotify was able to negotiate a lower royalty rate, but had to make several concessions, including allocating a percentage of monthly revenue to royalties rather than paying a fixed amount per stream, rates being tied to overall user count and ratio between free and premium, a minimum amount that had to be paid to the publisher, and different royalty rates for Spotify's free and premium users.[79]

Within that information are two big indicators that the suppliers of the music industry have a strong force of bargaining power of suppliers. First, Spotify relies heavily on licensing the rights of the music in order for its business model to properly function. This heavily puts the negotiating power in the hands of the record labels. Second, even when Spotify was able to negotiate down the rate of royalties, it had to give several concessions that were not at all in the company's favor. According to Spotify, as of 2020, the company has paid over $23 billion in royalties, with $5 billion of that amount occurring in 2020 alone.[80] This strong bargaining force of suppliers is a threat to Spotify's ability to increase profitability by negotiating lower royalty rates.

Bargaining Power of Suppliers – Non-Music Audio Creators = Moderate = Threat and Opportunity

In order to expand beyond offering just music on Spotify's platform, the company decided to pivot to a new strategy: "less music."[81] Daniel Ek, Spotify's cofounder and CEO, believes that the audio industry can become "more personalized, more immersive", and that more than 20% of the listening activity on Spotify will eventually be non-music content.[82] To get this started, Spotify began heavily investing in podcasting, spending over $800 million acquiring podcasting companies and signing exclusivity deals with popular podcasters such as Joe Rogan (who reportedly made a deal worth $100 million).[83] Spotify has also been working on carrying some negotiation heft in the comedy content sector, but that has not been going as well. On November 24, 2021, Spotify removed hundreds of comedians' content from its platform due to a breakdown in negotiations over royalties with Spoken Giants, a rights agency representing some of the people whose content was removed.[84] This situation is still ongoing, so it is unclear what the end-result of this showdown will be.

The bargaining power of non-music audio creators is nowhere near as strong as the music industry. Instead, it comes down more to individual players instead of major record labels. This provides both opportunities and threats to Spotify's ability to increase profitability. If Spotify can increase the listenership of non-music content on its platform, it might have more pull to negotiate lower royalty rates with these artists, allowing for a greater share of the profits. This doesn't count for non-music audio creators who have a large amount of influence like Joe Rogan, however. Those creators have a higher bargaining power, which is a threat to Spotify's ability to increase profitability through lower royalty rates.

Closeness of Substitutes = Weak = Opportunity

Overall, there aren't many substitutes that are as cheap or convenient as streaming music is, whether it's on Spotify or another competitor, particularly with Spotify's freemium business model. Assuming a consumer did want to choose an alternative, though, this section will explore the reasons that each alternative is not as viable or accessible as music streaming.

First, a consumer could go the old-school route and buy the music through CDs, vinyl records, or digital albums downloads. While this is effective in having a personal copy of the music, these options are still expensive, comparatively. The average sale price of a digital album on Bandcamp is $9.[85] CD albums can sell for even more than that, where a small-time indie album can be at least $18.99.[86] Finally, vinyl records, although popular with audiophiles, are also very expensive, with an average cost of $30 or higher for a record that can be of questionable quality (warps, scratches, etc.)[87] The cost of that single album could be anywhere from one to three months of a subscription to a streaming service where you have access to that album as well as a vast array of other songs.
Second, a consumer could instead just choose to listen to the radio. This is a viable option, as there is music available to listen to (with ads in-between), but the exact same kind of service is available on Spotify with a much wider range of music choice instead of the limited rotation of music that radio would have.

Finally, there is the risk of piracy of music content as an alternative. Ironically, this is the very issue that Spotify was founded to fight against, by providing a free alternative to listening to music instead of pirating.[88] While some may turn to piracy, the risk is significantly reduced due to the ease of free streaming access on Spotify.

