



**Safehouse
Capital**



Spotify®

Spotify Technology

Long Thesis

October 2020



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Prologue

Safehouse has been long Spotify Technology since September 2020. Spotify is the only investable pure play opportunity in the global music streaming space. We still believe the current price offers an attractive entry point for long term investors like ourselves.

We believe the company will continue to pioneer the growing streaming industry through its unique strategy which will lead to sustained user and topline growth and expanding margins.

In the next few slides, we try to articulate the key points which led us to take a position. We have spared you the nitty gritty details and instead are focusing on the key high-level elements.

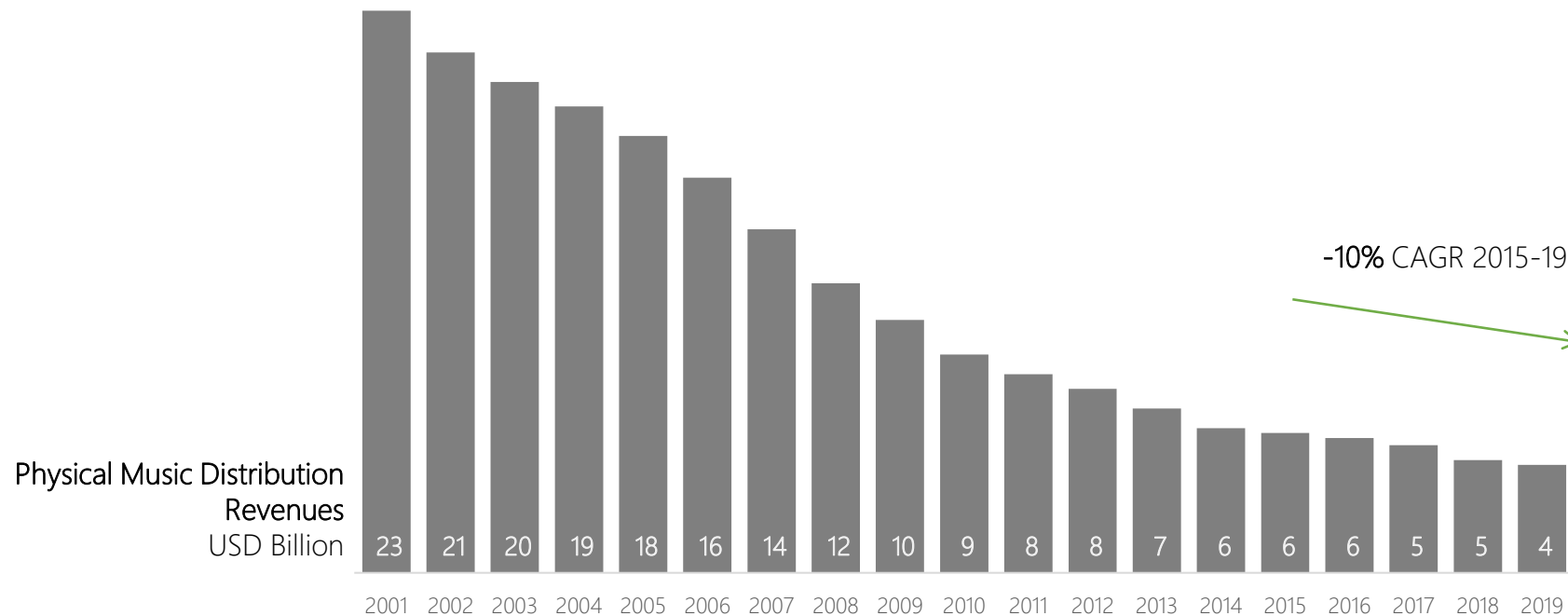


The industry then...

Before being disrupted by digital downloads, the music industry was reliant on physical distribution

The distribution model for the recorded music industry was based on **physical delivery** and **ownership** of music. The advent of the internet and peer-to-peer file sharing disrupted the industry causing a structural dismantling of the traditional model.

By 2008, almost 95% of all music was downloaded illegally.

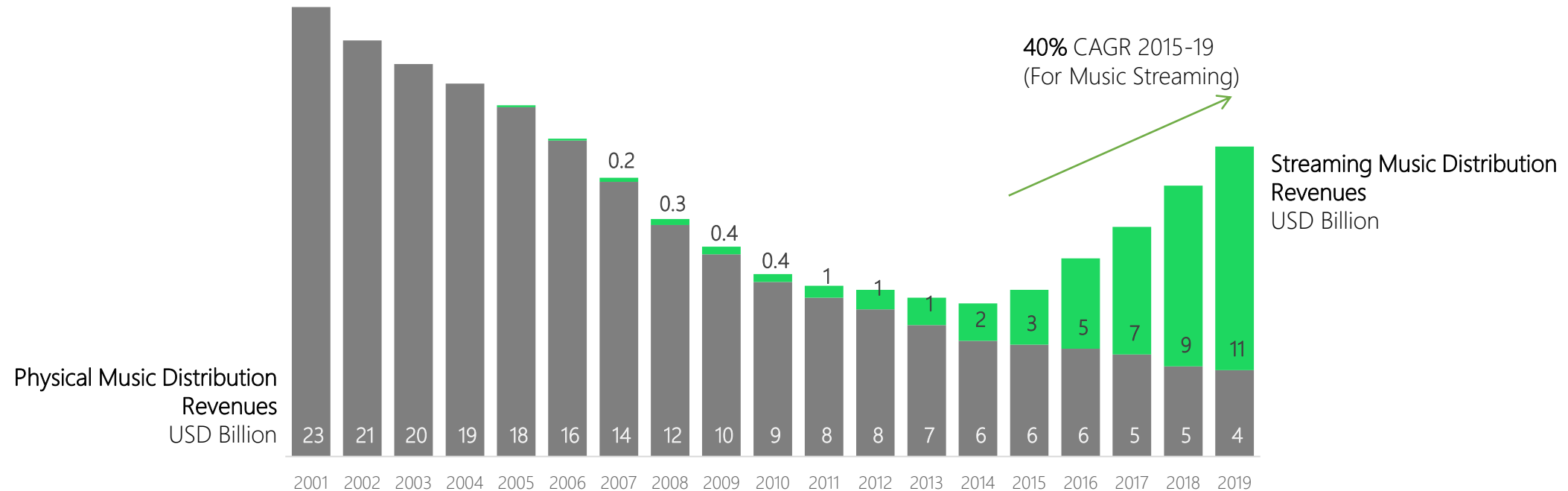


The industry now...

