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SPOT.N - Q4 2019 Spotify Technology SA Earnings Call

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CORPORATE PARTICIPANTS

Daniel G. Ek *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Paul Aaron Vogel *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

PRESENTATION

Operator

Welcome to Spotify's Fourth Quarter 2019 Financial Results Question-and-Answer Session. A copy of the company's shareholder letter issued premarket open today is available on the Investor Relations website, investors.spotify.com. This call is being recorded and an archived replay will be available on the IR site after the event concludes.

I will now turn the call over to Paul Vogel, Chief Financial Officer. You may now begin your conference.

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Great. Thank you, and welcome to Spotify's Fourth Quarter 2019 Earnings Conference call. Today's call will follow a similar format to prior quarters. We will start with opening comments from our CEO, Daniel Ek. After the remarks, Daniel and I will be happy to answer your questions. Questions can be submitted either through the widget alongside the webcast or by e-mailing directly to ir@spotify.com. We'll get to as many questions as we can, and the call will last approximately 30 minutes.

And let me quickly cover the safe harbor. During this call, we will make forward-looking statements, including projections or estimates about the future performance of the company. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed on today's call and in our letter to shareholders and filings with the Securities and Exchange Commission.

During this call, we'll refer to certain non-IFRS financial measures. Reconciliations between our IFRS and non-IFRS financial measures can be found in our letter to shareholders and the financial section of our Investor Relations page of our website and also furnished today on Form 6-K.

And with that, I will turn it over to Daniel.

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

All right. Hey, everyone, and thanks for joining us.

So Q4 was another strong quarter and 2019 a strong year, as the business once again met or exceeded our guidance by pretty much every measure. So we're very pleased with the momentum we have entering 2020.

In 2019, we outlined a vision to expand beyond just music, and we made significant progress in our goal to become the world's #1 audio platform. Just a year ago, we announced the acquisitions of Gimlet and Anchor and subsequently Parcast. And today, we've doubled down on our audio strategy with our acquisition of Bill Simmons' The Ringer, bringing a new group of highly loyal sports and pop culture fans to the platform.

We also shared today that in the fourth quarter, we saw approximately 200% growth in podcast hours streamed year-over-year, and it's clearer than ever to us that podcast listening is driving overall health in our business. Retention is up in each of our top 20 markets, and we know that retention leads to higher conversion and lifetime value. And as we said, we're just getting started.

And due not only to the acceleration in growth we're seeing at the top of the funnel, but really the improved engagement overall, I'm more confident than ever in our direction and in our strategic path in audio. History has shown us that while we're usually right in predicting the outcome of our strategy, exact timing can be uncertain. So in 2018, for instance, we indicated that our focus was on driving MAU growth, and we invested in product and innovation and launched an all-new free experience on our Ad-Supported tier to give users a more engaging, tailored experience. And while we saw positive leading indicators, it really took until 2019 for the benefits of our investments to pay off in a big way. And we've now seen 3 consecutive quarters of accelerating MAU growth, including our results today. And we now have 271 million monthly active users, and that's more than 0.25 billion users, and user growth is reaccelerating even in our most mature markets, like the Nordics.

And for a platform of our size, this reacceleration in MAU growth is a rare and a powerful signal for future revenue growth. And as a result, we feel confident that we made the right investments then and that we're making the right investments now, but we have been fairly conservative in including potential increased benefits into our 2020 guidance because we're cautious in our ability to predict the exact timing. I am, however, very confident that these investments in audio and improving our platform will result in faster subscriber and revenue growth, just as it did in our user growth and in greater user engagement, which we know drives improvement in churn and lifetime value. And as we grow, we continue to connect artists with fans on a scale that has never before existed, both through cultural moments, like our year-end Wrapped campaign, and also through developing tools and services in our marketplace offering.

Sponsored recommendations, our first promotional service for artists and labels, have performed impressively, and we're encouraged by both the creator and user response. One example of the potential of this tool in creating awareness and scale for an up-and-coming indie artist is the recent success of Caroline's Trippie Redd, who leveraged sponsored recommendations and opened at #1. We're still very early in this effort. And as adoption picks up among our partners, we expect the growth rate to pick up as well and become a meaningful source of gross profit expansion in the coming years.

So to summarize, I'm very pleased with the quarter and confident in our momentum entering 2020. We will continue to invest in our podcast efforts as we're seeing that our strategy is having tangible results on our business. And given that, we will continue to invest for growth.