Overall, the risk of a consumer turning to substitutes is very low, which indicates a weak force, providing an opportunity for Spotify to increase its profitability by increasing the number of users on its platform, both ad-supported and subscribed.

<u>Value Creation and Profitability:</u>
When determining a company's profitability, there is essentially three factors to factor: the value customers believe a company's products have, the price a company charges for those products, and the cost the company accrues making the product.[89] In order for a product to sell, the value customers attribute to the product must *always* be greater than the price the company is charging.[90] The profit a company makes is the difference between the price the company charges and the cost of making the product.[91] For a company to increase its profitability, it needs to increase the difference between the price and the cost, either by decreasing the cost or increasing the value of a product and the price along with it.[92]

Spotify's Profit Margin:
In 2020, Spotify posted a Gross Profit Margin (GPM) of 25.6%.[93] GPM is a ratio that takes the difference between net sales and the cost of goods sold and divides it by net sales.[94] Essentially, it is like the difference between price and cost with a bit of extra math.
Spotify's GPM of 25.6% is rather low when compared to its competitors in the Movies & Entertainment industry. In that same year, Netflix's GPM was 38.9%, Disney's was 33.1%, and Vivendi's was 45.2%, all three close to double-digits greater than Spotify's GPM.[95,96,97]

Factors behind costs:
The primary reasons behind the difference in GPM between Spotify and these other companies are three things: the cost of music licensing and royalties, research & development (R&D), and the cost of streaming delivery. As mentioned previously in Porter's force of Bargaining Power of Suppliers, the music industry suppliers have a lot of influence on negotiating royalty rates, with Spotify paying out $5 billion in royalties for 2020 alone.[98] In order to keep ahead of its competitors, retain its current subscribers, and convert ad-supported users to subscribers, Spotify needs to invest quite a bit into R&D,

spending roughly $1.022 billion for that purpose in 2020.[99] Finally, the cost of data storage and delivery for consumers to stream music on Spotify's platform also costs money. Spotify made a deal with Google in 2018, allowing Spotify to utilize Google's cloud storage services for roughly $149 million a year for three years.[100]

Of these three cost factors, the probable reason behind Spotify's GPM being so much lower than its competitors is the cost of licensing music and paying royalties to the music rights holders. If Spotify wants to increase its gross profit margin, it needs to boost listenership for its non-music audios, which don't have as heavy of control over the rate of royalties as music suppliers do.

Value Chain Analysis:

In a company, every function (such as production, marketing, IT, HR, etc) either helps in lowering the cost structure of a product or increasing the value that customers see of a product.[101] One concept that shows this idea is the concept chain, which describes a company as a chain of activities performed to turn inputs into outputs.[102] As seen above, Spotify's value chain starts with technology development, followed by licensing activity, data storage, marketing and sales, and then finally with customer support.

Technology Development - Strength

Spotify's technology development is most definitely its greatest strength, particularly when it comes to development in machine learning involving music and understanding consumer behavior. There are several examples of research currently being done, but for now, this presentation will focus on one: human-computer interaction

Spotify's research into human-computer interaction has a wide array of application, but its summarized focus is to understand "how people relate socially and emotionally to music and audio content, how they converse with voice assistants to request and describe music and how context influences audio consumption."[103] Essentially, this field of study focuses on how to design programs that can understand *why* humans behave the way they do and utilize that to respond accordingly. For example, Spotify's researchers published a paper in October 2020 that focused on how to design voice assistants to understand user motivations and what expectations they have when making generic requests like "play music."[104] Another example is a study on having the algorithm balance familiarity and similarity with discovering new music when making music recommendations, where the goal is to maximize consumer satisfaction while also improving new song discovery.[105]

Overall, although technology development requires a fair investment (as all R&D does), it pays off by increasing the platform's perceived value of consumers. This, in turn, becomes a strength for Spotify in ability to increase profitability by increasing retention and acquisition.

