EXECUTIVE SUMMARY[1]

Background. The music industry has experienced a significant transformation since the advent of Spotify. This pioneering subscription service revolutionized music consumption turning an industry in decline into one generating a vibrant, recurring revenue stream. Although we initially saw Spotify as a vehicle to bypass the traditional music industry's power structure, our perspective has changed.

Investment Thesis. Universal Music Group (UMG) is an undervalued gem in this evolving landscape. The rise of streaming has only reinforced its dominance, as UMG holds the key to an immense and diverse music catalog, and with that, the power to dictate terms in an industry where content is king.

Company Description. UMG stands as the titan of the music industry, with an extensive portfolio of record labels and publishing entities. With its rich history and deep relationships within the industry, UMG maintains an unmatched competitive edge. The company's intrinsic value is far beyond its financials; it lies in the music and artists they represent.

Record Labels & Publishers. UMG's portfolio of record labels and publishers is a testament to its industry dominance and position as a key gatekeeper in the industry. It's not merely a matter of owning a vast catalog; it's about representing the artists who create the music that the world craves.

The Balance of Power. The balance of power in the music industry is firmly in the hands of entities like UMG. While platforms such as Spotify offer a nice user interface, it is UMG and its peers who control the content. Subscribers follow the music, and without the music, there are no subscribers. This simple principle underscores the true leverage that lies in the music value chain.

Barriers to Success. The barriers to success in the music industry remain high, despite the seeming democratization brought about by streaming platforms. The role of record labels and publishers remains crucial in nurturing talent, marketing music, and negotiating with platforms.

Subscription Economics. The economics of music subscriptions have drastically enhanced the profitability of UMG and the major record labels. While platforms compete for subscribers, the content that attracts those subscribers remains a constant. UMG's extensive catalog provides that content and the associated leverage across the music ecosystem.

Growth Drivers. With its vast catalog and established relationships with both artists and streaming platforms, UMG stands to gain from increased music consumption. New markets, new advertising opportunities, and new pricing models are likely to provide additional growth avenues.

What's It Worth. UMG's intrinsic value extends beyond its financial statements. As we look towards the future, we see a company that not only stands strong in its industry but has the potential to shape it. UMG is more than just an investment; it's a stake in the soundtrack of our lives.

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[1] Executive summary provided by ChatGPT and lightly edited by Broyhill Asset Management.

BACKGROUND

"TIMES THEY ARE A-CHANGIN.'" - BOB DYLAN

We have followed the music industry for the last five years since Spotify went public via a direct listing. It would not be an understatement to say that the subscription music service single-handily changed how the world experienced music, shifted the long-held power structure amongst its key constituents, and turned an industry in secular decline into one generating a rapidly growing, recurring revenue stream. Spotify was so far ahead of the competition, that it dominated deep-pocketed rival offerings from Apple, Amazon, and Google, who failed to compete with the start-up despite virtually unlimited funding.

The streaming model is easy to understand thanks to an obvious analogue. Spotify is to music what Netflix is to video. The Netflix model has clearly demonstrated the benefits of content distribution at scale, as well as the advantages of a best-in-class tech infrastructure and user interface. While there are differences between the two business models, most notably, investment in content, the legacy structure of the music industry intrigued us.

> Notably, it appeared that Spotify removed the barriers to entry for artists, making it easier for musicians to bypass the labels and go straight to consumers. As such, we initially believed the company was positioned to garner an increasing portion of industry revenues, the lion share of which has historically gone to the music labels. If this view proved correct, the upside for Spotify was substantial. So we continued our diligence, looking for the right entry point into the world's leading music platform. We continued down this path, right up until we realized we were wrong.

As it turns out, a superior product doesn't always translate into a superior investment. Shares of Spotify opened their first day of trading at $165 in April 2018 and closed June 2023 at $160.

Spotify and Netflix have a lot in common. But the analogy broke down once we recognized one key differentiator. Netflix must keep running on a content hamster wheel if it wants to continue to attract and retain new subscribers. And that content keeps getting more expensive as more competition enters the market. That being said, Netflix customers don't expect access to every television series and every movie ever produced when they log into their account. They log into Netflix for House of Cards, Apple for Ted Lassos, or HBO (sorry, Max) for Game of Thrones. By contrast, imagine logging into Spotify and not finding The Beatles, The Stones, The Doors, Zeppelin, Hendrix, or Dylan. If all of these artists were only available through Apple, the strength of Spotify's algorithms and recommendations would be meaningless. Subscribers follow the music. No music. No subscribers. That's all you need to know about where the leverage lies in the music value chain.