The industry continued to decline until 2015 before streaming emerged as the savior

The streaming model saved the music industry by creating an alternate revenue model. Subscription based music streaming is truly aligned with music consumption compared to the traditional ownership model, as it allows users to access a vast library of music content, thus enabling music discovery. It also allows music creators to gauge engagement on a more granular level. Unlike CD sales, per stream data gives artists greater insight on the performance of specific songs.

Consumers were quick to switch from a limited consumption model (physical) to an unlimited one (streaming).



The competition then...

Emergence of music streaming

Pandora and Spotify proved the business case for music streaming and their success drew bigger players into the industry.

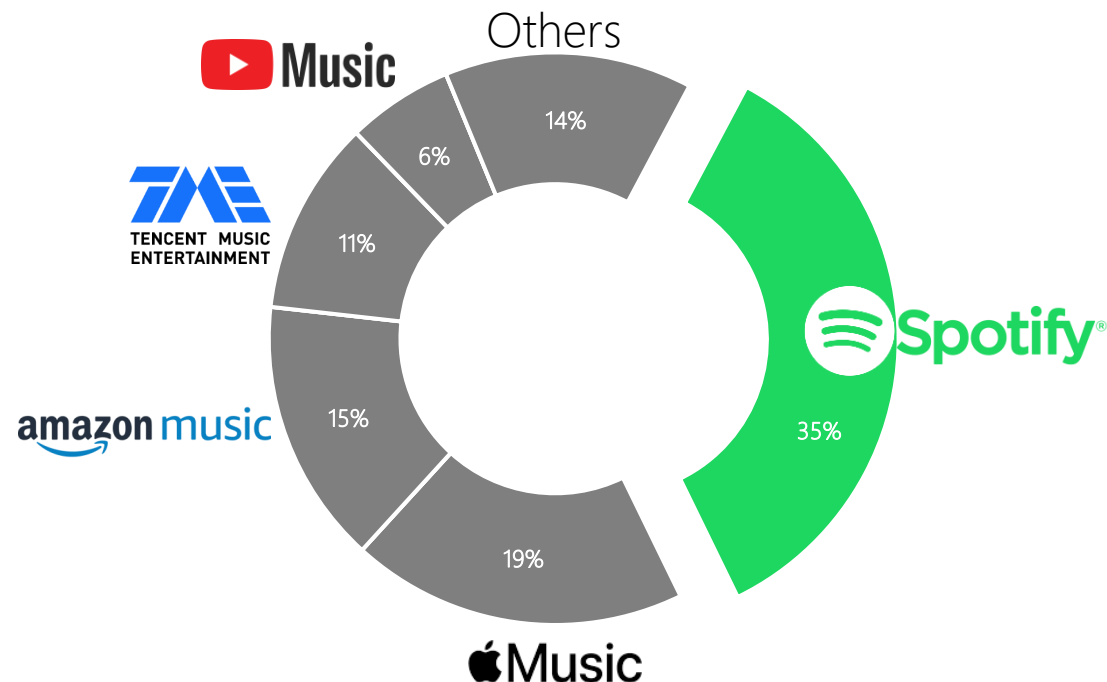


The competition now...

Spotify is the unrivaled leader

Since its inception, Spotify has defined the music streaming category through its innovation. Every competitor must differentiate itself from Spotify to gain subscribers. Today, Spotify has around 35% share of all paid music subscribers, almost double that of Apple.

Spotify is the only listed company that is a pure play on global music streaming.



What makes Spotify different?

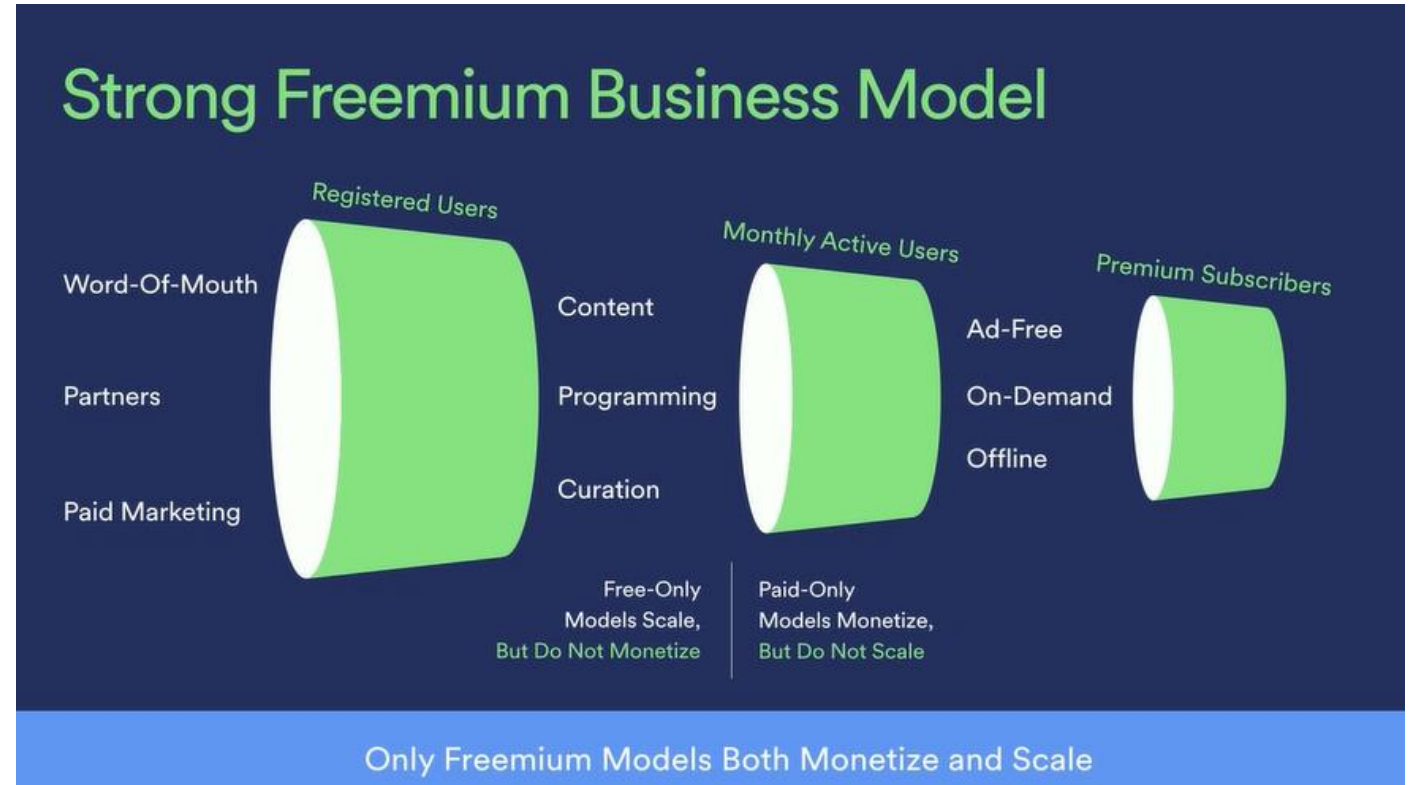
Spotify's freemium model drives demand for Premium

