Management CV

Full Profile

Spotify Technology S.A. (SPOT)

April 3, 2018

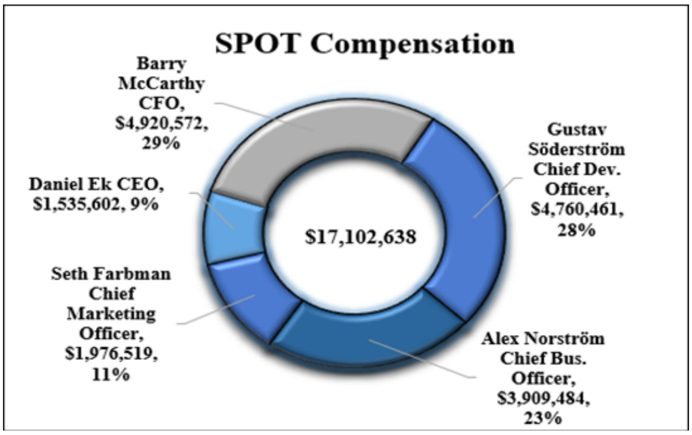
Rev/Employee: n/a	**Number of Employees: n/a**	**Avg ROIC: n/a**	**IT and Internet Services**

SPOT: Strong Team, Weak Model

Spotify's founder, Chairman & CEO, Daniel Ek (35) has built a global music juggernaut based on the principles of internet streaming and creating a two-sided market connecting musicians and their fans. Ek says the Company's goal is to enable 1 million musicians to live off their art and enable hundreds of millions of listeners to enjoy music at modest monthly fees. We think the visionary founder has a strong core management team but a high risk, low margin, business model. Spotify's executive team has been together for many years with two strong outside hires in 2015 (CFO and Chief Marketing Officer). Spotify is the first company to use a Direct Listing to IPO on the NYSE (today), and will trade under the ticker SPOT. Direct Listing is a vehicle usually used for spin-offs from listed parents and it's an unusual format where the Company will not receive any proceeds, but its VC's, private equity owners, and other insiders are able, but not obligated, to sell shares. Importantly, Dan Ek has said he will not be selling any of his personal shares in this process. SPOT is a controlled company that has a complex capital structure governed by the laws of Luxembourg. According to its F1 filing, Spotify currently has 159 million monthly active users and 71 million paying Premium users of the service, but faces daunting competition from Apple Music, Pandora, Google's YouTube and others. We don't like the co-founder's voting control of the shares, but think that the new group of seasoned public company Directors, who joined the Board in 2017, bodes well for better governance, needed improvements to pay alignment, and future capital allocation discipline.

Executive Team Skills Fit Dan Ek co-founded Spotify in April 2006 with fellow Swede Sven Hans "Martin" Lorentzon (50) and they initially launched the site across Scandinavia, the UK, France and Spain in 2008. Ek is a seasoned entrepreneur that has previously founded and sold several small technology companies in his native Sweden earlier in his career. That experience helped him to avoid the many pitfalls in venture financing and has brought him to this IPO still owning a significant amount of Spotify. Ek is now based in New York City as most of SPOT's growth opportunity is based on its U.S. subscriber growth and relationship with the L.A. based music industry labels. We like the founders serial entrepreneurial experience and the seasoned operating executives they have attracted to the management team. Early in his career, Ek founded an online advertising company, Advertigo, that he then sold to SPOT co-founder Martin Lorentzon’s company, TradeDoubler in 2006. Lorentzon (also a Director of Telia Sonera) is a reknown Swedish businessman who relinquished the SPOT Chairman role to Ek in 2016 and is reputed to be a billionaire. The pair worked on Ek's Spotify idea which they say came out of a Stockholm musician friend lamenting to Ek that he had to get a day job because he could not support himself from his music due to the rise of music piracy (Napster etc.). Initially Ek’s business model was predicated on streaming very low-cost royalty songs vs. the download-and-own model of iTunes. Ek studied engineering at the KTH Royal Institute of Technology in Stockholm, but dropped out before earning a degree. CFO Barry McCarthy (64) is well qualified for his role and became CFO in July 2015 after initially serving as a Board member for a year. We like the McCarthy's prior experience as the CFO of Netflix from 1999 to December 2010 and note that he was one of NFLX's early employees, joining when it only 40 had employees. Because SPOT's business model is so highly dependent upon royalty structures and accruals, we think the CFO role is unusually critical to the firm's operating prospects. We think McCarthy’s experience at Netflix gives him an unusual blend of financial expertise for a new age business predicated on user subscriptions, streaming technology and content royalty models. McCarthy led Netflix through its IPO in May 2002 and helped evolve the business model from mailing DVDs to subscribers, to streaming, to then financing company-owned content. He retired as NFLX CFO in December 2012. During the March 23rd investor day presentation, CFO McCarthy said that when he initially started at NFLX they had negative gross margins, which then increased to 35% after he left that firm and that SPOT’s gross margin had already improved 700 basis points from 13.6% in 2016 to 20.7% in 2017. We also note that McCarthy was an outside Director of SPOT competitor Pandora from 2011 to 2013. Since his retirement from Netflix, he has served as an "executive advisor" to VC firm Technology Crossover Ventures (and he was an early Spotify investor). He is a former investment banker and management consultant with a BA in History from Williams College and an MBA in