Music is universal. Unlike video, which is generally consumed once, we listen to the same music again and again for the rest of our lives. Growing up, we'd excitedly wait to buy a new album as soon as it was released. We'd play the best albums so often, we'd literally wear out the tape in the cassette. Fast forward to today (pun intended) and we no longer have to wait in line at Tower Records for new releases or worry about scratching CDs. We can stream music whenever and wherever we want. And every single time we do, somebody gets paid. But that somebody isn't always Spotify.

That somebody is usually Universal Music Group (UMG).

INVESTMENT THESIS

"I CAN SEE CLEARLY NOW, THE RAIN IS GONE." - JOHNNY NASH

Streaming transformed our experience with music, and with it, the economics of the music industry. Following a decade of disruption and decay, the current, subscription-based model has vastly improved the monetization of music, increased the margin profile of the record labels, while greatly enhancing the quality of their earnings.

Of course, none of this was lost on the market. After a hotly anticipated IPO, UMG shares peaked at 30x EBITDA before investors turned their attention to a number of challenges: artists capturing a greater share of economics; record labels losing share across streaming platforms; streaming platforms positioning for a larger slice of the pie themselves; expensive catalog acquisitions; a larger than expected equity incentive plan; and of course, the threat of disruption from AI-generated music. Against this backdrop, Universal shed roughly a quarter of its market capitalization in the first few months of the year. But this isn't another one of music's Kodak – or Napster – Moments. Instead, we think it's an opportunity to accumulate shares in one of the highest quality businesses we've ever owned.

We believe Universal Music Group benefits from a deep economic moat in the form of an oligopolistic industry structure, an invaluable and irreplaceable music catalogue, a tremendous track record and global scale making it artists' label of choice, and extreme content concentration which provides high negotiating power relative to fragmented distributors. Consequently, we think UMG is best positioned to capitalize on the momentous shift in the industry landscape, as they own and control the only thing that matters –the content that matters. And in Universal's case, that's roughly one-third of all music ever recorded. Unlike most assets held on corporate balance sheets, the value of a music catalogue increases over time. UMG's catalogue simply cannot be replicated. Over half of recorded music revenue comes from that catalogue today. It will continue to generate increasing enjoyment, and revenues, for generations to come. Simply put: old music is new music, for those that haven't heard it before. Distributors can't exist without it and as such, we expect the company to capture a larger share of the industry's value over time.

Music has become a growing tax on the digital economy, tightly integrated with social media, short-form video, podcasts, gaming, and fitness. It drives traffic and engagement which can be monetized across enormous subscriber bases, because it's critical to how we experience countless occasions throughout our lives. Outdated licensing deals are now being converted into revenue-share models. Meta Platforms recently struck such a deal. TikTok still pays the industry next to nothing, but could shell out billions if they follow YouTube's path. And newer platforms like Peloton and Twitch represent additional opportunities. At the same time, recent price increases from Apple and Amazon Music, provide Spotify cover to increase prices, which have remained flat since the service was first offered in the States. Importantly, these prices increases should flow right to Universal's bottom line.

We believe these highly profitable end markets, combined with the continued shift to digital, and operational leverage, will continue to drive significant margin expansion for Universal, and we see a number of catalysts on the horizon, not yet reflected in consensus estimates. If correct, as upward guidance revisions and positive earnings surprises unfold in the coming quarters, we expect UMG's valuation to respond accordingly.

