

Spotify: High-ROI Grower With Scale, Brand, and Network Effects

Arvind Mallik and Jonathon Fite of KMF Investments presented their investment thesis on Spotify Technology (US: SPOT) at Wide-Moat Investing Summit 2022.

Thesis summary:

Spotify is the top music streaming company. With 422 million monthly users (182 million paid subs) Spotify has a large and growing market share lead.

Streaming, especially the “freemium” model led by Spotify, has saved the once-declining music industry and restored it to growth over the past decade. Music streaming, the most affordable form of entertainment, has a big growth runway from penetration, developing markets, and advertising.

Going beyond music streaming, Spotify has rapidly established itself as the leading podcast company, with heavy investments in the platform and content.

The recent tech stock selloff, as well as controversy around its star podcaster Joe Rogan, has brought the stock down ~70% from the highs.

As a result of its heavy growth spending — much of it through the income statement — the stock may not look cheap at first glance. Looking deeper, however, the stock represents a compelling value, and offers the likelihood of strong compounding if high-ROI growth persists.

While the company has formidable, well-resourced competition — Apple, Google, and Amazon — it has established a moat with scale, brand, and network effects. The strategy focuses on optimizing the lifetime value (LTV) of its user base with AI-driven personalization, growing content (music, podcasts, audiobooks), and an ecosystem of creators and artists loyal to the platform.

The company’s highly capable founder and CEO, Daniel Ek, recently bought \$50 million of SPOT stock — one of the largest insider buys we have seen.

At the June 2022 investor day, Spotify revealed its long-term aspiration to be a \$100 billion revenue company by 2030, with 20% operating margins. Starting from Spotify’s recent enterprise value of only \$20 billion, this growth offers strong potential for compounding over the coming decade.

The following transcript has been edited for space and clarity.

Arvind Mallik: Jonathon and I are honored to be invited again to the Wide-Moat Summit. Thank you also for building this great network of value investors from whom we can learn so much. Given the market sell-off this year, we are excited to see what other ideas will be presented this year.

Our idea is Spotify, a company whose product we – especially Jonathon and his family – have enjoyed for many years. It was an expensive tech growth stock. During the recent sell-off,

which has brought the share price down more than 70% from its highs, this growth stock has become more of a compelling value stock, and we believe it's a long-term compounder.

Our presentation is meant to inform and educate fellow value investors and encourage them to do their own research. Our investment partnership recently purchased shares of Spotify. We hope our presentation proves insightful, and we're definitely keen to hear back from the MOI community.

Let me start with some background on our investment philosophy and strategy. We are long-term value investors inspired by Ben Graham, Warren Buffett, and many other great value investors. We're focused on finding good companies whose stock prices offer a margin of safety. Within that broad definition of value, we can be very nimble and flexible across industries, flavors of value, market caps, and even asset classes. We like to say that we go where the value is. Today, we are starting to see some value – even in the tech growth space – given the sell-off where we feel the market has thrown out the baby with the bathwater.

A few more words about our investment partnerships. We have a pure pay-for-performance structure inspired by the 1950s Buffett partnerships with zero management fee and only a profit-sharing structure with high watermarks. We also are quite transparent with our partners about the valuation of our holdings, the overall portfolio, and the investment thesis. This has helped create a patient and loyal base of partners that has allowed us to be contrarian during periods of market fear to find opportunities, whether during the 2008 financial crisis, the 2020 COVID market crash, or the current market decline.

We alluded to the different flavors of value investing, many of which were pioneered by different value investors we respect. We tend to group them into three rough buckets. The first is free cash flow-based valuations. Many of those include wide moat-type ideas such as those discussed at this conference. It includes high-quality buy-and-hold type companies, growth companies at a reasonable price, those which have a solvable incident, or what Mario Gabelli might label as private buyer value or strategic buyer value.

The second category are asset-based valuations where we're much more looking at the balance sheet, whether it's natural resource-type companies and commodities (which we found a lot during the commodity downturn the last few years), companies trading below replacement costs, discounted book, Ben Graham net-nets, or spin-offs. The third category is special situations, which include distressed debt and arbitrage opportunities. Those were more plentiful during the financial crisis, perhaps a bit less so now.

Over the last 15 years, our fund has pursued a mix of these. During the financial crisis, we found a lot of high-quality companies had come down to great prices and were highly compelling, as well as many special situations, especially distressed debt and other credit opportunities during that credit crisis. Over the last decade or so, we found that the broader market was chasing growth and momentum. During this time, we were focused much more on asset-based opportunities, including commodities and quality-type companies.

The recent market environment has very strongly favored these asset and resource conversion plays, especially oil and gas, but we see that the associated market sell-off in other areas is presenting growth-at-a-reasonable-price opportunities again. What we also see is that these different buckets of value investing opportunities elicit different engagement models by us as investors. With the free cash flow-based high-quality companies, especially the larger-cap ones, our investments tend to be completely passive where, while analyzing operations and financials deeply, our contact with management is fairly passive.