Finance from Penn's Wharton School. Gustav Söderström (41) is the Chief Research & Development Officer and longest tenured senior manager, who first joined SPOT in 2009. Söderström is responsible for 40% of all employees and product, design, data and engineering. We like his strong engineering experience and prior track record at major firms. Söderström founded the mobile phone software company Kenet Works that was acquired in 2006 by Yahoo!. He then was Yahoo!'s Director of product and business development for Mobile until he joined SPOT. Söderström has a Master's degree in Electrical Engineering from the KTH Royal Institute of Technology. Alex Norström (41) is the Chief Premium Business Officer, which generates about 90% of SPOT's TTM subscriber revenue. Norström's prior operating positions at SPOT include VP of Growth and VP of Subscription. Before joining SPOT, Norström was Chief New Business Officer of King Digital Entertainment, a London based social gaming developer known for its Candy Crush game. He has a M.Sc. in Business and Economics from the Stockholm School of Economics. Seth Farbman (51) has been Chief Marketing Officer since April 2015 after a successful four years at the Gap, where he was Global CMO and oversaw an overhaul of Gap's marketing campaign. Prior experience includes Ogilvy & Mather (OgilvyEarth, founder & senior partner) and various marketing and brand management positions at AT&T and Verizon. CMO Farbman has a BA in Journalism from Ithaca College and an MS in Communication from Syracuse University. He is currently a Director at J. Crew Group.



Compensation and Alignment Analysis We think SPOT's executive pay plan is still a work-in-progress and needs further improvements. Salaries are modest but as of the most recent F1 filing, we note that management's equity grants have no performance measures and their stock options vest solely on time with the Board having wide discretion in pay matters. This is not unusual in IPO firm's that have previously had close Board supervision of all management matters but it is equally unsuitable to a public company over any extended period of time. CEO Ek waived his salary until further notice in July 1, 2017. Prior to this his salary was $1 million and, in lieu of a salary, Ek has the ability to earn a $1 million cash bonus based on milestones that were, for year-end 2017: over 70 million Premium subscribers, greater than 150 million Monthly Active Users (MAUs) and 25% gross margin for 2H '17. Last year, actual results were 71 million Premium subscribers, 159 million MAUs, and 20.8% gross margin for the full year. In spite of not reaching the gross margin goal, the Compensation committee used their discretion and granted Ek the full $1 million cash bonus. The Board says it intends to benchmark management pay against 19 industry peers that we think are reasonable benchmarks. In 2017, CEO Ek was paid a total of $1.5 million, comprised of $440k in salary (through 6/30/2017), a $1 million cash bonus and $95.3k in other compensation. CFO McCarthy is paid a modest salary of $560k and CMO Farbman is the highest salaried executive at $900k. CFO McCarthy's total pay was valued at $4.9 million in 2017 and included $4.3 million in stock options and $88k in other compensation. SVP Söderström received $4.8 million, Norström received $3.9 million and Farbman received a total of $2 million. We like that stock options represented 76% of management's total compensation in 2017. We think good key performance indicators for annual cash bonuses might be metrics like: subscriber and/or ad revenues, premium subscriber counts, monthly active users (MAUs), or gross margin. Equity grants should be predicated on longer term metrics like paid subscriber growth, EBITDa margins, and ROIC. We think that the Board of Directors, five of whom only recently joined in mid-2017, will likely make dramatic improvements to the compensation plan during 2018 and 2019. SPOT bases the executive's Long-Term Incentive Plan (LTIP) on the grant of stock options while maintaining the right to issue Restricted Stock Units in certain cases. No RSUs were issued to executives in 2017. Management's stock options time vest on a quarterly basis over a 3.5 year period. We note the addition to the Board last year of long-time former Disney CFO Thomas Staggs and Padmasee Warrior, a Director of Microsoft. We think the Directors have lessons to share from Microsoft's turn-around and particularly its pay plan improvements that were catalyzed by activist investor ValueAct. For the year ended December 2017 the total compensation paid to the Directors and the operating officers of the firm totaled just over $28 million.