Licensing Activity - Weakness

If technology development was Spotify's greatest strength in the value chain, licensing activity is its biggest weakness. As mentioned multiple times previously, Spotify relies heavily on music rights holders, which results in it having to pay large sums of money for royalties ($5 billion in 2020 alone).[106] Even when Spotify was able to negotiate for lower royalty rates, it had to make several concessions that were not in its favor, including minimum royalties to publishers (whether or not the songs were played enough times that month to meet that level of royalties) and allocating percentages of revenue rather than fixed rates per stream.[107]

Although licensing activity is a necessary activity for Spotify to function as a service, it definitely a weakness. This weakness increases the cost structure of Spotify's value creation, which in turn reduces its profitability.

Data Storage - Strength

When a company like Spotify has a large database of audio files such as music and podcasts, it needs a way to store that data – preferably in a manner that's cheap and efficient. The best approach to that, then, was to outsource to a cloud service provider like Amazon Web Services or Google Cloud. In 2016, Spotify made an agreement with Google to utilize Google Cloud's network to manage Spotify's online services, data, and job executions.[108] According to Tyson Singer, VP of technology and platform at Spotify, Google Cloud "removed a lot of the operational complexity from (Spotify's) ecosystem", freeing up time for Spotify's engineers to dedicate time to addressing user needs and experiences.[109]

While the automation and free time makes a solid argument for Spotify's outsourcing data storage as part of the supply chain to be a strength, there is one concern that should be noted. Spotify has dedicated its entire infrastructure on a product being developed by another company. This risk is best explained with Amazon Web Services (AWS) recent outage. On December 7, 2021, Amazon's cloud-service network had a major outage, affecting several major websites and removing the remote access to computers of several universities, governments, and companies.[110] This outage was addressed and fixed in roughly five hours, but several companies had issues due to this outage. For example, Delta Airlines' phone lines were supported by AWS, so Delta's customers were unable to book or change trips during that time because of the outage.[111] Instacart, Venmo, Kindle, Roku, Disney+, and the McDonald's app all were not functioning for a large portion of the US due to the outage, and Netflix saw a 26% drop in traffic to its website because of the outage.[112] AWS's outage was thankfully short and any impact on business was quickly rectified, but it does reveal a potential issue with Spotify's reliance on Google Cloud's infrastructure. If Google Cloud had a major outage, Spotify has no back-up option to ensure its program keeps running, which leads to potentially significant loss of revenue.

However, that is a hypothetical scenario. In the meantime, the outsourcing to Google Cloud's infrastructure allows Spotify to dedicate more resources toward research, development, and improving the user experience. While there is a potential problem, the benefits currently outweigh the potential downsides. For the time being, the data storage portion of Spotify's value chain is a strength, improving its ability to increase profitability.

Marketing/Sales - Strength

For the last couple of years, Spotify has been all-in on increasing its share of podcast content. This has been done by both purchasing podcast networks such as The Ringer and Gimlet Media and signing lucrative exclusivity contracts with big-name podcast creators.[113] The biggest and most recent acquisition made by Spotify was signing a multiyear exclusive licensing deal with Joe Rogan, a creator with millions of followers.[114] This exclusive licensing deal, rumored to be worth $100 million, gives Spotify a huge opportunity to increase its userbase with fans of Joe Rogan, whether the users remaining ad-supported or end up subscribing to Spotify's Premium program.[115] This increase of users could be in the millions from a single acquisition - a substantially beneficial move to Spotify's work toward profitability, even with the large investment required.[116]

Another example of Spotify's strength in marketing and sales is its annual Spotify Wrapped, an annual campaign where Spotify visualizes user data about activities, songs listened to, etc.[117] This campaign is a resounding success for multiple reasons. First, it is entertaining to the users themselves and provides interesting insights that they want to share with their social network, increasing Spotify's brand reach.[118] Secondly, Spotify has also begun to incorporate the data made from Spotify Wrapped for entertaining advertising, such as an "out-of-home advertising installation showing how many times users streamed Bonnie Tyler's Total Eclipse of the Heart during the week of the lunar eclipse in 2017."[119] Finally, Spotify uses that data to appeal to potential advertisers.[120]

Spotify's proficiency in increasing usership through lucrative exclusive licensing and spreading its brand name through successful campaigns like Spotify Wrapped make the Marketing/Sales value chain activity a significant strength, helping it increase its profitability further.