Let's now open the call for questions.

QUESTIONS AND ANSWERS

Unidentified Company Representative

Okay. The first question we have is from Justin Patterson at Raymond James. This is for Daniel. Daniel, last year, you articulated Spotify's audio strategy, and engagement metrics have trended nicely since that time. Could you talk through how engagement is trending in both English and non-English content?

Second, The Ringer is a high-profile acquisition and a business with large reach and already high CPMs. Should we be viewing this content as it becomes exclusive? Or do you see value derived through growing global reach and improving CPMs?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. So first off, we're very pleased with the overall growth of podcasting, with 200% year-over-year growth in engagement. And that's a global phenomenon. It's not just a U.S. phenomenon. And we see the similar trend that we do, without sort of breaking out specific markets, everywhere. As in podcast users not only are more engaged overall, but because of that engagement, they're also listening to more music. So it's really just a very, very healthy user trend that we're seeing. And that user trend, as I said in my opening remarks, we think leads to higher lifetime values as well.

And as it relates to the second question around The Ringer and what we're going to do, we're still opportunistic as we think about it. But I think the best answer I can give is if you up level this conversation and think 10 years out, I think the trend that we're investing in is that radio is moving online because users get a much better user experience. It's on demand. It's tailored to their needs. And what we really did with The Ringer, I think, is we bought the next ESPN. And we think that's going to be a tremendously valuable property as we look at the development of sports over the next decade and the billions of people that will start listening to audio. So we're just very excited about it and yes, we will invest in that trend.

Unidentified Company Representative

Great. The next question is from Eric Sheridan at UBS. Is there a way to unpack the components of gross margin, full year guidance, headwinds, tailwinds and call options so investors can better understand what might cause under or outperformance over the next 12 months against your long-term business goals?

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. So if you look at gross margin, I would say at a high level, there's a couple of trends: One, we've been pretty consistent that in our most recent round of label negotiations that we didn't expect much change to the rates we were paying. And in 2020, we expect that the royalty side of the cost of revenue should be pretty consistent with where it was in 2019. So then in 2020, you've got 2 other factors going on. One is the benefits from the marketplace, and then two would be some near-term drag from the investments we're making in content. And so the biggest factor that's causing the midpoint or the 70 percentile of our guidance range to be below in 2020 versus '19 is that investment in content. You've seen it today with the investment in The Ringer. We think the benefits of that are pretty strong, as Daniel outlined. And so some of it will be a function of how quickly we invest, how aggressively we invest and how quickly the marketplace strategy grows.

Unidentified Company Representative

Great. The next question is from Ross Sandler at Barclays. Your 28 million Premium sub net adds for 2019 were higher than the total of Apple, Amazon and YouTube combined from what we can tell. Any high-level comments on how you are viewing the competitive landscape right now? Do you feel better about your position than you did a year ago?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. We feel really good about the position we're having. And I think in earlier shareholder letters, you've also seen us comment on the fact that we see much higher engagement among Spotify users than we do with competing services. And we think that leads to better retention. And retention in subscription world is really the game. So we feel really good about where we are.

Unidentified Company Representative

Great. The next question is from Mark Mahaney at RBC. Can you provide any color to how you expect ARPU growth to trend in the future? Are there possible factors that could cause ARPU to stabilize and even grow in the next 1 to 2 years?

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. Thanks, Mark. So ARPU had been improving. We had seen throughout most of 2019 that the ARPU declines did moderate throughout the year. They were down about 5% in Q4, down low single digits for the year. There's a number of factors that impact ARPU. I would say, first, at a high level, we're still thinking about growing top of funnel. The most important thing for us is growing users and growing subscribers, and we'll continue to stress growth over ARPU and profit in the short term.

That being said, there's a couple of factors that impact ARPU moving forward. One is product mix. The other is geographic mix. In the Q4, ARPU was negatively impacted by the addition of the 90-day trials to which were an extension in new in Q4 that we hadn't had before. That did impact

ARPU a little bit. Going to 2020, there's some -- some parts of that will continue or have continued into Q1. Geographic expansion will continue to weigh somewhat on ARPU. And in general, I think for 2020, we're looking at ARPU to be down in the low to mid-single digits again.