However, for smaller-cap companies where we're able to build meaningful positions and also often get on the boards through a friendly advisor-type approach, we find ourselves much more active and advising companies on operations or capital allocation. Depending on the nature of the investment, our engagement style also differs.

Jonathon, I'll hand it over to you to dive deeper into our idea.

Jonathon Fite: Thanks, Arvind. It might be good to spend a minute on acknowledging the current market context.

For much of the last decade, adherence to value-based investing strategies has not fared that well when compared to simply going along the S&P, in particular, holding a basket-of-things stocks that buoyed much of the S&P Index. In fact, I think a lot of us wonder what was happening as a number of famed value investors made waves articulating their "value investment thesis" on growth names like Netflix, Amazon, and others.

However, the recent tech wreck, if you will, is notable. There are a lot of echoes to the 1999-2000 dotcom era. Jeremy Grantham of GMO has been calling for this reckoning for a few years now. Beginning in February 2021, we've started to see some real carnage in the tech space. It's been incredibly severe. There were many names that we think deserved some of that carnage. There were so many COVID beneficiaries that are now down 70%, 80%, or 90%. We've seen those price declines. We're still boggled how some electrical vehicle companies that had no sales but a great PowerPoint deck reached \$100 billion market caps.

When we see this magnitude of decline across the sector, the contrarian side of us begins to beg the question of "Maybe there's some stuff that's overdone?" and "Maybe there might be some real value in there?"

If we look at an overview of the broad markets and plot them on a cheapness-to-performance ratio - and this is one of the simplest measures of cheapness; looking at a real high-level metric of P/E as a measure of cheapness, and we're looking at returns - we see that the major players in the index, the FANG companies and the other big tech stocks that have buoyed the index over the last couple of years, are seeing the largest declines so far this year. Even with those declines, using some of the simplest metrics of value, they still don't seem that cheap.

The only place to hide so far this year has been in energy and some other assets and traditional value plays, but energy in particular has been a strong performer. Fortunately, this has been our biggest sector allocation over the last couple of years and continues to be so. It has truly buoyed KMF this year. We've fared pretty well in the context of the broader market carnage.

However, when we see some of these great businesses we've admired for the last decade that have historically been at prices we didn't feel comfortable paying, when we see them fall 50%, 60%, or 70%, we start to ask, "Might these companies represent some real value?" especially if you are willing to dig past the headline earning numbers and develop some differentiated insights. That brings us to our investment thesis today for Spotify.

Spotify is the number one audio streaming platform in the world. It currently has more than 400 million monthly active users, many of whom benefit from its freemium model - the free/premium model blend where folks can try the service in a free, ad-supported way. This

creates a moderate ad business for Spotify. Along with those 400 million-plus MAUs, there are also about 200 million paid subscribers spanning 183 markets around the globe.

Even with the recent share price declines, Spotify optically doesn't look that cheap using traditional valuation metrics like EV/EBITDA, P/E multiples, or others. Yet, as we dig into the business, we find it to be a wide-moat business. Oftentimes, such companies come with valuations that are hard for dyed-in-the-wool value investors to get excited about. We believe Spotify today represents an interesting wide-moat opportunity at a highly attractive entry point when you look beyond the headline numbers.

Let's dig into this a little more. Based on the recent price performance, it seems a lot of investors perceived Spotify as a COVID beneficiary. The stock tripled during the pandemic as lockdown orders and work-from-home scenarios increased the opportunities for on-demand streaming and audio listening. However, the recent price declines from almost \$400 a share all the way down to below \$100 have taken the stock back to pre-pandemic levels even while the company has dramatically extended its lead over its rivals.

When it comes to Apple, Google through its YouTube Music offering, and Amazon Music, it's important to acknowledge these are well-funded competitors that do create threats to Spotify's moat. Still, Spotify has a huge lead in the number of paid subscribers and somehow that lead continues to get larger year after year. It begs the question why. What is it about Spotify as a business that allows it not only to be the number one player but to continue to grow that lead over time? It's not just that it had a big head start and its growth is slowing while the big competitors finally show up with their massive wallets to eat Spotify's lunch. In fact, we've seen the opposite. With each year, Spotify's lead continues to widen. We think this is an extremely important indicator of its moat.

Early on, we might have thought that the moat could be attributed to Spotify's technology advantage. The company was the first to figure out instant on-streaming – no delay, no buffering, just click the button, and music start streaming. Eventually, though, this wasn't a unique enough value proposition, and everyone else copied that technology platform. What we believe to be the biggest driver of its competitive differentiation is its personalization engine. Spotify knows what you like based on what you listen to. Then it introduces new music to you that you've never heard before, but somehow it thrills you. You discover all kinds of new artists that weren't in your historical CD collection. In fact, Spotify does this not only by genre but by mood or time of day. It knows that you typically listen to something different on Saturday morning when you're cleaning the house versus on Thursday afternoon while you're working versus Friday night when you have people over for drinks.