Customer Support - Strength
Spotify has a decent reputation for its customer service, with a Net Promoter Score (NPS) of 46, well above the industry average of 19.[121] An NPS can range between -100 and 100, so a score of 46 is very good.[122] On top of this, Spotify successfully handles customer support purely through chats, emails, Twitter conversations or its "Spotify Community", where Spotify encourages users themselves to help each other out.[123]

Spotify's ability to reduce overhead on its customer support activities through text-only customer support already points toward this value chain activity being a strength in its ability to improve profitability, but Spotify being able to accomplish this while creating a community that interacts together turns that strength up to 11.

Functional Level Strategies:
Spotify's focus as it pertains to Functional Level Strategies (FLS) is a combination of Innovation, Efficiency and Quality. By utilizing its R&D efforts for Innovation, Spotify can maximize its efforts toward Efficiency and, in turn, Quality. Compared to the other three strategies, Customer Responsiveness seems to be a bit of an after-thought.

Innovation:
Spotify invests a significant amount of money each year in its R&D department – in 2020, the company spent over $1 billion in R&D.[124] The innovation efforts in Spotify's R&D department span both process innovation and product innovation, including projects like developing language technologies to improve global user experience, understanding the emotions and interests of consumers and changing recommendations based on that, and the creation of music with the assistance of AI.[125] All of these projects have wide-ranging applications within the company, from increasing employee efficiency on large tasks to improving audio quality, leading to greater customer satisfaction. Early in 2021, Spotify announced its innovative projects involving non-music audio like podcasts.[126] These projects include allowing content creators to incorporate music tracks into their storytelling to create a better end-experience, being able to turn written content into a podcast and create a website for the podcast all within a few clicks through Anchor and WordPress, creating direct interaction between podcast creators and listeners, and allowing the incorporation of video into podcasts.[127] Finally, Spotify is creating its own form of paid subscriptions for content creators on its platform.[128] Together, these changes all increase the quality of life of content creators using Spotify's platform. This potentially will result in more creators utilizing Spotify to distribute their content, which will provide a greater of diversity of content, appealing to a wider userbase. This potential increased appeal could lead to an increase in user population, which would directly lead to an increase in revenue and, in turn, profitability, making this FLS a strength.

Efficiency:
The most important strategy being taken that improves efficiency is the incorporation of Spotify's AI research into various aspects of the company. In an interview with Sidney Prescott, the head of intelligent automation at Spotify, she talked about focusing on finding the most tedious, repetitive tasks being done at the company.[129] After finding these tasks, Sydney's group would work on developing an AI program "with the express purpose of establishing new efficiencies."[130] By utilizing AI to handle the tedious tasks, Spotify employees would have more free time to focus on projects that could make a big difference in the company that were previously at a lower priority than the repetitive tasks.[131] As Sydney said, "Enabling these efficiencies means a quicker time to market and new and improved products and features … Ultimately, it all comes together to better the customer experience of Spotify users."[132] Within the interview, Sydney gave an example of a project her group was currently working on, where the task is to perform quality analysis on audio ads to ensure it passes various tests of quality and integrity.[133] Before the intelligent automation group started working on this project, that was a task that required manual oversight by one of Spotify's employees, but they were able to automate the process, increasing the efficiency of the company further.[134]

This increase in efficiency will hopefully allow employees more free time to focus on projects that would add value to Spotify as a platform, allowing Spotify to increase its profitability in turn, making this FLS a strength.

