

Desautels Capital Management

Consumers Industry Review

Consumers

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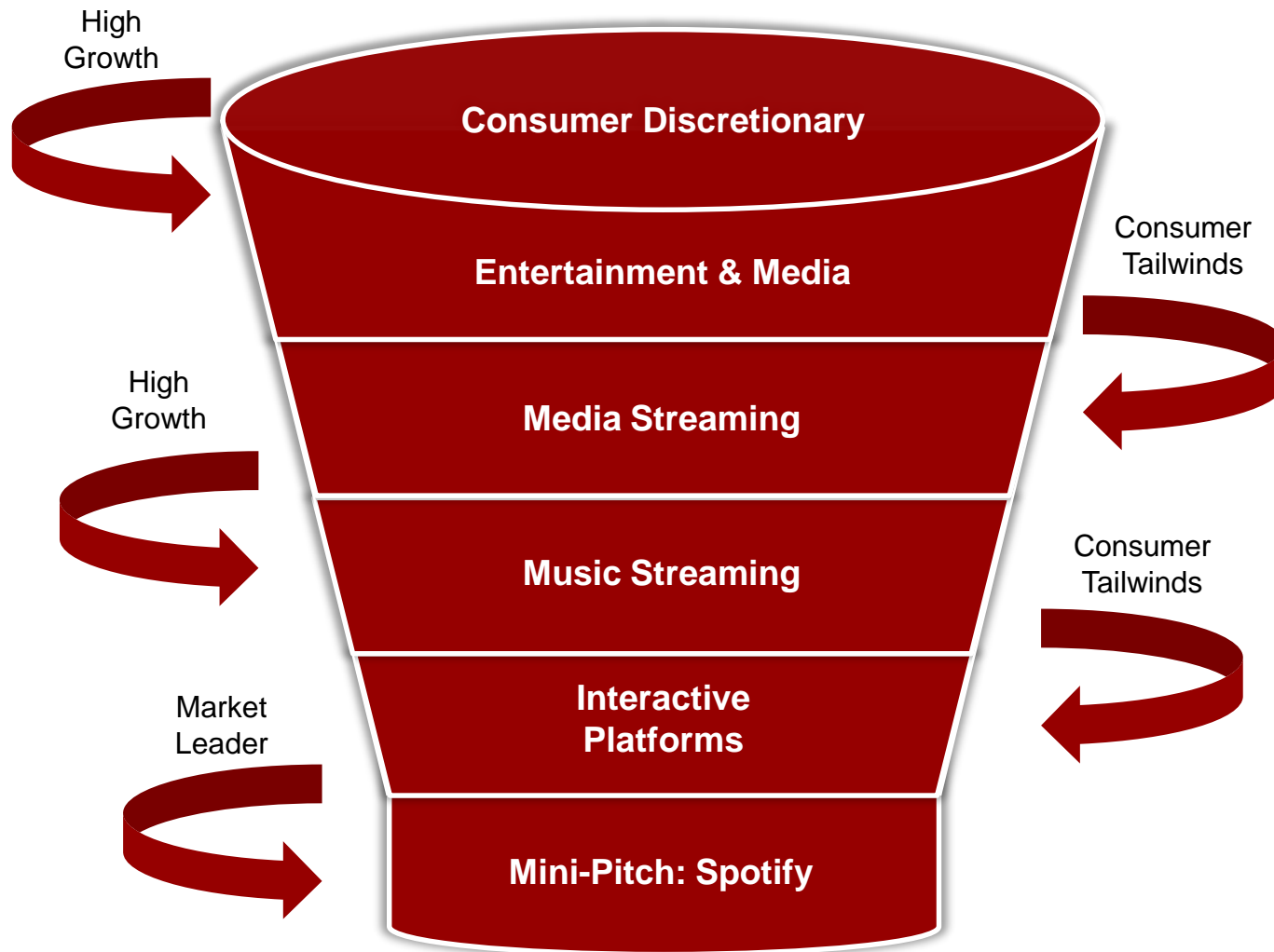
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Structure Overview



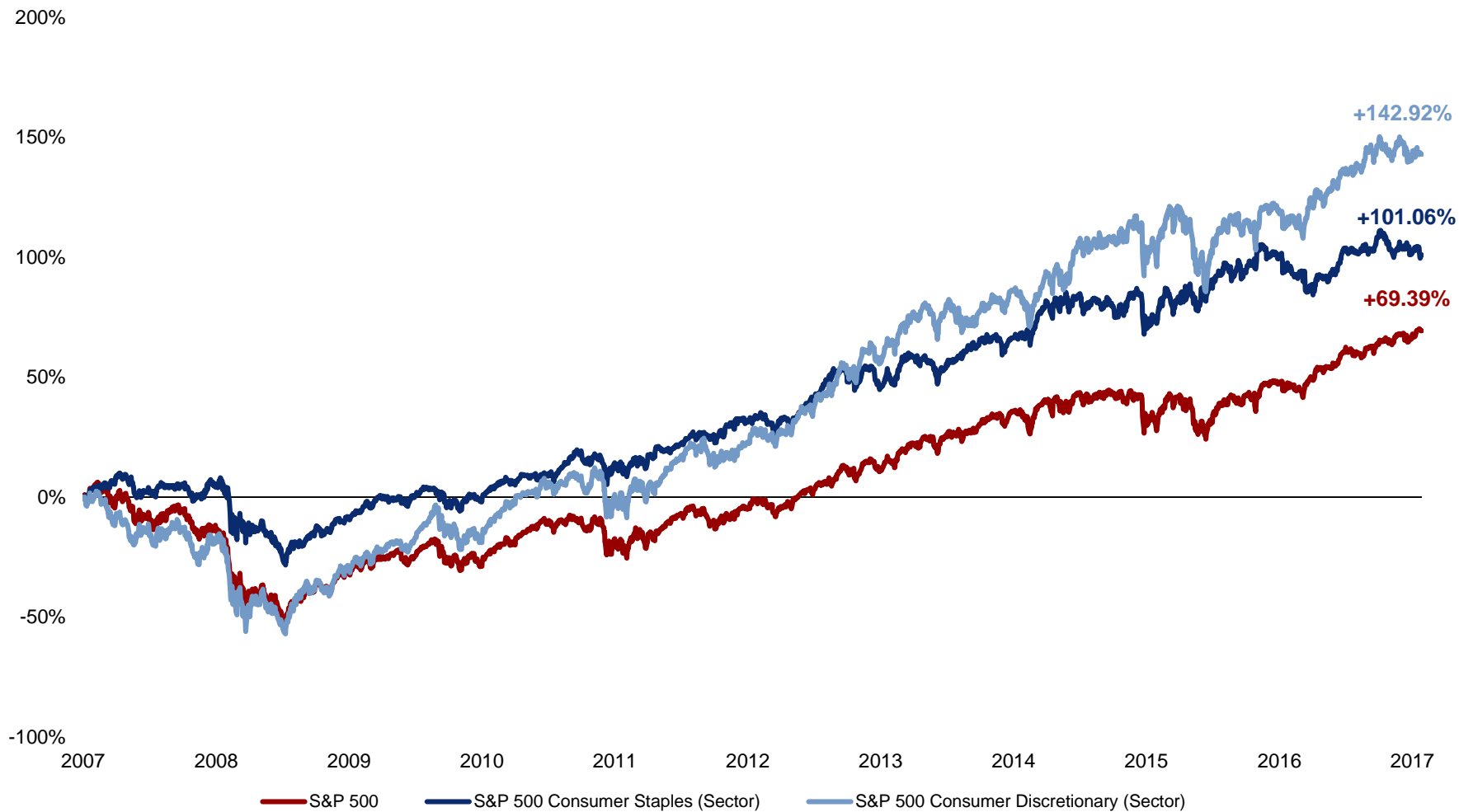
Consumers Sector Outlook

SECTION I

Macroeconomic Environment

Consumers Sector Outperformance

Equity Market Valuations: Bull Market for 10+ Years

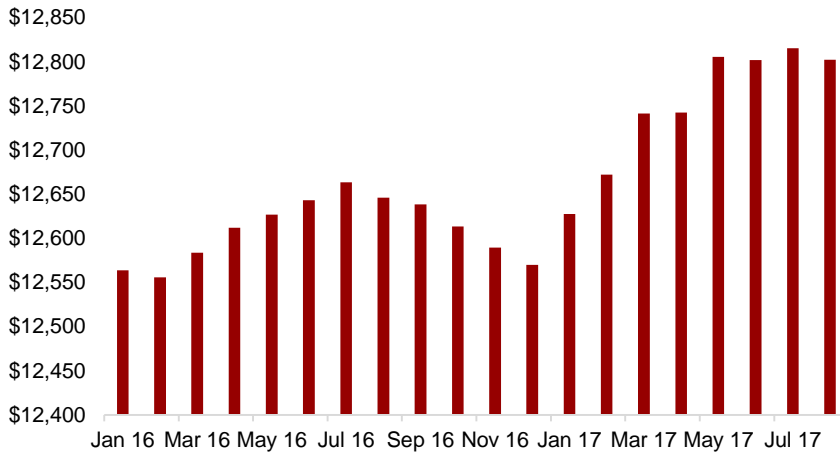


Source: Bureau of Economic Analysis, Capital IQ

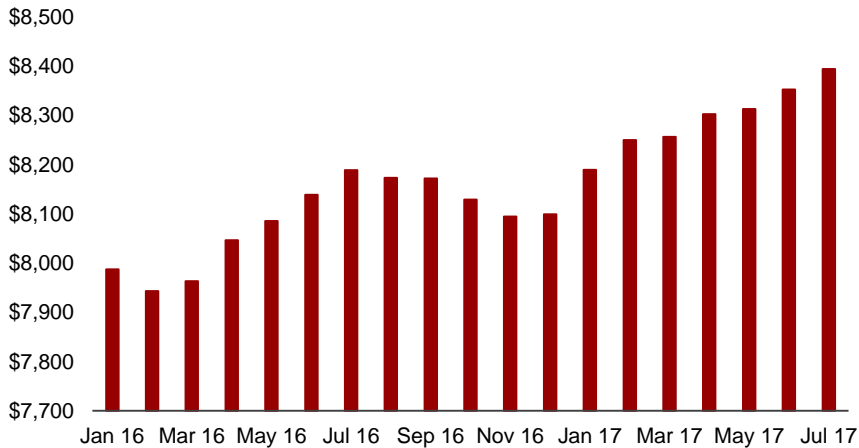
Macroeconomic Environment

Macro Indicators Show that Economy is Approaching its Peak

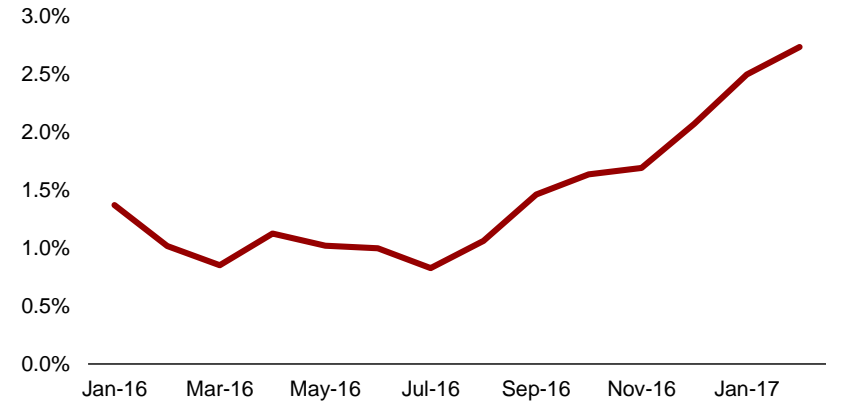
U.S. Real Disposable Income (billions)