This personalization engine is extremely powerful. Spotify's artificial intelligence and machine-learning tools have assets that none of the other players have, mainly dramatically more listeners to learn from and then vastly more user-generated playlists. Spotify has over a billion playlists to help learn your preferred moods, genres, beats, and acoustic styles! Apple, the next largest competitor, has 30 million. It's more than an order of magnitude difference. It's not even close. This is a huge-scale moat for Spotify that is increasingly more difficult for others to catch up to. Because of those users and playlists, both independent artists and the major labels are clamoring more and more to be in Spotify's curated playlists. This is a key driver behind how streaming, and Spotify in particular, has saved the music industry.

Let's take a quick moment to step back and examine some of the industry context and how that's a growth driver for Spotify now. Many probably remember the music file-sharing platforms of the late 1990s and early 2000s, things like Napster, Morpheus, and Kazaa. With

the digitization of music into easily transferable MP3 files, these pirate radio platforms devastated the revenues and profits of the music labels which historically controlled distribution.

Apple's iPod – a thousand tunes in your pocket at 99 cents a pop – was a model that helped slow the erosion a bit, but the industry continued to be in a tailspin until music streaming finally reached some scale in the 2014-2015 timeframe, which happens to coincide with Spotify's global adoption. The industry overall is back in growth mode even as the penetration rate of paid subscribers is still pretty low in comparison to global smartphone adoption. We think both industry growth and the huge room to drive incremental penetration in global smartphones present some truly interesting macro tailwinds for Spotify's growth going forward.

We can see how assumptions of higher penetration rates aren't unreasonable given the entertainment value proposition. If we look at various media types, music remains one of the cheapest sources of entertainment on a cost-per-hour consumption basis. If we go back 20 years or more and look at this on an inflation-adjusted price of what we used to pay to consume music when we were buying tapes and CDs, we're still nowhere near the level of spend consumption of 20 to 25 years ago. Again, lots of room for music streaming to continue to grow in the years to come.

Let's talk about Spotify's monthly active users. This has been the core story of the business. While the platform has about 420 million monthly active users today, the company is forecasting that it will hit about a billion MAUs later this decade, an estimate that aligns with projections from Deutsche Bank. It's interesting to note that while the market treated Spotify like a huge COVID beneficiary, the growth has been pretty consistent, whether before COVID, during COVID, or post-COVID reopening. We think there are a number of factors behind this, including expansions into new countries, greater penetration of new artists driving a wider catalog of music and music appreciation, and the continued migration from the freemium offering to paid subscriptions. As people try the product in the ad-supported model and find that they love it, the conversion rates from a free user to a paid subscriber have been pretty consistent over the last couple of years. With monthly active user rates climb towards a billion users, this will be a natural tailwind for paid subscriber growth, which is Spotify's largest revenue stream.

On top of this, the platform is going to have an even larger ad-supported audience. This is another key growth driver of the business. While the ad-supported freemium model exists, Spotify has historically under-monetized this user base. However, over the last couple of years, it has made a number of investments, both organically and also significantly through some key M&A activities, to build its ad stack monetization platform so that greater monetization of that free user base can be more realistic. As both paid subscribers and ad monetization grows, the average revenue per user should continue to grow. Again, all tailwinds for revenues and margins over time.

The current ad-supported user base generates only a fraction of the revenue versus Spotify's paid subscribers, and we see this as a significant opportunity for growth. Yet, in relation to some other key ad-supported competitors, Spotify has tons of room to fully monetize this cohort of listeners. Facebook earns \$35.00 to \$50.00 per user, and YouTube earns about \$9.00 per user. Spotify is currently only monetizing that free user base through ad monetization at maybe \$3.50 to \$4.00 per-user rate. An intentional focus and capability building over the last couple of years has now enabled it to maybe go after this market a bit further and to see broader diversification of these revenue streams. It's an interesting

diversification and growth of revenue over time.

Spotify has been known as a great tech developer and innovator for the streaming space, and it is clear the company has been strengthening its platform to grow not only standard audio music streaming but a number of revenue streams, from ad stack monetization and content personalization to podcast hosting and distribution. It has been busy creating the capabilities needed to grow this business over the next decade. In addition, there have been a number of acquisitions to support Spotify's marketplaces business, which is now becoming an incremental and quite important contributor to its music business gross margin. For example, if an independent artist wants to sit in their bedroom, record a song, and post it on TikTok, they can do that. However, if they'd prefer to have a professional producer, sound mixer, and studio recording environment, Spotify now provides these services to its artists. With independent artists representing an ever-growing mix of the available catalog, this is a meaningful growth driver to revenues and margins for Spotify over time.