Spotify has a two-tier product offering:

- 1) a free ad-supported version with full access to Spotify's content library with minor limitations on functionality (advertisements/limited skipping)
- 2) a monthly subscription-based ad-free version with full access and full functionality

Apart from being a standalone business line, the free version serves as a funnel to the high margin subscription business.

Over 60% of new paid subscribers come through the ad-supported version.



One of the core advantages of a freemium business model is that it combines the scalability of a free version with monetization potential of a paid application.

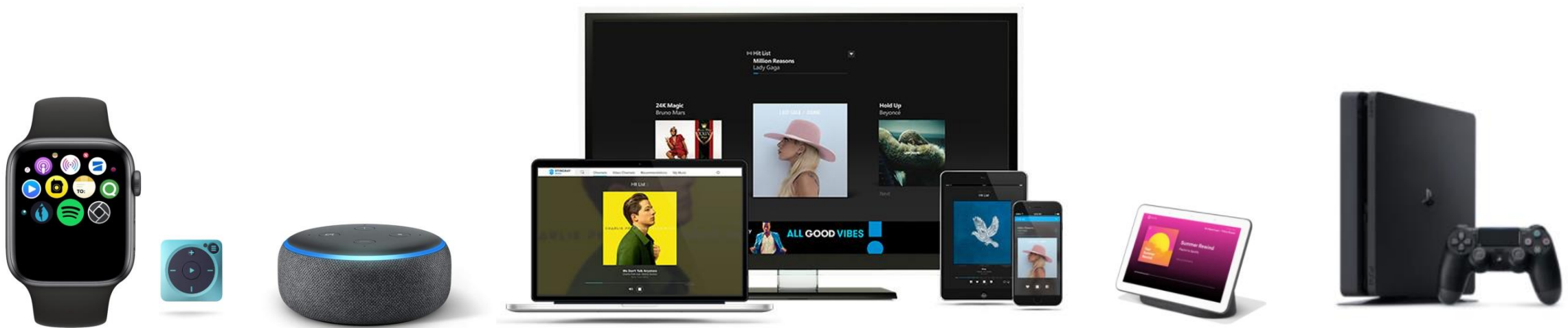
What makes Spotify different?

Spotify works on all hardware

Spotify is ubiquitous i.e. it works seamlessly across Android, iOS and desktop operating systems. It is compatible with wearable devices like the Apple watch, home speakers like Alexa as well as car speakers.

Today, all big tech companies are moving into hardware. Spotify has so far avoided developing their own hardware, instead partnering with all hardware manufacturers to integrate their software with their products and thus creating a more **seamless experience** for listeners as they hop from one device to another throughout the day. 75% of premium subscribers listen to Spotify on multiple devices.

This software centric/hardware agnostic approach has helped them achieve scale and ubiquity. We believe this strategy reinforces Spotify's moat as software is more accessible to a wider audience than hardware.



What makes Spotify different?

Two-sided marketplace

Spotify's focus has always been to create a platform which creates value for both the listener and the creator of audio content. This focus allows the artists to engage their audience more effectively while allowing listeners to discover new artists.

This allows Spotify to optimize engagement and benefit both sides of the value chain.

Artists

- Monetization
- Discovery
- Distribution
- Promotion
- Analytics
- Tools for Creation



Listeners

- Playlists and Personalization
- Discovery
- Cross-Platform Flexibility

What makes Spotify different?

Two-sided marketplace

Spotify for artists

“Spotify for artists” allows music creators to directly engage with their listeners on a music platform (instead of a social media platform) and gauge the type of music that resonates best with their fans.

Artists can promote their music to new listeners based on their music preferences/location & sell concert tickets/merchandise.

With Spotify’s acquisition of SoundBetter, a leading global music production and collaboration marketplace, new artists can get all the professional help they need to create studio quality music.

Artists can also pitch their upcoming, unreleased song to Spotify’s playlist editors, who can place those songs on lists such as “Fresh Finds” and “New Music Friday”. Being featured on these playlists can significantly expand an artist's reach.

Spotify views artists as partners; investing in and supporting their growth.

Source: Company Website



What makes Spotify different

Two-sided marketplace

Spotify for listeners

Spotify understands that it is more than a streaming service; it is a “music discovery” platform.

