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Spotify: Face the Music (update 2016)
Facing Increased Competition

After sampling some of the new music releases of early 2016, Daniel Ek ended his Spotify session. Soon, millions of Spotify users would learn he had just listened to Andrew Gold's cover of The Beatles' "Norwegian Wood," as the profile of Spotify's CEO was one that every new Spotify account followed by default. Some users might be curious enough to click and listen to the album, share it on Facebook, or include one of its songs in a virtual mixtape that could be posted online. The company was proud of the social features of Spotify's client software, which had probably played an important role in the tremendous growth the service had enjoyed since its launch back in 2008.

But Spotify was making lots of other noise. The company had just raised $1 billion in convertible debt and the media were full of speculation that the company was preparing to fight off the threat of the technology giant Apple's new streaming service, Apple Music.[1]

Did Spotify have something to fear? After all, it was the world's leading on-demand music streaming service. In early 2016, it reportedly had more than 100 million users, 30 million of whom paid a monthly fee for Spotify's premium services.[2] It had entered the difficult U.S. market with great success, and it already had a presence in more than 50 countries. Spotify's catalog contained more than 30 million songs, including the libraries of all the major recording labels.

Yet not everything was so favorable. While Spotify had been able to fend off other competitive threats, Apple's streaming service, Apple Music, was gaining users at a frantic pace. In just six months, it had attained 10 million paid users, a milestone that took Spotify many years to achieve.[3] And this happened while Spotify had still been unable to achieve profitability – net losses in 2015 had gone up to €184.5 million,[4] and the company had yet to post a profit since the service's debut in 2008. Some analysts pointed to how other companies offering streaming music, such as Rhapsody, had been unsuccessful in the past.

Spotify was going to face the biggest challenge in its short existence, and Ek was probably aware that the company could not afford any misstep. Despite its impressive success up to that point, some believed it still could go on to become yet another casualty in the troubled history of digital music.

This case was prepared by Professor Govert Vroom, and Isaac Sastre, case writer, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. August 2016.

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The History of the Music Industry

The Music Industry Before the Digital Era

In 1999, the recorded music industry was at its peak. With $38 billion in global revenues,[5] it was riding a wave of growth as more convenient playback media such as the CD had replaced vinyl records and cassettes. CDs combined the accessibility of a small and cheap cassette player with much higher sound quality and fidelity.

Recorded music came into existence with the invention of the phonograph by Thomas Edison in 1877, which enabled sound to be reproduced using an engraved cylinder, the "record." Recorded music would become popular throughout the 20th century with the emergence of mass media such as the radio, which brought music to millions of homes. Music enthusiasts wanted a way of listening to their favorite songs without having to wait for them to be broadcast again on the radio or television, and sales of recorded music exploded.

Soon, a new business model emerged where recording companies, called "music labels," contracted artists to produce music for them. These labels acted as both producers and publishers, coordinating and handling the recording, manufacturing, promotion, marketing and distribution of music. The finished records were sent to final distributors (from small music stores to nationwide chains or department stores, or eventually even online retailers such as Amazon), which sold them to the final customer.

Recorded music was published in albums of several tracks (usually around 10). Some hit songs were released as singles, which could be sold for a lower price and were also used for promotional purposes, but the transition to compact disc (which had very similar production costs regardless of the length of the recording) had reduced the sales importance of the single.

In 1999, this business model had remained undisturbed for decades. Eventually, the market had become concentrated in the so-called "big five" major labels: EMI, Sony Music, Universal Music Group, BMG, and Warner Music Group. These larger companies often also acted as the publishers of smaller independent companies, which lacked the capacity to develop effective distribution and marketing arms. This increased the major labels' market share even further.

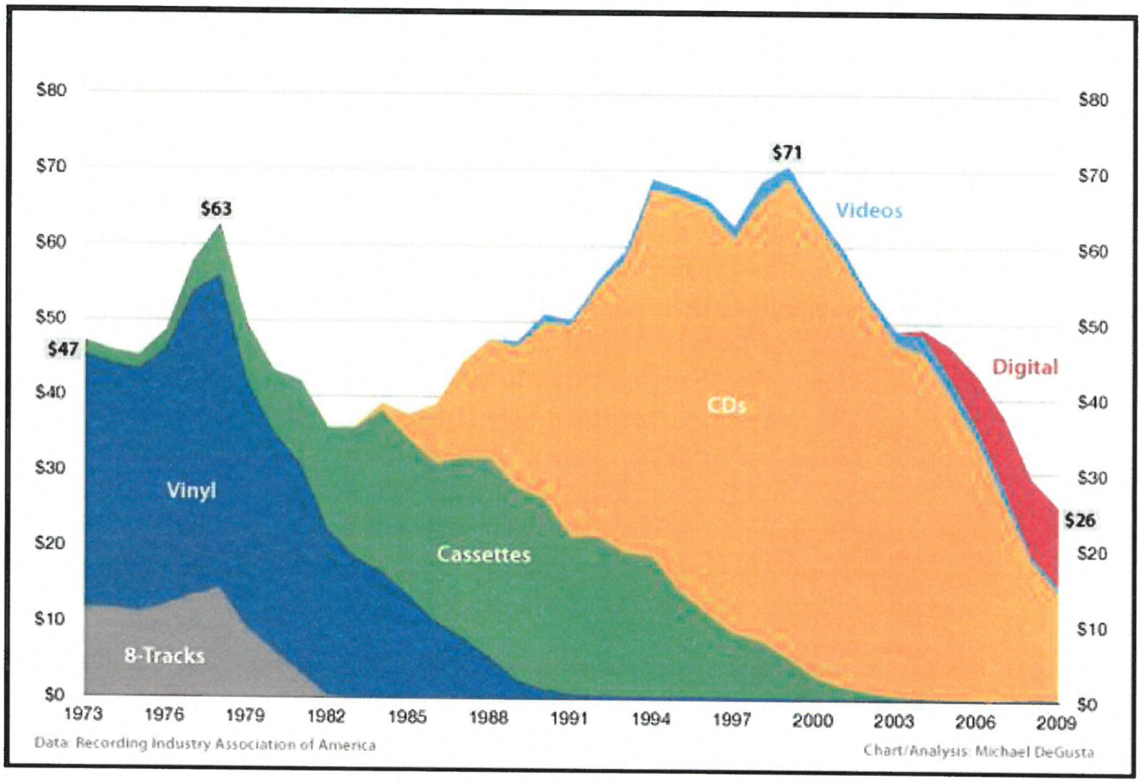
However, in June that year, 1999, while the recording industry was enjoying its best year ever, a group of entrepreneurs launched the file-sharing service Napster. The service allowed users to share files easily through the Internet, and became the first step that would unravel the entire industry as it had been understood up to that point.