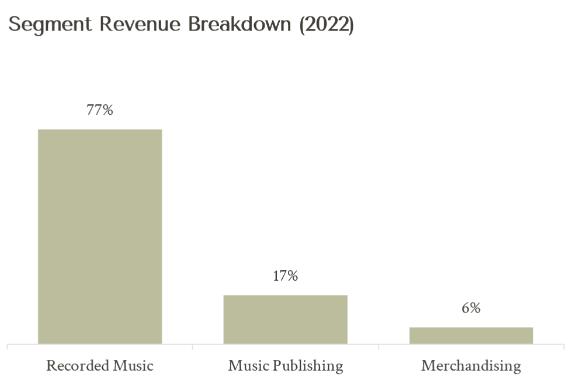
COMPANY DESCRIPTION

"WE ARE THE CHAMPIONS, MY FRIENDS. AND WE'LL KEEP ON FIGHTING 'TIL THE END." — QUEEN

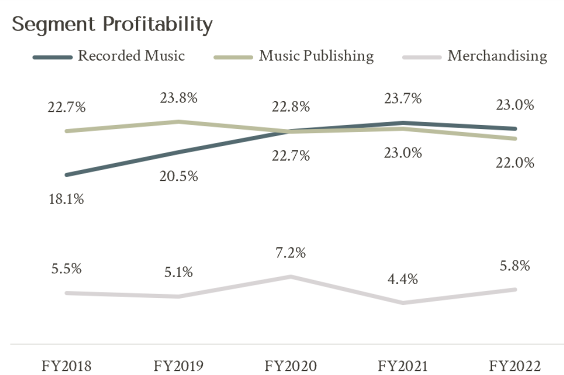
Universal Music Group began in 1898 with the founding of Music Corporation of America (MCA). After decades of corporate ownership twists and turns through the 90s and early 00s, Vivendi ultimately gained full ownership of the renamed UMG in 2006. In March 2020, Vivendi sold a 10% stake to a Tencent-led Consortium, which later exercised its option, to acquire an additional 10% stake in UMG in January 2021. The company went public on the Euronext Amsterdam stock exchange in September 2021. In addition to Tencent, major shareholders include Bollore SE (18%), Vivendi SE (10%), and Pershing Square (10%), leaving the free float at ~ 42% of the total shares outstanding.

Today, UMG is the world's largest music company. They own record labels like Interscope Records, Capitol Records, and Def Jam Recordings. They also own music publishing companies. The business model boils down to finding and signing talented musicians, funding their production, marketing their brand, and facilitating distribution. Led by Sir Lucian Grainge, an industry icon, UMG boasts a roster of artists that consistently top the charts.[2] In Spotify's 2022 Wrapped, all five of the most-streamed artists globally were represented by UMG, which also represents all of the top five artists on Spotify's top historical artist chart.[3] This, in turn, has translated into very strong fundamentals. In addition to the top charts, UMG's financial performance indicates that the company is the best at what they do. Since streaming took hold in 2015, revenues have grown 10.6% annually as operating margins have expanded 500 bps driving 13.9% annual growth in operating earnings. We see no sign of this slowing soon.

The business operates in three segments. Recorded Music consists of the discovery and development of artists, as well as the related marketing, promotion, distribution, sale, and licensing of the music created by those artists. Recorded Music represents the bulk of the company's sales. Music Publishing acquires and administers the rights to musical composition and licenses those rights for use in a variety of formats. Merchandising, the smallest of UMG's three business segments, generates revenue primarily from retail sales, touring, and concessions.



Source: Company Filings



Source: Company Filings

[2] The Last Mogul: An Interview with Universal Music's Lucian Grainge

[3] The Top Songs, Artists, Podcasts, and Listening Trends of 2022

The simplest way to think about this business is with the help of another analogy. Record labels are the venture capitalists of the music industry. And within that framework, UMG is the equivalent of Sequoia. They search for talented artists, fund their development, help create and promote their music, and support and guide them throughout their careers. In exchange for the early investments labels make to promote artists, they typically receive the rights to their recordings. Those rights ensure that the label gets paid every single time a song is played for the next hundred or so years. Most of those bets turn out to be duds. But a few turn out to be Taylor Swift.

INDUSTRY OVERVIEW

"I'M STARTING WITH THE MAN IN THE MIRROR, I'M ASKING HIM TO CHANGE HIS WAYS"

- MICHAEL JACKSON

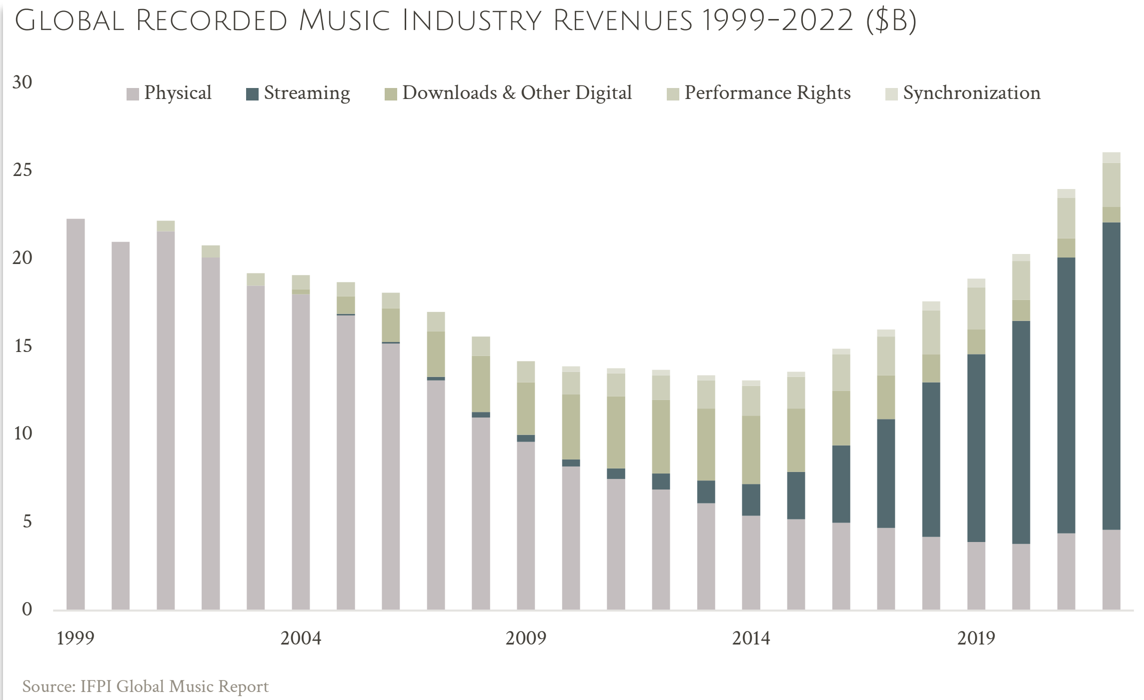
The transition from physical sales to digital distribution was perhaps the single most material change in music history. It nearly destroyed the industry but ultimately revealed the path forward.