A few years ago, this marketplaces business represented about \$20 million of contribution margin. Today, that's closer to \$200 million. This will continue to grow over time and is a significant driver of the music business continuing to improve its gross margins as we move forward.

In addition, while most people consider the revenue and royalty share with the music labels as the big gross margin driver for Spotify, CEO Daniel Ek has stated multiple times – and underscored this at the company's recent Investor Day – that this is not where the margin opportunity lies for Spotify. You could argue that given Spotify's scale and its importance in today's world of music distribution, it would have significant negotiating leverage to take a larger share of revenue in that royalty negotiation with the labels, but Daniel has stated that he wants to keep that revenue share relatively flat and instead drive higher margins through additional value-added services to the labels.

For example, if the production capabilities of the marketplaces business are being used by independent artists, they can also be used by the major record labels. As Spotify's personalization engine creates new Discover Weekly playlists, its users get exposed to new artists, and new artists find that being inserted in that one playlist for the first time gives them their big break. This is huge for independent artists and the traditional labels as well. Since they're trying to optimize their own marketing promotion and distribution costs, they are willing to pay Spotify for inclusion in these curated playlists. They're increasingly paying for it, whether it's the Rap Caviar or the weekly playlists. These curated playlists in addition to the file sharing of user-generated playlists are a huge growth opportunity as the labels and independent artists try to tap into that user base.

This isn't a great example of what we call the Charlie Munger win-win. I think a lot of investors try to focus on where those label negotiations are going. Instead of battling the labels on the royalty rate, which inevitably creates a win-lose for somebody, Ek is saying, "Let's just keep this status quo. Everything's good. Let's figure out how to create value for the labels, which is great for the artists and the labels and hugely margin-accretive for Spotify." The marketplace business is a massive component of why the music gross margins are growing over time.

Quietly, the music business has been doing very well. The combined entity reporting historically has not been very good. At the recent Investor Day, Spotify provided a lot of insight into how the music business is doing in relation to some of the other segments. The core music business has quietly but significantly benefited from the businesses acquired over

the last decade. Most of that noise around Spotify's financials has been attributed to the podcast capability and the talent acquisitions. Over time, though, the gross margins for this core streaming business continue to improve, and the company expects them to move from the mid-20s to the current level of the high-20s to a mid-30s margin level over the next several years. Again, continued tailwinds for Spotify's growth.

Let's talk about Spotify's investments and some of the noise surrounding the business for the last couple of years. That's primarily around its content acquisition. Similar to what John Malone did with SiriusXM and Reed Hastings with Netflix, Spotify has been making large investments in owned content that attracts and scales across its growing user base. In the mid-2000s, when Howard Stern got his huge deal to go to satellite radio, everyone thought that deal was nuts, but it created a massive migration of Stern listeners to the satellite radio platform, which created scale for Sirius. That content investment created a huge user base to spread those investments across.

Netflix did the same thing when it moved from licensing other people's content to producing its own. Some would probably argue today that Netflix went too far down that model - greenlighting anything that walked in and could fog a mirror - but we still think the core analogy of acquiring significant owned IP and content to attract and scale a user base is an appropriate analogy.

Spotify's deal with Joe Rogan, which has proved controversial given some of Rogan's comments in the COVID era, is probably the most significant deal in the podcasting arena. If we dig into some of the details related to the Rogan podcast, we find that it's still the number one program across 93 markets. In many markets, the Joe Rogan Experience was the most listened-to show every month. This drives both user acquisition and subscriber adoption for the platform with a truly engaged audience, which is great for subscription conversion and ad monetization. In fact, Rogan's listeners return to Spotify more than any other user segment on the platform, and they listen to more content than any other user on the platform, which has all been critical to making Spotify the top US podcasting platform. This is great for both subscription growth and ad monetization, and we believe it helps create a beneficial network effect.

Thus, aside from the scale moat, we now have an incremental moat around a network effect because as more users flock to this content, more content creators and more artists want to bring their content to that targeted and unique user base. Perhaps more importantly, we now have a growing ad stack that is available to marketers who want to access a very well understood demographic and a marketing ad stack in an era where Apple's privacy policies have greatly impaired many of the ad targeting capabilities of other platforms, like Facebook and Snapchat.

As value investors, we need to look at some of the financial profile of the business because we think some of the headline numbers are a little misleading and require a bit of digging under the surface to better understand the business. Our thesis is that Spotify's personalization engine has created a moat that attracts both users and artists to the platform. Combined with the creator tools in its marketplace segment, this has created a robust music streaming franchise that's going to grow margins over the next couple of years. This strong core music business has enabled Spotify to fund acquisitions to grow new revenue streams. It has enabled it to grow into the leader for podcasting where it has a huge subscriber and ad monetization growth runway in front of it. That business is now starting to get to scale.

