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Spotify: Face the Music (Update 2018)

Seeking Profitability

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In the second half of 2017, Spotify was locked in talks with Warner Music Group, one of the three "majors," the largest music publishers in the world, in order to sign a new licensing deal. This followed deals with the other two majors, Universal and Sony Music. Even though the terms of the deals were being kept under wraps, speculation mounted. Was Spotify getting a reduced royalty rate? If so, would it be enough to reach profitability? And what would Warner and the other majors have asked for in return? Somewhere in Spotify's headquarters in Stockholm, the CEO Daniel Ek was surely aware that the new deals with the three big majors were key for the future of the company.

Did Spotify even have anything to worry about? After all, it was the world's leading on-demand music-streaming service by a significant margin. By mid-2017, it reportedly had more than 140 million users, 60 million of whom paid a monthly fee for Spotify's premium services.[1] The Swedish company had entered the U.S. market successfully, and it already had a presence in more than 60 countries. Spotify's catalog contained more than 30 million songs, including the libraries of all the major recording labels and many independents. In 2016, revenues shot up to nearly €3 billion.

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 two years it had picked up 30 million paid subscribers, a milestone that it took Spotify eight years to achieve.[2] Spotify's largest question mark remained its profitability. Operating losses in 2016 came to €350 million. Moreover, the company had yet to post a profit since the service's debut in 2008. Despite several successful rounds of capital raising, Spotify had taken out a $1 billion loan in 2016, under terms that analysts called "strict" and even "draconian."[3] Some analysts pointed to how other companies offering streaming music, such as Rhapsody, had been unsuccessful in the past. Could the same happen to Spotify?

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After it had made streaming music popular all over the world, finding a path to profitability was going to be Spotify's biggest challenge. The new deals with the majors would be a centerpiece of that effort. But would those be enough? Would Spotify be forced to sacrifice too much? Despite its impressive success up to that point, some believed Spotify could still go on to become yet another casualty in the troubled history of digital music

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,[4] 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.

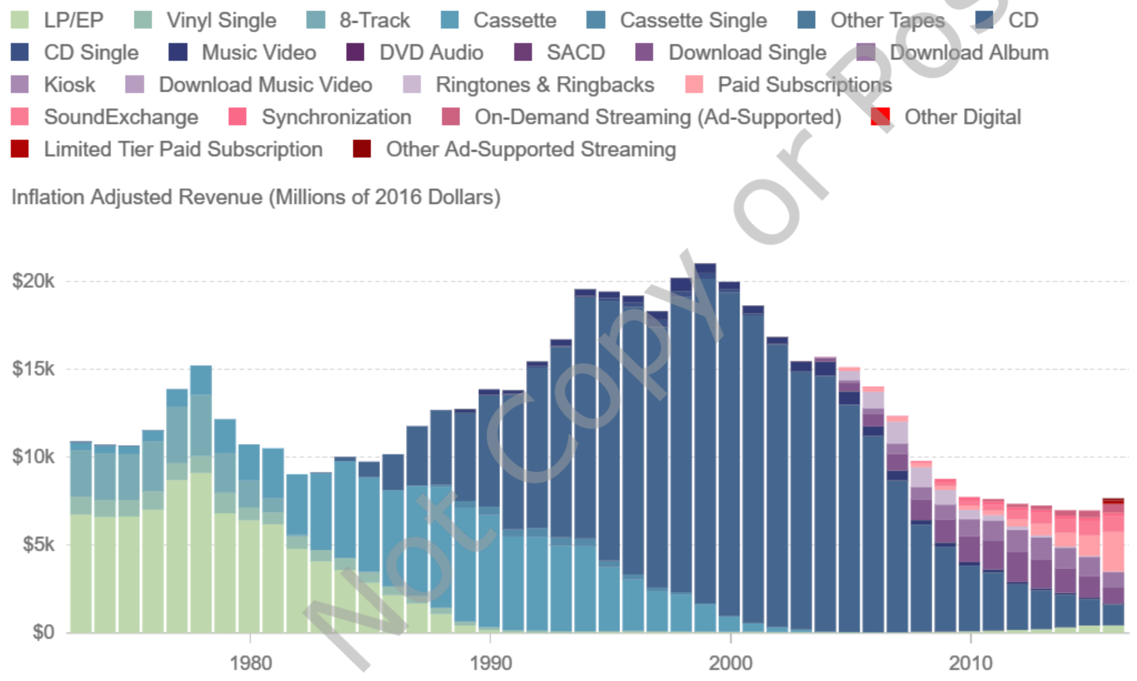
The Digital Medium and the Rise of Music Piracy

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.[5] 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.[6]

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.[7] 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 – 2016 Dollars per Capita



Source: "U.S. Sales Database," RIAA, 2017, https://www.riaa.com/u-s-sales-database/, accessed October 19, 2017.

The industry, in general, blamed piracy for these lost sales,[8] 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."[9]

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