After years of growth fueled by lumpy, one-time purchases, the birth of Napster and other file "sharing" services, meant it was no longer necessary to visit a "brick and mortar" store to buy a CD or an album to listen to music. It also meant that industry revenues were set to steadily decline. That decline lasted more than a decade and saw industry revenue drop 41% from $22B to $13B. As new models for music consumption emerged, the decline slowed with the launch of iTunes, then reversed with the birth of Spotify. Since then industry revenue has grown at 9% annually.

In contrast to physical purchases or one-time downloads, streaming gave global consumers free access to all of their favorite artists at their fingertips. It also transformed the music industry from a business dependent upon break-out hits to a steady, predictable, subscription-based model.

As a result, music is cheaper than it's ever been for anyone, with unlimited access to unlimited songs at anytime, anywhere in the world. Not surprisingly, people are listening to – and streaming – more music than ever. Over the past five years, streaming has grown 23% annually from $4.4 billion to $17.5 billion. It is the primary growth driver for the industry, accounting for 67% of the overall market last year.[4]

Simply put, streaming drastically altered the economics of the music industry into a recurring, rapidly growing, high-margin stream of cash flows, with little seasonality and limited economic sensitivity. Importantly, it's accomplished this while benefiting all stakeholders across the music ecosystem. Record labels and publishers get higher profits, higher margins, and faster growth. Listeners get better music, more choices, and cheaper prices. And streaming platforms have an enormous opportunity to monetize current and future subscribers.



RECORD LABELS & PUBLISHERS

"IT'S A NEW DAWN, IT'S A NEW DAY, IT'S A NEW LIFE, FOR ME, AND I'M FEELING GOOD."

- NINA SIMONE

There are three major music companies in the world – Sony, Warner, and Universal – that collectively control over 70% of the global recorded music market, and have rights to 98% of the top one thousand singles.[5]

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[4] IFPI Global Music Report 2023

[5] CMA Music and Streaming Report

While the dynamics of the industry have changed dramatically over the past decade, at least one thing has remained consistent: the majors' share of streams has remained remarkably stable. At year-end, their combined share totaled roughly three-quarters of the global streaming market.

Label Shares of Total UK Streams

	Universal	Sony	Warner	Other
2015	30-40%	20-30%	10-20%	24%
2016	30-40%	20-30%	10-20%	23%
2017	30-40%	20-30%	10-20%	21%
2018	30-40%	20-30%	10-20%	22%
2019	30-40%	20-30%	10-20%	23%
2020	30-40%	20-30%	10-20%	24%
2021	30-40%	20-30%	10-20%	25%

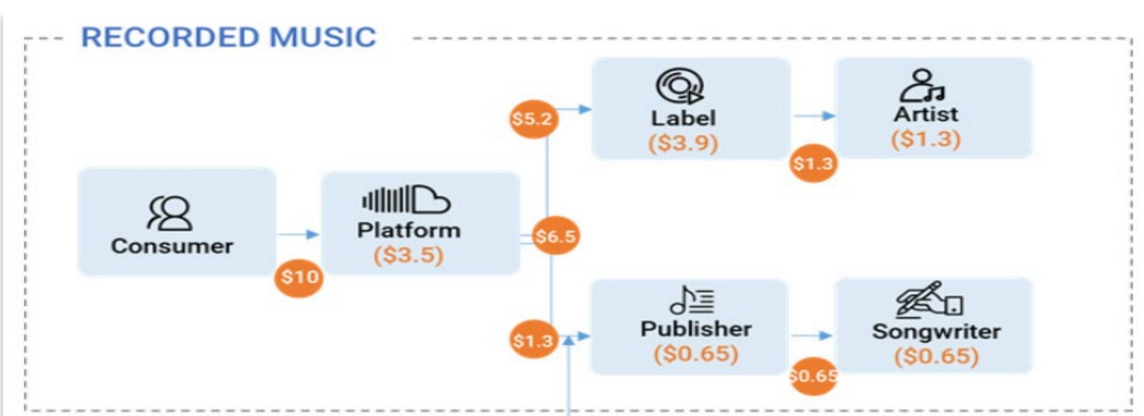
Source: CMA analysis of data from Official Charts