I think one of the reasons why the stock has sold off over the last six to nine months is that those investments in the podcasting side of the business have driven down margins even further. Everyone's worried about rising rates, and anything associated with tech sold off. Still, that ad platform or ad monetization business tied to the podcasting side of the house is now starting to reach enough scale that it can contribute to the overall business.

At the Investor Day, management outlined how growing the second major business line around podcasting has offered some lessons on how they can scale across other business lines. Music is the core. Spotify has spent the last three to four years building podcasting, and it's just now going to start contributing at scale to the business. Those lessons have taught Spotify how it can maybe enter in some new verticals, namely around audiobooks, where Amazon's business has innovated a lot over the last 20 years. Spotify thinks it can take share and improve the margins of that business as well as the broad audio education market. These are a couple of new verticals that might provide some interesting growth.

Across all of these segments, what we find is that most of the investments are being made through the income statement, which occludes the profitability and the traditional value metrics of the business. For instance, if we look at Spotify's research and development costs, nearly all of this is likely some form of what value investors would consider growth capex, but since that spend is classified on the R&D line, it runs through the income statement, burdening earnings and EV/EBITDA metrics, rather than below-the-line assessments if it were growth capex investments on the cash flow statement.

Similarly, if you look at Spotify's marketing and sales expenses, we think a good portion of those costs are being targeted at growing the user base, but that growth investment is burning through the income statement. We prefer to view Spotify by getting an adjusted view of its profitability to see what this business might be worth if the company pared back or suspended some of its growth investments. What is this adjusted standstill free cash flow view of the business? What is this core business worth? We think it's got a good scale moat. What would that be if it didn't grow in the future? Importantly, if we get this standstill free cash flow view, we can then begin to assess and measure how effective these growth investments in the income statements are. What kind of returns is Spotify generating from those investments?

With the 2021 financials, we've backed out the R&D expenses and taken a simple 20% SWAG of the sales and marketing expenses. We think, in reality, that a larger percentage of this marketing spend is probably targeted to growth, but we're going to assume 20% for now to try to be conservative and keep things simple. Once we adjust for the current euro-dollar exchange rate and apply a simple 10X multiple, saying, "What is a no-growth business worth?" If it has a moat, and it doesn't grow, it's probably worth 10X free cash flow. With a 10X multiple that kind of cash adjusted, the no-growth price of the business is roughly about \$100 a share. Interesting!

At roughly \$100 a share, you're getting all future growth in the company for free. The stock has recently traded below these levels. Today, it trades maybe slightly above it. It seems to us the market simply doesn't believe that any of the growth opportunities are going to materialize, or if they do, there's not going to be any profitable growth ahead for Spotify in the years ahead. At KMF, we're taking the other side of that bet. Who knows what's going to happen in the market over the next couple of months? Over the next couple of years, we believe there are just too many growth drivers to ignore for Spotify, whether it's the company's continued march higher in terms of monthly average users, that MAU stack converting into paid subscribers, the ad stack getting monetized at a more realistic level, the

growth of the marketplaces businesses, its mixed shift to more independent artists where it gets a higher rake, its value-added services for artists and creators and labels, and new verticals like audiobooks and education. Some of those things are probably going to hit, so buying this business at a no-growth price seems like an extremely interesting opportunity for us.

The question logically becomes, “How much upside is there in this business?” We’ve taken a stab at summarizing what we think Spotify could be worth in a few years. Over the last several years, Spotify has reinvested about 75% of its standstill free cash flow. Said another way, if you look at those R&D and sales and marketing expenses that are driving growth, they have been about 75% of the cash generated before those investments. That’s a pretty high reinvestment rate. If I invest 75% back in the business, hopefully I get some growth out of that. That 75% reinvestment rate has typically generated returns in the 35% to 45% range. I’d call those pretty good returns.

If you believe Spotify can continue to reinvest at those rates with those types of returns, the stock’s a multi-bagger over the next couple of years. You can make your own assumptions for how good the investments and podcasts are going to turn out, what kind of growth audiobooks or education markets might bring, or how much margin contribution the marketplace business has, but in our view, the longer you hold this thing, the better it becomes. This is one of those “maybe never sell” type of companies. You could easily earn multiples of your invested capital.

You can take the flip side and say, “What does the current market price imply?” It essentially implies that the reinvestment rates declined pretty dramatically, and the returns on those reinvestments converge to maybe a 10% to 15% cost of capital. We think there are too many growth drivers for the current price to be reflective of the value of the business in the coming years.

This is our view using a simple return on invested capital reinvestment rate analysis, but at the recent Investor Day, Daniel Ek made some interesting comments. Over the next eight to nine years, or by the end of the decade, management want this to be a \$100-billion-business with 20% operating margins. Maybe they get there. Maybe it takes a little longer than he thinks. However, Spotify is a \$19 billion market cap business. Even if only a few things go okay, we think it presents an amazing value in today’s tech wreck.