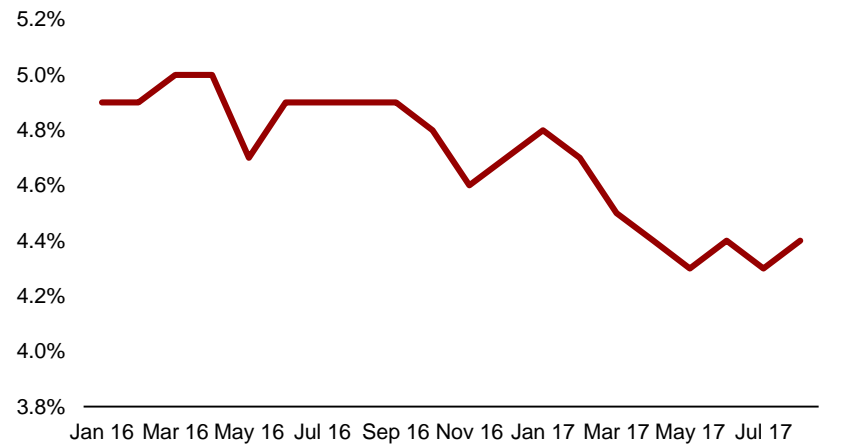
Wage Growth



Inflation: Annual US CPI Growth



Unemployment Rate



Source: Bureau of Economic Analysis, Capital IQ

Consumers Sector

U.S. Consumer Sector Snapshot

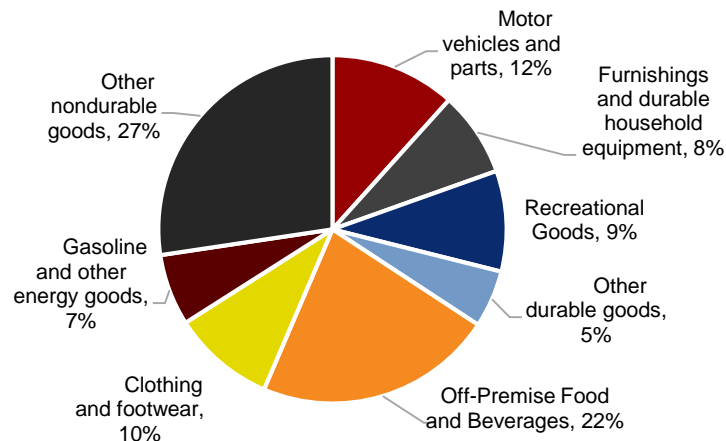
The U.S. Consumer

- August 2017 consumer confidence index rose by 2 points and remained at its 6 month high of 122.9
- Although the fed is expected to continue to raise rates they are expected to be gradual
- The U.S. unemployment rate is low and initial jobless claims continue to indicate further growth in employment.
- Wage growth has improved, which should continue as the labor market remains quite tight.
- Change in spending mix as millennials make up a greater percentage of total retail spending

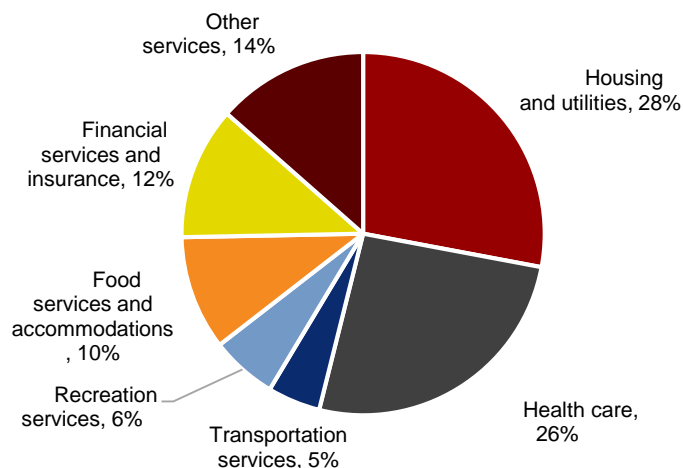
Retail Outlook

- In August, the Census Bureau reported a robust 0.6% gain in sales m/m while the previous month was reported a 0.3 % gain
- The Census Bureau also showed that department store sales fell 3.3% over the year ago period, while non-store retailers (online) rose a robust 10.5%
- We believe this is helping to “right size” the retail industry that had seen oversupply
 - Similar to the creative destruction seen in the oil industry over the last year

U.S. Goods Spending Breakdown (32% of Total)



U.S. Services Spending Breakdown (68% of Total)

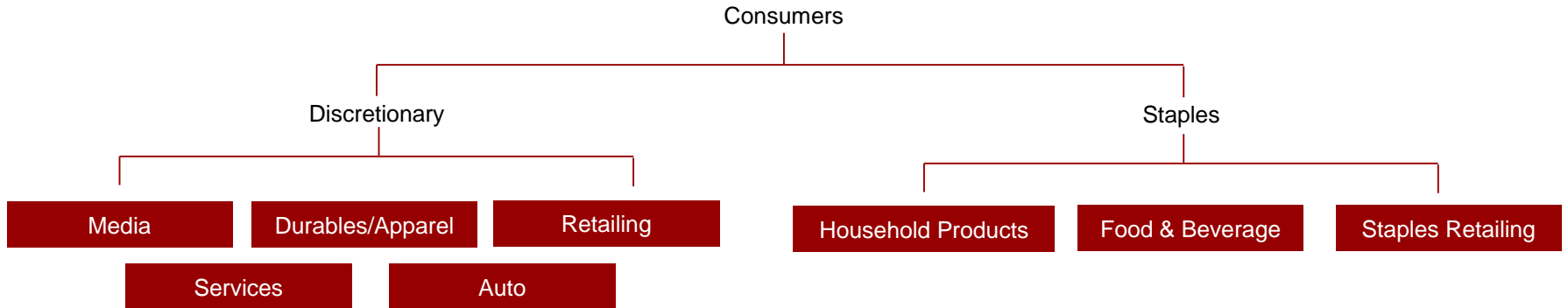


Source: Bureau of Economic Analysis, Capital IQ

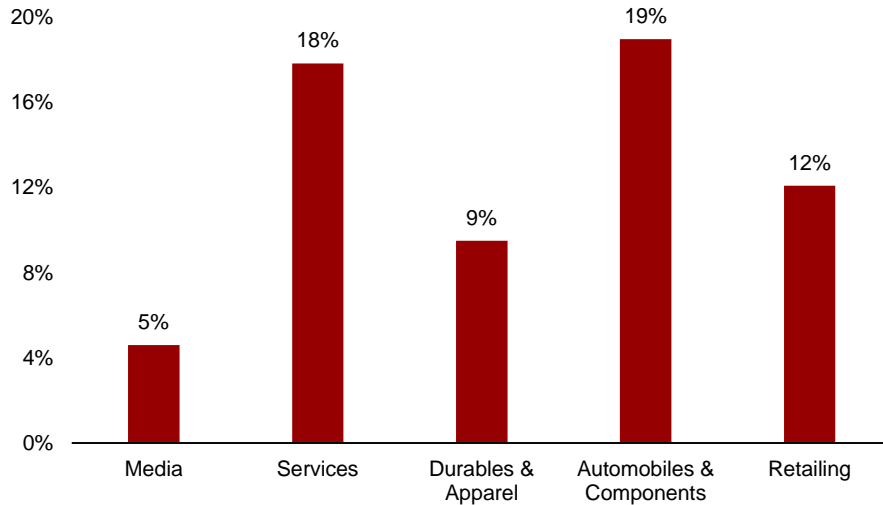
Consumers Sector

Overview of Consumers

Consumers Overview

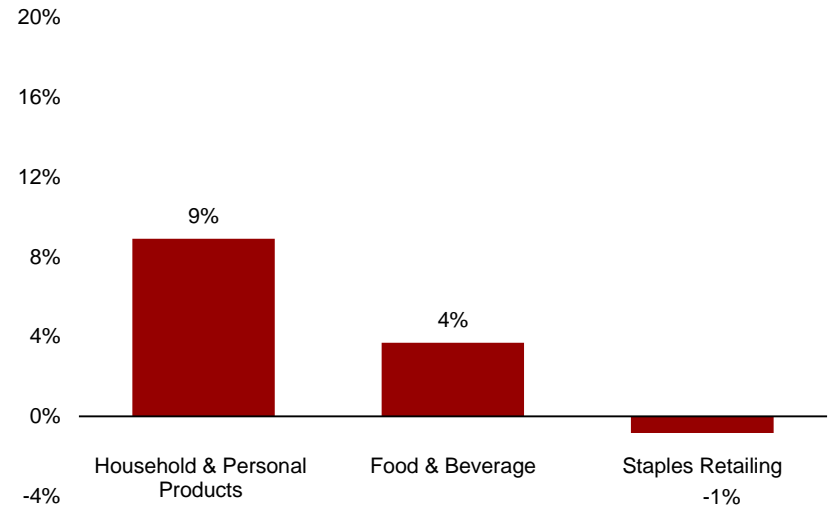


Consumers Discretionary Growth (LTM)



Source: Bloomberg

Consumers Staples Growth (LTM)



Entertainment & Media

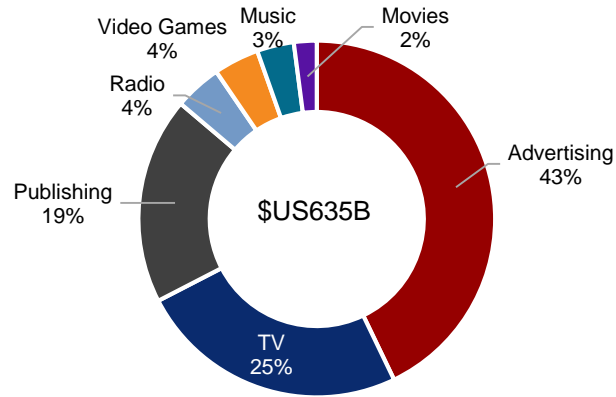
SECTION II



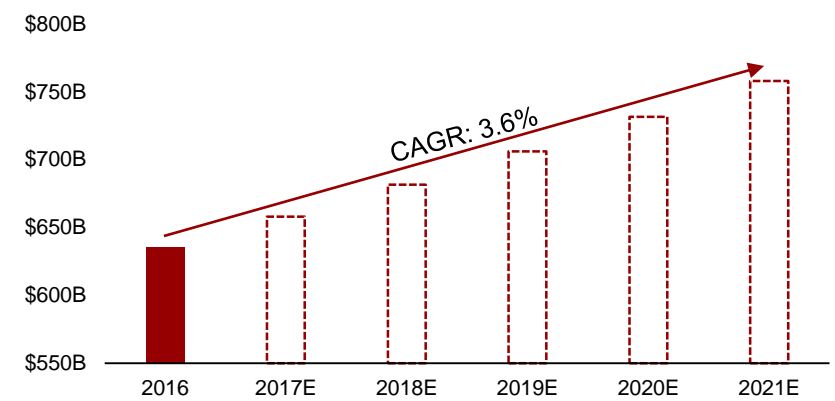
Entertainment & Media Overview

Technological Innovation Resulting in High Growing Subsectors

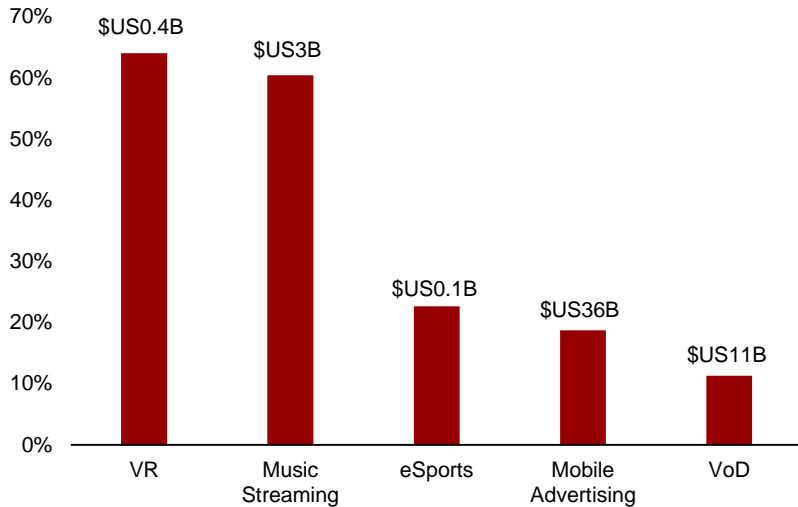
US E&M Industry Constituents



US E&M Industry Growth



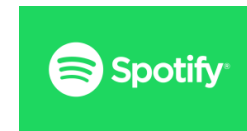
Fastest Growing E&M Subsectors (2016-17)