Unidentified Company Representative

Great. The next question is from Maria Ripps at Canaccord. Can you address the contribution of the EUR 30 million benefit to gross profit from the 2-sided marketplace? What were some key components included in that figure? And what were the key drivers incorporated in your target of 50% growth? To what extent do you expect sponsored recommendations to start contributing in 2020?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

A lot's happening in the marketplace department, and you should -- again, sponsored recommendation is one of the few products. You saw Soundtrap. You saw some strong subscriber growth there. You saw us acquiring SoundBetter as part of our marketplace offering. So it's really a portfolio of different services that are the makeup of this. And as we come into 2020, you will certainly see us invest more and launch new products and offering. And the function of the growth is really just to take up among our creator base how many of them are using these tools and services and to what extent they're using these tools and services.

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

And I would just add. And within that EUR 30 million, it's a gross profit number because some of the benefits we see are on the revenue side. Some of the benefits we see just directly hit the gross margin in the form of different royalties or license payments. So that's why we framed it out as a gross profit benefit.

Unidentified Company Representative

Great. The next question comes from John Egbert at Stifel. Can you discuss the slow start in the Ad-Supported business during Q4 in a little greater detail? And in general, how do you see demand for programmatic audio ads developing in 2020 relative to past years? What are some of the impediments to the programmatic demand growing faster?

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. So Q4, we just, quite frankly, got off to a slow start. We talked about in Q3 some of the impact we had from the migration to a new order management system. Some of that carried over into Q4, not necessarily the technology side, but just on the momentum we had in the first half of the quarter. The momentum came back in the second half of the quarter. We hit plans for the back half, which just wasn't enough to make up for some of the shortfall in the first half.

I would say on the programmatic side, the growth has been really strong. We continue to be really optimistic about programmatic audio. We're investing in the technology side. When you think about the advertising side, in Q4 alone, we launched Dynamic Ad Breaks. So another product to help us monetize the ad platform better. On the podcasting side, we announced the addition of streaming audio insertion (sic) [Streaming Ad Insertion], which is a tool which we think will help us monetize podcasts going forward as well. So in general, we expect advertising to be stronger in 2020, and we expect it to ramp throughout the year. So the progression should get better, particularly as the podcast inventory grows.

Unidentified Company Representative

Great. Next question is from Richard Greenfield at LightShed Partners. Where is your podcast market share in the U.S. today? And for younger skewing podcasts, how high have you seen it rise relative to your competitors?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. It's really hard to get accurate third-party measurements of where you stand in podcasting. But generally speaking, what we can say is that we're taking market share pretty much in all territories that we're in. Internationally, by some third-party estimates, we're now #1 in many, many of those markets already. So we're very pleased with that development. In the U.S., it's tricky to get accurate measures. So I can't really say the exact numbers, but we feel good about that we're taking market share for sure.

Unidentified Company Representative

Great. Next question is from Lloyd Walmsley at Deutsche Bank. How are conversion rates from MAU to Premium as you have expanded into newer markets? There's a lot of MAU growth coming from lower-converting markets. How should we think about that impact on conversion rates with strong MAU growth the last few quarters?

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. So I'd say a couple of things. At a very high level, any time MAU is growing, we feel really good about the health of the business. As we mentioned, we've seen 3 quarters in a row of accelerating MAU growth. So for a company our size to see MAU growth accelerate over 3 quarters, we feel really good about.

There are always periods of time where conversion looks like it's getting better and there's periods of time where conversion looks like it's getting wider. But in general, what we've seen in history is that when we see top-of-funnel growth in MAU growth, we see conversion come to Premium over time. And then we see the benefits on the revenue side from more subscribers and more advertising inventory. So we feel really good about it. We don't see anything in terms of a geographic mix at this point in time that would change our ability to convert or any of those dynamics to be different than we've seen in history.

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Just the addition I want to say is, as we said in our letter, the growth reaccelerated across 3 of our largest regions: North America, Europe and LatAm. So it is really an MAU story across all markets, not just the sort of emerging markets, which I feel really good about. And by some estimates now, we should be the largest U.S. audio streaming service as well. So we feel pretty good about that.

Unidentified Company Representative

Great. The next question is from Ben Swinburne at Morgan Stanley. And this one's for Daniel. Daniel, can you give us an update on label negotiations and whether marketplace revenue is being held back by the lack of agreements with remaining majors?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. We really don't have anything new to say about it. As we said many times before, we feel confident about the outcome. But as always, with the timing, it is difficult to predict. We feel that the discussions, however, are trending in the right direction.