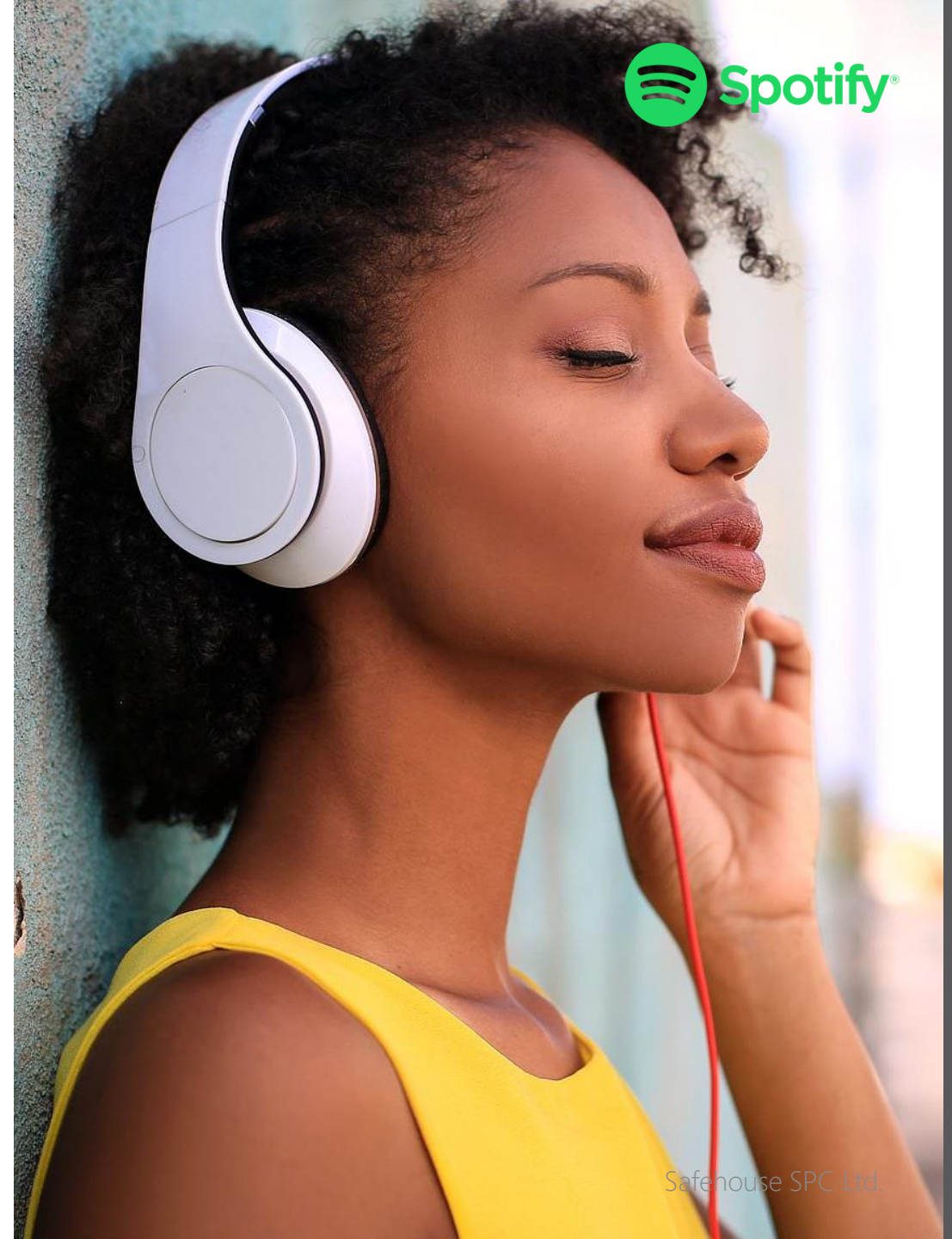
The company is laser-focused on removing all the friction that hinders music discovery. Spotify’s algorithm learns user preferences and makes recommendations. The freemium model allows users to listen to as much content as they like at no marginal cost.

The level of personalization offered by Spotify is unmatched. Listeners can build their own playlists, share them with friends, follow others and switch from device to device without losing any data.

The more time a listener spends on Spotify, the more data points Spotify receives and the more powerful their “discovery” becomes.

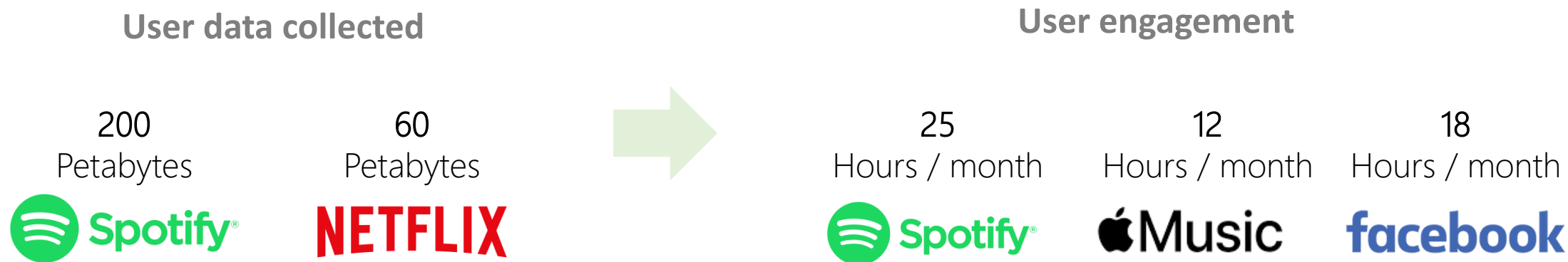
30% of music streamed is recommended by Spotify’s algorithm.

Source: Company Website



Data

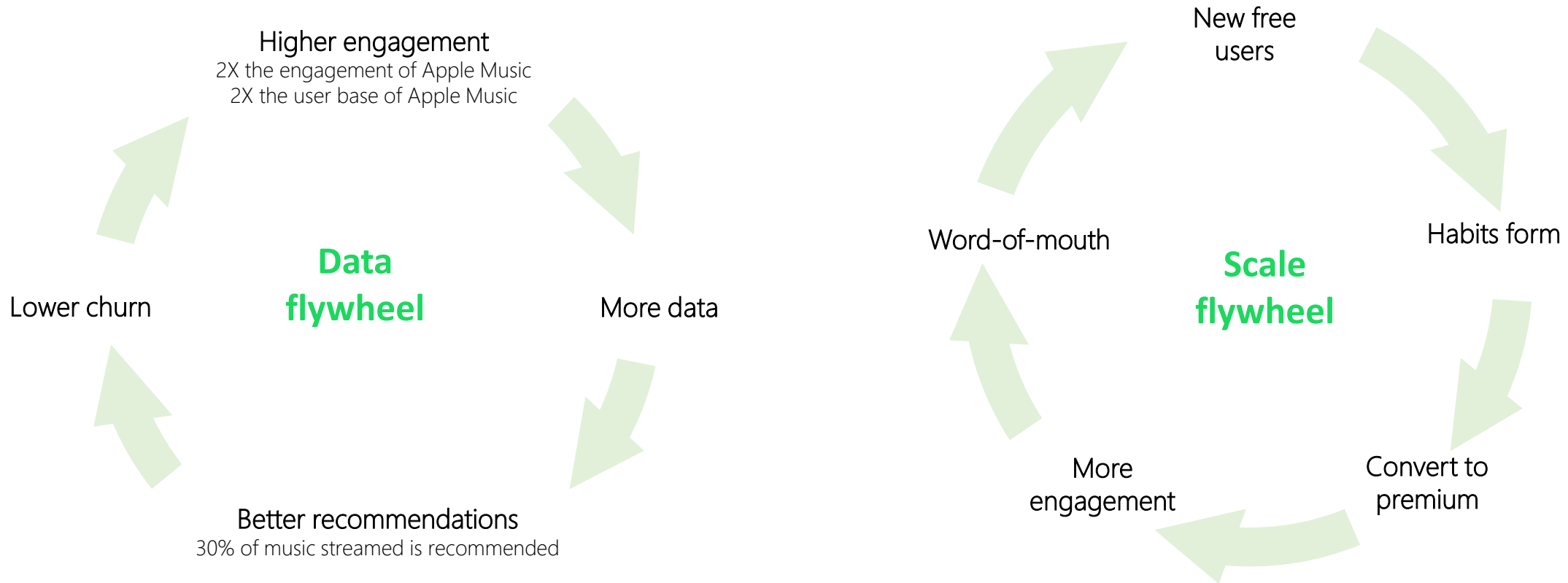
Spotify's collection and use of data gives them unrivaled engagement among peers