Equity Ownership Analysis SPOT is a controlled company and a foreign issuer that was founded in Sweden, is incorporated in Luxemburg, and is now listed on the New York Stock Exchange. SPOT is organized under the laws of Luxembourg where it maintains its registered office. We worry that the direct listing route of SPOT will provide a significant liquidity event for early venture investors like TPG, Dragoneer and others without providing any capital to the existing business. Equity ownership is concentrated with the two co-founders Daniel Ek and Martin Lorentzon owning a combined 40.2% of outstanding shares (27.1% and 13.1%, respectively), but including various warrants and options and the 10:1 (that can be up to 20:1) Beneficiary Certificates "BC"s for each ordinary share beneficially owned (totaling 373 million certificates) they control 80.5% of the voting power. As of March 21, 2018 the two co-founders collectively had 373,041,200 BCs outstanding and the Board has the right to distribute additional BCs at their discretion. The beneficiary certificates carry no economic rights and only provide additional voting rights. We have a strong disdain for these type of additional voting features that are divorced from underlying economic ownership. We note that Ek's 49.6 million of beneficial share stake includes shares owned by Tiger Global (12.8 million), TME Hong Kong (4.3 million), Tencent (16.1 million) and Image Frame (9.1 million) for which he contractually votes their proxy due to his indirect ownership of D.G.E. Investments. Early investors that may be net sellers of their stakes in the coming months include: Tiger Global (12.8 million or 7.2%), Tencent (16.1 million or 9.1%), Sony Music (10.2 million or 5.7%) and TCV (9.6 million or 5.4%). Spotify and TenCent did two private transactions in January 2018 such that both Spotify and Tencent own minority stakes in Tencent Music Entertainment "TME" that required three year lock-ups without the other parties prior consent. This is the only contractual lock-up aggreement among the registered shareholders of the company which may mean there is significant overhang in the shares in the coming weeks. Martin Lorentzon owns 23.6 million or 13.1% of shares including 1.92 million warrants in the Company purchased for $5.76 in October 2016 and exercisable at $50.61 at any time prior to October 17, 2019. CFO Barry McCarthy is the third largest holder of shares at 142,680 shares owned and 1.7 million stock options at a weighted average exercise price of $44.46. Directors receive RSUs for their service that vest ratably over four years.

Capital Allocation Practices Spotify has TTM revenues of over $5 billion, but has never made an operating profit. Organic growth and tactical acquisitions are likely to remain the major use of the firm's capital and the public listing of the shares creates a valuable currency for future M&A negotiations. Management says that it does not expect to pay cash dividends or make other distributions on its common shares in the foreseeable future. Under Luxembourg law, at least 5% of any net profits per year must be allocated to a "legal reserve fund" to equal at least 10% of the Company's total share capital. The Company’s clearly stated agenda is to use its capital to grow the global scale of music offered and subscribers to increase the firm's the enterprise value. The F1 says that the firm's growth strategy will focus on increasing paid subscribers, deeper penetration of existing markets, entering new markets, increasing advertising revenues, and improving ‘Spotify for Artists’ which is the contribution platform for Artists to deal directly with SPOT. The firm's R&D spending doubled in 2017 to $396 million from $207 million the year before, which represented 10% of TTM revenue. SPOT's F1 says that it turned free cash flow positive in 2016 with FCF totaling $109 million in 2017. The Company has no long-term debt.

Material Fiduciary Issues Technology Crossover partner Woody Marshall represents its investments (about 5.4%) on the Board and he has been on the Board since 2015 but the parties have terminated their agreement for his Board rights. The nine person Board is comprised of two classes of Directors. As a Luxembourg based firm, most of the firm's intangible assets are located and governed by laws outside of the U.S. and there is no treaty for reciprocal civil or commercial judgments between the two countries judicial systems. We think SPOT's high dependence on outside content and a royalty based business model represents risk. The firm is highly dependent upon royalty arrangements with with Universal, Sony Music, Merlin, and Warner Music. Auditors have cited a material weakness in the firm's accounting based on the complexity of calculating royalty payments payable to the supplier music labels. A substantial part of this complexity arises from the unique ability of a SPOT subscriber to download music and listen to it while being disconnected from the Internet for up to 30 days as royalties accrue. The F1 cites that "we are at risk of artificial manipulation of stream counts and failure to effectively manage and remediate such fraudulent streams could have an adverse impact..".