Quality:
In terms of Quality as a Functional Level Strategy, Spotify focuses on consistently achieving Quality as Excellence so that it eventually can result in Quality in terms of reliability. Spotify primarily achieves this through utilizing AI to more properly coordinate the consumer's content recommendations.[135] Spotify takes the massive amount of data being provided to it by listeners every day and feeds it to the AI to help its machine learning, allowing it to be more accurate about music recommendations.[136] One example of the outcome of Spotify's AI-generated recommendations is Discover Weekly, where every user is presented with a curated list of thirty songs every Monday based on the user's search history pattern and possible music recommendations.[137] Utilization of this AI is doubly-effective in that it both gives users a consistent reason to return and gives exposure to artists who may not have gained it otherwise.[138]

This ability to keep users returning increases retention, allowing for a greater continued stream of revenue and eventually potentially increasing profitability, making this FLS a strength for Spotify.

Customer Responsiveness:
With the focus on AI in all the other strategies, it's a little surprising that there isn't any sign of it being utilized to handle customer responsiveness. Although customer support is currently only handled through text via chat messages, email, social media messaging, or community forums, the people handling the customer support are entirely human.[139] In 2016, Dan Gingiss was able to conduct an interview with some of the people behind Spotify's Twitter support channel, @SpotifyCares.[140] In the resulting article that Dan wrote, it's revealed that Spotify's service agents are based in Cambridge, England, and are proficient in multiple languages, including English, Spanish, Portuguese, and German.[141] As these agents go through Spotify's customer support training, they are first assigned to e-mail duty, giving them more time to understand the proper solutions and the style of talking required by Spotify as a brand.[142] As Dan wrote, "Potential agents must submit to multiple writing tests and have high quality scores from their e-mail work before being considered for social media customer service."[143] This carefully trained text customer support, combined with the creation of a community of users aiming to

help each other, helps build a high quality level of customer satisfaction, resulting in a Net Promoter Score of 46, overall a very good score.[144]

Although the system Spotify has created functions well overall, it has started to see stress under the platform's continually increasing userbase. During the creation of this presentation, there was constantly a heading notifying anyone looking for customer support that there would be a long wait and apologizing for the inconvenience.[145] Taking both factors into account, Spotify's Functional Level Strategy involving Customer Responsiveness is a mix of strength and weakness. Whether the balance between the two results in a boon or a bane to profitability depends on what actions the company takes to rectify the issues showing levels of strain.

Corporate Financial Performance:

When analyzing the performance of a company's value-chain activities, it is essential to understand that company's financial performance and how its strategies affect profitability.[146] When doing this, the best way to determine financial performance is through benchmarking, comparing the company's performance either to its competitors or against itself in prior periods of time.[147]

Return on Invested Capital:

Return on Invested Capital (ROIC is a measurement of the financial performance of a company by dividing its net profit by its invested capital.[148] Net profit is the money left over after expenses and taxes are managed, and invested capital originates from interest-bearing debt and shareholders' equity.[149] Spotify's ROIC performance has been rough, primarily due to its consistent yearly losses. In 2018, Spotify reported an ROIC of -2.2%.[150] The next year, in 2019, its ROIC looked marginally better at -1.9%, a whole 0.2% higher than the year before.[151] In 2020, however, Spotify's ROIC plummeted to -7.4%, 5.5% lower than the previous year, indicating a much larger loss than in previous year.[152] The significant decreases in ROIC portray a weakness in Spotify and its profitability.

Return on Assets:

Return on Assets (ROA) is a measurement of profitability made by dividing the company's net income by its total assets.[153] The higher an ROA is, the more efficiently the assets are being utilized.[154] Spotify's ROA performance from 2018 to 2020 looks just as poor as its ROIC, dropping from -2.1% to -3.9% and then -10.2%.[155] This continual drop in ROA indicates a significant weakness in Spotify and its profitability.