Arvind, do you have any additional commentary on the valuation side?

Mallik: You covered it thoroughly, Jonathon. To add a little to the long-term guidance given at the recent Investor Day, that \$100 billion with 20% operating margins comment, in between, there’s a 40% gross margin, so both gross margin and growth leading to the operating margin expansion, trading at 1X that long-term operating profit (should the company achieve that) would definitely result in a multi-bagger. Clearly, Daniel Ek sees that as the company steadily invests in this growth and adds different verticals, growing podcasting and inflecting that towards profits, then adding audiobooks and so forth. That’s the runway for Spotify’s highly ambitious aspiration of growing almost eightfold over the decade.

In addition to the valuation-based downside protection or margin of safety, Spotify has a very strong balance sheet, which makes it quite resilient during the current market downturn. The company has a lot more cash than debt and is free cash flow-positive even though it does not have accounting-positive earnings because of the investments and other factors. It does have

a negative working capital business model, which is very attractive. As it grows, because its incoming cash flows from subscribers come in before the outflows, growth is accretive to free cash flow and adds to the margin of safety.

Also noteworthy is that on the liability side, the company has \$1.2 billion of what are called exchangeable notes. It's quite interesting that these are zero-coupon bonds that Spotify issued when the stock price was very high. They're from a convertible debt when the company's stock price was much higher than at present and should be viewed more as quasi-equity, even as debt, although they are due in a few years. Between those, all in all, the company has a very liquid and solid balance sheet to navigate the current environment.

The stock price implies that the market doesn't necessarily believe as much in the moat, but the fact that Spotify has grown and fended off tough competition and has not only maintained but grown its market share and also increased its gross margins in the music streaming business indicates strong management, very strong scale, brand, and network effect moat. We also believe there is a meaningful switching cost moat even if there isn't necessarily a strong intellectual property or licensing moat.

In terms of its evolution, the company started off with a very high-caliber software capability that amazed the marketplace with the instant playback, but over time, the fulcrum of the moat has moved to the curated playlists, artificial intelligence-based capabilities on the playlist, and the brand affinity and recommendation engine. We believe it is a more sustainable moat that isn't purely driven by innovation but uses the existing scale of 400-plus million users and drives penetration among those users and beyond. It almost becomes more of a social network in its own right.

Management is another big strength of Spotify's. CEO and founder Daniel Ek owns more than a billion dollars' worth of shares. One thing that caught our eye last month is that he purchased more than \$50 million of Spotify stock in the open market - not far from the current stock price - in one of the strongest insider buys we've seen recently at any company. That definitely shows he is putting his money where his mouth is. Clearly, the view is the stock is undervalued at these current levels.

When we invest at KMF, we are very much focused on intrinsic value and buying at a margin of safety to that intrinsic value. Still, we've found there are often catalysts or events that help drive the stock price and unlock value to help as you approach intrinsic value. We tend to put those catalysts into three types of buckets.

Operational is management rolling up their sleeves to achieve profitable growth. With many of our portfolio companies, we often get quite hands-on - whether through participation with the board or as friendly advisors - to help them in that regard. There are often financial catalysts such as stock buybacks, debt placements, asset sales, and other means to unlock value. Spotify has been fairly astute. In terms of its awareness of intrinsic value and the lifetime value of its user base, we've observed that it seems quite thoughtful about how to look at its business from a lifetime value of customers and also in issuing convertible debt when the stock was richly valued during 2021. By the same token, when the stock has fallen 70%, for Daniel Ek to see it as a bargain and buy shares shows what an astute view the company has of its financial position and valuation.

Among the operational catalysts, also noteworthy at the recent Investor Day was Daniel Ek and the management team pointing to inflections that are likely in the next year or year and a half on the podcast business, where they move much more from investment mode into

monetization mode and expecting an inflection in gross margins and operating margins in that division. That should be a good operational catalyst as well.

Finally, on the macro side, it's noteworthy that Spotify has grown into more than 180 markets and already dominates not only in developing markets (where much of the free cash flow and revenue come from) but is a top player in many emerging markets. As those emerging markets grow and average revenue per user in them grows with the expansion of their middle classes, it should be a nice tailwind for Spotify as well. Also, several analysts and the management team themselves acknowledged that there's also quite a bit of latent pricing power in the business they've chosen not to monetize that should come into play in the years ahead as well.

We like the Manual of Ideas Investment Checklist that you often use in some of your publications, John, so we'll use it to summarize our investment thesis. We find that Spotify does check most of these MOI investment criteria. The stock has a compelling value with the price having declined 70% from its highs to what we see as a no-growth price where the optionality of growth provides a healthy upside. A strong balance sheet and liquidity position and positive free cash flow from a capital-efficient business model provides good safety. There's also the moat from brand, network effects, and switching costs.

