“Albanian Army”

Alice is the new general manager of a medium-sized record label. It is a sector she had always wanted to work in: musicians, groupies, contracts, launches, megastars, music critics... But this morning she must make a decision about a distribution deal that does not appear to be particularly attractive: she must decide whether or not to license the label’s songs to Spotify.

**SPOTIFY**

Defined as a new way of listening to music, it is a music streaming service, with a very basic, easy-to-use platform: if you download its simple app and you have an internet connection, it offers more than 15 million songs, including many from the major record labels. Essentially, three services are offered:

- **Spotify**: a free version, limited to ten hours of music a month, with occasional advertising and visual banners
- **Unlimited**: €4.99 a month, with unlimited music and no advertising
- **Premium**: €9.99 a month, with availability on mobile devices and enhanced sound quality.

As the founder of the company Daniel Ek explains, Spotify has achieved something better than piracy: today, people listen to more music. In a world in which Google provides the search, Facebook the identity and Amazon the retail, Ek wants Spotify to be the soundtrack: “*We’re bringing music to the party*”.

**History of Spotify**

Spotify was founded in Stockholm in 2006 by Daniel Ek and Martin Lorentzon, two geek chic millionaires who had already established several start-ups. At the age of 23, Ek decided to embark on a new project; his aim was to have a destabilising influence in a field that he loved: music. The pair invested the millions they had saved in seeking to purchase licensing rights from record labels, arguing that their free model would eventually generate more sales for the industry. Ek’s personality was a key factor: “*He has this Zen-like patience and an ability not to crack under pressure or get frustrated*”.

Spotify is a service that is currently available in 15 countries, including Austria, Belgium, Denmark, Finland, France, Germany, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom. It has been available in the USA since July 2011 (following years of negotiation with the major record labels).

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1 Copyright © 2012. ESADE. Barcelona

Case developed for the Department of Marketing Management at ESADE by the Associate professor Gerard Costa. Special Thanks to the faculty on Northeastern University’s Tier 1 grant: "Proof of Concept for Interdisciplinary Research in Music Industry".

"...it disturbed me that the music industry had gone down the drain, even though people were listening to more music than ever and from a greater diversity of artists". Daniel Ek
Spotify’s innovation

The technology employed is relatively simple: “Spotify provides music almost instantaneously, with a basic hybrid architecture that combines P2P technology with direct streaming from a large database”. The benefits of this system are that future service growth is more easily scalable; fewer servers are required, and hence a smaller investment; and it is not considered to be an illegal pirate network of shared files, since the music is provided by Spotify and it can only be used by the client. Innovation has also been developed in other areas of management:

. Social. Spotify observed that one of the most positive features of the experience of listening to music is sharing it, and so Spotify turned it into a social experience through a new music section on Facebook that allows you to create and share lists with your friends, vote or send music.

. Collaboration. Spotify collaborates with the industry beyond the area of licensing. It has created label-specific apps for “The Warner Sound” and Def Jam, for example; it has collaborated with Sony Music Sweden to create the Filtr service that generates playlists on Facebook, and with Universal Music in the case of TweetVine on Twitter.

. Innovation in Cobranding. It has captured potential users through services and advertising collaborations with the telecom operators Telia Sweden, Virgin UK and SFR France; and with SEAT, Samsung, Volkswagen, Chevrolet and Coca Cola.

THE MUSIC MARKET

The classic structure of the market and its value chain have been modified as a result of streaming (see Annex 1). The current process still begins with a talent, contracted by record companies which go on to possess a unique product on a monopolistic basis. The end product is delivered to an end consumer, through a value chain in which the key players, their functions and the value created by each one of them have changed.

- Artists: “Let’s keep the music special, f*** Spotify”.

The general reaction from musicians has been negative for two reasons: firstly, on economic grounds, since they consider that these services eat into revenue from other more traditional digital services, with the result that their revenue has fallen in all the countries where Spotify is available; and secondly, on ideological grounds, because they feel that streaming turns their work into a low-value commodity.
Celebrities have been able to choose: Coldplay, Adele and Tom Waits have decided not to fully license their songs; on the other hand, Justin Bieber’s representative does not agree: "they should then tell radio not to play records for free and call YouTube and say don’t allow my music to stream on videos for free.” In the end, these celebrities can control digital distribution in their contracts, or simply boycott it with an unexpected bout of flu or by not attending promotional appearances.

- Record industry: “the record labels are in bed with Spotify”

These are the companies that record, produce, publish, distribute and market the music: this involves campaigns, promotions, concerts and negotiating with the distributors. They are increasing their market concentration and power; the “Big Six” of 1998 have been whittled down to three large groups that control 80% of music in the USA and 70% worldwide, a market that is worth between $30 and 40 billion: Sony, Universal and Warner. The remaining record companies are classed as independent, whatever their size or structure.