Traditional "Tech Companies" Dominating Consumers Sector

NETFLIX

ACTIVISION®



hulu



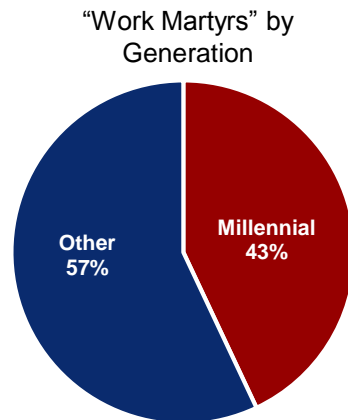
Source: Capital IQ, PwC

Trends in Entertainment & Media

Passive Entertainment

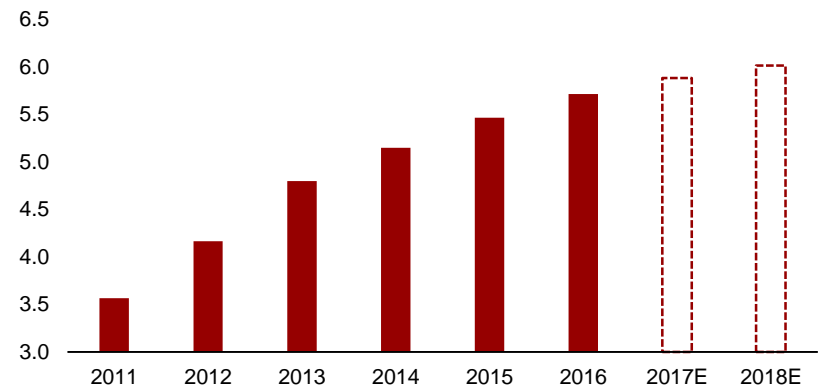
Millennials – Not as Lazy as You May Have Thought

- Project Time Off conducted a survey on “Work Martyrs”
 - “No one else at my company can do the work while I’m away.”
 - “I want to show complete dedication to my company and job.”
 - “I don’t want others to think I am replaceable.”

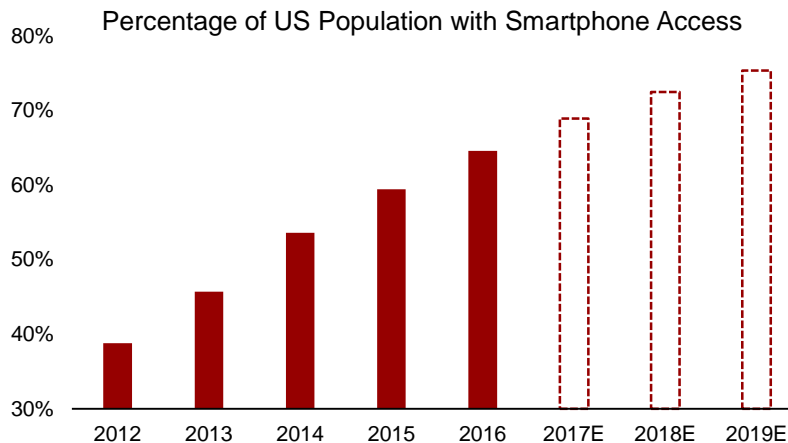


Digital Media A Growing Portion of Consumers Lives

Hours Spent on Digital Media



Smartphone Usage Means Digital Media Accessed From Anywhere



Rise in Passive Entertainment

- As millennials represent a growing portion of the US population, the “average” consumer will become busier
- Despite this, consumption of digital media is on the rise
- This paradox is due to consumers consuming media more passively
 - Ex. Watching VoD while eating
 - Ex. Listening to music in the shower
- Companies that can offer passive, convenient, and engaging entertainment will be more appealing to consumers

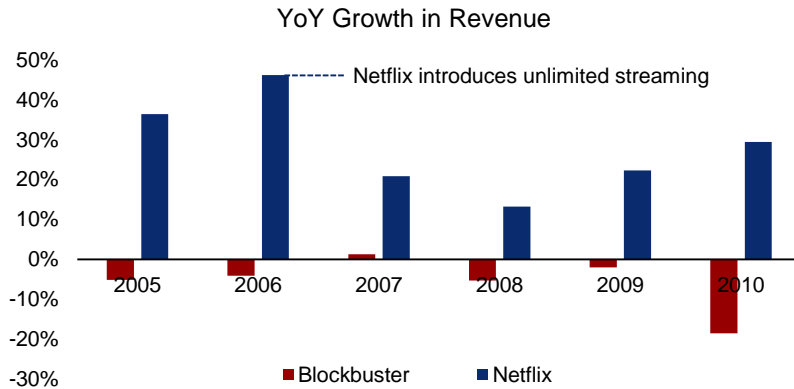
As consumers become busier, passive entertainment becomes increasingly important.

Source: Bureau of Economic Analysis, Harvard Business Review

Trends in Entertainment & Media

Rise of All-Access Models

Case Study: Blockbuster Goes Belly Up



PwC: Access is the New Ownership



86% of millennials agree access makes life more affordable



83% agree access makes life more comfortable

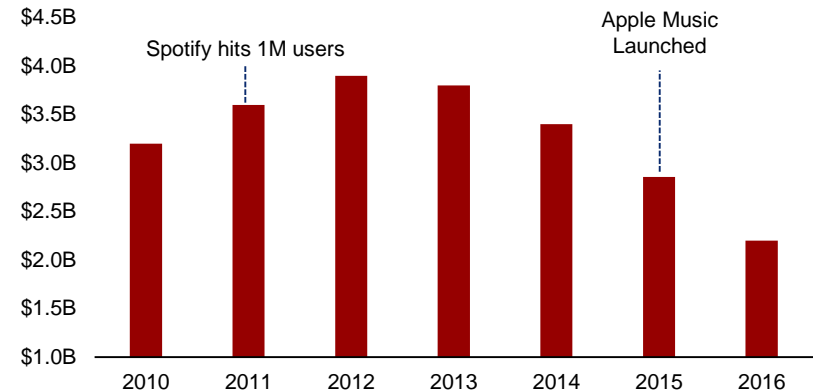


57% agree access is the new ownership



43% agree owning feels like a burden

Case Study: Drop off in iTunes Sales after Launch of Apple Music



Passive Entertainment Drives Popularity of All-Access Model

- Rise in passive entertainment leads to increasing demand for all access models
 - Pay a set fee for unlimited access rather than purchasing products/services one-by-one
 - Reduces time spent searching for product (aligns with millennials becoming busier)
 - Increases optionality and convenience
- More economical option for mass consumption

Millennial generation is driving the rise of all-access models.

Source: Company Reports, PwC

Trends in Entertainment & Media

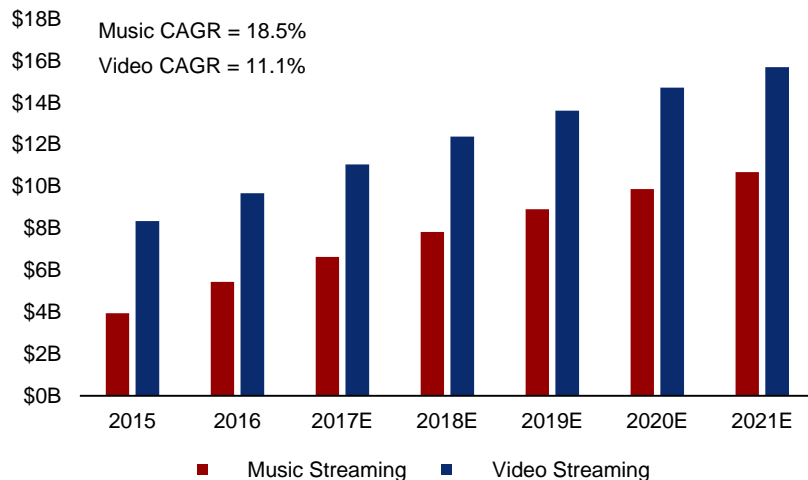
Music Streaming Capitalizing on Trends Best

E&M Markets that Capitalize on Trends

Market	Passive Entertainment	All Access Model
Amusement Parks	✗	✓
E-Sports	✓	✗
Fitness Centers	✗	✓
Music Streaming	✓	✓
Video Streaming	✓	✓

Capitalizing on both trends within E&M

Global Music Streaming Growth



Music Streaming Offers Stronger Investment Opportunity

- 1 Music streaming is growing faster
- 2 Music streaming is a newer, more relevant trend
- 3 Market leader is still private (less scrutinized industry)

Music streaming is the fastest growing market amongst those segments that capitalize on highlighted consumer trends.

Source: Statista

Music Streaming

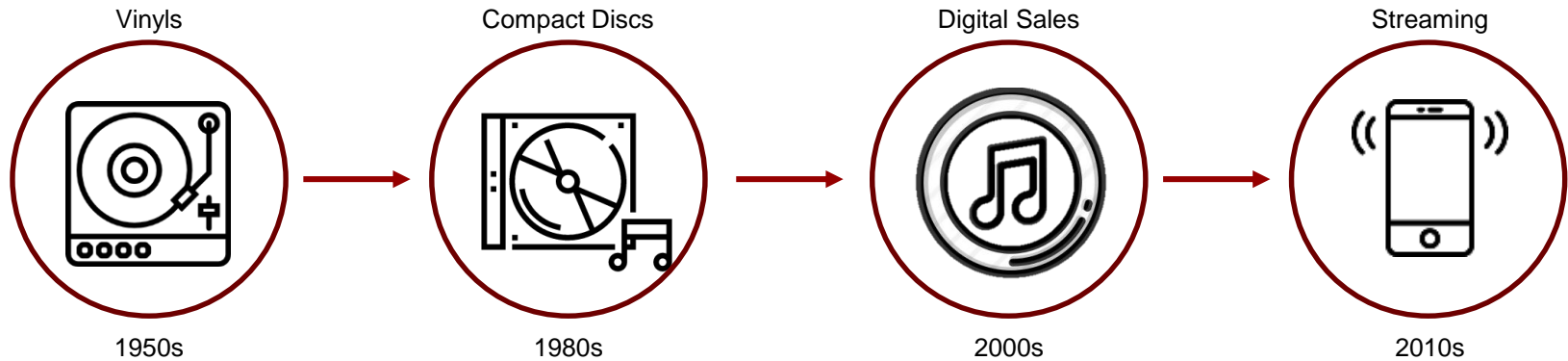
SECTION III



Music Streaming Overview

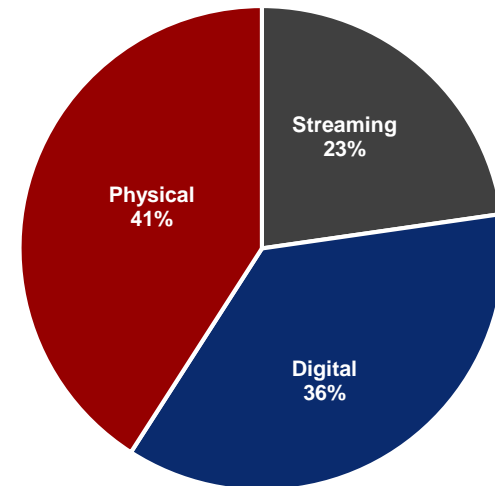
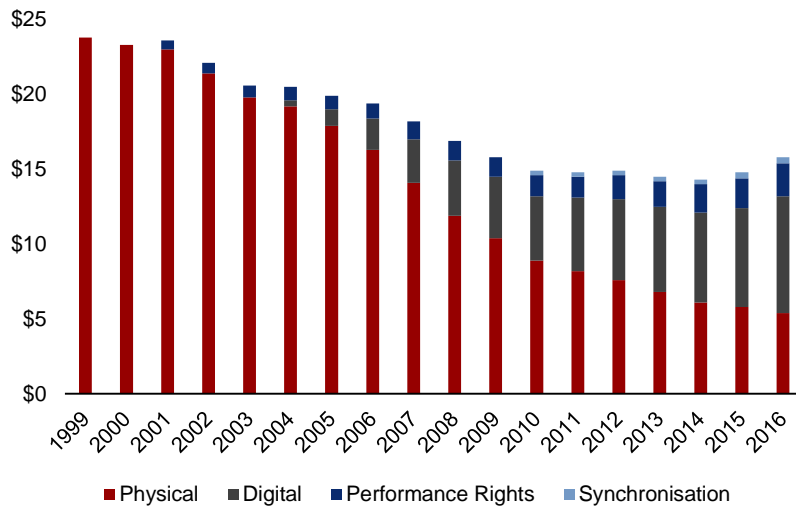
Evolution of Music Consumption

