

Spotify: Face the Music

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After sampling some of the new music releases of early 2014, Daniel Ek closed his Spotify session. Soon, millions of Spotify users would learn he had just listened to Kanye West's "Atmosphere," as the profile of Spotify's CEO was one 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 mixed tape 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 secured a \$200 million credit facility, and despite the company's efforts to avoid the issue, the media was full with speculation that the company was about to go public.¹

And why not? After all, Spotify was one of the leading music streaming services in the world. It had over 24 million users, of which six million paid a monthly fee for Spotify's premium services.² It had just entered the difficult U.S. market with great success, and it was already present in 56 markets. Spotify's catalog contained more than 20 million songs, including the libraries of all major recording labels.

Yet Ek knew that not everything was so favorable. Spotify posted a net loss of €58.7 million in 2012,³ the red ink growing alongside its user base. Despite that, some artists protested the low rates that, according to them, Spotify paid to the creators of the music it played. Worryingly, tech behemoths like Google and Apple were entering the market with their own music streaming services. And some analysts pointed at how other companies offering streaming music, like Rhapsody, had not been successful in the past.

If Spotify was going to IPO, Ek needed to convince potential investors that Spotify had a sound long-term business model. Many other music streaming services had failed before, and despite Spotify's impressive growth, some believed it 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 Boquet, case writer. December 2014.

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The History of Digital Music

The Digital Medium and the Rise of Music Piracy

At first glance, one might say the advent of digital music had been bad news for the music industry. From a peak of \$38 billion in global revenues as of 1999, it had fallen to \$16.5 billion in 2013, when digital was already bringing in the majority of revenue.⁴ The industry, in general, blamed piracy for these lost sales,⁵ but Daniel 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.⁶

The United States was the world's leading market, providing 30% of the income of the global recording industry. U.S. companies dominated most of the worldwide music market and had the world's most popular bands under contract. Thus, the United States became the place where most of the developments in digital music would take place.

One of the most notorious events in this story befell on July 27, 2001, at the Northern California District Court in San Francisco.⁷ In one corner sat the Recording Industry Association of America (RIAA)—the trade association representing the interests of the record labels and music distributors in the United States. On the other side was Napster, the company that in 1999 had launched a service that allowed users to search and download music files for free. In just two years Napster had amassed 60 million users, who shared songs without paying artists or labels.⁸

Three developments had made Napster possible:

- *MP3 compression technology.* In 1993 the Moving Picture Experts Group—the expert 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.⁹ 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, and, in 2000, 43% of the U.S. population already had access to it, a percentage that rose throughout the years and reached 81% in 2012.¹⁰ At first, most Internet connections were slow, and several minutes were needed 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 instant play of music tracks and videos. In 2013, it was estimated that 390 million of these connections existed in the United States alone, more than the entire population of the country.¹¹
- *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 allowed. For example, a typical portable digital music player was eventually able to contain the user's entire music collection, as opposed to just the 60-90 minutes of a typical CD or tape. Users could easily browse and play any song and could store and display information like song title, band, genre, etc. They could then create playlists with 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.

When Judge Marilyn Hal Patel finally ordered an injunction of Napster, its users were swapping more than 165 million songs per day.¹² Despite the music industry's efforts to stop them, further sharing networks would emerge: Gnutella, Kazaa, Torrent, eMule, and others. These networks removed the need for a centralized database hosted in a physical location, which made it impossible to shut them down. The genie was out of the bottle. The industry would have to figure out what to do with it.

The First Steps of the Industry

The first companies that marketed digital music usually lacked the backing of the recording industry. For example, in 2000 eMusic launched a service offering unlimited track downloads from a library of 125,000 to those who paid a monthly subscription.¹³ However, only artists from independent labels were available. By way of comparison, in 2014 most leading digital music services had libraries of 20-25 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 amount of downloads accrued.¹⁴ 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 2003.¹⁵ On the other hand, eMusic was still operating in 2014, allowing customers to download a fixed number of tracks for a set monthly fee.

The reaction of the major labels to the new technology was initially litigious. Besides suing 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.¹⁶

Indeed, the first attempts from major labels to enter the digital market showcased 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. For example, PressPlay only allowed two songs from the same artist to be downloaded each month, it didn't allow songs to be copied to portable music devices, and every downloaded song “expired” at the end of the month and had to be downloaded again.¹⁷ MusicNet and PressPlay relied on a subscription model and, if terminated, the tracks became unplayable. 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 major artists.

Soon the labels abandoned these services; MusicNet was sold in 2005¹⁸ and Press Play was sold in 2003, merging with the Napster brand for the latter's re launch as a legal service.¹⁹ Both Music Net and Press play were jointly placed at number nine on PC World's list of the “Worst tech products of all time.”²⁰

One of the allies of the major labels in these failed efforts was RealNetworks, a company that had thrived in the 90s developing video and audio streaming technologies for the fledgling Internet; RealNetworks' protocols allowed users to see videos and listen to audio without downloading them to their computer. In April 2003, RealNetworks acquired Listen.com as the basis for a new service: Real One Rhapsody (later shortened to Rhapsody).