And as it relates to the marketplace thing, it's really a question of adoption. So to what extent that's impacted by any of the label discussions, I don't really know, and it's kind of hard to predict. But we certainly expect it to progress over the year. And we feel very confident in terms of just when you look at the leading indicator of just how the tools are performing, this is a really powerful tool. So for a music market tier, having something like sponsored recommendation, it's really a dream come true. And because of that, we expect the demand to pick up over the year.

Unidentified Company Representative

Great. The next question comes from Kevin Rippey at Evercore ISI. Sales and marketing are ramping up. Can you give us some incremental color? Wondering how the new free trial initiatives are impacting LTV to SAC ratio.

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. So on the sales and marketing side, there is a lot of nuance and seasonality right now. So the 90-day free trial impacts sales and marketing because those costs end up on the marketing side. Historically, when we've had the 3 months for EUR 0.99, those costs have ended up in the gross margin side. So in periods of time, where the offer is 90 days free, it hit sales and marketing. In other periods of time, its hits gross margin. So that can fluctuate quarter-to-quarter depending on which promotion we're running. So that sales and marketing line was impacted by having more of those free trials in Q4. And there will be some seasonality as we experiment and continue to adjust our promotional activity throughout 2020.

And when looking at LTV to SAC, nothing's really changed. The numbers have been pretty consistent over the last year or 2 in terms of LTV to SAC ratio. So we feel really good about continuing to add users and valuable users.

Unidentified Company Representative

Great. The next question is from Steven Cahall at Wells Fargo. Presently, what sort of economics do you get when a user listens to your podcast that you do not own? How might this trend going forward? And what percentage of podcast listening is on podcasting that you do versus do not own?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. We haven't broken out what our share of listening is for our own original content versus not, but I think it's fair to say that we're just very early in the monetization of podcasts overall. And as it relates to third-party content, i.e., content that we've just licensed and put on the service, right now, all monetization is their own, and we're not participating in that. So as Paul mentioned earlier, as you look at the ad opportunity going into 2020, part of that is us experimenting with ad tools. And quite a few of them have the potential, obviously, of being very powerful for third-party podcasters as well. So long term, we feel very, very excited about the opportunity. And we think we can bring a whole another game of monetization for podcasters, and that, that will lead to just the overall growth of the podcasting industry.

Unidentified Company Representative

Great. The next question comes from Heath Terry at Goldman Sachs. Can you update us on where your capabilities sit in terms of your advertising technology platform? How much of your Ad-Supported and podcast ad inventory is being sold programmatically and targeted and measured through your ad tech stack? How would you characterize the road map for your ad technology, particularly for podcasts? And what impact do you expect this to have on monetization of your non-subscription listening?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. I think I can start and maybe Paul can chime in here. We obviously have a quite strong track record of monetizing music audio content. Monetizing podcast audio content is somewhat different, certainly how it works today but also where we want to bring the industry to. So we're developing a lot of those tools. Some of them you've heard us talking about, like the SAI inserts, which is streaming audio inserts (sic) [Streaming Ad Insertion]. And we're still early days in terms of the development of those and trialing of those. But for us, when we look at the overall opportunity, it is pretty clear that we don't -- we haven't added Internet-level monetization yet to audio. So all the things that you've come to expect in video and display in terms of measurability, in terms of just targeting, a lot of that is lacking in podcasts today. And you've seen it time and time again, as you add those capabilities, you generally can raise CPMs across the board because advertisers feel more certain about the results that they're getting. And if we do that, that's going to be a tremendous benefit for all the podcasting creators, but it's also going to be a tremendous benefit for Spotify.

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Again, just to follow up on that, I would say 2 other things. One, in terms of other technologies, so Dynamic Ad Breaks is another tool that we've developed, which is unique to Spotify. And it will allow us to monetize better and also monetize shorter sessions on the advertising side better. We haven't historically done a great job of monetizing users on shorter sessions, so this will help with that.

And in terms of the programmatic question, it's about 25% of ad revenue and growing. And we feel really optimistic about how big Programmatic, Ad Studio as well our self-service tool, how well they're doing and how much they could continue to grow over time.