History of Music Consumption



Global Recorded Music Industry Revenue (US\$ Billions)

Music Consumption by Platform (Percentage of Total Sales)

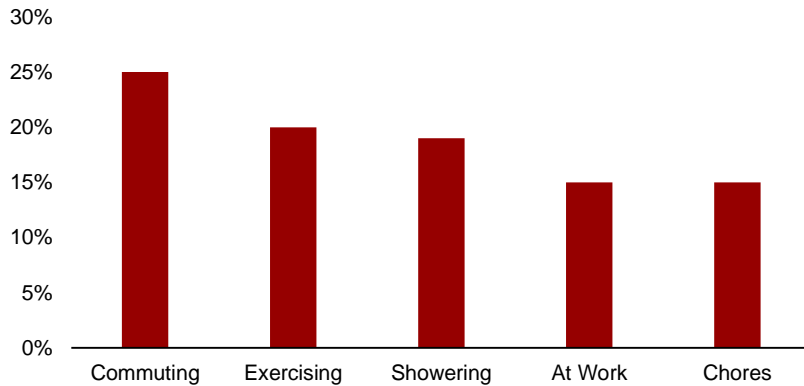


Source: IFPI 2017 Global Music Report

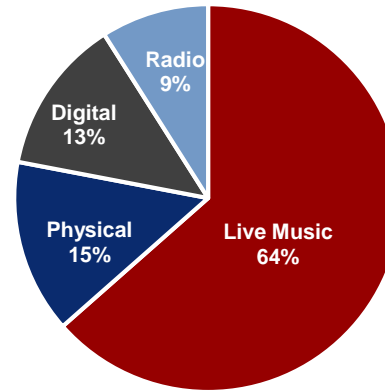
Music Streaming Overview

Evolution of the Fan

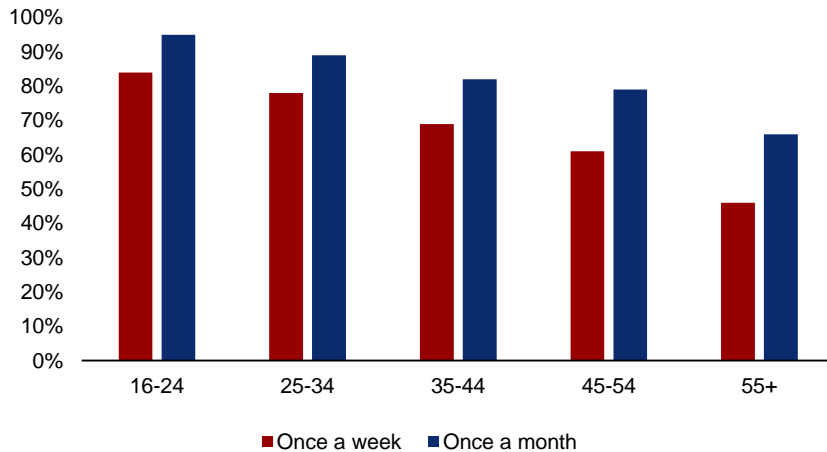
Fans Increasingly Listening to Music Passively



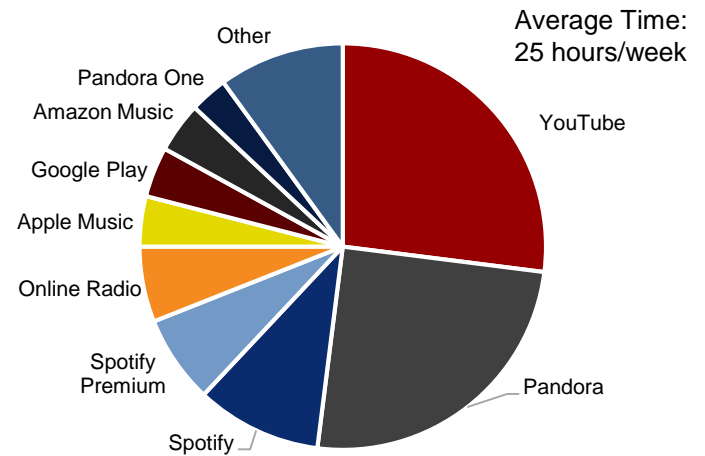
Digital Representing Growing Portion of Average Music Spend



Demographics of Streaming Listeners



Time Spent Listening Per Week Per Platform



Technology has transformed both the supplier and consumer side of the music industry.

Source: Nielsen, Statista

Why Music Streaming Came to Be

Napster's Introduction Transformed the Music Industry

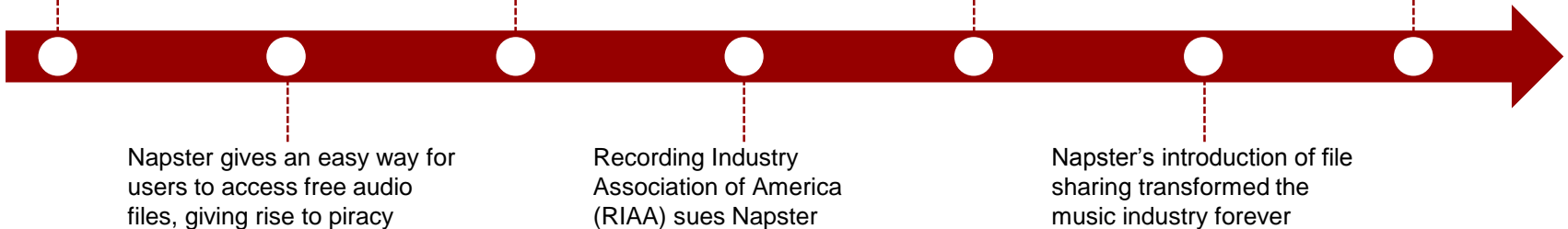
Sean Parker: Not Just the Dude from *The Social Network*

1999: Parker founds Napster, first P2P network designed for sharing digital music

2000: Napster peaks with 80M users sharing pirated audio files

2001: RIAA wins court battles, forcing Napster to shut down network for good

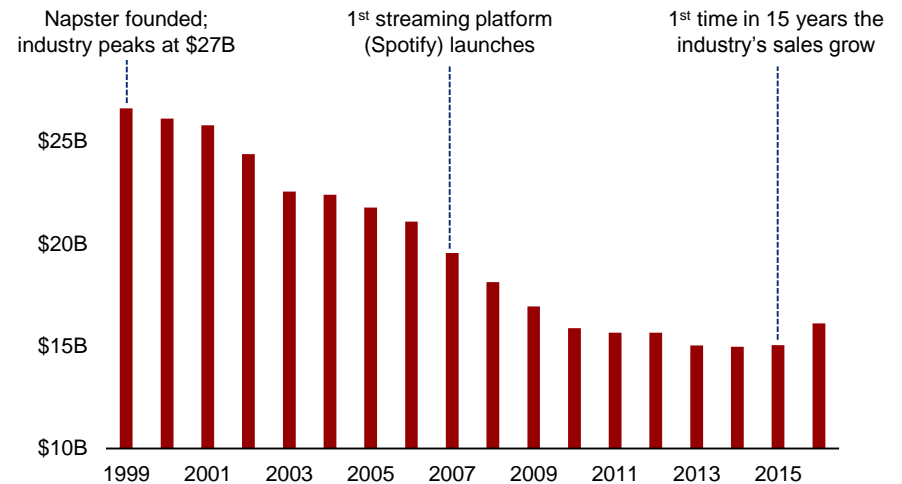
2014: Music industry experiences 15 years of declining revenue



Despite Napster's Demise, Piracy Stuck Around



Global Music Industry Sales (US\$B)



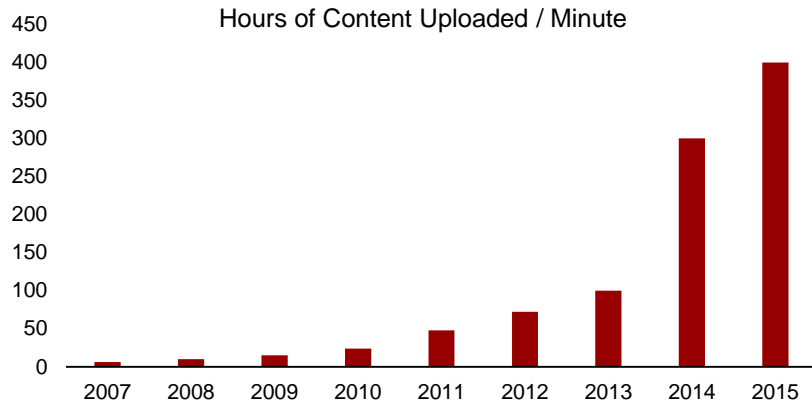
Introduction of Napster transformed the music industry due to the ensuing rise of piracy.

Source: Lifewire, Music Business World

Why Music Streaming Came to Be

Streaming: The Industry's Answer to Piracy

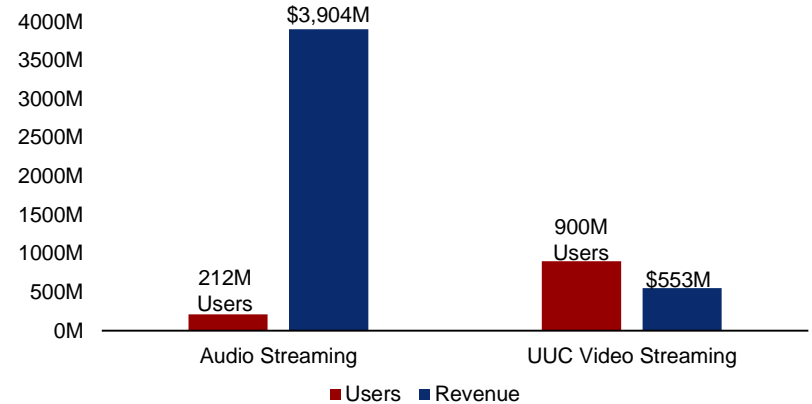
Rise of YouTube



Why Streaming Was the Answer for Consumers

- 1 Greater convenience aligned with busier consumers
- 2 All-access model coincided with the rise of the smartphone
- 3 Unlimited usage model aligned with access over ownership

Value Gap: UUC Represents a Disproportionate Amount of Sales



Why Streaming Was the Answer for Suppliers

- 1 Converting YouTubers to paid subscribers meant higher \$
- 2 Convenient way to consume may result in lower piracy
- 3 Artists could reach a large audience with minimal effort

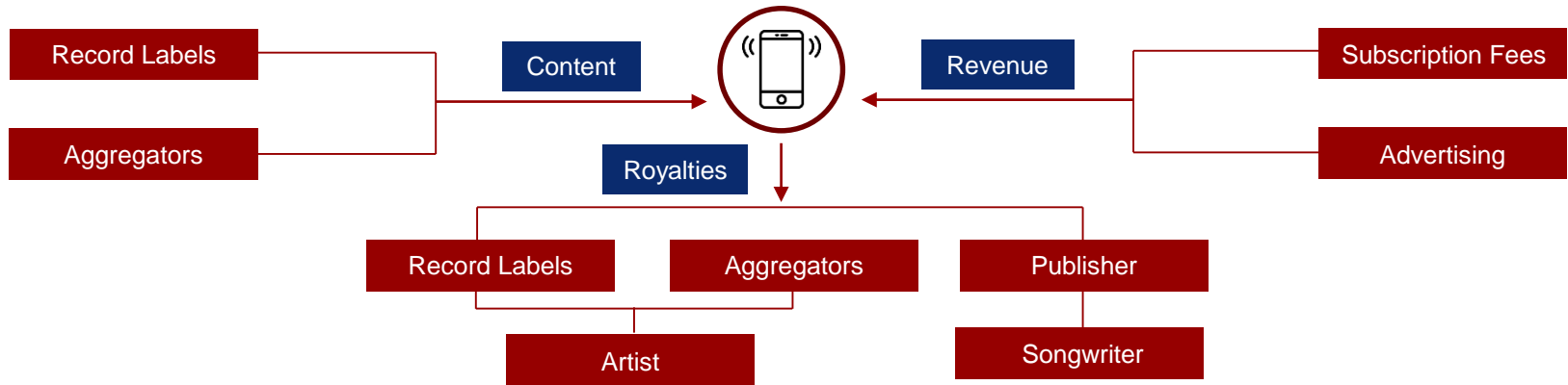
Music streaming represented a solution that answered both the consumer's and the supplier's needs.

