Pashalgnatov/iStock

Time to Face the Music?

THE STREAMING MUSIC SERVICE has excited investors, musicians and the listening public. But with profits unseen, antagonistic artists and growing competition, how should Spotify change its tune?

On the face of it, Spotify seems a success story. Launched in Sweden – home of the infamous site for illegal downloads, The Pirate Bay – the streaming music service has managed to convince a nation, as well as millions of other people around the world, to pay for music again. But after five years of rising popularity and a growing user base, a series of challenges is casting doubt on hyperbolic claims that Spotify might hold the key to saving the troubled music industry.

Despite having 50 million active monthly users worldwide, around 10 million of whom are paying subscribers, Spotify has yet to post a profit. Indeed, the last available figures from 2012 report a loss of 58.7 million euros, higher than the 46.8 million of the year before.

Why such shortfalls? Operating expenses are high, but revenues pose the real challenge, generated from two sources: advertising, which offsets the costs of letting 40 million people listen to unlimited songs for free in exchange for advertising interruptions; and premium subscribers who pay $10 a month for an ad-free experience. But as with similar "freemium" business models, it's not clear how to convert the "free riders," who represent four times the number of paying customers.

In the absence of other revenue streams, the bulk of Spotify's funding continues to come in the form of venture capital, with $538 million invested at the end of 2013 and ongoing top-ups. Spotify will have to show it is working on addressing these issues or risk losing investor confidence. When start-ups rely on regular capital injections for their survival, it is the money that increasingly calls the shots, and investors are likely putting pressure on Daniel Ek, the chief executive, to turn up the volume.

Troubled Talent

Another pressure on profitability is that Spotify pays out 70 percent of its revenues in royalties. While Spotify presents this as evidence that its business model is pro-musician and a viable alternative to piracy, not all the artists are so convinced.

Spotify negotiates with and pays the labels, which then distribute revenues to the artists. Musicians complain that Spotify's rates are too low: with payments of only a few cents per stream, a song has to be played more than 100 times for an artist to earn the equivalent of one MP3 download.

This has created vocal enemies among some musicians, with Taylor Swift making headlines in late 2014 for withdrawing her entire back catalog from Spotify, citing unfair compensation as the reason. Ironically, it is top-selling artists like Swift who are precisely the ones who stand to make the most off Spotify's business model, while smaller, lesser known acts have much more to lose from fewer listens.

Spotify may be wise to pursue a business model that rewards talent, so as not to bite the hand that feeds it. Yet if it can't get around the middlemen (the labels) and it is alienating even the top acts (to say nothing of the little guys) then this could spell serious trouble longer term.

Islands in the Stream

In considering tinkering with its business model, Spotify is not operating in a vacuum. It is not the first to experiment with subscription-based digital music provision, and given its popularity, Spotify now has even more competition to contend with.

Apple's purchase of Beats Music makes it poised to become Spotify's biggest rival. Competition also comes in the form of iTunes Radio, Google Music Play, Rhapsody (which acquired Napster), Deezer (a Paris-based service beginning to make inroads in the United States) and YouTube, among others.

How can Spotify work on its larger, structural issues with competition like this nipping at its heels? And with Apple able to ensure the diffusion of its acquisition on iPhones and iPads, should Spotify be focusing on building bridges with rival device makers?

There may be other options. Dominant global leaders like Apple and Google appear eager to cut themselves a bigger slice of the digital music pie. Spotify could conceivably be a viable acquisition. After all, many players in the digital world have gone this route. Might Spotify's Daniel Ek be hedging his bets, waiting to sell the venture for a few billion the way Jan Koum and Brian Acton did when they sold WhatsApp to Facebook? For some entrepreneurs, the exit is the end goal, and they live instead for the next project.

Yet if Spotify wishes to remain independent, it's going to have to find new streams – not of music but of cash. □

The case study **"Spotify: Face the Music"** (SM-1613-E) by IESE's Govert Vroom and Isaac Sastre Boquet is available from IESE Publishing at www.iesep.com.

> Spotify has a tough fight on its hands, but I think it is well-positioned to come out a winner.

Fight While There's Still Time

by Adrian Zaugg
Head of Corporate Strategy
Swiss Broadcasting Corporation

ALTHOUGH THE PICTURE SEEMS BLEAK, I believe Spotify has many things going for it. It may not have been the first to offer digital music, but it was the first to offer it in a legitimate way that really took off. It now has a great catalog, and the image it projects is appealing: independent, Swedish, cool.