The Digital Medium and the Rise of Music Piracy

Two years later, in 2001, Judge Marilyn Hal Patel ordered an injunction against Napster, after the Recording Industry Association of America (RIAA) brought a suit against the company.[6] Napster users had been using the service to share music in digital format illegally. In just two years Napster had amassed 60 million users, who were swapping more than 165 million songs a day without paying artists or labels.[7]

Music sales had been falling dramatically, which had prompted the RIAA to start an intense campaign against music piracy. Yet, despite its efforts, sales would continue in free fall for years to come, reaching an all-time low of less than $16 billion in 2011.[8] In a little more than a decade, the music industry had been cut in half. Figure 1 shows the dramatic drop in music spending per capita throughout the first decade of the 21st century, compared with the previous state of the industry.

Figure 1
U.S. recorded music revenue – 2011 dollars per capita



Source: Michael DeGusta, "The REAL Death of the Music Industry," Business Insider, February 18, 2011, http://www.businessinsider.com/these-charts-explain-the-real-death-of-the-music-industry-2011-2.

The industry, in general, blamed piracy for these lost sales,[9] but Ek had his own opinion of what had happened:

> "I realized convenience quite often wins... It's not that people don't want to pay for music... It was the only point in time when the stolen product has been much, much better than the one you legally acquired... For me it was a pretty big given why we ended up where we ended up in the music industry."[10]

What had happened? Three key developments had brought about the age of digital music:

- *MP3 compression technology.* In 1993 the Moving Picture Experts Group – the group tasked with setting the standards for digital audio and video formats – published the MPEG-1 Layer III standard for digital audio, commonly known as "MP3." The MP3 standard reduced the size of a music file by an order of 10, while keeping a quality that was nearly undistinguishable from larger, lossless formats on all but high-end playing devices.[11] The result was that users could rip their audio CDs, store their entire record collection on their computers, and easily share it with friends.

- *The rise of the Internet.* The Internet was opened to commercial operators in the early 1990s. In 2000, 43% of the U.S. population already had access to it, a percentage that rose throughout the years and reached 84.2% in 2013.[12] At first, most Internet connections were slow, and it took several minutes to download a single music track. However, soon faster connections were developed and offered by Internet service providers. These so-called broadband connections would eventually allow music tracks and videos to be played instantly. In 2015, it was estimated that there were over 147 broadband connections per 100 inhabitants in the United States, of which the vast majority (116) were mobile connections.[13]

- *New devices.* These new digital formats spurred the development of a wide range of software and devices capable of creating and playing digital music files. These devices had greater capabilities than the older analog or CD player technologies. For example, eventually a typical portable digital music player was able to contain the user's entire music collection, rather than just the 60 to 90 minutes of a typical CD or tape. Users could browse and play any song easily and they could store and display information such as song title, band name or genre. They could then create playlists of their favorite tracks and easily move music between the player and their computers. All in all, these players possessed features and usability that were unheard of in older technologies. Portable digital players quickly became very popular. Later, the massive adoption of smartphones would further increase the user base and capabilities of devices able to play digital music.

Despite the music industry's efforts to stop them, file-sharing networks similar to Napster would emerge: Gnutella, Kazaa, Torrent, and eMule, among others. Trying to shut them all down became a never-ending game of whack-a-mole. The genie was out of the bottle, and the industry would have to figure out what to do with it.

The First Steps to a Digital Industry

The first companies that marketed digital music usually lacked support from the recording industry. For example, in 2000 eMusic launched a service offering unlimited track downloads from a library of 125,000 tracks to those who paid a monthly subscription.[14] However, only artists from independent labels were available. By way of comparison, in 2016 most leading digital music services had libraries of 20 million to 30 million tracks. Likewise, in 2001 MP3.com was offering unsigned artists the chance to distribute their music through its website, paying them according to the number of downloads accrued.[15] Both companies would change ownership and business models in the following years. MP3.com eventually shut down and sold some of its assets – including its coveted domain name – to CNET Networks in 2003.[16] On the other hand, eMusic was still operating in 2016, allowing customers to download a fixed number of tracks for a set monthly fee.

The initial reaction of the major labels to the new technology was litigious. As well as suing the makers and users of music-sharing networks similar to Napster, they also tried – but failed – to obtain an injunction to prevent the sale of the Rio PMP300, the first commercially successful portable MP3 player.[17]

Indeed, the major labels' first attempts to enter the digital market demonstrated the industry's wariness of the new technology. In the early 2000s, two joint ventures backed by the major recording labels were launched: MusicNet – supported by EMI, Warner, and BMG – and Pressplay, backed by Sony and Universal. Both services had several limitations that made them unpopular with users (such as the limited number of tracks playable per month, and the limited number of tracks from the same artist playable per month). Furthermore, MusicNet and Pressplay only had the music of the labels that backed them, so users needed to purchase two separate subscriptions if they wanted to listen to all the major artists. Soon the labels abandoned these services: MusicNet was sold in 2005[18] and Pressplay was sold in 2003, merging with the Napster brand for the latter's relaunch as a legal service.[19] Both MusicNet and Pressplay came joint ninth on PCWorld's list of the "worst tech products of all time."[20]

The Success of the iTunes Model

The industry, however, did not have to wait long for its first massively popular digital music service. In February 2003, Steve Jobs unveiled the iTunes Store during his keynote speech at a special Apple event. At launch, iTunes offered a catalog of 200,000 songs, with backing from major and independent labels, which sold for 99 cents a track.[21] Initially, iTunes was available for only Mac computers, but support for Windows was added a few months later, greatly expanding the potential customer base.[22] By the end of the year, the store had already sold 25 million tracks.[23] The service would grow exponentially, and by 2013 its customers had downloaded 25 billion tracks, and the catalog had expanded to 26 million tracks.[24] Despite these numbers, Apple long claimed that iTunes' music sales did not provide the company with significant profits.[25] However, the iTunes sales drove sales of iPods, which had big margins for the company.[26]

On the heels of iTunes' success, several companies replicated its model for selling digital music. For example, Sony launched the Sony Connect Music Store in June 2004, selling tracks and albums at the same price as iTunes.[27] Likewise, Apple's longstanding rival Microsoft launched Zune Marketplace in 2006.[28] These stores were not as successful as iTunes: Sony Connect closed in 2008,[29] while Microsoft discontinued the Zune brand and launched Xbox Music in 2012.[30] Major labels fully backed these and other offerings, as they had done with iTunes.