In terms of management, Ek has shown a very strong record as a founder, owner, and operator, and he is now also showing strong alignment by putting his money through his recent \$50 million insider buy. The company has a healthy capitalization balance sheet.

Performance-wise, the underlying business has continued to deliver strong results. There's been a steady rise in monthly active users. The recent controversy around the Joe Rogan podcast plus the overall tech wreck has led to the shares trading at depressed levels. We do see many catalysts, including macro, from the ad shift to the turnaround in the podcasting profitability, that might unlock value.

We see Spotify shares having substantial upside potential as a compounder over the coming years.

We're eager to hear back from and engage with the MOI community, which comprises many value investors whom we respect.

The following are excerpts of the Q&A session with Arvind Mallik and Jonathon Fite:

John Mihaljevic: Jonathon and Arvin, thank you so much for the compelling presentation on a name everyone knows but not everyone has looked at in as much detail.

Let's start with a general question. In the past, you've also presented companies that trade at, let's say, deep-value multiples of EV/EBITDA. How do you weigh the cheapness versus the business quality? In this case, the business quality seems compelling, but I'd love to understand the process of how you decide to go for this investment versus something that's maybe at 6X EBITDA but doesn't have quite the outlook.

Fite: That's a bit of the art to this. When we began as Buffett devotees, it was all about "How do I find a Coca-Cola trading at 10 or 12 times? Let me buy it and never sell it." Or the simplistic "Let me just go buy some Ben Graham net-nets" because you don't have to do much thinking on those. You keep screening for something that's maybe not a biopharma stock, buy a basket, and move on.

As you do more of this, you increasingly appreciate what Charlie taught Warren, which is that great businesses are the best things to own. I think many value managers lacked in the last decade. It was hard for us in particular to fathom how good a business Facebook and Google are. When you're running a valuation model, you don't expect businesses to quintuple revenues and grow earnings 20X over a decade, yet we saw some of these businesses with truly special business models do that.

We don't want to fight yesterday's war, but we've looked at the FANG stocks for five, six, seven years. Alphabet is another major position of ours because we think of the other FANG plays. We still think that it has probably some of the best differentiation and differentiated business model and long-term growth at a reasonable price. However, so many of these other great companies were too expensive for our appreciation of the business to also resonate with our dyed-in-the-wool view of value.

In the 2015-2020 period, we found a lot of hard-asset plays, like in the shipping arena, where there had been so much overbuilding in the late 2000s and early 2010s that company after company was going bankrupt. When we see carnage in an industry, the contrarian us goes, "Let's go dig into that pile of rubble and see if there's anything worth buying." The same with the energy space, which was so unloved with the evolution of ESG models.

For the last four or five years, the bulk of our attention has been on the lower multiple asset replacement view that would benefit from a macro tailwind of rising rates, rising inflation, rising demand for energy, and those types of things.

The last year in particular, since Cathie Wood's ARK fund peaked out in February 2021, you saw all of these companies that had no business having any kind of valuations completely implode. It was very much akin to where Jeremy Grantham was talking about companies being taken out to the woodshed and shot, but we avoided a lot of that. However, in that sell-off where we think a lot of that stuff was warranted, Amazon down 33% is interesting, Google down 33% is interesting, even Tesla down. We still wouldn't buy Tesla today, but it being down 40% is interesting. Spotify down 70% was too compelling to us.

While we're beginning to trim some of our energy exposure and some of our exposure to other hard asset plays, like shipping, because those have run up so much over the last year, we still think energy is a core ballast to our portfolio. We see more upside risks to oil prices than dramatic downside risk. We still think it's prudent. When everyone's on one side of the boat, we want to move to the other side. When everyone was avoiding energy like the plague, that was a great time to be playing in distressed and convertible debt or some of the post-bankrupt equities of energy companies.

Today, when you see companies with great business models down 70%, 80%, or 90%, we think that's a great place to allocate capital. I wouldn't say we do one or the other. I always wore the old Ocean Pacific shorts after they were five years out of fashion. I tend to do everything that everyone else considers unpopular when they leave it but, from an investment perspective, I think that works out okay.

Arvind, why don't you jump in there with your view of the world?

Mallik: I think you covered it well, Jonathon. To us, some of this is about sizing and balance with the portfolio as well. While the energy and commodities part of the portfolio has run up, we are somewhat rebalancing towards the high-quality part of it as well. We'd rather not have everything purely be deep value but also have balance into the higher quality at

reasonable price, growth at a reasonable price, and a small number of special situations as well.

Mihaljevic: You talked about how audio is quite cheap for what it offers. How do you think about the ARPU that Spotify could get to over the next five or 10 years?

Fite: That's one of the key metrics to track, but I think everyone spends a lot of time focusing on one or two very simplistic metrics and not looking enough at some of the underlying things that are more important. For instance, you can get the total revenue for the company, look at MAUs, look at subscriber MAUs, and track that. If you look at other companies, you look at what kind of free business models are just ad-supported and how they're able to monetize users. There are companies whose ARPUs are multiples of Spotify's.