The competition is growing and fierce; moreover, in the world of the Internet, we in the business like to say that "the winner takes all." When it comes to digital music, we haven't seen a clear winner yet, and Spotify is going to have to invest heavily if it wants to become that winner.

Spotify has the potential to become the winner, but it faces some tough choices. As a strategist, I am adamant that Spotify should stick to its "freemium" business model. Free drives reach, and as long as there's no clear winner, reach is everything.

Spotify does need to work on improving its offer to paying customers. This might mean offering eternal downloads – downloads of songs that can be kept even if the customer ceases to use Spotify.

One major trend I noted during a recent visit to the Consumer Electronics Show in Las Vegas was hi-res audio. After a decade of listening to poor-quality MP3s, hi-res audio is becoming a key consideration for the music industry. Spotify should seek to capitalize on this trend.

After all, people are willing to pay for a really strong product. That's why the iPhone is still so popular despite Samsung being cheaper. Spotify needs to focus on being that strong product, and people will pay for it.

Even the bad press around Taylor Swift isn't entirely detrimental: just because some musicians feel there isn't enough payback, the public is at least reminded that Spotify does pay royalties. This makes people feel good when they listen to a song on Spotify – it's one of the good guys.

I don't see labels and artists choosing to have pre-Spotify launches as a strike against Spotify, but rather typical music industry marketing behavior. Spotify might try to explore ways of working with the music industry marketing effort, negotiating album launches as supplementary services to its paying users. This could convert more people to paid accounts.

If Spotify really wants to raise its game, it needs to address the weaknesses associated with fast growth. It needs to consolidate its network of users and its team. It has had to grow very fast to get where it is today, and fast growth burns a lot of cash. It takes a while to get a return on investment. Spotify's problems are understandable, but they need to be addressed. If resources are limited, why not go public?

No doubt, Spotify faces a big battle ahead. It's a volatile industry, and no one can honestly predict what's going to happen next. With competition as formidable as Apple and Google, Spotify has a tough fight on its hands, but I think it is well-positioned to come out a winner: it has the recognition, the feel-good factor and a strong existing client base. Alternatively, it could sell.

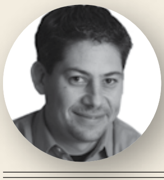
Either way, Spotify shouldn't leave it too late: fight for the business or sell, but a decision has to be made. Often, in Europe, we have a follower mentality when it comes to strategy – observing, adapting, incremental changes – but these circumstances demand that Spotify, if it wants to stay in the game, be a pioneer.

Tips for Turning Up the Volume

- Leverage feel-good factor: it's legal, it pays royalties, it's one of the good guys.
- Sell or go public, but above all, decide!
- Improve offer to paying customers: eternal downloads, hi-res audio, marketing pre-launches.

Spotify has a clean user interface, but there is opportunity for doing even more.

Room to Grow



by Alejandro Arnaiz
Director of Business Development, MNO Americas, Skype

SPOTIFY DIDN'T CHANGE THE MUSIC industry but it has helped it by introducing a frictionless access model that exposes consumers to more music than ever before. To succeed, Spotify needs to consolidate its market position through an increased user base and engagement, price adjustment and deeper interaction with artists.

Coming from the communications segment, I see apps that have reached 100 million monthly active users in less than four years. For Spotify, there is room to grow. Increasing its user base will help Spotify on the revenue side, as well as putting it in a stronger position for an acquisition or an IPO. The key is to become an important part of people's lives. Build that, and monetization opportunities will follow. As a result, Spotify will be better positioned to control its own destiny.

To increase the user base, I would look at removing friction for the end user. As a preemptive but also proactive strategy, I would consider building a strong ecosystem of end points through which users can experience the service at any moment during the day. To have significant impact, these devices must target the mass market. Given that online sales of digital music are tied to connected devices, I would seek to collaborate more aggressively with mobile operators, OEMs and similar distribution channels.