Unidentified Company Representative

Great. Our next question is from Todd Juenger at Bernstein. Premium subscribers as a potential -- as a percentage of total music streaming MAUs seem to have leveled off at about half of your total most mature markets in Scandinavia. The U.S. seems to be tracking at a similar percentage. Do you believe that represents what the overall proportion of Premium looks like in wealthy markets as they approach maturity?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Actually, I don't think we've seen that trend. I mentioned in my opening remarks that we're seeing a resurgence in user growth in, say, the Nordics as well. And if you look at what that means historically is that, once we see user growth, that's the strongest leading indicator we have for future subscriber growth, too. And the trend has been -- continues all the way, which is that we keep on seeing commercial rates going up across the board, Nordics being way higher than the figures you're mentioning. It's hard for me to predict whether we're going to see the same trend across all other geographies. But we feel very confident that the longer the user stays with us, the more engaged they are, the more likely they are to convert into a paying customer. And that trend keeps ongoing even 10 years past our launch into the territory. So as it relates to newer territories, you certainly see some of the same indicators. Obviously, the methods in how they're converting are somewhat different based on local geographic nuances.

Unidentified Company Representative

The next question is from an individual investor. Does the management think that social is core to the music listening experience? How important is social feature in driving discovery, interaction and engagement in music? Does Spotify intend to create more such social features in the app?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Music is inherently social, and we see that in pretty much all of our listening data. What most people associate with social, however, is user-to-user networks of people talking about music and exchanging songs. We have made a number of those experiments in the past in a number of those product launches. And for some of you that have been following us for a long time, you know that we launched Spotify in the U.S. with Facebook integration. So we have been early pioneers in social. We keep on testing social efforts. Over time, the strong goal for us in social is to connect artists and fans directly. We think that's the most powerful thing we can do. And to the extent that we invest in social, you should expect us in those over user-to-user communication.

Unidentified Company Representative

The next question comes from another individual investor. What is the response to Spotify Lite then outside of the U.S.? And how do you see your non-U. S. growth continuing to play out over the next several years?

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

Yes. The response to Spotify Lite has been strong, I would say really in all markets where we have launched it. Again, it appeals to a very different demographic of users than what we would normally see. So we're encouraged by that. And we realized as Spotify grows into more territories, data and connectivity is a big impediment for a lot of consumers. And it's something that we take for granted in the western world where we have abundant access to cheap data, but we're still dealing with many territories where data usage is a real thing. So having Spotify Lite, which really protects the consumer and makes them aware of how much data they're using and enable them to listen more via WiFi, has been a strong driver for retention and growth.

Unidentified Company Representative

Great. This is the last question. It comes from Richard Kramer at Arete. Can you talk about cash flow in Q4 and into 2020? Most of the free cash flow seems to have come from working capital in Q4 with lower accrued expenses.

Paul Aaron Vogel - *Spotify Technology S.A. - CFO, VP, Head of Finance/FP&A, Treasury and IR*

Yes. So free cash flow was strong in Q4. So for the full year, we generated about EUR 440 million of positive free cash flow. Q4 did benefit from some -- we have some payments that can -- tend to be irregular in nature, and it always happens in the same period of time. There are some of those payments we expect to happen in the first half of 2020, most likely in Q1. So it's very possible that we'll have a -- either Q1 or Q2, but most likely Q1, we'll have a negative free cash flow.

But in general, free cash flow has been very strong. It was up pretty nicely in '19, about a couple of hundred million over '18. We expect free cash flow to be positive in 2020 as well. We do benefit from working capital. We don't expect any of those dynamics to change. And like I said, we will likely have potentially a negative free cash flow in Q1 just based on the timing of some of the payments that got pushed from Q4 into Q1. But in general, we expect free cash flow to be positive and strong again in 2020.

Unidentified Company Representative

Great. I'm going to hand it over to Daniel for some closing comments.

Daniel G. Ek - *Spotify Technology S.A. - Co-Founder, CEO & Chairman*

All right. Well, in closing, we're seeing that our investments in user experience and in podcasting have resulted in accelerating user growth around the world, giving us a strong quarter and an even stronger year. We see so many positive indicators in the business, including top-of-the-funnel acceleration, improvements in retention and churn and positive engagement trends. And we're making strong progress on our path to becoming the world's #1 audio platform, and we're confident that our results will prove us right again. Thank you so much for taking the time to do this call with us today.

Operator

This concludes today's conference call. Thank you for joining us. You may now disconnect.

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