Source: IFPA, Statista

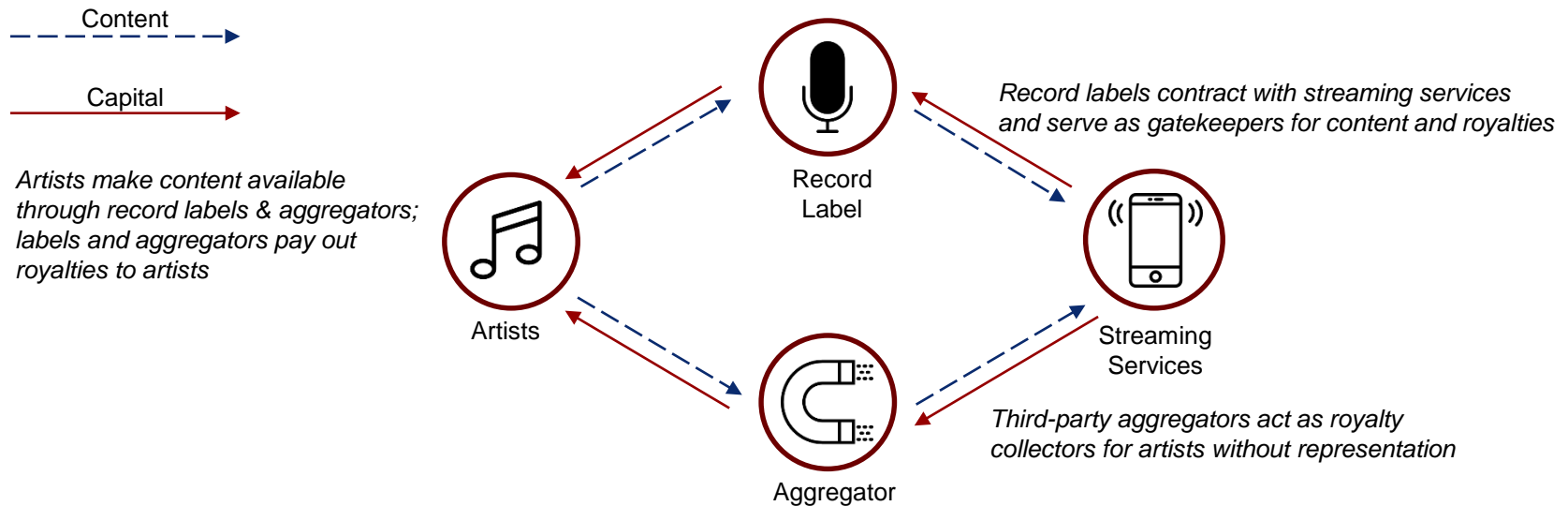
Business Model

Boils Down to an Agency Model

Business Model



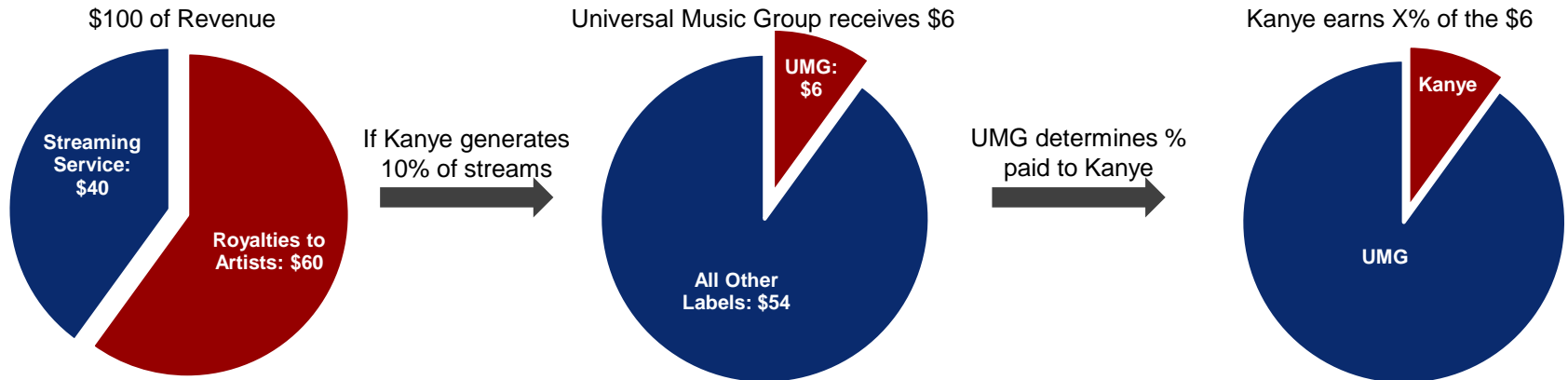
Uploading Content



Business Model

Agency Model Implies High Variable Costs

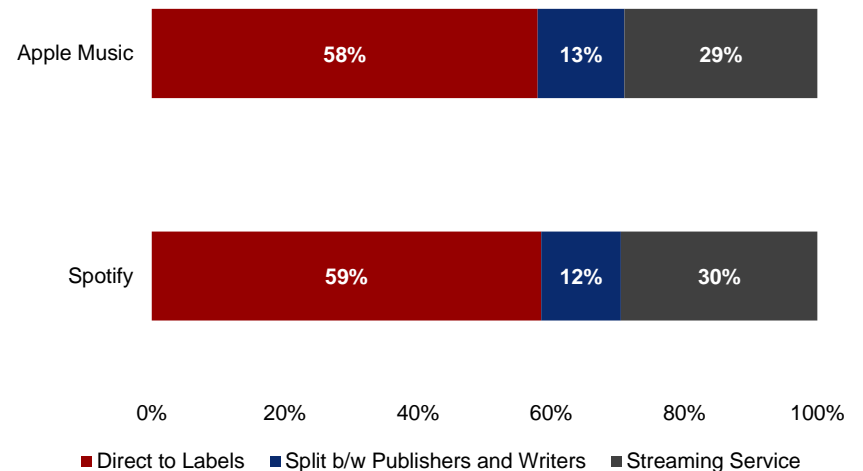
Royalty Payment Breakdown



Freemium vs Premium

	Premium	Freemium
Price	Paid	Free
Revenue	From Subscriptions	From Ads
Features	All Included	Limited
Content	All Included	Limited
Rationale	Higher Margin	Increases Exposure

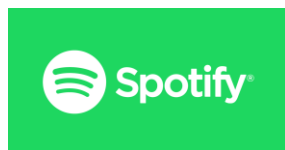
Dependence on Record Labels Results in Low Margins



Competitive Landscape

Added Functionality of Interactive Platforms Increase Popularity

Interactive Platforms



Non-Interactive Platforms



Comparison of Interactive vs Non-Interactive Streaming Services

Platform	Market Leader	Format	Revenue Generation	Growth (LTM)	Music Discovery	Passive Ent.	All Access Model	Switching Costs
Interactive		Music On-Demand	Primarily Subscribers	37%	Through analytics	High	High	High due to playlists
Non-Interactive		Online Radio	Primarily Ads	12%	Through radio	High	Medium	Low

Competitive Landscape

Interactive Platforms

Competitor Analysis – Largely Consolidated Industry

	Amazon Music	Apple Music	Google Play Music	Spotify	Tidal
Description	Amazon's music streaming arm	Apple's music streaming arm	Google's music streaming arm	First pure-play streaming service	Service founded by coalition of artists
Revenues	n/a	\$2.8B	n/a	\$3.06B	\$64M
Market Share (% of Subscribers)	12%	21%	n/a	43%	1%
Price	\$9.99	\$9.99	\$9.99	\$9.99	\$9.99
Ad-Supported	No	No	Yes	Yes	No
Catalogue	>10M	30M	30M	>30M (largest)	25M
Exclusive Content	No	Yes	No	No	Yes (most)
Ancillary Offerings	Discounted price with Prime	3 month free trial with iPhone	Includes YouTube Red	Through partnering firms	None
Social Media Integration	No	music.ly	Google+	Facebook	None

Big Four: focus for deep dive

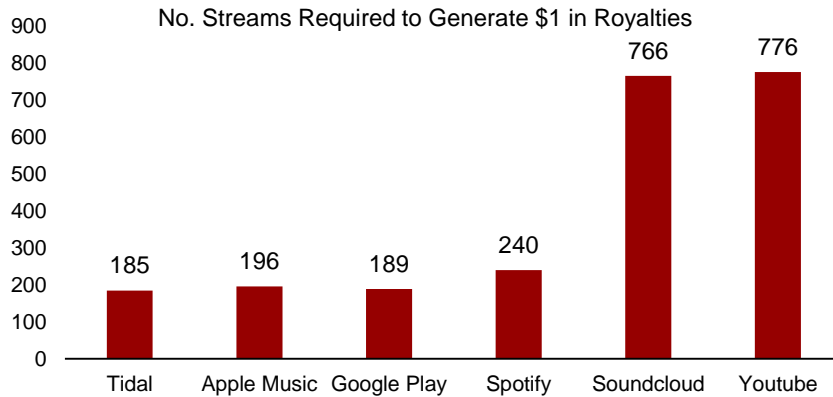
Too small / unlikely to enter public markets

Source: Company Reports, Nielsen

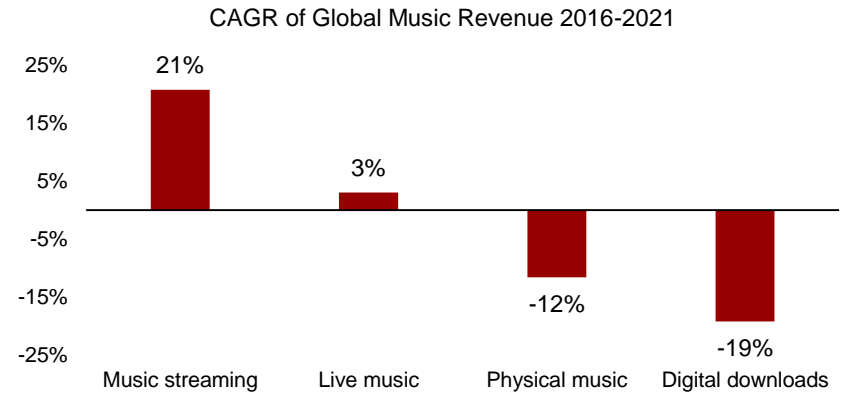
Competitive Landscape

What Makes a Streaming Platform Competitive?