User engagement and viral growth will come from people's interaction with the service. Spotify has a clean user interface for searching, discovering, playing and sharing. There is opportunity for doing more: finding concerts, purchasing memorabilia and tickets, gifting, sharing beyond the song or playlist and interacting with artists. Messaging apps that integrate in-app purchase options or brand accounts are seeing accelerated growth, user engagement and revenues. This combination of elements must have the casual listener in mind, as the music addict is on board already.

From a monetization perspective, the simplest thing would be to charge a symbolic fee to all free users. We have seen that if the product is compelling, people will pay for it. However, considering Spotify's fixed operating expenses, I would seek to increase its paid user base and optimize the food chain.

The key argument is that music has price elasticity. The average annual music spend in 2010 was $45 to $65, consistent with online or CD sales before. Spotify, at twice that cost, could renegotiate lower monthly fees with the labels, tapping into a larger market with a lower disposable income. Obviously further analysis is required to reach the ideal price point.

Optimizing the food chain also means working closer with artists. By leveraging connected devices and social channels, Spotify has a much broader and faster reach than traditional media. It can and should be positioned as a marketing and promotion channel: new releases, concerts, in-app purchases for tickets and merchandise. As the user base and engagement grow, artists will see value in Spotify and want more exposure to its users. Labels certainly have their own objectives, but the direction the music industry is heading won't change, and it is in the best interest of everyone involved to make this work.

Tips for Turning Up the Volume

- Increase paid user base by offering more compelling interfaces.
- Collaborate more aggressively with mobile operators, OEMs and artists.
- Position it as a channel for marketing and promotion: new releases, concerts, in-app purchases for tickets and merchandise.

> Use the social dimension to send signals about the importance of payment to others in the user's network.

Play to the "Ego Factor"

by Reza Ghassemi
COO & CMO, Shot & Shop
Former Manager of Strategic Alliances, Google Spain

WHILE MANY REGARD SPOTIFY as the online music listening service par excellence, the race among contenders in the streaming music space has only just begun. Spotify may be in pole position, but it would be reckless to declare victory too soon, as the competition is gaining fast.

Apple's forthcoming Beats-powered music service is being touted as "the Spotify killer." There's no telling how many users will end up switching over and paying for Apple's apparently cheaper version, but it could certainly inflict serious damage. In addition, Google's Play Music and YouTube's Music Key are fiercely vying for listeners. Apart from these heavyweights, there are several noteworthy upstarts, and given aggressive promotional and expansion campaigns by Deezer, Sonos, WiMP and the like, these rival music streamers will likely become household names before long.

The good news for Spotify is that, according to some recent reports, it appears to be turning a corner and revenues are starting to exceed costs for the first time. As 90 percent of those revenues come from premium users, the strategic focus should be on boosting those numbers, either by converting more basic users to premium, or attracting new users who join as paid subscribers from the start.

One way of achieving this would be to join up with complementary brands and services that bring added value to the Spotify community. For example, a subscriber to a movie-and-television streaming service like Wuaki would be a suitable target to try to attract additional subscribers to Spotify. Spotify could also sign agreements with Internet service providers to offer a bundle of streaming services.

Meanwhile, the company is sitting on a goldmine of data collected from its 50 million users. That wealth of information on user interests and trends needs to be leveraged, both to further improve the experience as well as generate new sources of revenue. Third parties, such as major players in the music business and advertisers, would be more than willing to pay for better targeted market segments.

Another area to exploit is the social dimension. Often, users don't become subscribers, not because of any major price barrier, but out of sheer laziness or, worse, a general belief that nobody else is paying so why should they?

To tackle this, Spotify might take inspiration from LinkedIn, whose premium account holders get a visible badge next to their name, which has a signaling effect on others in their network. Spotify could play to this "ego factor," experimenting with ways of turning the issue of payment into a status symbol, and letting the natural forces of social networking and peer pressure encourage others to join the club.

Finally, Spotify must resolve its headline-grabbing disagreements with those in the music industry who call the business model into question. Enhanced relationships with artists, composers and relevant influencers across the sector would certainly help generate new ambassadors for the brand.

This, in turn, would at the very least help to grow the user base of the basic service, thereby increasing the pool of those who might eventually switch over to premium. Even if the conversion rate stays the same, the net effect of having a larger user base translates into more money overall.

Tips for Turning Up the Volume

- Explore joint marketing opportunities with third parties.
- Use data to improve the experience and generate new sources of revenue.
- Make premium subscriptions a status symbol.