Nevertheless, iTunes and other similar stores still came with a significant restriction. Digital rights management (DRM) technologies were embedded in the tracks purchased. These limited the number and type of devices on which these tracks could be used, ensuring that the customer could not distribute the files freely after purchasing them. Moreover, they also allowed the stores to control how tracks could be used.

For example, tracks purchased from iTunes could be played on no more than five devices. Moreover, besides a computer, only Apple devices such as the iPhone, iPod or iPad could play iTunes tracks. As a consequence, iPod sales skyrocketed in parallel with iTunes' success, reaching 22 million in 2009.[31] Likewise, Sony Connect tracks could be transferred only to compatible devices that supported Sony's ATRAC3 format, such as the Walkman or the PSP (PlayStation Portable) gaming console. Meanwhile, Zune customers had to procure a Microsoft-certified device, such as one of Microsoft's own Zune-branded line of players.

However, this changed in late 2007 when a new entrant, the online retailing giant Amazon, launched its own digital music store. Labels allowed Amazon, unlike its competitors, to sell tracks without DRM.[32] Users could buy from Amazon and play the songs on any number of devices that supported the MP3 format, including iPods, Zune players and Walkmans. Unlike Sony and Microsoft, Amazon was successful and quickly became the second largest digital music store in the United States.[33] The competition soon followed its path: iTunes, the market leader, abandoned DRM in 2009.[34]

Artists too began to experiment with the opportunities that the digital format presented. For example, in 2007, the high-profile British band Radiohead skipped music labels and released their album *In Rainbows* directly to their fans as a digital download on the band's website, letting customers choose the price they wanted to pay.[35] No sales figures were released. Attempts like Radiohead's to upset the usual release process were, however, piecemeal.

Streaming and the Smartphone Era

RealNetworks was a company that had thrived in the 1990s developing video and audio streaming technologies for the fledging Internet. RealNetworks' protocols allowed users to watch videos and listen to audio without downloading the files to their computer. In April 2003, RealNetworks launched a new service: RealOne Rhapsody (later shortened to Rhapsody). This became the first major label-backed music streaming service.

Rhapsody offered a subscription model where users paid a monthly fee of $9.95 for the ability to stream an unlimited number of songs from a library of 330,000 tracks. Users could not download the tracks directly to their computers. Rhapsody was a moderate success, reaching 800,000 subscribers in 2009. However, its growth rate slowed and ultimately declined. In 2010 it had lost 100,000 subscribers, and analysts at the time doubted its ability to compete with other music services that were not using a streaming model. Rhapsody was spun off from RealNetworks in February 2010, in order to help the parent company achieve profitability.[36] In 2013 the now independent Rhapsody acquired Napster, and started using that brand name for most of its business outside North America.[37]

Rhapsody's failure to gain traction seemed to indicate that the market preferred stores with the iTunes model, where users could buy and own digital music. However, other streaming services soon appeared. Pandora launched in 2005 and was followed by similar services such as Slacker Radio and MOG.[38] Pandora allowed users to listen to customized "radio stations" for free, while it got revenue through advertising. Its "Music Genome Project" analyzed and broke down songs according to multiple traits. Users could then "like" or "dislike" songs that were being played, and the service would attempt to learn their music tastes and play only music that would interest them.

During the second half of the 2000s, smartphones became popular. They fused the functionality of a portable media player with a computer with an Internet connection, allowing users to access Internet music services while on the go. In 2010, nearly 300 million smartphones were sold worldwide.[39] This greatly benefited streaming services, which could not be used on regular portable music players as an active Internet connection was required. According to Pandora, the introduction of a smartphone app in 2008 practically doubled its growth overnight.[40]

In 2013 Pandora claimed 70 million monthly users in the United States and Canada, dwarfing other subscription-based streaming services.[41]

One of these streaming services was Spotify, which was rapidly expanding in the U.S. market.

Spotify

Daniel Ek and Martin Lorentzon founded Spotify in Sweden in 2006 after having both worked for several Scandinavian-based online start-ups. Ironically, Sweden was infamous for hosting The Pirate Bay, the largest search engine for downloading illegal music and video content on the Internet. Spotify finally launched in October 2008 in Sweden and other Western European markets after announcing deals with all major labels plus several independent companies that allowed Spotify to stream their catalogs.[42]

Initially, Spotify allowed only a limited number of users to join its unpaid service. The company periodically sent out "invites" to its existing users, which they could use to invite their friends. Paid subscription users were not subjected to this and could join at any time. Spotify lifted the limitation in 2009 in the United Kingdom and proceeded to do the same in most of its markets in the following months.[43]

Spotify launched in the United States in 2011, when it already had 10 million users throughout Europe. This time, Spotify used a different approach. Instead of throttling free users, it offered six months of free premium use to all U.S. customers. Afterwards, they could pay for a subscription or start using the free, ad-supported version of the service. Spotify grew quickly in the United States, and in March 2013 it claimed one million paid U.S. subscribers – and six million worldwide.[44] The growth did not slow down, and in March 2016 Ek announced on Twitter that Spotify had reached 30 million paid subscribers. In June that year, Spotify reported its total user base (paid+free) had reached 100 million active users[45].

Spotify kept expanding its presence over the world: Germany, Australia and New Zealand were added in 2012, and in 2013 the service became available in Italy, Poland, Portugal, Mexico, Hong Kong, Malaysia, Singapore, Estonia, Latvia, Lithuania and Iceland. In 2016, Spotify was available in more than 50 countries, spanning the Americas, Europe, Asia and Oceania.

The Spotify Business Model

In 2016, Spotify was offering two service tiers in most of its markets: free and premium. Both tiers allowed on-demand unlimited listening of every song in the Spotify catalog, an unlimited number of times, from any desktop computer or tablet. Users of the free service had their playback interrupted every few songs by short audio adverts. During the previous years, Spotify had slowly been increasing the number and frequency of the commercials, and also had added visual adverts to the user interface of free customers. However, premium users could listen to music without being interrupted by adverts, had access to higher-quality audio, and enjoyed other features.

Spotify also provided a mobile app that could be installed on Android or iOS smartphones. Notably, only premium users could play music on demand with the Spotify mobile application. Free users were not able to select a particular song but could create a "station" that would play random music that followed certain user-provided guidelines (e.g., genre, era or artist). Table 1 shows the differences between the two service tiers and compares them with Pandora, the largest streaming service in the United States in terms of number of users.