They have an industrial capacity and can finance the process in exchange for contracts that are known as “unrecouped”: the record companies make an investment and provide the finance, and the artists are responsible for paying back all the costs before they can begin to earn royalties (with the exception of the big stars); and in this way the distributors’ payments rarely reach the artists. Furthermore, these contracts are evolving towards the 360 concept: rights are being extended to cover all the activities of the musician (explicitly live concerts and merchandising, the two new sources of revenue), providing evidence that the record label is diversifying its business model and adapting to trends.

The industry is practically a monopoly thanks to copyrights. The contracts that record companies offer the distributors reflect their power: equity stake clauses or ownership of part of the distributor (the three major groups hold 20% of Spotify), guaranteed minimum payments, free detailed monthly reporting with data on all the companies, most favoured nation clauses that guarantee they will match any other record label on improvements in the future, and restrictions on the disclosure of payments made under penalty of invalidating the licenses granted.

- Distributors: “from brick and mortar to on-demand listening experience”

The transformation of music distribution began in 1999 with Napster: a quick, free service, without restrictions, which offered cost-free music downloads in MP3 format. The industry succeeded in closing Napster after two years, but it had now been demonstrated that consumers did not want to buy albums, but to listen to a song whenever they wanted without buying the album: enter Daniel Ek’s “lost generation”, who believe that music should not be paid for.

iTunes appeared in 2001 as a virtual store charging $0.99 for every song downloaded, and today it is the biggest retailer worldwide. It represents the so-called happy medium that the industry longed for, the alternative to piracy in the form of a platform for selling songs, and
it paid out a total of $3.2 billion to record companies in 2011. However, by offering singles it has also collaborated with piracy in killing off the CD.

Pandora has been the third digital model: an online radio which, through its *Music Genome Project*, analyses the 400 attributes of each song and adapts itself to the tastes of each listener, personalising the service. Although it has succeeded in attracting more than 80 million users, its model must fulfil the requirements of the DMCA: it must pay out fixed royalties pre-established with the record labels, and this has led to permanent losses.

It would appear that cloud technology (remote online data storage) will be an important future trend, enabling any company to develop and create the next Spotify. Other possible developments: several global brands fighting to relaunch their music channels; for example, Microsoft trying to incorporate its Zune platform into Xbox, Google relaunching Google Play for its Android system, and Apple trying to do something similar with its social network Ping.

Physical retailers have simply disappeared. 77% of stores closed between 2000 and 2010, and it is expected that another 12% will close by 2016. Their attempts to compete lie in specialist independent stores and the revival of vinyl (which has climbed from 1 million units in 2005 to some 4 million units in 2011).

- End consumer: “all-you-can-eat music”.

Spotify has been a turning point for the consumer: possession is not necessary for enjoyment. A Tower Records megastore offered an enormous range, a convenient location, low prices and a good shopping experience. iTunes improved the range, the convenience, the prices and the product with just singles. In turn, Spotify offers the consumer an advantage as a system: it boasts an enormous catalogue, complete availability, a great user experience that is more rewarding than piracy, but what’s more, it’s free, and there are many services to enjoy and share without possession. The end result for the consumer is that the sale of music as a product loses value; the consumer feels that the market has evolved from the transaction based on push to pull based on a flat rate.

**CONCLUSIONS ABOUT THE SPOTIFY MODEL**

In terms of figures, Spotify’s success cannot be questioned, but there is an enormous lack of transparency when it comes to providing information (Annex 2). This has led to various analyses being made in the sector about the key factors that will determine its success or failure.

- Acquisition of Licenses: a difficult task that will be Spotify’s next challenge when the initial licenses expire in two years. Ek will have to generate sufficient cash in order to avoid the record companies asking for higher royalties and he will have to try and engage in different negotiations with different clients.
- **Rapid growth in the number of users:** thanks to cobranding with Facebook, Spotify has been able to grow, with a million new users in its first week. It will have to maintain these sources of growth.

- **Profitability.** Large investors such as the company Andreessen-Horowitz continue to advise against investing in Spotify, raising doubts about the profitability of its business model: “It’s a great service with a big lead on other music streamers. But as it scales and gains traction, the record labels will increase their tax. There’s no way Spotify will pay the same fees if it hits 15 million subscribers as it does now. That will make it harder for Spotify to return the multiple most investors want any time soon”.

- **Royalties.** While the contract stipulates that the price cannot be revealed, it is estimated that Spotify pays $0.003 per song streamed, compared with $0.7 that iTunes charges to sell a song. Spotify has individual agreements with some 400 record labels, to which it pays 70% of its income. These figures must be compared with those obtained traditionally from the sale of a CD (Annex 3).