Lower Average Revenue Per Fan is the Drawback of Streaming



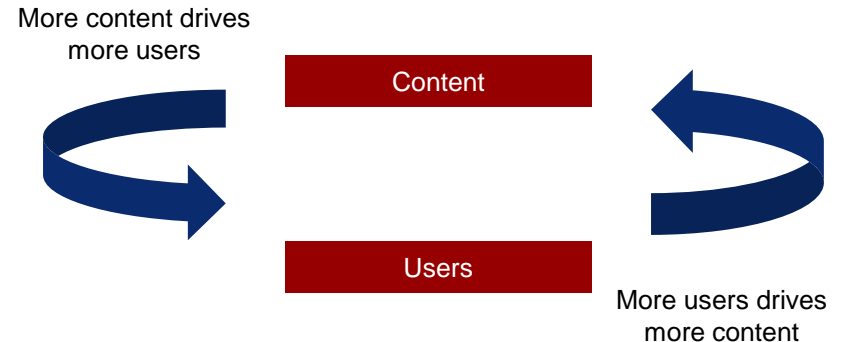
Streaming Quickly Becoming Most Popular Platform



Case Study: Even Taylor Swift Can't Succeed Without Streaming

- Feud between Swift and Spotify in 2014 made her pull her music off the platform for putting her music on the free tier
- 69% drop in second-week sales of "1989" suggests that Swift's boycott wasn't enough to urge her 71 million fans to buy her album
- Re-released 1989 discography to free and premium tiers on Spotify, Amazon Music, Tidal, Pandora Premium
- Shift on artists' financial dependency on streaming; artists not present on the services lose out on its enormous base of listeners (50mm on Spotify 27mm on Apple Music)

Network Effects Prominent in Streaming



Leaders in music streaming will be those that can drive more content and users to their platform

Source: Digital Music News, Forbes, Statista

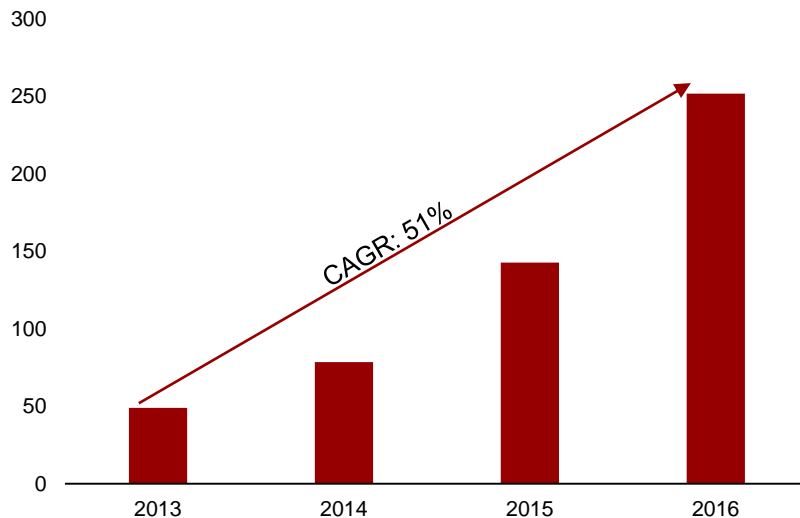
Drivers of Users #1: Data Analytics

Consumer Trends Create Need for Data Analytics

Passive Entertainment

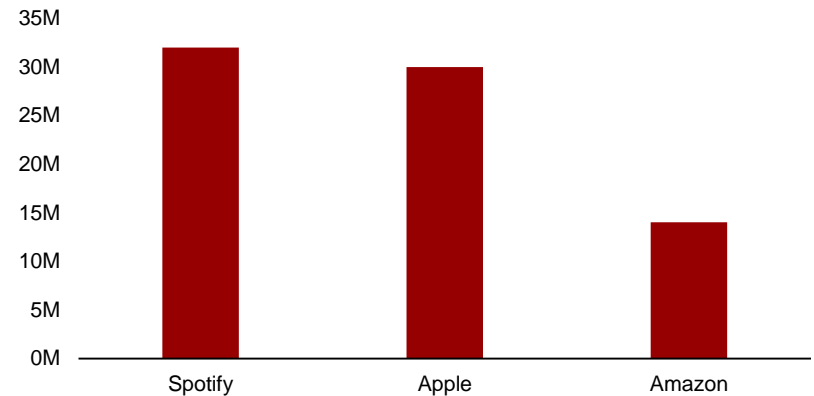
- Consumers are getting busier which means they have less time for music discovery
- With majority of music consumption occurring on streaming, its becoming more important to integrate music discovery onto service
 - Before, music discovery could be passively done through radio
 - Now, there is no clear way to discover new music
- This is creating a need for consumers to passively discover music on streaming services

Rising Amount of Streams Represents War Chest of Data



Source: Company Reports, Nielsen

Paradox of Choice: Mo' Songs, Mo' Problems



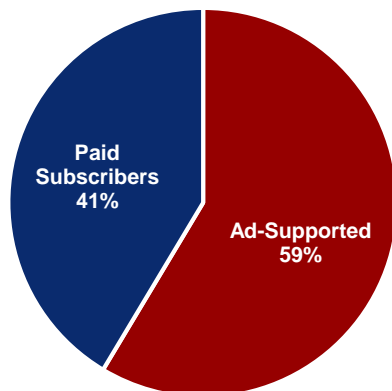
Data Analytics Provides Convenient Music Discovery

- Each new stream represents an additional data point on individual consumers that can be leveraged to recommend music
 - Over 250M audio streams per year across all platforms
- Big 4 have each integrated data analytics to recommend music to listening customers
- As consumers increasingly trend towards passive entertainment and become busier, data analytics will become a point of differentiation
- Streaming services can drive users onto their platforms through accurate music recommendations

Drivers of Users #1: Data Analytics

Importance of Data Analytics: Higher Margins For All

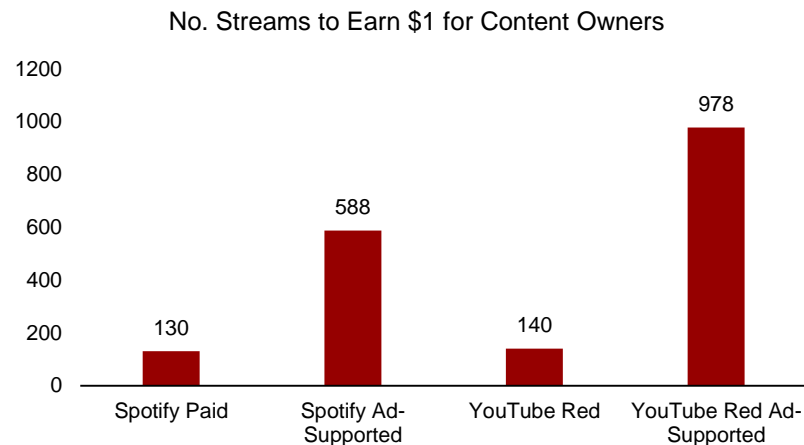
User Breakdown: Ad-Supported A Large Portion of Users



Data Analytics Drives Conversion to Higher Margin Segment

- Music recommendations is an exclusive feature for premium subscribers only on platforms that have both subscribers and ad-supported users
- Presence of strong analytics can drive ad-supported users to convert to premium subscribers
 - This would result in a margin expansion for firms who are able to convert users
- Network effects amplify the power of analytics to convert users since seeing your friends using these features would incline you to use them

Value Gap: Freemium vs Premium



Conversion Also Beneficial for Artists

- Greater percentage of paid subscribers also means greater royalties for artists and record labels
 - This results from the royalty per stream model that the industry has adopted
- On average, paid subscriber generate 3x as many royalties
- As a result, streaming services can apply data analytics and music recommendation program to drive both users and content to their platforms

Data Analytics drives both users and content to platforms due to its power to convert users from ad-supported to paid subscribers.

Drivers of Users #1: Data Analytics

Competitor Analysis

Criteria (Rationale)	Amazon Music	Apple Music	Google Play Music	Spotify
Amount of Transferrable Data	+/- From Amazon Prime	+ From iTunes	+ From Google and YouTube	+ Pioneer in streaming
Experience in Music Analytics	- None in music	+/- From iTunes but wasn't recommending then	+ From YouTube	+ Using data analytics since 2012
Quality of Recommendations	- Small catalog means mainstream rec.	+ Known to have human-curated playlists	+/- Copying features from Spotify but unestablished	+ 71% of DW users save a song
Industry Perception	+/- Strength comes from integration with Alexa	+ Second to Spotify	+/- Unestablished due to novelty of service	+ Consensus that Spotify is leader
Defensibility of Positioning	n/a	+ Scale and experience of Apple ensures innovation	n/a	+ Consistently acquiring data analytics companies
Overall	+/- Growing catalogue will help improve	+ Leader	+/- Time will tell	+ Leader

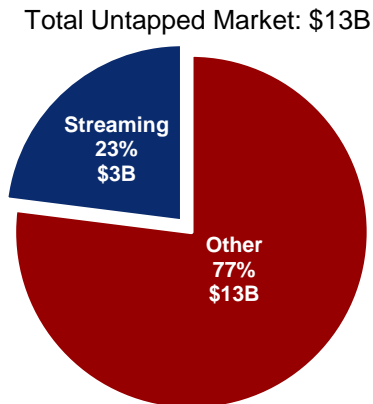
Industry commentary suggests that Spotify and Apple Music are clear leaders in data analytics.

Source: *TrustedReviews, The Guardian*

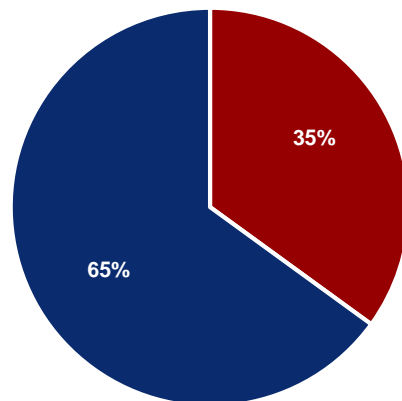
Drivers of Users #2: Partnerships

Partnerships Increase Exposure to Skeptical Consumers

Addressable Market for Streaming Remains Large Despite Growth



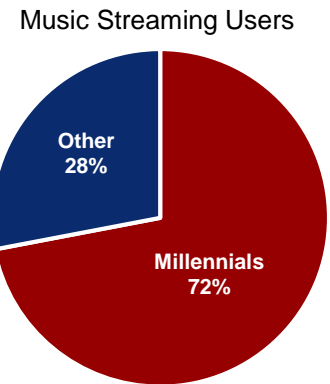
Piracy Still a Viable Alternative



- Have acquired music illegally
- Have not acquired music illegally

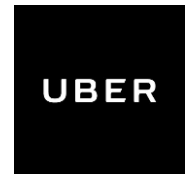
Old Habits Die Hard: Non-Adopters Stuck in Old Ways

- Early adopters of streaming have been millennials who are accustomed to disruption
- Large part of population is stuck in old ways and doesn't see the value proposition of streaming
- Top Reasons users don't subscribe:
 - 46%: Too expensive
 - 38%: Won't use it enough



Partnerships: The Extra Nudge Needed to Win New Customers

- Streaming services forming strategic partnerships to win users
- Partnerships can either increase exposure to consumers or offer the consumer a stronger value proposition
- This is especially important for Spotify which does not have an existing customer base to cross-sell to



Partnerships help show the value of streaming to more skeptical consumers that may not initially see the benefits of streaming

