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Carter Kaufmann

**Spotify Technologies S.A. (SPOT) – Investment Stock Report**

**Investment Recommendation: “Buy”**

**Executive Summary:**

With the signature green and black backdrop, Spotify is a digital music service offering music fans of all different kinds of tastes and backgrounds the chance to listen to some of their favorites. The app has a home screen, which categorizes some of your favorites and most played songs, artists, albums, playlists, and podcasts - all in one place! Spotify also has the technological capability to give you the opportunity to explore new offerings similar to what you’ve already listened to that you may enjoy but have never heard before to help expand upon your current tastes and get you to go out of your ~musical~ comfort zone. You can search for or download any song or podcast of your choosing and create your own music library with playlists styled and crafted just the way you like them! Spotify offers a vast array of music genres that can appeal to any listener, such as rock, hip-hop, rap, indie, techno, house, jazz, classical, or alternative – just to name a few. The platform also has different variations of the same songs in case a listener preferred a specific version/beat. Spotify offers two different segments: Premium and Ad-Supported. Premium provides subscribers with unlimited online and offline high-quality streaming of music and podcasts across different devices, such as computers, phones, or tablets. Users can connect via speakers, receivers, televisions, cars, game consoles, and smart watches. There are also no commercial breaks which is a wonderful perk to Premium. The Ad-Supported segment provides users with limited on-demand online access of music and unlimited online access of podcasts on compatible mobile phones, computers, or tablets.

Gone are the days where people buy CD’s and record players, unless you’re a vinyl junkie of course! But for the most part, all music lovers stream their music today through platforms such as Spotify, Apple Music, YouTube Music, Amazon Music, Pandora, or SoundCloud. Not only does Spotify have a larger array of podcasts than most of the other streaming services, but you can also use the app to listen to your favorites while using other apps at the same time! Say you were driving and wanted to listen to music – you could have navigation up at the same time as Spotify, all connected through Bluetooth. That way you know where you are going, and you have a good time getting there! Spotify partnered with Samsung, which was a very good move on their part, Samsung Galaxy phone users gain exposure to the app automatically downloaded on their new phones and also get a free trial of Spotify Premium! Samsung is a major player in South Korea and leads to South Korean consumers being very excited about Spotify, according to Q4 2020 earnings call. I would consider Spotify’s stock to be a “Buy”. Not only am I a subscriber to the Premium segment, but I also have Spotify merchandise. I recently bought a green and black T-shirt with the company’s name and symbol on it, prior to starting this project and taking a deeper dive into researching the company.

**Company Profile and Management Team:**

Spotify was founded on April 23rd, 2006 in Stockholm, Sweden by Daniel Ek, who is the CEO, Founder, and Chairman of the Board of Directors and Martin Lorentzon who is also a co-founder and director of Spotify. Prior to starting Spotify in 2006, the CEO Daniel Ek, founded Advertigo, an online advertising company acquired by Tradedoubler, held various senior roles at the Nordic auction company Tradera, which was acquired by eBay, and served as the Chief Technology Officer at Stardoll, a fashion and entertainment community for pre-teens. Martin Lorentzon worked at Telia Company, Sweden’s main telecom operator from 2013 to 2018. He also founded Tradedoubler, an internet marketing company based in Stockholm, Sweden. He has held senior roles at Telia Company and Cell Ventures, and holds a Masters of Science in Civil Engineering from the Chalmers University of Technology. Paul Vogel is the CFO of Spotify. Before joining Spotify, Mr. Vogel spent the majority of his career in portfolio management and equity research at Barclays. Before Barclays, Mr. Vogel was in various roles in finance as a portfolio manager at AllianceBernstein and as a research analyst at Morgan Stanley and DLJ. He is also a CFA charter holder and has a BA in Economics from University of Pennsylvania.

Spotify was created in response to the growing piracy problem that the music industry was facing. “The only way to solve the problem was to create a service that was better than piracy and at the same time compensates the music industry” – Daniel Ek. I’m sure they are well-known internationally, but before doing this project I would not have known or recognized the CEO or CFO by name, especially since Spotify was started internationally in Sweden. Spotify is headquartered in Luxembourg.