Return on Equity:

Return on Equity (ROE) measures the efficiency of a company in generating profit from the investment of shareholders, made by dividing net income by its shareholders' equity.[156] The greater the ROE, the more efficient the company is at producing a profit from investment.[157] Unfortunately, Spotify does not indicate this, with its ROE from 2018 to 2020 plummeting from -6.7% to -9.0% and finally -24.0%.[158] Like the measurements before this, this massive decrease in ROE demonstrates a weakness in Spotify and its profitability.

Cost of Goods Sold:

Cost of Goods Sold (COGS) is, as the name implies, the direct costs of making the products sold by a company.[159] The resulting number from COGS is then subtracted from sales to calculate gross profit and the company's gross margin.[160] In Spotify's case, its gross margin each year stayed remarkable close, with 2018 being 25.73% (($6.025 billion - $4.475 billion)/$6.025 billion), 2019 being 25.45% (($7.587 billion - $5.656 billion)/$7.587 billion) and 2020 being 25.57% (($9.626 billion - $7.165 billion)/$9.626 billion).[161]

This means that both Spotify's COGS and revenue increased at roughly the same rate every year, indicating neither a strength or a weakness. However, an average of 25% is well below the Movies & Entertainment industry, which averaged between 8-12% higher, depending on the year.[162] With that information in mind, the change in Spotify's COGS over time indicates a weakness in both the company and its profitability.

<u>Benchmarking Analysis – Spotify to Competitors:</u>
When benchmarking a company's financial performance, it is a good idea to compare it to other companies after doing a historical comparison to itself.[163]

Return on Invest Capital
When comparing ROIC between companies, Spotify is the weakest performer, with none of the other companies having a negative ratio.[164] Disney had the highest ROIC in 2018 with 16.8%, but fell by nearly half afterward, while Netflix continued to climb.[165,166] The difference in growth became even more stark in 2020, when Netflix was the only company to have its ROIC increase.[167] Vivendi has consistently been in the middle of the road, with it not having the worst performance but not the best, either.[168]

Return on Assets
For ROA, Spotify once again severely underperformed, but was joined by Disney in having a negative score at least once, with Disney having an ROA of -1.3% in 2020.[169,170] Like with its ROIC, Netflix did not start with the highest ratio, but steadily grew where the other companies struggled.[171] Vivendi performed well, here, increasing its ROA from 0.5% in 2018 to 4.5% in 2019, and only decreasing by 0.2% in 2020.[172]

Return on Equity
ROE shows the starkest difference between Spotify's performance compared to its competitors, with a difference of over 50% between Spotify and Netflix in 2020.[173,174] Disney started off with a solid ROE in 2018, which then fell by nearly half in 2019 before going into the negatives in 2020.[175] Vivendi showed decent growth over the three years, going from 0.9% in 2018 to 10.0% in 2020.[176]

Cost of Goods Sold
As mentioned in the previous slide, COGS on its own is not a major indicator without comparing it to the company's revenue for that year. When comparing gross margins, Spotify still performed the worst with an average margin of 25.58%, but Vivendi ended up being the best performer with an average gross margin of 43.78% between 2018 to 2020.[177,178] Disney comes in second with an average gross margin of 39.13% over the three years, followed closely by Netflix at 38.02%.[179,180]

Statement of Competitive Advantage
The best way to determine competitive advantage in an industry is by comparing the average ROIC of each company.[181] With this in mind, Netflix currently holds the competitive advantage, with a 3-year average ROIC of 12.43%.[182]

Benchmarking Spotify's Financial Performance
Spotify performed the worst in all four measurements by a wide margin, never even coming close to its competitors. As it stands right now, Spotify's inability to produce a profit is a major weakness in the company.

<u>Spotify Strategy – From External Analysis:</u>

Macro-Environment

International Expansion

Spotify is on the right track by expanding into countries that are newer to the internet but have rapidly growing populations coming online for the first time. If Spotify can get a hold of this population early on, it would be able to potentially create a large userbase that could be developed into having brand loyalty to Spotify. This would create a decent new source of revenue and increase Spotify's profitability.