Table 1
Spotify service tiers in the United States compared with Pandora (2016)

	SPOTIFY			PANDORA	
	Free		Premium	Free	Pandora One
	Mobile	Desktop and tablet	All devices	All devices	All devices
Full catalog access	Yes	Yes	Yes	Yes	Yes
Playlists	Yes	Yes	Yes	No	No
Play tracks on demand	No*	Yes	Yes	No*	No*
Ad-free listening	No	No	Yes	No	Yes
Sound quality (kb/s)	128	128	320	64	192
Offline mode	No	No	Yes	No	No
Monthly fee	$0		$9.99	$0	$4.99

* Maximum of six track skips per hour.

Source: Prepared by the authors.

Spotify often ran promotions to try to sign up more customers to its subscription services. In early 2016, it was offering a free month of premium service to all new users in several countries. It also entered frequent deals with carriers in order to offer bundles and discounts to Spotify customers. Spotify did little advertising of its own.

Spotify's functionality was simple. When the user launched the application, music started to play automatically, resuming the last active playlist. Users could search for any song straight from the home screen, access their list of favorite songs and artists, access their playlists, and browse the most popular tracks and artists of the moment. The radio feature brought several preset thematic radio stations and allowed users to create new ones using a variety of guidelines. Spotify also had a "discover" feature that suggested new artists based on the user's listening habits. (See **Exhibit 1** for several screenshots of the mobile and desktop Spotify clients in 2014.)

Spotify had several social features. Inside the app, users could "follow" their friends to see what music they were listening to. Users could also follow artists, bands and other personalities in order to get news about them and be alerted if they released new songs on Spotify. Integration with Facebook and Twitter allowed users to see their friends' activities and favorite music and artists and generated items about their listening habits on these social networks. Users could also share songs on Facebook, so their friends could listen to them even if they were not Spotify customers.

Spotify tried to develop even closer integration with Facebook[i] and at one point forced users to log onto Spotify using a Facebook account. This was badly received and Spotify soon reversed its plans.

All users were also able to save and share their playlists through e-mail, messaging applications and social networks. A noncustomer could click and listen to the playlist but would be asked to register an account with Spotify. Playlists were a popular feature, and third-party websites, such as Playlists.net or Shareplaylist.net, had been set up where users could share, discuss and rate them.

Spotify promoted autonomy within its structure, with the aim of fostering innovation and quick decision making and the speedy implementation of improvements, design changes or features. There were little formal dependencies between working groups (called "squads"), but cross-pollination and informal interaction between squads and particular members were strongly encouraged. The company even allocated 10% of its employees' working hours to "hack time," during which they were asked to come up with and test new ideas or features, in an unrestricted environment. This culture enabled Spotify to be agile and react quickly to changes in the environment, while pushing innovations quickly. As Ek put it, "we aim to make mistakes faster than anyone else."[46]

Financial Performance

When Spotify launched in 2008, it did so with major music labels taking 18% of its shares, for a contribution of 100,000 Swedish kronor ($13,500).[47] Spotify's rapid expansion required significant investment but the company had no trouble raising capital. Between 2007 and 2015 it successfully completed seven funding rounds, reportedly raising a cumulative total of $1.06 billion with a 2015 valuation of $8.53 billion. It also raised an additional $1.5 billion in convertible notes and convertible debt in the first half of 2016.[48]

On the face of it, Spotify's performance during its short life had been nothing less than impressive. In 2014 it surpassed €1 billion in revenue for the first time, and the number of users kept growing at a frantic pace. However, there was an obvious downside. Since its launch in 2008, Spotify had yet to post a profit. The explosive growth of the company had been accompanied by growing losses, as Spotify expanded into several markets in a very short time. Spotify's financial situation was thought to be secure, given the amount of financing it had been able to secure. See Table 2 for Spotify's financial data.

The single largest expense was the cost of goods sold. This consisted mainly of the royalties Spotify paid to rights holders in order to get access to their catalog to offer to Spotify customers. Spotify signed several agreements with these rights holders, usually the publishing label. The agreements were valid only for a particular country, since laws and contracts could vary wildly between different countries. To launch in the United States, Spotify signed deals with all the major labels in 2011.[49]

[i] Sean Parker, founder of Napster and former Facebook president, served on Spotify's Board.

Spotify did not pay a fixed amount per stream. Rather, it allocated a fixed percentage of its monthly revenue to royalty payments. Specifically, in 2013 Spotify claimed that 70% of its revenue was being allocated to royalties.[50] Tracks received an amount depending on how many times they had been streamed compared with the total amount of streams in Spotify. Royalties were allocated on a country-by-country basis, taking into account the revenues and plays of that country.

Table 2
Spotify financial data 2009–2015, in millions of euros

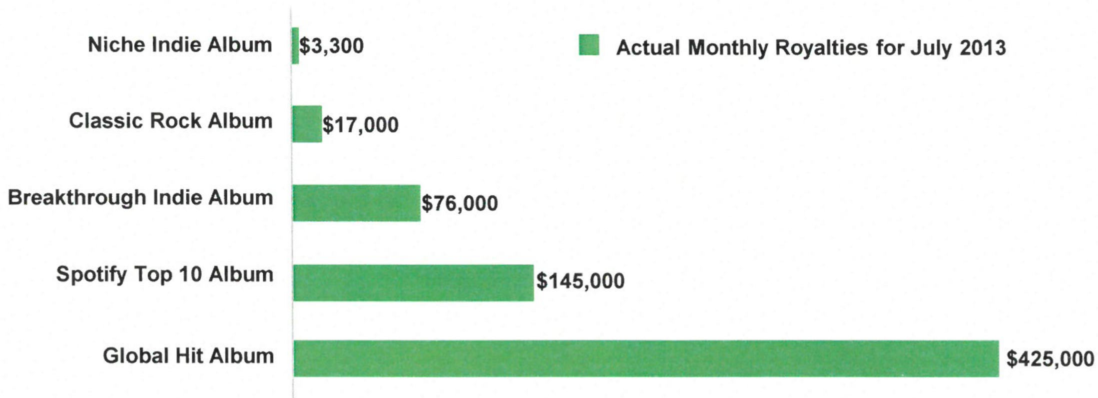
	2009	2010	2011	2012	2013	2014	2015
Revenues	**13.3**	**73.9**	**188.1**	**430.3**	**746.9**	**1,081.7**	**1,945.3**
• *Subscriptions*	N/A	52.6	156.9	374.8	678.7	982.9	1,744.4
• *Advertising*	N/A	21.1	27.6	55.0	68.2	98.8	195.8
• *Other*	N/A	0.1	3.6	0	0	0	5.1
Cost of sales	N/A	76.8	183.8	386.5	614.5	876.1	1623.6
as % of revenue	N/A	104	98	90	82	81	83
Gross profit	N/A	**−2.9**	**4.3**	**43.8**	**132.3**	**205.6**	**321.7**
Operating expenses	N/A	19.0	51.2	120.7	223.5	370.7	506.2
• Research and development	N/A	N/A	N/A	37,9	72.7	121.0	143.3
• Sales and marketing	N/A	N/A	N/A	54.1	110.8	173.0	246.5
• General and administrative	N/A	N/A	N/A	28.6	40.0	76.7	116.4
Operating income	**−18.5**	**−21.9**	**−46.8**	**−76.9**	**−91.2**	**−165.1**	**−184.5**
as % of revenues	−139	−30	−25	−18	−12	−15	-9
Active users at end of year (millions)	2.5	5	10	20	36	60	89
Paid subscribers at end of year (millions)	N/A	N/A	N/A	5	8	15	28
Percentage of paid users	N/A	N/A	N/A	25	22	25	31
Headcount	N/A	N/A	N/A	N/A	953	1,354	1,610