Spotify is a growth industry, because if the economy is down people will still use Spotify to stream and listen to their music. It is not a Covid-dependent company either, like Zoom or Peloton, which is a plus. Spotify is expanding upon their hybrid model and the way that employees work and where from. Instead of “Work from Home”, they are taking a “Work from Anywhere” approach.

**Recent Developments/News:**

Q4 2020 Spotify Earnings Statement

Spotify has around 165 million users. They have launched into new markets, such as South Korea just recently. They’re looking to drive revenue growth by expansion into new markets. They tripled the number of podcasts they offer within the time span of a little over a year. They had around 700,000 in 2019 and 2.2 mil today. Spotify podcast listeners will top Apple’s for the first time starting this year (in 2021). Their advertising business finished above forecasts in Q4 2020. However, a downside is that they will be dealing with inventory constraints for the next year or two. The founder and CEO of Spotify Daniel Ek said that, “2021 brings more uncertainty than any other year” because of the Covid bounce back. Spotify recently acquired Betty Labs, rival of Clubhouse, becoming a part of the hot live audio trend. Betty Labs created the live audio social app called Locker Room which focuses on sports. The rise in popularity of these apps first came onto the scene amidst the pandemic last year with the launch of the app Clubhouse. Other social media companies like Twitter and Facebook are following in Spotify’s footsteps by experimenting with the live audio features as well. Spotify announced its permanent, flexible ‘Work From Anywhere’ policy, rather than ‘Work From Home’. The ‘Work From Anywhere’ policy at Spotify grants the employees more freedom to choose if they want to work in an office, remotely, or at a coworking space that the company will pay a subscription for. They will be given more choice and flexibility about the location in which they want to work from. **“Big cities are not the only places where meaningful work can happen,”** said Travis Robinson, the Head of Diversity, Inclusion, and Belonging at Spotify. I think that’s a very important lesson that the world learned this year, as employees of not only Spotify but every company start to branch out of the big cities and move into places where taxes are cheaper and they can have more land for less money and work remotely all at the same time.

**Valuation:**

**Free Cash Flows**

Spotify is free cash flow positive according to Paul Vogel in the webcast with Morgan Stanley.Looking at the Cash Flow Statements from 2019-2023, Spotify’s free cash flow has been mainly positive except for the first quarter in ’21, and is on track to be the highest to date at the end of ’22 ($529) and even higher at $793 in ’23. This may be due to the increase in sales from ’22-’23, as seen on the income statement, from 13,093 to 15,488. This represents an increase of around 182.92%.

**WACC**

After looking at the weighted average cost of capital model, Spotify’s debt-to-equity ratio is long-term debt divided by stockholders equity from the balance sheet. In this case, at the end of the fiscal year 2020, the math is $701.95 million divided by $3,412.41 million which equals 0.21 or 21%. These were the figures posted by gurufocus.com. This means that it’s equity-to-total-capitalization is 79% (100%-21%). Spotify’s equity weight is around 0.9877 and its debt weight is 0.0123. The current risk-free rate is around -0.54%. Beta is around 1.58 and market premium is around 6%, so cost of equity equals -0.54% + 1.58\*(6%) = 8.94%. To get Spotify’s cost of debt, we divide its interest expense ($65.69 million) by its total book value of debt ($696.53 million). The cost of debt is equivalent to 9.4315%. The latest two-year average tax rate is 11.965%. So finally, WACC equals 0.9877 \* 8.94% + 0.0123 \* 9.4315% \* (1 + 11.965%) = 8.96%.

**Enterprise Value**

Spotify’s enterprise value for the fiscal year of 2020 was $58,429 million. To calculate this value, I added the market capitalization value of $59,852.42 + long-term debt of $701.95 – the cash/cash equivalents of $2,125.30 = $58,429 million. Spotify’s more current enterprise value is $54,502 million. So from Dec 2020 to the present, Spotify’s enterprise value decreased by $3,927 million. These figures were from gurufocus.com as well.