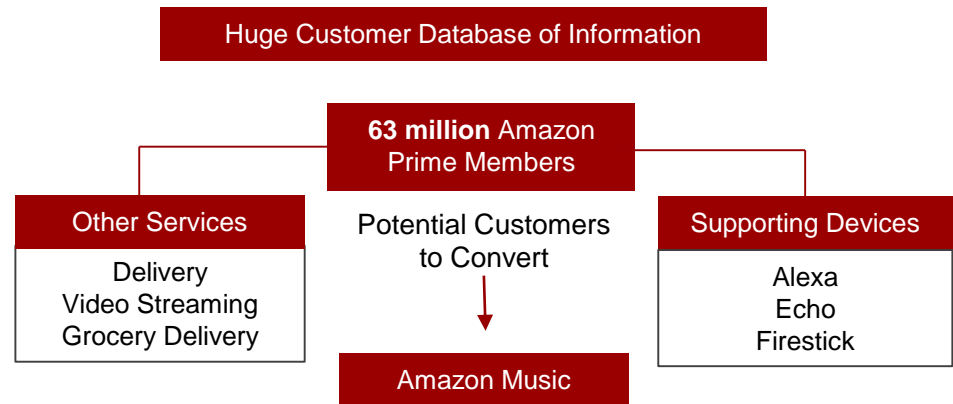
Source: Ad Week, IFPI, PRS for Music, Statista

Drivers of Users #2: Partnerships

Competitor Analysis

Amazon, Apple and Google's Existing Customer Base Can Be Leveraged to Cross-Sell

- Three of the most valuable brands in the world all have existing customer bases
 - Ability to cross-sell streaming service to customers at lower price or in a bundle
- Threat to companies like Spotify who don't have adjacent services
- Free exposure without needing to make new partners
- Gives customers good value for bundling adjacent services and products - rides the all-access model trend



Spotify's Response: Strategic Partnerships

- More difficult to gain exposure beyond subscriber base than the above companies
- Relies on forming strategic partnerships to either:
 - Increase the value for the customer by bundling
 - Gain exposure to potential customers to convert
- Fido and Spotify Partnership: provides Fido users with a two-year "teaser" to Spotify Premium
 - Long enough period of time to increase switching costs
 - Can optimize conversion further by prompting an automatic subscription option at end of two-year period



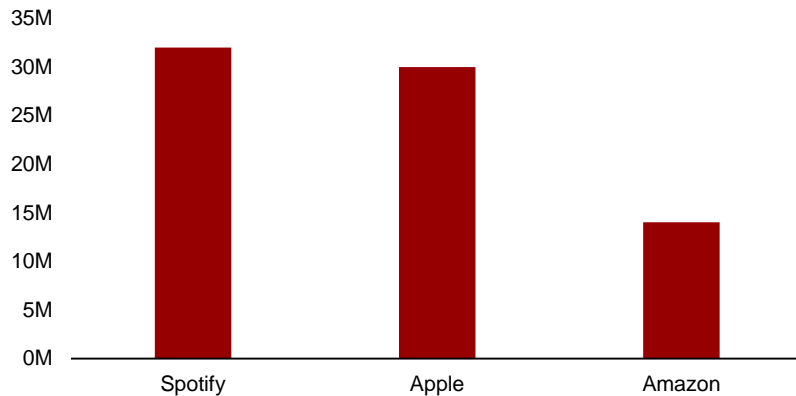
Value to Customers: Two services included in one bundled price

Spotify is able to use strategic partnerships to match the exposure Amazon, Apple, and Google enjoy through their existing customer bases.

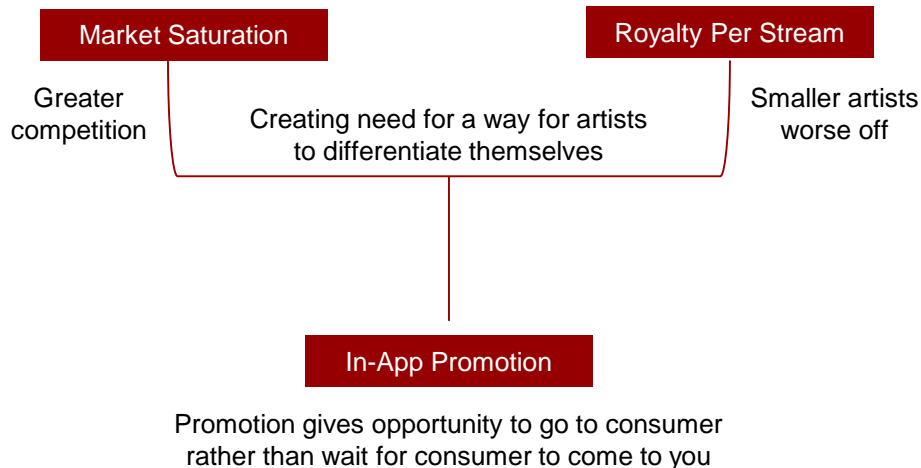
Drivers of Content #1: In-App Promotion

Market Saturation Creating Need for Promotion

Influx of Content Making it Difficult for Artists to Market Selves



In-App Promotion Provides Solution to Streaming's Downfalls



Royalty Per Stream Model Hurts Smaller Artists

- Lack of fixed royalty per stream means revenue generated for artists is beyond their control
 - One artist may be harmed due to another artist's success
- Especially harmful for smaller artists who do not represent a large percentage of total streams
- Creating a need for a solution which helps young artists get themselves off the ground and increase their streams

Lack of Monetization Represents a Potential Growth Opportunity

- In-App promotion thus far has been limited to free services provided by the streaming platform
 - Ex. Featured on playlists, recommended music, advertising live music events on behalf of artists, providing data on streams to the artists
- Promotion has not yet expanded to include full-out advertisements or sponsored content
- If a platform can find a way to do this without disrupting the user experience, there is high potential for growth especially if content continues to arrive at these platforms

As influx of content continues, in-app promotion will become an increasingly important criteria for artists.

Drivers of Content #1: In-App Promotion

Competitor Analysis

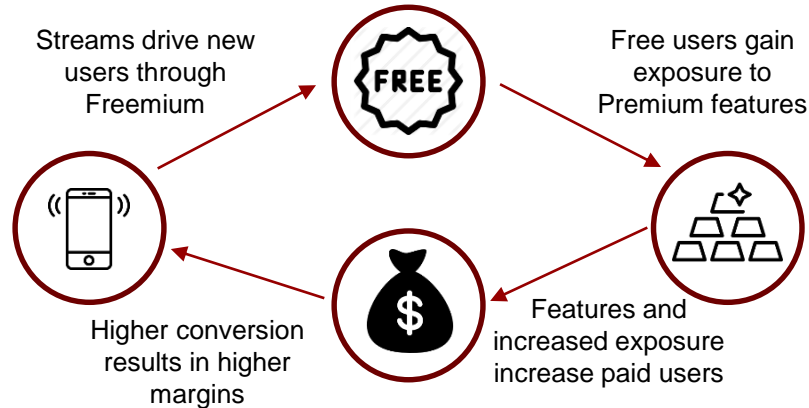
Criteria (Rationale)	Amazon Music	Apple Music	Google Play Music	Spotify
Artist / Fan Interaction	- No clear artist / fan interaction platform	+ Apple Music Connect: share content and news	- Very limited features, no fan interaction	+ Spotify for Artists: manage, content on profiles and interact with fans
Artist Analytics	+ Partnered with TuneCore to provide listening stats	+ Compatible with AWAL, analytics app for artists	+/- Limited	+ Real-time stats available for use by Artists
Artist Discovery	- Mainstream catalog - little exposure for new artists	+ Up Next: monthly features on new, hot artists with, recommended playlists	+ New Release Radio	+ Discover Weekly, Release Radar
Exclusive Content	+/- "Audio Acoustics": collection of exclusives	+ Known to have exclusive deals with major artists	- Doesn't avoid but hasn't landed many exclusively	- Avoids exclusivity
Other Features	+/- Integration with Alexa	+ Strongest artist / fan interaction	- None	+ Paid advertising, concert promotion through partners
Overall	+/- Downfall is lack of long tail	+ Second to Spotify	- Undeveloped artist platform	+ Leader

Spotify and Apple Music lead the way in terms of in-app promotion. As these features grow, the firms may be able to leverage lower payouts.

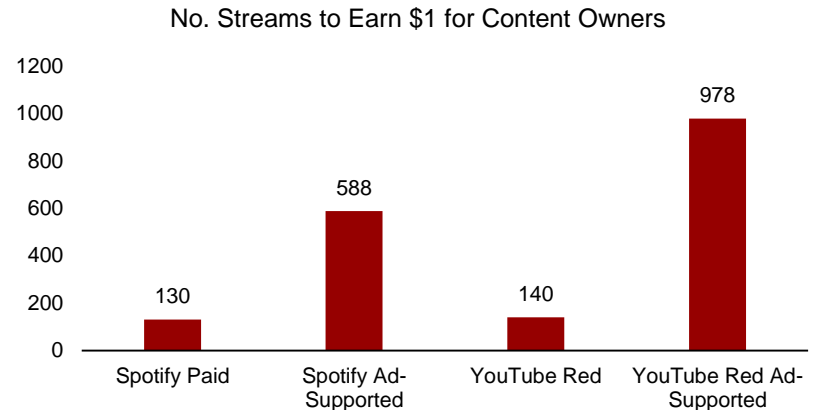
Drivers of Content #2: Plugging the Value Gap

Driving Conversion Key for Both Platforms and Artists

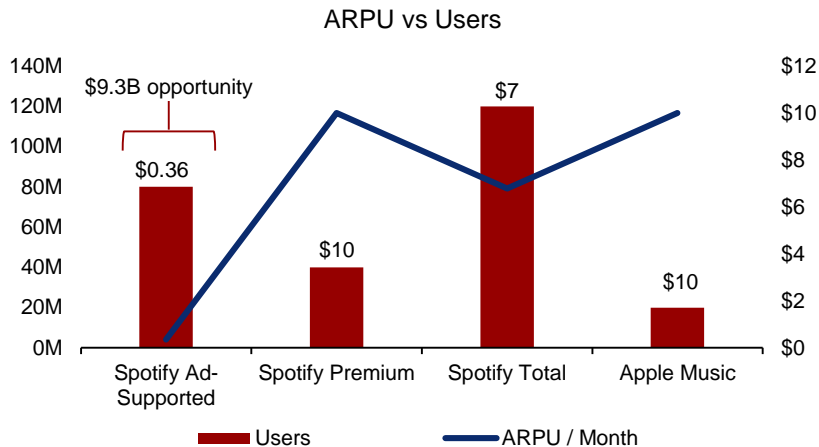
Tradeoff: Freemium Used to Drive Paid Subscribers But At A Price



Value Gap Means Artists Also Desire Higher Conversion



Cost Benefit Analysis: Apple Music vs. Spotify (2016 Data)



Spotify Can Dominate By Focusing on Conversion

- Spotify has been taking the Amazon approach – focus on revenue growth, think about margins later
- Once Spotify lists there will be an increased focus on profitability
- As Spotify approaches a critical mass of users, it can focus on converting ad-supported users
- Conversion opportunity represents \$9.3B in annual revenue if 100% converted (\$4.6B if 50%)
- How Spotify can drive conversion
 - Increasing exclusive content on Premium
 - Advertising music discovery services to ad-supported users
 - Increase playlist collaboration to drive network effects

If Spotify can convert its existing base of 100M+ ad-supported users to paid subscribers, it can further establish itself as the market leader.

DCM Outlook

Streaming Platforms To Become the Facebook for Audio

Going Beyond Music

- Streams represent a platform for engaged listeners – there's no restriction to what they listen to
- Possible additions
 - Audio books, podcasts, Khan Academy, TedX etc.
- Spotify has already started to introduce podcasts to their library
- By doing so, streaming services could become Facebook for audio

TEDx



Integrating Content Creation to Streaming

Fortune on Spotify / SoundCloud Merger (September 2016):

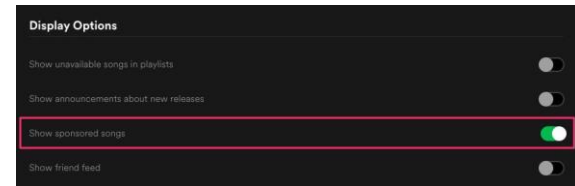
“Acquiring SoundCloud brings a lot of potential benefits. For one thing, it would diversify the company's content base in the sense that SoundCloud focuses much more on original content than Spotify and other streaming services.”