Source: Enders Analysis and case writers' estimations based on public sources.[51]

Royalty payments were made to publishers and master rights holders depending on the particular agreements that Spotify had in place and any applicable laws of the particular country in question. Artists were then paid by the label or publisher according to their contractual royalty rates. Thus, different artists with the same amount of plays could receive very different royalty payments. See Figure 2 for examples of actual monthly royalty rates.

Yet, despite the large share of revenue destined to royalty payments, Spotify faced increased criticism from artists for the low amounts they received. The Musicians' Union in the United Kingdom, for example, formally asked in 2013 that a minimum pay rate be set – something that would greatly increase Spotify's costs if implemented.[52] Spotify defended itself by pointing out that actual royalties received by artists depended on their deals with the labels that published them, but this did not stop some high-profile artists from publicly speaking out against the company, with some even pulling their songs from the service.

Figure 2
Monthly royalty rates for five anonymized albums



Source: "Spotify Explained," Spotify, December 2013, http://www.spotifyartists.com/spotify-explained/.

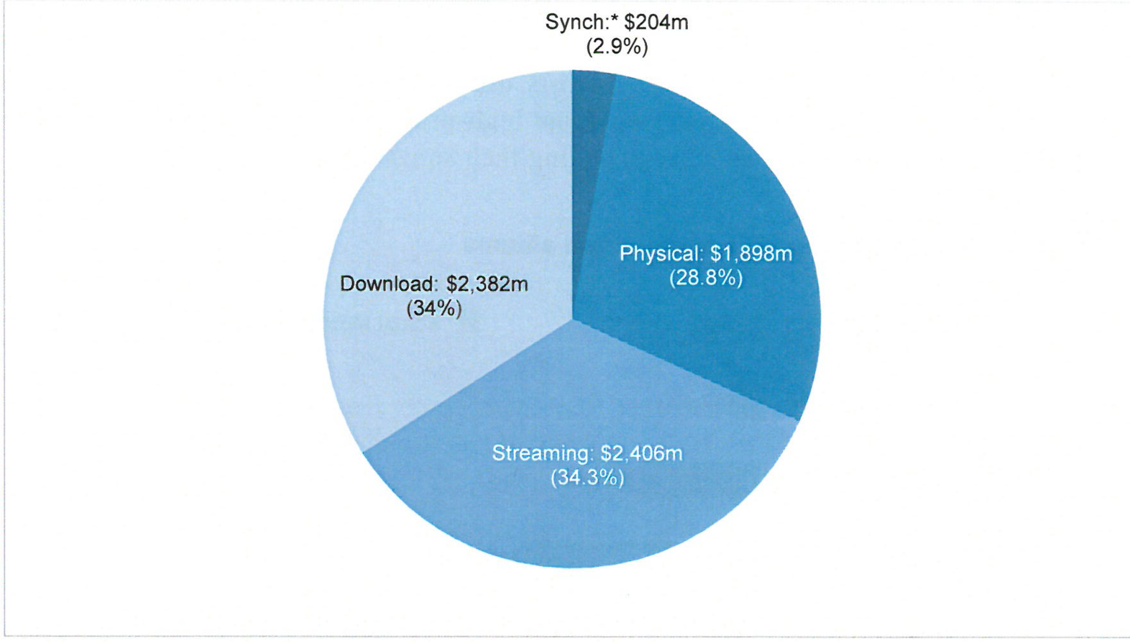
Yet something was clear – consumers were massively embracing Spotify and music streaming. When Adele released her bestselling album *25* in November 2015, in just six weeks it sold 7.5 million copies in the United States alone. Yet in the same period, the hit song "Hello" from the same album was streamed 129 million times.[53]

The Music Industry in 2016

Significantly the music industry, which was once built exclusively on the sales of physical records through mainly brick-and-mortar stores, was seeing digital taking over as the biggest source of revenue. Renowned music store chains such as Tower Records were closing down, while music was increasingly being consumed in digital form. (See **Exhibits 2** and **3** for data on the music industry in 2016.)

In particular, in the United States – the largest market for recorded music in the world – the watershed moment had been reached in 2011. In that year, digital sales outperformed physical revenue for the very first time. In the U.S. market in 2015, CDs, vinyl records and cassettes accounted for less than one-third of industry sales ($7 billion according to the RIAA, a small 0.9% increase from 2014). See Figure 3 for revenue source distribution in 2015.

Figure 3
Revenues of U.S. music industry by source (2015)



* Synchronization rights were royalties paid for permission to synchronize music with other media (i.e., films, TV shows or videogames).

Source: Joshua P. Friedlander, "News and Notes on 2015 Music Industry Shipment and Revenue Statistics," RIAA, March 2016, https://www.riaa.com/wp-content/uploads/2016/03/RIAA-2015-Year-End-shipments-memo.pdf.

Regarding the labels, compared with the situation in 1999 the market had witnessed further concentration. The "big five" major labels had been reduced to three – BMG was sold to Sony in 2008, and EMI merged with Universal in 2011. In 2013 the three major labels accounted for nearly 90% of the distribution market of recorded music.

Table 3
Recording industry U.S. market share in 2013

Company name	Distribution market share of album sales and track equivalent (10 tracks = 1 album)
Universal Music Group	37.7%
Sony Music Entertainment	30.4%
Warner Music Group	20.8%
Others	11.4%

Figures may not add up to 100% due to rounding.

Distribution market share includes sales of music owned by the label and music owned by third parties (generally artists or smaller labels) but distributed through the label.