On the ad-supported business, we believe there's a huge runway. There's some ARPU revenue growth there as well, but I think there's huge ARPU growth on the ad monetization side for the free users, especially with the personalization engines.

One of the reasons Facebook is down by 50% or 60% is that its ability to do targeted ads has been impaired. The company is investing significantly not only in its Meta platform but in trying to stop using the aggregation it got off of your iPhone or Android platform to figure out what you like and target ads to you. It can't do that now, so it's trying to use AI engines to figure it out in a slightly more amorphous way. Facebook is probably going to have enough resources to do that, but it's impacted its business in the near term.

Spotify has a tremendous amount of data because it knows what you listen to and what podcasts you follow. It doesn't have to look at what you're checking out on other apps to get some interesting demographic data on you that is going to be important to ad marketers. The fact that Spotify has under-monetized that historically and has got some extremely interesting capabilities to deliver into that space going forward should be a huge driver for ARPU growth.

On the traditional paid subscriber side, we think there's still some pricing power there. We think - like Amazon Prime or others - a dollar or two a month of an incremental price increase. Netflix seems to be trying to test that elasticity a little, but we believe there's some meaningful price elasticity where it could move some price increases for the premium model.

Whatever Spotify gets on the back end - whether it's topline revenue from users or these marketplace businesses and the net royalty rates after value-add services to the labels - ARPU growth can happen in a lot of different facets rather than by just charging more per month. It's what Spotify might take to provide some of those services to independent artists to be included in the Discover Weekly playlist. There are so many different vectors for ARPU growth to happen other than raising the price for users.

We think it's pretty meaningful, but that's where Ek says, "There are other vertical lines of business we'll go into. We think gross margins are going to go from the mid-20s up to 40 as a company." He believes all music may level out at a 35% contribution margin rate. He thinks podcasts may be in the 40% to 50% range. He thinks audiobooks are going to be closer to 40%. Education may be meaningful. The way he sees it, once they achieve scale, these other lines of business will be more profitable. There are lots of drivers to that ARPU as we march towards a billion active users by the end of the decade.

Mallik: Yes, all very important points. One quite thoughtful insight the Spotify management

team gave during the recent Investor Day was this balancing act between the ARPU, which has multiple dimensions across regions, and churn. One of the noteworthy things is that the company's churn has come way down.

As markets mature, the actual user churn and attrition go down a lot. Once that happens, the company often starts exercising some pricing power. What's been dilutive to ARPU in the last few years is the massive growth and penetrating new emerging markets where the average rates are much lower. That's brought down the ARPU on an aggregated average basis. On a market-by-market basis, the company has experimented with raising rates and has been able to do so without affecting its churn rate or user attrition. That's been pretty meaningful. Management are quite thoughtful about that.

One of the segments in the Investor Day was devoted to customer lifetime value. Spotify is ultimately trying to optimize the marketing investments to obtain a customer and also optimize the value of that customer through various offerings, whether it's continuing as subscribers or upselling them into some podcast or audiobook over time and charging them more as well. It's not just about the rate per month, but also the overall ROI on that customer.

About the instructor:

Arvind Mallik is a Managing Partner of KMF Investments, a pure Pay-for-Performance Private Investment Partnership based in Denton, Texas. KMF seeks long-term capital appreciation by investing in companies whose intrinsic value is significantly higher than the market price. Since its founding in 2008, KMF has found opportunities in world dominating franchises, hard assets below replacement costs, businesses at large discounts to liquidation value, and firms with beneficial exposure to rising interest rates. Prior to founding KMF Investments, Mr. Mallik was a Senior Manager in the Strategy practice of Accenture. At Accenture, he helped global companies formulate and execute strategies to enter new markets, develop innovative new services and solutions, and reduce their operating costs to improve shareholder returns. Mr. Mallik obtained a BS in Chemical Engineering and BS in Bioengineering from UC Berkeley, and an MS in Chemical Engineering from MIT. He graduated with highest honors from both institutions.

Jonathon Fite is a Managing Partner of KMF Investments, a pure Pay-for-Performance Private Investment Partnership based in Denton, Texas. KMF seeks long-term capital appreciation by investing in companies whose intrinsic value is significantly higher than the market price. Since its founding in 2008, KMF has found opportunities in world dominating franchises, hard assets below replacement costs, businesses at large discounts to liquidation value, and firms with beneficial exposure to rising interest rates. Prior to founding KMF Investments, Mr. Fite was a Senior Manager in the Strategy practice of Accenture, where he helped companies improve shareholders returns. He is also an Adjunct Professor for the College of Business at the University of North Texas. Mr. Fite graduated with honors from the University of Arkansas with a BS and MS in Industrial Engineering.

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