"With over 3 billion music events collected per day, Spotify has more than 5x more data than its nearest competitor."
 – Gustav Soderstrom, Chief R&D Officer

The flywheel effect

The largest number of users combined with significantly higher engagement helps Spotify compound it's lead against competitors



Growth drivers

Thus far, most of Spotify's growth has been volume related as global penetration remains low. As the market matures, Spotify may activate a new growth lever.

Growth lever 1: Further penetration

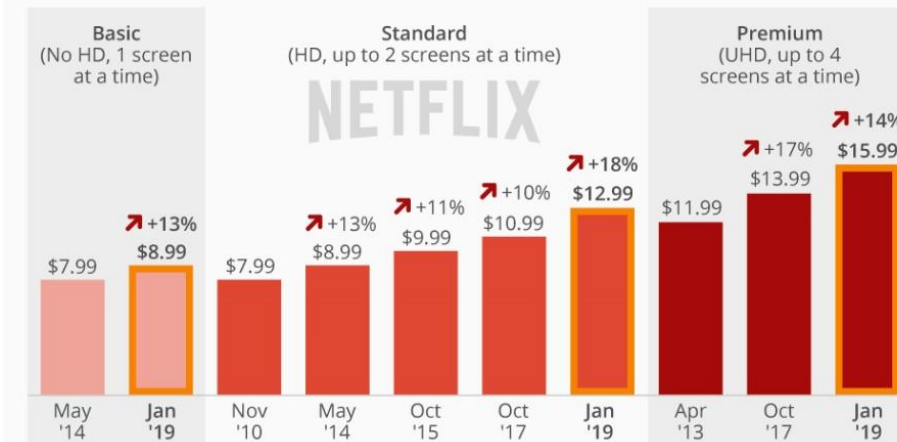
Total Smartphone Users	3,500,000,000
Total Smartphone Users in China	882,000,000
Total Smartphone Users ex. China	2,618,000,000
Spotify Paid Users	138,000,000
Spotify Share ex. China	39%
Implied Total Paid Streaming Ex. China	353,846,154
Implied Global ex. China Penetration	13.5%

Growth lever 2: Price increases

(aided by content differentiation)

A Brief History of Netflix Price Hikes

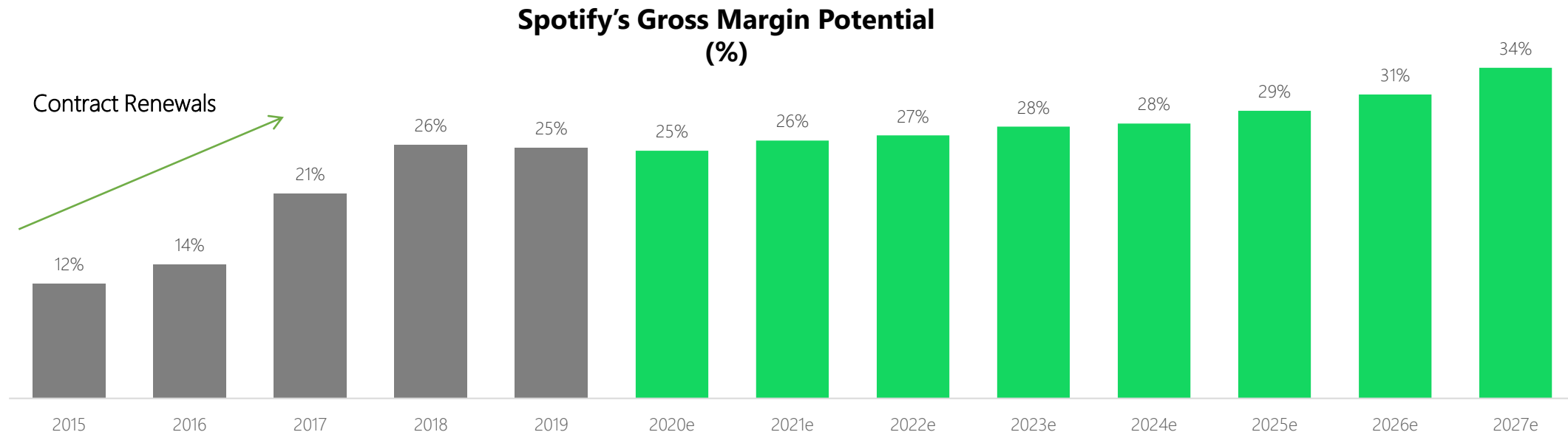
Changes in price of a Netflix subscription in the United States*



Like Netflix, the number of Spotify users can still double from here. We think the company will continue differentiating itself and as the market starts to saturate, it will increase prices. It is a question of when not if.

Gross margin potential

In the past 5 years, Spotify has grown rapidly giving it scale and bargaining power with the big three music studios. Due to its importance, Spotify was able to renegotiate better royalty agreements leading to better gross margins.