Alice is now beginning to understand why her predecessor in her job posted interviews with Jeffrey Bewkes and David Bowie on the wall.

…”It’s a little bit like, is the Albanian Army going to take over the world? I don’t think so.”
Jeffrey Bewkes, Time Warner CEO, 2010, talking about Netflix

"Music itself is going to become like running water or electricity. So it's like, just take advantage of these last few years because none of this is ever going to happen again. You'd better be prepared for doing a lot of touring because that's really the only unique situation that's going to be left. It's terribly exciting. But on the other hand it doesn't matter if you think it's exciting or not; it's what's going to happen.

(...) I don't even know why I would want to be on a label in a few years, because I don't think it's going to work by labels and by distribution systems in the same way. The absolute transformation of everything that we ever thought about music will take place within 10 years, and nothing is going to be able to stop it. I see absolutely no point in pretending that it's not going to happen. I'm fully confident that copyright, for instance, will no longer exist in 10 years, and authorship and intellectual property is in for such a bashing."
ANNEX 1. VALUE CHAIN

- MUSICIANS
- PUBLISHERS
- MANUFACTURERS
- DISTRIBUTORS
- RETAILERS
- CUSTOMERS

- MUSICIANS
- PUBLISHERS
- RETAILERS
- CUSTOMERS
ANNEX 2. SPOTIFY. QUANTIFICATION OF RESULTS

The case illustrates the lack of transparency that exists with respect to figures in the management of the digital distributors, and specifically with regard to Spotify. Below are some of the figures compiled: they are incomplete, they overlap and they are contradictory.

<table>
<thead>
<tr>
<th>SPOTIFY DATA 2011</th>
<th>MARKET DATA 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 13 billion songs played in the last year</td>
<td>• In December 2011 digital music sales topped $5.2 billion in downloads</td>
</tr>
<tr>
<td>• 28 million songs shared on social media</td>
<td>o 50.3% of the market, exceeding physical sales for the first time</td>
</tr>
<tr>
<td>• (Approximately) 2.5 million paying subscriber clients:</td>
<td>• Streaming penetration: worldwide average 32% of homes</td>
</tr>
<tr>
<td>o 85% paying $10</td>
<td>o 48% in Norway</td>
</tr>
<tr>
<td>o 15% paying $5</td>
<td>o 44% in Spain</td>
</tr>
<tr>
<td>• Copyright payment to the record companies: $150 million</td>
<td>o 43% in Sweden</td>
</tr>
<tr>
<td>o 2010: $55 million</td>
<td>o 37% in France</td>
</tr>
<tr>
<td>• Spotify user profile: 33% under the age of 24.</td>
<td>o 32% in the USA</td>
</tr>
<tr>
<td>• Market share:</td>
<td>o 18% in the UK</td>
</tr>
<tr>
<td>o 2% of the 500 million people listening to music online worldwide</td>
<td>o 15% in Japan</td>
</tr>
<tr>
<td>o Only present in 15 countries, and present in the USA as of one year ago</td>
<td></td>
</tr>
</tbody>
</table>

In December 2011 digital music sales topped $5.2 billion in downloads
- 50.3% of the market, exceeding physical sales for the first time
- Streaming penetration: worldwide average 32% of homes
  - 48% in Norway
  - 44% in Spain
  - 43% in Sweden
  - 37% in France
  - 32% in the USA
  - 18% in the UK
  - 15% in Japan
ANNEX 3. RRP OF CD AND BREAKDOWN OF COSTS

<table>
<thead>
<tr>
<th>COST</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Musicians’</td>
<td>0,16</td>
<td>1</td>
</tr>
<tr>
<td>Packaging/manufacturing</td>
<td>0,80</td>
<td>5</td>
</tr>
<tr>
<td>Publishing</td>
<td>0,80</td>
<td>5</td>
</tr>
<tr>
<td>Retail</td>
<td>0,80</td>
<td>5</td>
</tr>
<tr>
<td>Distribution</td>
<td>0,96</td>
<td>6</td>
</tr>
<tr>
<td>Artists'</td>
<td>1,60</td>
<td>10</td>
</tr>
<tr>
<td>Label</td>
<td>1,76</td>
<td>11</td>
</tr>
<tr>
<td>Marketing/promotion</td>
<td>2,40</td>
<td>15</td>
</tr>
<tr>
<td>Label</td>
<td>2,98</td>
<td>19</td>
</tr>
<tr>
<td>Retail</td>
<td>3,84</td>
<td>24</td>
</tr>
<tr>
<td><strong>PRECIO</strong></td>
<td><strong>16,10</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>