Source: Adapted from "Nielsen Entertainment and Billboard's 2013 Mid-Year Music Industry Report," http://www.nielsen.com/content/dam/corporate/us/en/reports-downloads/2013%20Reports/Nielsen-Music-2013-Mid-Year-US-Release.pdf.

These major labels thus still controlled most of the distribution of music, which was now being delivered to customers through two main types of digital retailer:

- Download operations sold single tracks or albums digitally. Users could select an album or a track, listen to a sample, and then pay an amount (typically around $1 for a song and $10 for an album) to download it to their computer or portable device. The market was dominated by Apple's iTunes. Other relevant players were Amazon.com and Google Play Music.

- Streaming allowed customers to listen to music without downloading it to their device. Thus, unlike with downloads, users never "owned" the tracks. Streaming services usually obtained revenue via paid subscriptions or advertising. Pandora was the market leader in terms of users, but Spotify had the most revenue. Other important players were Tidal, SoundCloud, and Apple Music.

Interestingly, digital and physical customers seemed to display distinct consumer behavior. For example, the vast majority of digital unit sales were single tracks, but physical sales were dominated by albums, with singles not even attaining 1% of unit sales.

The Competition

In June 2015, Apple's CEO Tim Cook uttered the famous words "and one more thing..." to unveil the company's main new product during his keynote address at the Worldwide Developers Conference in San Francisco. The product, which Apple was going to push with all its considerable might, was the new streaming service Apple Music.[54]

In May 2014, Apple acquired Beats – a manufacturer of audio accessories and components – for $3 billion.[55] Beats also owned a streaming service called Beats Music, which Apple integrated into its product ecosystem and relaunched as the new Apple Music. The new service boasted of radio stations curated by famous DJs, social features that allowed artists to interact with fans, exclusive deals with artists, and integration with the Siri voice commands feature that most Apple products had. All this was at the same price point as Spotify's premium service: $9.99 a month. As a promotional offer, new customers had three free months of the service. Apple, however, was not offering a free version of the service. (See **Exhibit 4** for a comparison between Spotify, Apple Music and several other streaming music services operating in 2016.)

Apple Music became an overnight success. In February 2016, Eddy Cue, Apple's senior vice president of Internet services, announced that it had achieved 11 million subscribers in just six months.[56] Spotify had taken five years to reach that figure.

However, Apple Music was only one of several music streaming services that had been launched since Spotify had entered the U.S. market. Other big digital companies were trying to get a piece of the growing streaming market. In 2013, the tech giant Google launched its own subscription service, Google Play Music All Access, which came preloaded in all Android smartphones. The online retail leader Amazon.com included streaming music in its Amazon Prime membership plan in June 2014.[57]

And the streaming market was already crowded to begin with. Besides these new entrants, Spotify also faced competition from several other streaming music services. These could be divided into two kinds:

- On-demand: The most similar competitors were other on-demand streaming services. Besides the aforementioned Apple Music, Amazon Prime Music, and Google Play Music All Access, other noteworthy services were Rhapsody, SoundCloud Go, and Deezer. These worked in a similar way to Spotify, allowing users to play any track they wanted from each service's catalog.

- Internet radio: These companies did not offer tracks on demand. Instead, users could listen to preset radio stations or create customized ones. This model allowed companies to pay reduced royalty rates compared with on-demand streaming services such as Spotify, and therefore they were able to offer lower pricing. Pandora was the most successful of those services.

Competitors did not stand still as Spotify grew. For example, Rhapsody acquired Napster in late 2011.[58] Deezer, while still not available in the United States, far surpassed Spotify in its international footprint: by 2016, it was available in 186 countries or territories.[59] Moreover, there were strong rumors that Pandora, which had more than 70 million users, was preparing to launch an on-demand streaming service by the end of 2016.[60]

This intense competition had already claimed its first casualties. Last.fm, an Internet radio service owned by CBS Corporation, discontinued its music streaming service in 2014. In November 2016, Rdio – a streaming service launched by Skype founders Janus Friis and Niklas Zennström – filed for bankruptcy and was purchased by Pandora.[61]

However, the existing competition was not the only thing to which Spotify had to pay attention. There were several new trends that could signal new disruptions of a market that was barely settling down. Spotify had been the standard bearer of the streaming revolution, but it risked being left behind if it rested on its laurels while the market changed again.

New Trends

Artists

Artists generally complained about the reduced royalty rates that streaming music paid in comparison to other distribution methods, and they were seen as trying to reassert their position in the music business.

For example, in November 2014, Taylor Swift – one of the top-selling artists of the 2010s – removed her entire catalog from Spotify and other streaming services, complaining that the free service undermined the royalty payments artists received.[62] She similarly threatened to pull her catalog from Apple Music when the company announced that it would not pay royalties for users who were in Apple Music's free three-month trial period. Apple ultimately relented.[63] Swift was one of the highest-profile artists – but not the only one – who was trying to influence the changing landscape brought about by digital music and streaming.

In March 2015, the rapper Jay Z relaunched the streaming service Tidal as an artist-owned streaming service. Among its stakeholders were high-profile artists such as Rihanna, Madonna, Kanye West, Beyoncé, and Daft Punk. The service claimed to pay the highest percentage of its revenue as royalties of any existing streaming service, while offering the same basic price point as Spotify.[64]

Others were using the competition between several digital platforms to sign exclusive or promotional deals in exchange for financial advantages. For example, in April 2016 the chart-topping rapper Drake released his new album *Views* exclusively through Apple Music,[65] while Beyoncé's new album *Lemonade* could be streamed only via Tidal.[66] This sort of practice was not limited to high-profile musicians, as independent or regional artists were also entering exclusive deals. So far Spotify had refused to compete for these exclusive deals and had even spoken openly against them.[67]

Bundling of Services

Companies such as Amazon and Google were trying to leverage their bargaining power and presence in other markets to bundle music streaming services with other services, in particular video streaming. For example, Amazon's Prime service offered access to not only music but also movies and television shows, all for a monthly fee ($10.99) that was just $1 more than Spotify's premium service cost. Not only that, but Amazon Prime also included several other services such as an extensive e-book library and cloud storage. Amazon Prime's streaming music library, however, was much smaller than Spotify's.[68]

In October 2015, Google launched YouTube Red, which was bundled with its existing Google Music All Access streaming service.[69] YouTube Red allowed access to all YouTube videos – including music videos from several participating labels – without ads. It also featured exclusive content from popular YouTube video creators such as PewDiePie, who had millions of followers.