We think this is far from over. Apple Music and Spotify account for c. 30% of Warner Music Group's (WMG) revenues and it is likely a similar proportion for the other large music studios. The big three music studios (Universal, Sony, WMG,) control c. 90% of the market today. The more popular streaming becomes and the more revenue it generates for the studios, the more favorable royalty agreements will become for the streaming providers.

Warner Music Group example

Below we show a simple example based on ours and consensus estimates in order to understand how much Apple & Spotify will contribute to revenue in 5 years

Base case assumptions:

- Total revenue grows by 9.5% per year (consensus estimates)
- Apple & Spotify grow by 17.5% per year (Spotify guidance is 15-20%)
- Apple & Spotify account for 30% in 2020 (WMG reported 27% in 2019).

WMG (mn USD)	2020	2021e	2022e	2023e	2024e	2025e
Total Revenue	4,453	4,876	5,339	5,846	6,402	7,010
% growth		10%	10%	10%	10%	10%
Apple & Spotify Share	1,336	1,570	1,844	2,167	2,546	2,992
% growth		18%	18%	18%	18%	18%
% of total	30%	32%	35%	37%	40%	43%
Other Revenue	3,117	3,306	3,495	3,679	3,856	4,018
% growth		6%	6%	5%	5%	4%
% of total	70%	68%	65%	63%	60%	57%

Safehouse assumptions:

- Total revenue grows by 9.5% per year (consensus estimates)
- Apple & Spotify grow by 22.5% per year (Spotify guidance is 15-20%)
- Apple & Spotify account for 30% in 2020 (WMG reported 27% in 2019).

WMG (mn USD)	2020	2021e	2022e	2023e	2024e	2025e
Total Revenue	4,453	4,876	5,339	5,846	6,402	7,010
% growth		10%	10%	10%	10%	10%
Apple & Spotify Share	1,336	1,636	2,005	2,456	3,008	3,685
% growth		23%	23%	23%	23%	23%
% of total	30%	34%	38%	42%	47%	53%
Other Revenue	3,117	3,240	3,335	3,391	3,394	3,325
% growth		4%	3%	2%	0%	-2%
% of total	70%	66%	62%	58%	53%	47%

Streaming will account for c. 40-50% of music studio's revenue in the next 5 years. This will lead to further gross margin expansion as the shift of power away from studios continues.

Competition

Pricing remains uniform across most paid music subscriptions, yet Spotify boasts the highest number and ratio of paid users

Company	Users (mn)	Subscribers (mn)	% Premium	Cost	Per Stream Payout	Free Version
Apple Music	68	68	100%	\$9.99 / month	\$0.0056	No
Amazon Music	55	55	100%	\$7.99 / month	\$0.0120	Only with Prime
YouTube Music	1,000	20	2%	\$9.99 / month	\$0.0080	Yes
Pandora	61	6	10%	\$9.99 / month	\$0.0015	Yes
Deezer	16	7	44%	\$9.99 / month	\$0.0044	Yes
SoundCloud	175	-	-	-	\$0.0000	Yes
Tidal	3	3	100%	\$9.99 / month	\$0.0099	No
Spotify	308	138	45%	\$9.99 / month	\$0.0032	Yes

Along with Deezer, Spotify has a healthy ratio of premium subscribers which we believe is vital for balancing scale and monetization.

Spotify also has close to two times more paid subscribers than Apple Music and has the widest funnel outside of YouTube and SoundCloud.

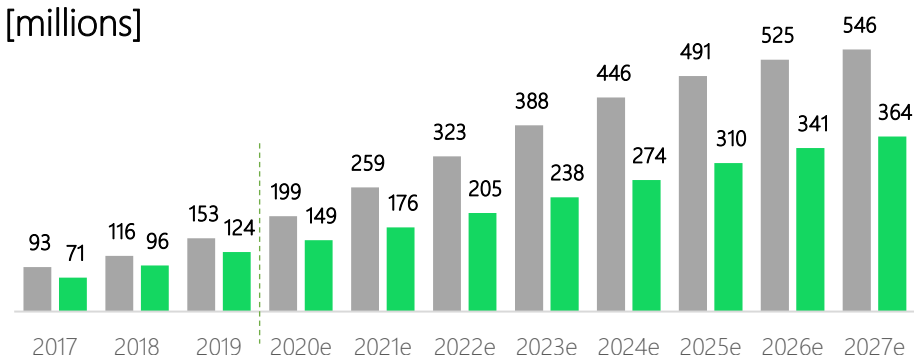
Business fundamentals

User growth

Ad-Supported MAUs

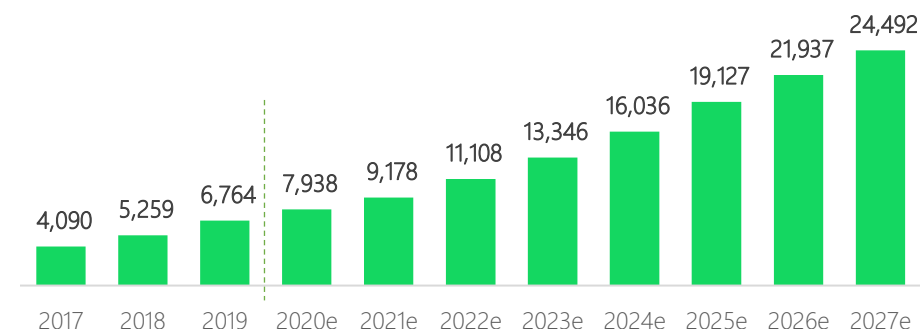
Premium subscribers

[millions]



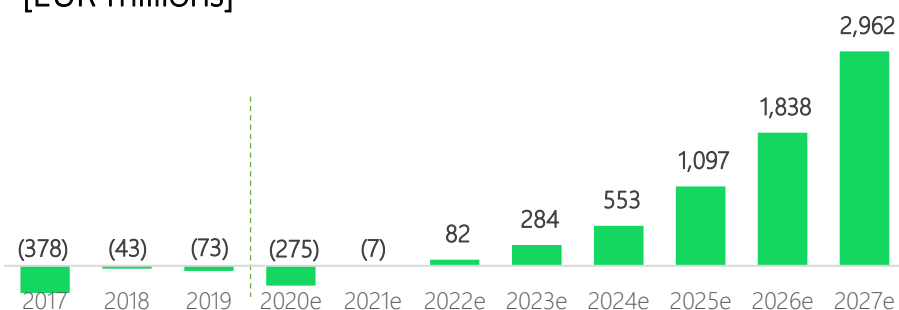
Revenues

[EUR millions]