FT on Importance of Integration (September 2016):

“The big question for the streaming market is whether you can be a standalone company in a category when you have companies like Amazon and Apple looking at music as a loss leader, just to sell more iPhones or Echo speakers.”

Monetization of Artist Advertising a Possibility

- As content increases, artists have a more difficult time marketing
 - Limited opportunity to visually differentiate yourself on streaming
- Creates an opportunity to monetize artist promotion
 - Could be integrated with data analytics (recommended music)
- Spotify recently tested a beta version for this:



Implications of Trends

1

High growth potential through expansion

2

Potential to become leader by differentiating from competition

3

Potential to enter and disrupt other markets (e.g. audiobooks)

Mini-Pitch: Spotify

SECTION IV



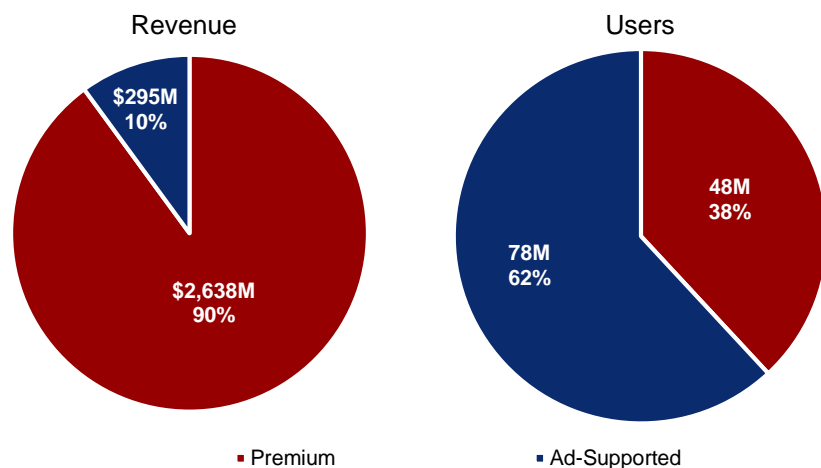
Company Overview

Spotify – Market Leader in Interactive Platforms

Spotify Overview

- Pioneer music streaming platform (founded in 2005)
- Interactive platform but has online radio integrated into the platform
- Generates revenues through subscriptions and advertisements
- 140M total with 60M as paid subscribers (largest stream)
- Has the three major record labels (Sony Music, Universal Music Group, and Warner Music) as equity investors
 - Increases alignment and ensures labels don't squeeze margins or pull content

Revenue Breakdown (2016)



Financial Summary

	2016	2015	YoY Growth
<i>(US\$M)</i>			
Revenue	\$2,934	1,929	52%
COGS	2,483	1,664	
Gross Profit	451	264	70%
Gross Margins	15%	14%	
Op. Expenses	800	501	
Op. Income	(349)	(236)	n/a

Expected Listing by End of 2017

- Expecting a direct listing on the NYSE in Q417 valued at \$13bn
- Spotify would be the first, and largest direct listing on NYSE
 - Direct listing allows public investors to buy Spotify shares without raising new money allowing them to save on traditional IPO fees
- As of 2015, Spotify was valued at \$8.5bn when it raised \$526mm
- No capital being raised – insiders looking to cash out

Case Study: Pandora

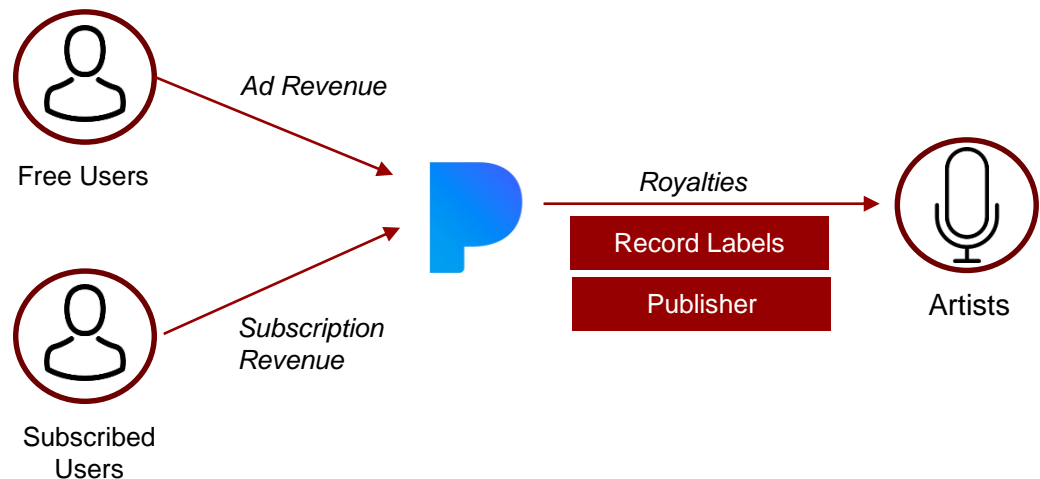
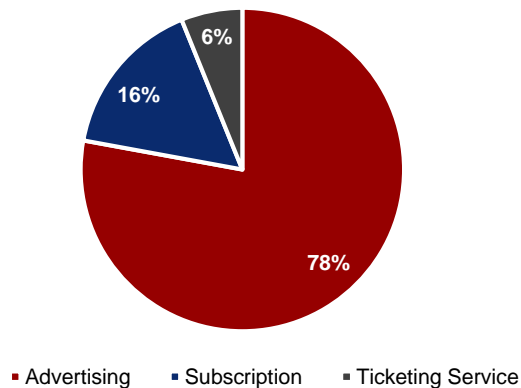
Overview

Company Overview

- Pandora is an online radio and streaming service that went public in 2011
- Generates personalized playlists using the company's Music Genome Project which analyzes musical features to give recommendations and customer feedback
- Recently launched Pandora Premium, an unlimited on-demand access to content for \$10.00 a month
- Pandora currently has 76mm active listeners and 4.86mm paid subscribers

Revenue Segments & Business Model

Revenue Breakdown FY16

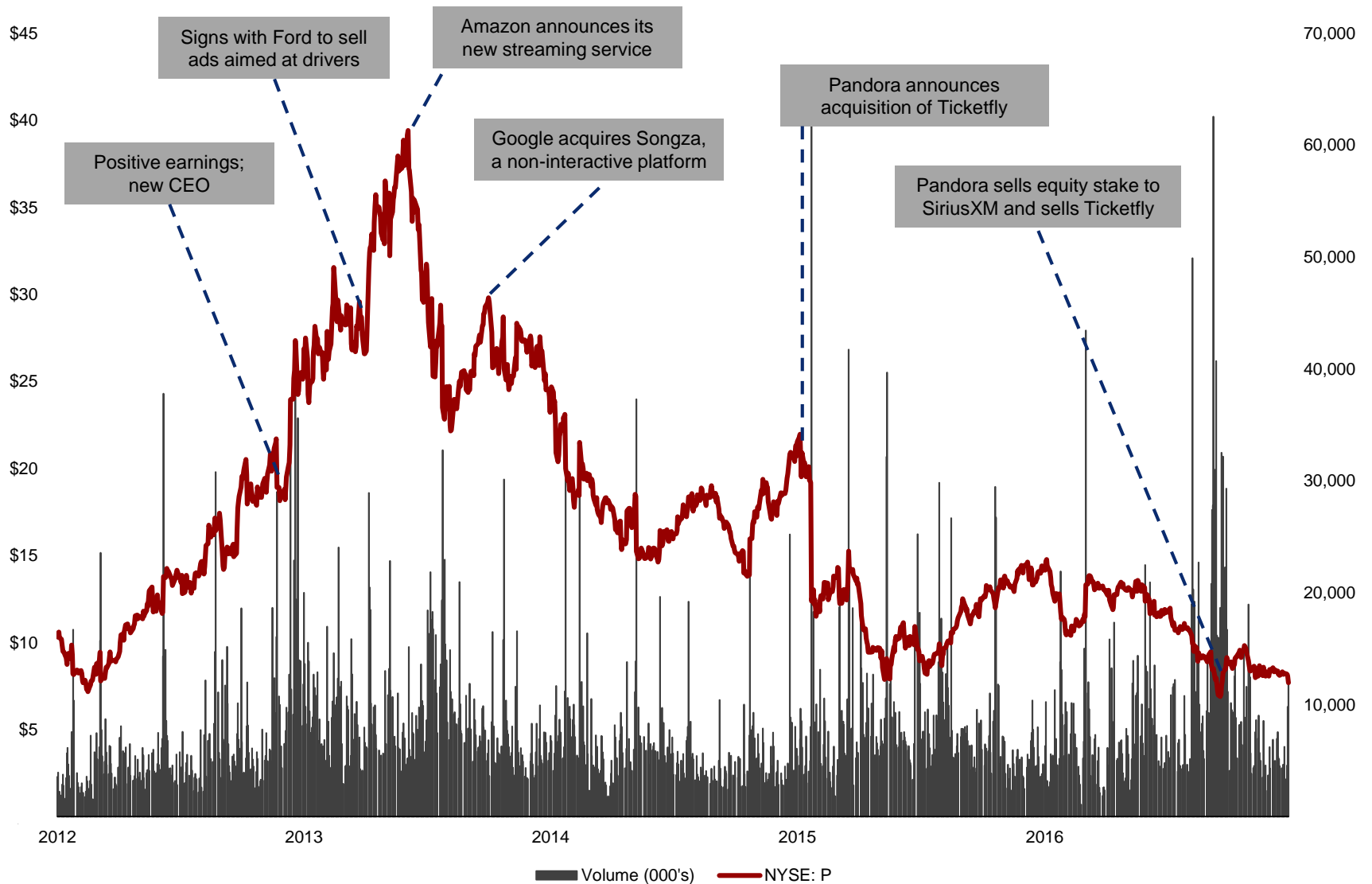


Market Overview

Public Market Overview	
<i>value in USD \$mm as of Oct.3,2017</i>	
Share Price	7.92
52 Wk High	14.95
52 Wk Low	6.76
S/O	242.62
Market Cap	1921.55
Add: Total Debt	352.20
Add: Minority Interest	0.00
Add: Preferred Shares	173.10
Less: Cash & Equivalents	227.60
Enterprise Value	2219.25

Case Study: Pandora

Rise of Interactive Streaming Platforms Drives Price Down 79% Since Peak



Investment Thesis

Strong Fundamentals But Valuation Will Determine Recommendation

1

Market leader that capitalizes on consumer trends best

- Spotify's partnerships increase exposure to new markets and drive customers to the platform
- Market-leading data analytics drives conversion from ad-supported to premium
 - Increases margins for Spotify and drives content from artists due to greater ARPU
- In-app promotion ensures influx of content continues
 - Promotion becomes more important as content increases creating potential for monetization

2

Margin expansion opportunity due to financial alignment with record labels

- Big three record labels (Sony, Universal, and Warner) all have equity investments in Spotify
- As Spotify reaches a critical mass of users, it could reduce royalties to artists to drive margins
 - Artist industry is too fragmented for a coalition to form and pull enough content from Spotify to drive away users
 - Major labels are aligned with Spotify due to equity investments so will not pull content
 - Result: higher margins without materially impacting user or content base

3

Potential valuation mispricing due to Pandora's woes

- Pandora's underperformance in the equity markets may impact Spotify's valuation and result in a mispricing due to misconceptions regarding the prospects of music streaming
- Further analysis is required to develop a full thesis on valuation

Despite strong fundamentals, valuation post-listing will ultimately determine recommendation.

Next Steps: Awaiting Public Markets Listing For Information

Quantify Spotify's Advantage
In Respect to Consumer
Trends

Analyze Conversion Rates
and Understand Ability to
Drive Margins

Value Spotify to See If
Company is Undervalued

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