**Summary**

Spotify is currently trading at $276.91. The valuation price is targeted at $323.39 by looking at the company’s EV/EBITDA, P/E ratio, and PEG ratios. This shows upside potential of 16.79%. This presents a return of $46.48. Upside potential indicates an overweight stock. P/E is expected to rise dramatically to 522.2 mil by the end of 2023. On this day last year, Spotify was trading at right around $135.93, and today the company is trading at right around $276.91, which shows a 203.72% increase over the past year.

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**Bull Story** – I am very bullish on Spotify for a multitude of reasons. I will name 4 of the main ones specifically. The first reason is because paying to stream music has become normalized in society of recent years. This helps create a comfortable subscription revenue base for the Stockholm-originated firm. Considering subscriptions to be fixed costs has become more of a mainstream concept, especially fueled by the pandemic as more people were stuck inside their homes and had time to explore technology, download the app, and listen to music/podcasts. The second reason I’m bullish on Spotify is because they raised their price to have an increased revenue and margins in some non-core markets, which can lead to a greater bottom line and profitability for the powerhouse firm. Users are barely phased by the price raises since they are only around a dollar or two extra per month. A third reason I’m bullish on Spotify is because of their recent strong international presence and moving into new markets. As the CEO Daniel Ek summarized in the Q4 2020 Earnings Call, they are very happy about expanding into South Korea and partnering with Samsung to give their brand name and reputation more South Korean exposure. As far as things go in Russia, Spotify is happy with what they saw in regards to user turnout there last year. Spotify also launched mini Premium plans in India and Indonesia. If they could set a precise and well thought out price target in these countries, there offering could be very lucrative, and attractive to the people there as well. The final reason I am so bullish on Spotify is because of their podcasting. And that may be the biggest reason too. This is what has differentiated them from the other music streaming platforms in the game. The Joe Rogan Experience has blown up in popularity with so many listeners and the company even listed podcasting as one of the main reasons why their gross margins increased in Q4 2020.

Spotify is a growth company that is looking to expand into new markets and gain market share, who saw tremendous growth in 2020 despite Covid. They excel at appealing to their target audience – consumers who love music and that is why they are one of, if not the most, popular music streaming platform around the globe. They have a Discovery Mode with no upfront investment that is gaining traction and their podcasts business is expanding rapidly as well. After listening to their CFO Paul Vogel talk to Morgan Stanley, I found him to be very well-spoken. I think he is great at his job and is really a man of the numbers. He has a very reputable background and resume working at Barclays, AllianceBernstein and Morgan Stanley. He also got his CFA designation and graduated from UPenn with a Bachelors in Economics.

**Bear Story** – Many famous companies like Blockbuster, Blackberry, Toys R Us, had bear stories. You never would have expected it or saw it coming at the time. The same can happen to Spotify; or any top-name company for that matter. You never know if their stock will plummet or if the firm will go bankrupt. The underlying point is that you never know the future of any company, nobody has a magic 8-ball. It doesn’t matter how great of an industry Spotify is in being in the music/audio entertainment industry or how great the management team is, but there are always downsides and reasons why they aren’t good buys. In regards to Spotify, they have a decent amount of competitors such as Apple Music, YouTube Music, Amazon Music, Pandora, SoundCloud, etc. so one of these companies may be an underdog story and steal Spotify’s thunder/spotlight. These big players in the market such as Apple, Google/Alphabet and Amazon all offer something very similar. Spotify’s whole deep-dive into podcasts approach was already taken into account with the stock price and by publications, the media, and the general public. And the stock is still trading below earnings. Spotify is looking to raise prices soon on their offerings, they only refrained from doing so in 2020 because of the poor economic conditions at the time with the Coronavirus pandemic. If people started buying CD’s again or the way in which people listened to their music changed in the future, then Spotify’s stock would plummet. With all of our world’s AI advances, Alexa, renewable energy such as with electronic vehicles, we have advanced immensely in such a short period of time. And those are only a few of the many various examples. It wouldn’t be much of a surprise if someone in this huge world came up with a new, better way to listen to music. Anything is possible.