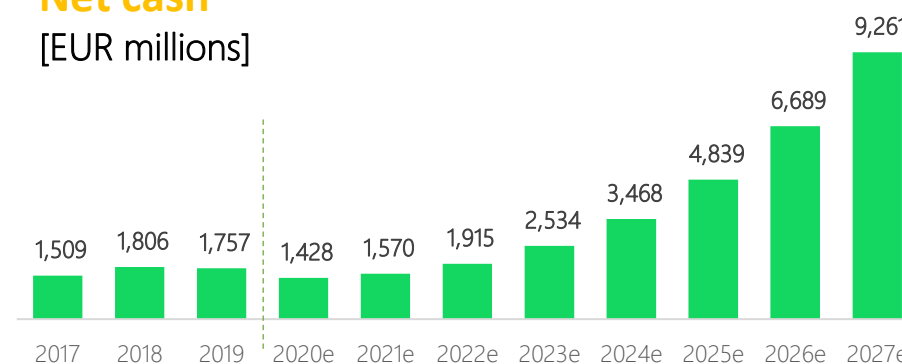
Operating profits

[EUR millions]



Net cash

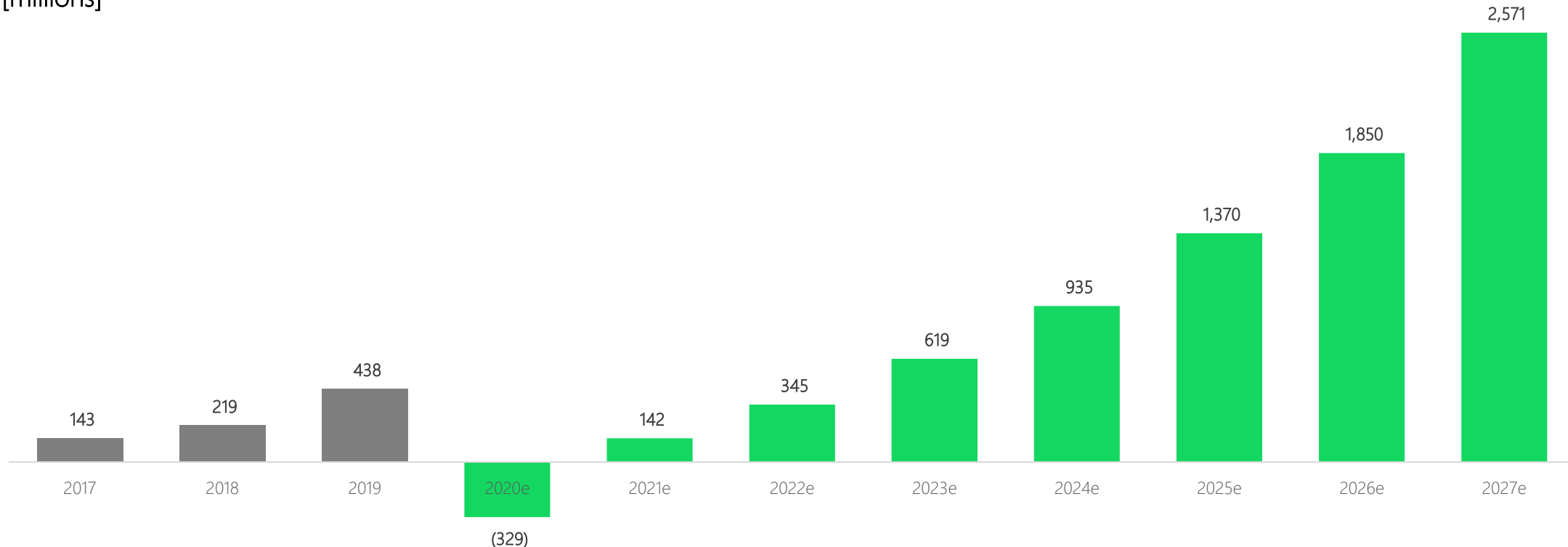
[EUR millions]



Cash is king

While Spotify is not profitable, it has been free cashflow positive for some time. This has given the company ammunition to invest.

Free cash flow [millions]



Acquisitions

The company has been allocating cash towards strategic acquisitions on both the technology and content side. We believe this will increase in tandem with cash generation.

2013	Tunigo	Music discovery app
2014	The Echo Nest	Music intelligence and data platform for developers and media companies
2015	Seed Scientific	Data driven analytics provider for personalization/recommendation
2016	Cord Project	Short voice messaging app
	Soundwave	Music discovery app
	CrowdAlbum	Photo/video aggregator
	Preact	Cloud based subscription improvement company
2017	Sonalytic	Audio detection startup
	Mighty TV	Video streaming app
	Mediachain Labs	Blockchain startup
	Niland	Machine learning algorithms for music search & discovery
2018	Soundtrap	Digital audio workstation
	Amy Schumer	Originals/Exclusive
	Joe Budden	Originals/Exclusive
	Loudr	An artist royalty track and payment company
2019	Obama/Higher Ground	Originals/Exclusive
	Parcast	A storytelling-driven podcast studio
	Gimlet Media	An award-winning narrative podcasting company
	Anchor	A free platform for podcast creation
2020	DC Comics	Licensing/Exclusive
	Kim Kardashian	Licensing/Exclusive
	Joe Rogan Experience	Licensing/Exclusive
	The Ringer	A podcast and media company founded by Bill Simmons

Podcasts

This year, Spotify ramped up its investments into exclusive Podcasts, this is a game changer

The global podcasting industry has a market size of c. USD 10bn. It is expected to grow at over 20% per year for the next 10 years.

Spotify signed exclusive deals with Joe Rogan, Michelle Obama, Kim Kardashian, DC Comics, Amy Schumer and Joe Budden.