Vertical Integration

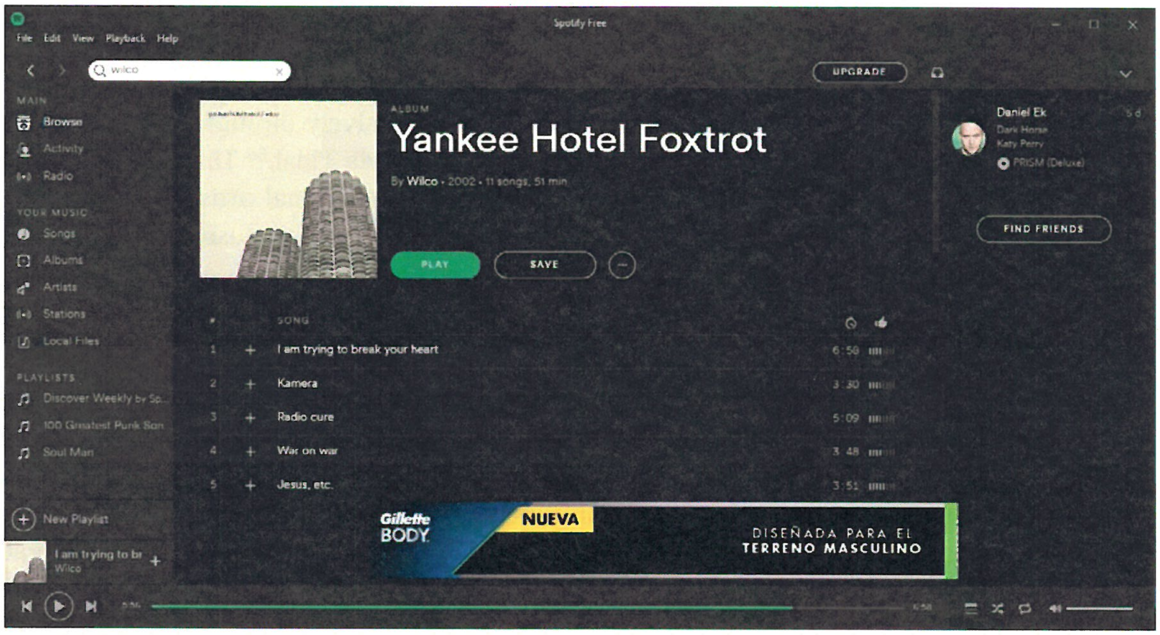
Lastly, another trend in streaming was vertical integration. Netflix, a video streaming service that offered films and television shows from major studios, had started a policy of investing a sizable part of its revenue in producing its own content, spending lavishly on shows with high-profile actors and directors. In the same way, it de-emphasized the catalog belonging to major film and television studios. In the first quarter of 2016, it attained 81 million subscribers globally,[70] making it one of the most popular paid streaming services in the world. Other video streaming services were following this path, with Amazon Prime, Hulu, Crackle and Yahoo! Screen producing their own shows. Could this trend also be translated to music streaming, with companies such as Spotify producing their own music?

Thus, as Ek left Spotify's U.S. headquarters in New York, several questions might have crossed his mind. Could Spotify see off the new competitive threats? Could it become a profitable business? Moreover, could it really live up to its own hype and help the music industry grow again after more than a decade of continuous decline? Industry observers, and Ek himself, often pointed to how Sweden's music industry grew by 27% between 2008 and 2013, far ahead of the industry in other developed countries, with Spotify leading the charge as streaming made up 70% of Sweden's total music revenue.[71] But could this be replicated elsewhere?

Exhibit 1

Screenshots of Spotify's User Interface in 2016

Free users:

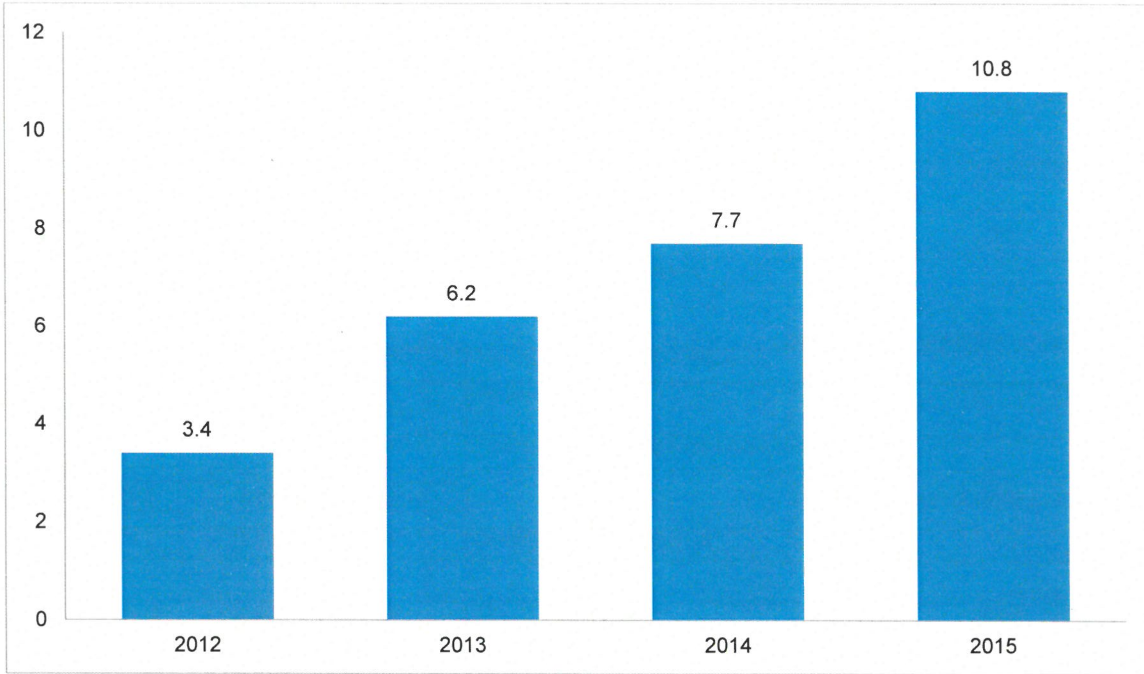


Subscribers:

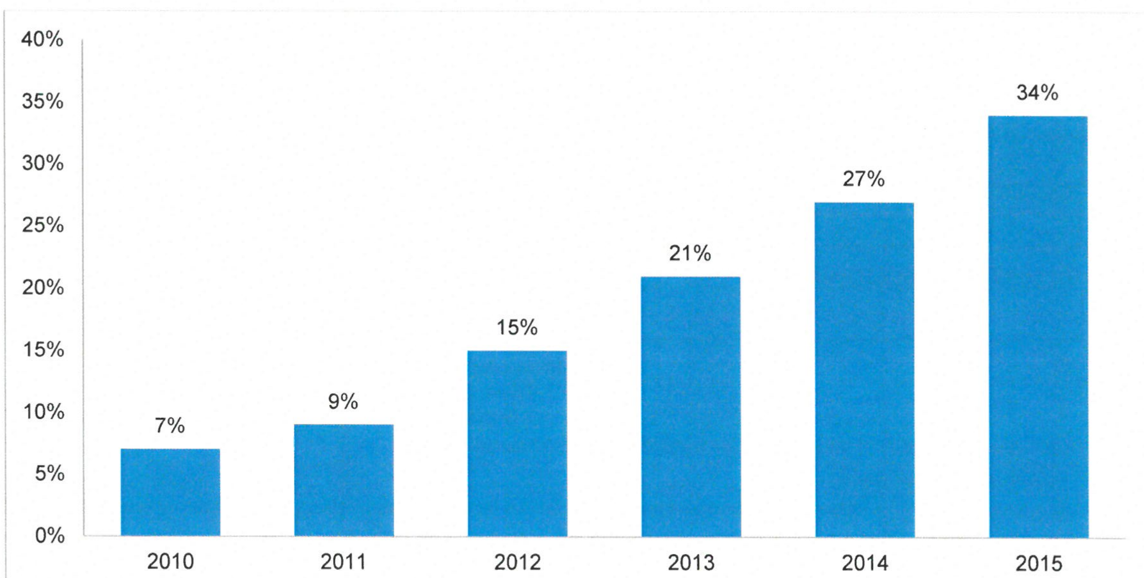
Exhibit 2

Streaming Growth

Total paid streaming subscriptions in the United States (in millions of dollars)



Proportion of total U.S. music industry: revenues from streaming



Source: Joshua P. Friedlander, "News and Notes on 2015 Music Industry Shipment and Revenue Statistics," RIAA, March 2016, https://www.riaa.com/wp-content/uploads/2016/03/RIAA-2015-Year-End-shipments-memo.pdf.

Exhibit 3

2015 Year-End Recording Industry Revenue Statistics

United States unit shipments and estimated retail dollar value (in millions, net after returns)

		2014	2015	% change 2014-15
Digital permanent download				
(Units shipped)	Download single	1,199.1	1,021.0	−14.9
(Dollar value)		$1,407.8	$1,226.9	−12.8
	Download album	117.6	109.4	−7.0
		$1,150.9	$1,090.7	−5.2
	Kiosk[1]	1.6	2.2	38.4
		$2.6	$3.7	43.2
	Music video	6.8	3.2	−52.8
		$13.6	$6.4	−52.8
	Ringtones and ringbacks	26.6	21.9	−17.7
		$66.3	$54.6	−17.7
Digital subscription and streaming				
	SoundExchange distributions[2]	$773.4	$802.6	3.8
	Paid subscription[3]	7.7	10.8	40.2
		$800.1	$1,218.9	52.3
	On-demand streaming (ad-supported)[4]	$294.8	$385.1	30.6
TOTAL DIGITAL VALUE		**$4,509.5**	**$4,789.0**	**6.2**
	Synchronization royalties[5]	$189.7	$202.9	7.0
Physical				
(Units shipped)	CD	142.8	122.9	−13.9
(Dollar value)		$1,832.6	$1,520.8	−17.0
	CD single	1.0	0.4	−59.5
		$3.8	$1.2	−67.5
	LP/EP	13.2	16.9	28.3
		$314.9	$416.2	32.2
	Vinyl single	0.5	0.5	4.1
		$5.9	$6.1	2.6
	Music video	4.1	3.3	−20.4
		$91.2	$73.2	−19.8
	DVD audio	0.1	0.2	169.7
		$2.1	$5.4	153.2
	SACD	0.0	0.0	39.8
		$0.8	$1.1	40.5
	Total physical units	**161.7**	**144.2**	**−10.8**
	Total physical value	**$2,251.3**	**$2,024.0**	**−10.1**
	Total retail units	**141.3**	**124.5**	**−11.9**
	Total retail value	**$2,112.0**	**$1,898.0**	**−10.1**
TOTAL DIGITAL AND PHYSICAL				
	Total units[6]	**1,513.4**	**1,302.0**	**−14.0**
	Total value	**$6,950.5**	**$7,015.9**	**0.9**

% of shipments[7]	2014	2015
Physical	33%	30%
Digital	67%	70%

Retail value is the value of shipments at the recommended or estimated list price.

[1] Includes singles and albums.

[2] Estimated payments in dollars to performers and copyright holders for digital radio services under statutory licenses.

[3] Streaming, tethered, and other paid subscription services not operating under statutory licenses. Subscription volume is annual average number of subscriptions.

[4] Ad-supported audio and music video services not operating under statutory licenses.

[5] Includes fees and royalties from synchronization of sound recordings with other media.

[6] Units total includes both albums and singles, and does not include subscriptions or royalties.

[7] Synchronization royalties excluded from calculation.

Source: Joshua P. Friedlander, "News and Notes on 2013 Music Industry Shipment and Revenue Statistics," RIAA, March 2014.

Exhibit 4

Comparison of Selected Music Streaming Services Operating in 2016

	Launch date	Claimed library size	Major label support	Play tracks on demand	Free service	Mobile app	Monthly premium fee (U.S. market)
Spotify	2008 (Sweden)	30 million	Yes	Yes	Ad-supported Shuffle mode on mobile	Yes	$9.99
Apple Music	2015 (U.S.)	30 million	Yes	Yes	Not available	Yes	$9.99
Deezer	2007 (France)	30 million	Yes	Premium only	Ad-supported Shuffle mode on mobile	Yes	€9.99[1]
Google Play Music All Access	2013 (U.S.)	30 million	Yes	Yes	Not available	Yes	$9.99
Tidal	2014 (U.S.)	30 million	Yes	Yes	Not available	Yes	$9.99
Pandora	2005 (U.S.)	1 million	Yes	No	Ad-supported Six track skips per hour (24 per day maximum)	Yes	$4.99
Amazon Prime Music	2014 (U.S.)	1 million	Yes	Yes	Not available	Yes	$10.99[2]
Rhapsody	2001 (U.S.)	30 million	Yes	Yes	Not available	Yes	$9.95

[1] Deezer was not available in the U.S. market as of January 2016. The price given is for the French market.

[2] Also included access to other Amazon Prime services such as Amazon Video, a free e-book library, free delivery of Amazon purchases, and cloud storage.

Source: Prepared by the authors.

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