**Morgan Stanley Technology, Media, and Telecom Conference/Webcast with Spotify CFO Paul Vogel**

One of Spotify’s goals is to be the largest global streaming audio player. According to Vogel, they always had a plan with the number of new markets they can launch into at one time. They’ve entered different types of markets, fast ones but also not as developed ones. They had more users and subscribers in Russia much faster than they thought they would. To recap, they’re involved with a lot of markets that have plenty of growth potential, which they are really excited about. CFO Mr. Vogel said Spotify’s gross margin is a big debate in regards to the stock. The high end of Spotify’s long term guidance raised to 40% gross margin. When asked what is driving the higher margin outlook, Vogel said that if you look at the ranges the low end hasn’t changed, they changed the upper end of that range – the opportunities of podcasts and advertising networking if it goes really well there could be upsides to margins, they feel good about being able to hit that lower end. With all the initiatives they have, they could do even better than they thought with their direct listing three years ago. They’ve modeled out all different scenarios – low end and high end opportunities. Vogel said that 1.3 billion of exchangeable debt was brought in - a lot of cash from the balance sheet. The company is free cash flow positive. They are continuing to think about the optimal capital structure for the business.

Being that it was a tough year and all with Covid, Spotify still had a really strong 2020. When asked if Covid helped or hurt Spotify, Vogel responded that it was both helpful and a hindrance, in different ways. The company beat their expectations on the user side and premium side, some came from Russia. They still beat by 4 or 5 million the number of subscribers they had from the beginning of the year, which was a pretty significant increase. They didn’t have one quarter that blew through the roof like some other streaming companies, but there was a tailwind from a user perspective, and headwind on the advertising side. He acknowledged the team effort – they were very resilient. He also did acknowledge that the company has been thinking about price increases and how to approach it, but pushed back on it with the poor economic environment of 2020. There was a ton of uncertainty with Covid, being a tailwind or headwind in 2020. Were not too sure when everything will be back in person, but we are expecting things to get back to closer to normal soon. Spotify has around 30 million net user subscribers which is the largest figure Spotify ever had. They felt good about how they ended 2020. “Nothing ever goes up in exact straight lines,” – Mr. Vogel. There are always ups and downs, but the next five years seem really promising and they feel really good about where they’re headed. Last year was a huge one for growth. They expanded into 25 new markets, and had broad based pricing growth.

Spotify’s absolute number one goal is gaining market share. Podcasting was a powerful growth driver for Spotify in reaching this goal. The company found a high correlation between podcast growth and better engagement, but unfortunately couldn’t prove causality. The size of the podcast pool is still relatively small compared to the rest of the business, but they had pretty good user growth last year. Vogel said he expects there to be more exclusive podcasts on Spotify by 2025 within 3-5 years. Spotify has continued to announce more market place products, and have continued to grow the financial benefits of it. Spotify is seeing a buy-in from the record label and artist community. Marquee and Discovery Mode are big hits – no upfront investment, win-win opportunities. They grew faster than 50% in 2020 with marketplace. According to Vogel, the company has three main buckets – overall music bucket, market place, and podcasts.

**Summary Statement:**

Spotify is currently trading at $276.91. According to FactSet, the stock’s target price is $323.39. This shows upside potential of 116.79%. This presents a return of $46.48. Spotify had a direct listing when they went public on April 3rd, 2018. Spotify is currently outperforming the S&P and is an undervalued stock. Spotify had a one-year low of $116 and a 1 year high of $387.44. They have a 50 day moving average price of $294.36 and a two-hundred day moving price of $293.02. Spotify’s market capitalization is around $53.5 billion, they have a EBIT of -326, a P/E ratio of -67.43 and a beta of 1.64. Spotify announced ($0.66) EPS for the past quarter, and posted a negative net margin and ROE. They had revenue of $2.16 billion during the quarter. Spotify presents a good “Buy” opportunity since it’s in a growth phase and its gross margins are on the rise.

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