There are several reasons why we believe this will create significant value for Spotify:

1. This will increase the proportion of fixed costs within their cost structure which is overwhelmingly variable today
2. This will help the company acquire new users/subscribers
3. This will help the company offer differentiated and unique content
4. This will help the company gain a lead in the high growth podcasting market

As Spotify continues to invest in unique and exclusive content, the user acquisition combined with the fixed cost structure of these contracts will allow the company to improve the bottom line due to better operating leverage. We expect Spotify to continue making similar deals due to the reasons mentioned above.

JRE podcast

Signing a USD 100mn multiyear deal with Joe Rogan Experience (JRE) is not as expensive as it sounds

		Assumptions
JRE # of monthly listeners	12,000,000	As of May 2020
% conversion to Spotify	30%	Safehouse assumption
New Users on Spotify	3,600,000	
% Paid Subscribers	45%	Current ratio of premium subscribers on Spotify
# of Paid Subscribers	1,620,000	
% Free Users on Spotify	55%	
# of Free Users	1,980,000	
Price/Paid Subscriber/Year (USD)	63.72	Current Average Annual ARPU
Price/Free User/Year (USD)	5.64	Current Average Annual ARPU
Annual Revenue from Paid Subs (USD)	103,226,400	
Annual Revenue from Free Users (USD)	11,167,200	
Total Annual Revenue (mn USD)	114,393,600	

We believe the company can generate over USD 100mn in revenue per year relative to the one-time investment of USD 100mn paid to Joe Rogan

Valuation

We expect upside of 73-210% over the next 5 years

Base Case

Assumptions (mn EUR)	2020e	2025e
Ad Supported Users (mn)	199	491
% CAGR		20%
Paid Subscribers (mn)	149	310
% CAGR		16%
MAUs	348	801
% CAGR		18%
Ad Supported ARPU (EUR)	0.32	0.64
% CAGR		15%
Subscriber ARPU (EUR)	4.44	4.44
% CAGR		0%
Revenue	7,938	19,127
% CAGR		19%
Gross Profit	1,994	5,579
% margin	25.1%	29.2%
EBITDA	(172)	1,479
% margin	-2.2%	7.7%
Valuation	2020e	2025
EV/ Sales	5.1x	3.5x
Enterprise Value (mn USD)	40,232	66,945
Less Net Debt	(1,157)	(4,839)
Market Cap (mn USD)	41,389	71,784
Shares Out (mn)	185.80	185.80
Share Price (USD)	262.86	455.89
% Upside/(Downside)	N/A	73.4%
Discounted to today (USD)		310.3
% Upside/(Downside)		18.0%

Bull Case

Assumptions (mn EUR)	2020e	2025e
Ad Supported Users (mn)	199	631
% CAGR		26%
Paid Subscribers (mn)	149	320
% CAGR		17%
MAUs	348	952
% CAGR		22%
Ad Supported ARPU (EUR)	0.32	0.70
% CAGR		17%
Subscriber ARPU (EUR)	4.44	5.39
% CAGR		4%
Revenue	7,938	24,325
% CAGR		25%
Gross Profit	1,994	7,540
% margin	25.1%	31.0%
EBITDA	(172)	4,902
% margin	-2.2%	20.2%
Valuation	2020e	2025
EV/ Sales	5.1x	5.0x
Enterprise Value (mn USD)	40,232	121,624
Less Net Debt	(1,157)	(6,980)
Market Cap (mn USD)	41,389	128,604
Shares Out (mn)	185.80	185.80
Share Price (USD)	262.86	816.75
% Upside/(Downside)	N/A	210.7%
Discounted to today (USD)		555.9
% Upside/(Downside)	N/A	111.5%

Valuation

At half of Netflix's multiple, the stock has upside of over 100%

USD mn	Peloton	Netflix	Stitch Fix	Tencent Music	Teledoc	Spotify
Enterprise Value	37,605	244,611	3,389	22,097	18,227	47,188
Paid Subscribers (mn)	1.4	192.5	3.0	47.1	43.0	138.0
EV / Subscriber (USD/subscriber)	26,861	1,271	1,130	469	424	342
Netflix Premium to Spotify	3.7x					
Implied EV Valuation at 50% of Netflix	87,679					
Less: Net Debt	1,157					
Market Cap	88,836					
Share count (mn)	186					
Share Price (USD)	563					
Upside/(Downside)	116%					

Management



In the last ten years...



Grew its revenues 15 times



Grew its revenues 260 times



Grew its revenues 1,672 times

What do all these companies have in common with  Spotify ?

...they are all **founder led companies**

We believe it is vital for disruptive companies to keep their founders at the helm in order to truly execute their vision and achieve their true potential

Risks

- Further consolidation between music studios puts pressure on royalty agreements leading to worsening gross margins
- Consolidation of streamers excluding Spotify will increase competition impact user growth and/or churn
- Pushback from artists on pay per stream prices (happened in the past with Taylor Swift)
- Launch of a new streaming service by competitors like Netflix which could offer an audio/video streaming bundle
- Introduction of a freemium model by Apple which could hinder user growth
- Unfavorable renegotiation of Podcast agreements once up for renewal
- Continued bundling of services by competitors (Apple & Amazon) limit Spotify's ability to increase prices
- Regulation of artist royalties

Audio's Opportunity and Who Will Capture It

by Matthew Ball

"TV achieved full penetration in the United States (90%) by 1961, at which point the average family watched five hours per day. Over the next 40 years, television went from being free to costing a minimum of \$60 per month. And while many households expressed annoyance at the volume of unwanted channels they were forced to buy, the diversity and quality of the content in the cable bundle led to a nearly 75% increase in view time. Investments in audio should have a similar impact, while also allowing Spotify to hike its price (thus lifting industry revenues)."

"The company's self-service podcast creation platform, Anchor, now allows podcasters to instantly integrate any of Spotify's 40 million licensed songs into their shows and without needing to manage licensing, royalties, etc. This means anyone can be a fully-fledged DJ and produce their own radio shows. In addition, audio journalists can feature as much music (and as much of an individual track) as they'd like in their reports or discussions, rather than needing to just talk about a song or limit playback to a few seconds. Spotify's interactive platform also allows the user to instantly add songs they hear snippets of to their library or pause the podcast to listen to the entire track."

"Meanwhile, Spotify and Apple Music have not just the majority of an artists' fans on their platforms, but also the greatest insight into these fans. No one can do a better job of reaching Beyoncé fans than Spotify — including Beyoncé. And it costs the company nothing to reach them."

Please reach out to us at safehousecap.com

