

COMMERCIAL DUE DILIGENCE MEMORANDUM

Target Asset: Spotify Technology S.A. (SPOT)

Sponsor: Deal Team (Analyst: H. Singh)

Date: January 6, 2026

1 EXECUTIVE SUMMARY: THE "MARGIN TRAP" THESIS

Recommendation: DECLINE GROWTH EQUITY INVESTMENT (Current Terms).

Rationale: While Spotify commands a dominant **32% global market share**, the asset is structurally "un-leveragable" in a traditional LBO framework due to fixed margin caps.

- **Commercial Reality:** Spotify is a distribution utility, not a SaaS platform. Gross Margins (GM) are structurally capped at ~**30-33%** due to variable royalty costs (approx. 63-70% of revenue paid to rights holders).
- **Unit Economic Bifurcation:** The business relies entirely on the Premium user. Premium ARPU (~€4.85) is **11.5x higher** than Ad-Supported ARPU (~€0.42). The "next billion users" (Ad-Supported) are dilutive to ROIC unless conversion rates improve materially.
- **Hidden Value (The "Float"):** The only redeeming LBO characteristic is the **negative working capital cycle** (~€2-3B float), where subscribers pay upfront and Spotify pays labels on roughly 60-day terms. This provides an interest-free funding source, but it is insufficient to offset the margin cap.

Verdict: We cannot underwrite margin expansion beyond 35% without a fundamental change in Copyright Law or label disintermediation.

2 MARKET STRUCTURE & COMPETITIVE POSITION

Spotify defends a leading position against capitalization-asymmetric competitors who treat audio as a loss leader.

Table 1: Global Music Subscriber Market Share Estimates (2024-2025)

Platform	Market Share	Trend	Strategic Incentive
Spotify	31.7%	Stable	Profit (Core Business)
Apple Music	13-15%	Stable	Ecosystem Lock-in (Loss Leader)
Amazon Music	11-13%	Declining	Prime Bundle Value Add
YouTube Music	~9-10%	Growing	Video/Ad Synergy

Key Risk: In the US, Apple Music holds ~30.7% share, creating a duopoly that limits Spotify's pricing power. Apple can absorb royalty hikes to pressure Spotify's margins; Spotify cannot reciprocate.

3 UNIT ECONOMICS: THE "CHAINSAW" ANALYSIS

The investment case rests on the "Bifurcated Economy" of the user base. We have modeled the Q4 2024 financials to isolate the value drivers.

Table 2: Unit Economics Breakdown (Monthly Basis) - Q4 2024 Data

Metric	Premium User	Ad-Supported User	Delta
Users (MAU)	263 Million	425 Million	Free base is 1.6x larger
Monthly ARPU	€4.85	~€0.42	11.5x Premium Multiple
Gross Margin %	~30% (Est)	~5-10% (Est)	Premium drives 95% of GP
Contribution Margin	€1.45	€0.04	36x Profit Multiple

Implication: Volume growth in "Rest of World" (Ad-Supported) is vanity metrics. 100 million new Ad-Supported users generate the same Gross Profit as roughly **2.7 million Premium users**. *Note: Ad-Supported ARPU derived from €537M revenue / 425M users / 3 months.*

4 SENSITIVITY ANALYSIS: PRICING POWER VS. CHURN

The Prompt: Can Spotify raise prices to expand margins, or will churn destroy the value?
Model Inputs:

- **Base Subscribers:** 200 Million
- **Base Price:** \$10.00/month
- **Price Increase:** 10% (\$11.00)

We modeled the 12-month revenue impact under two scenarios to test "inelasticity."

Table 3: Revenue Impact of Price Hike (12-Month Horizon)

Scenario	Churn Assumption	12-Month Revenue Impact
Scenario A (Bull Case) <i>Assumes high stickiness</i>	Flat (2.0%) No change in retention	+\$2.28 Billion Pure price capture
Scenario B (Bear Case) <i>Assumes shock reaction</i>	Spike (3.0% for 3 mo) Then settles at 2.2%	+\$1.64 Billion 28% Value Destruction

The Math:

- **Scenario A:** 200M subs \times \$1 increase \times 12 months = \$2.4B (simplified). Real churn of 2% reduces this slightly, but the net gain is massive.
- **Scenario B:** A churn spike to 3% (vs 2)
- **Conclusion:** Even in the Bear Case (Scenario B), the price increase is **accretive**. This proves pricing power exists, BUT ~70% of that incremental dollar flows to labels via royalty agreements.
- **Net Benefit to Spotify:** Only ~\$0.30 of that \$1.00 increase drops to Gross Profit.

5 CASH FLOW & WORKING CAPITAL (THE "FLOAT")

While P&L margins are thin, the Balance Sheet offers a significant LBO lever.

Mechanism:

- **Inflow:** Premium users pay monthly in advance.
- **Outflow:** Royalties are paid to labels/publishers on Net 60 or Net 90 terms.
- **Result:** Spotify operates with **Negative Net Working Capital** of approx. -€2.8 Billion.

PE View: This "interest-free loan" from suppliers funds growth. However, this balance has likely peaked as growth slows. It is a one-time financing benefit, not a recurring profit engine.

6 FINAL INVESTMENT VERDICT

1. **No Operating Leverage:** Gross Margins have a hard ceiling at ~33% unless the "Two-Sided Marketplace" (Discovery Mode) radically reduces royalty rates.
2. **Pricing Power Dilution:** We proved pricing power exists (Section 4), but the *value capture* of that power accrues primarily to Universal/Sony/Warner, not Spotify shareholders.
3. **Recommendation: PASS.** The asset trades at a Tech valuation (Revenue Multiple) but possesses Media economics (Variable Cost).