Copyright Law

While this change may not directly result in an increase of profitability, it is an essential step Spotify must take if it wants to avoid large financial losses like with the previous settled lawsuit with Wixen Music Publishing. Getting involved in lobbying to change copyright law can also be to the benefit of Spotify in the long run, with it potentially being able to reduce the significant power record labels in the music industry currently wield.

Porter's Five Forces

Bargaining Power of Buyers - Advertisers

This force is partially addressed with the international expansion strategy, but Spotify increasing its userbase population is essential to increase its negotiating power with advertisers. This higher negotiating power would allow Spotify to charge higher advertising rates, resulting in an increase in profitability for the company.

Bargaining Power of Suppliers – Non-music Creators

Spotify's best opportunity to increase its revenue and become more profitable currently lies in its non-music audio products, where it doesn't have to pay as much in royalties as it does to the music industry. Increasing the amount of non-music audio content will increase the diversity of options for interested parties, potentially increasing the number of people listening to that content, which would result in an increase in profitability for Spotify.

Spotify Strategy – From Internal Analysis

Business Model

Spotify should retain its business model. Currently, it is the only major difference between it and its biggest competitors in the music streaming industry, Apple and Amazon. If Spotify moved away from the freemium model, it would potentially eliminate over half of its total userbase, removing one of its current strengths. Instead of changing the model, Spotify should double-down on it or enhance it by offering an even better level of product services at a higher price as a third option. If Spotify continues to focus on improving its end-user experience to improve retention and providing content that draws new interested users, its trend of losses will eventually turn around and become profitable.

Value-Chain

Spotify has two significant issues within its supply chain, currently. The first, and most important, issue is in the licensing activity value chain segment. Currently, almost all the negotiating power is in the hands of the music industry record labels. Spotify needs to find a way to gain enough leverage to be able to either negotiate down licensing costs or end some of the concessions the company made in the last round of negotiations. If that's possible, the biggest detriment to Spotify's potential profitability will be less damaging.

Secondly, although the outsourcing of Spotify's data to the Google Cloud infrastructure has been beneficial overall for the company, the threat of cloud-service outages like what happened to AWS earlier is a serious concern. To help ensure at least a minimal level of usability in the worst-case scenario, Spotify needs to establish redundancies to reduce its vulnerability to potential outages.

Functional Level Strategy

While having text-only customer support through email, chats, or Twitter messages allows for a much lower overhead and simpler quality assurance, it also risks dehumanizing the business. With the longer waiting times currently existing through the text-only channels, customers could become more upset, misunderstanding the delayed response as a lack of a response and a failing of the company. To address this, Spotify needs to either increase its customer support budget to accommodate for the increase of customers and subsequent increase in customer issues or create a new process that will streamline the customer support pipeline, making it more efficient.

Secondly, the idea behind the investment in podcast content is a sound one, but it is also risky – Spotify has spent a *lot* of money investing in podcast content in the last couple years. It might be beneficial to adapt currently existing systems to improve upon what the company has already acquired. In the meantime, Spotify would also be well-purposed to invest in other non-music content, such as audiobooks. This would follow the mantra of “less music” while also increasing the options for potential users. The increased options increase the chances of increasing the population of active free users (and ad revenue along with it) and subscribers, which would increase revenue and profitability along with it.

Corporate-Level

Horizontal Integration

At the corporate level, Spotify would be best served to continue its horizontal integration. One potential idea is to acquire music/sound studios so that Spotify can create its own line of “Spotify Originals” or whatever the coined term would be. This benefits Spotify in two ways – first, Spotify can become its own record company, creating another flow of revenue that doesn’t require any royalties other than what Spotify would owe its artists. Second, this expands Spotify’s non-music related content options substantially, allowing it to produce whatever it believes would provide the best increase of user population to continue increasing its revenue from the freemium model.

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