Each of the majors, along with smaller independent labels, enter into licensing agreements with streaming services that provide music to their subscribers. Streaming is divided into two categories.

- Subscription or paid streaming represents the majority of industry profits today. Premium subscribers pay a monthly fee to the platform which is split between the streaming service and the rightsholders (record labels and publishers) based upon a pre-determined, negotiated agreement. Payments to artists have historically been made based on their pro rata share of music streaming (more on this later as it is a central component of our investment thesis).

- Ad-supported streaming is free. The platforms generate ad revenue from their "free subscribers" and share some of that revenue with the labels in agreements similar to the example above. As we'll discuss later in the report, there is a huge gap between the two models, which we believe represents a significant untapped opportunity.

The retail price of an individual Spotify subscription in the US, for example, is $9.99 per month. Spotify only keeps ~ 30% of this and pays out the remaining ~ 70% to the music's rights holders (most often UMG). This 70% is then divided between the artist's record label, which keeps the lion's share of the revenue, and the song's publisher, who make payments to the artist and songwriter as outlined below.



The physical shift to streaming has been accompanied by a financial shift in profit margins at the record labels. As global streaming revenue has tripled over the past 5 years, UMG's margins have expanded from 14% to 18%. At the same time, the risk profile for music's venture capitalists has improved as more data has improved decision making while reducing upfront costs.

This shift has come with additional benefits. As it turns out, even with unlimited access to all of the music ever created, Trevor Noah was right: we just spend more time listening to the four songs we liked in high school. Those four songs serve the labels well, as "catalog" (music more than a year or two old) comes with much higher margins for the labels as royalty rates are higher and most of the costs to develop it were incurred a long time ago. This is another critical component of the UMG investment thesis, which we will expand on in the next section.

THE BALANCE OF POWER

SPOTIFY, THE APP WITH THE ENTIRE HISTORY OF RECORDED MUSIC THAT YOU ONLY USE TO LISTEN TO FOUR SONGS THAT YOU LIKED IN HIGH SCHOOL. - THE DAILY SHOW

Streaming represents the bulk of music engagement and contributes the most royalties to the industry over the longest period of time. As a result, many investors still believe that the companies providing these services to the consumer are best positioned to reap the economic rewards. However, the data doesn't support the narrative, as these companies do so at the slimmest profit margins along the entire value chain.

One just needs to examine margins across the ecosystem to understand where the value lies, with DSPs operating at the lowest margins of all.

Company	Company Type	Average Gross Margin*	Status
UMG	Label/Publisher	48%	Public
Warner Music Group	Label/Publisher	48%	Public
Tower Records	Specialty Retailer	31%	Bankruptcy
Spotify (Premium)	Digital Service Provider	28%	Public
Valley Media	Distributor	11%	Bankruptcy
Spotify (Ad-Supported)	Digital Service Provider	9%	Public

Source: Company Filings

Streaming platforms have many costs associated with providing free music to subscribers. The largest of which is licensing the music they stream (representing revenues to the labels). They also incur the cost of marketing to subscribers and hence, are left to compete only on the quality of user experience, leaving them stuck in the middle, sandwiched between listeners and rightsholders.

Music is evergreen. We can listen to our favorite songs hundreds of times without getting bored in the least. In contrast, consider how many movies you've watched more than once. As we said at the start, we believe music content is much more valuable than video content, and as a result, streaming platforms have much less leverage in the music ecosystem than they do in video. If you doubt this logic, just ask yourself one question: how many music apps are on your phone relative to the number of video apps? For most people, the answer is one. That's because while there are many firms producing video content, most of the music in the world is produced by three firms. So that one music app on your phone (i.e. Spotify) is forced to provide all of the music from all three record labels to all of their customers. That's just not the case for Netflix, or Apple, or Amazon, or Hulu, all of which differentiate themselves with exclusive content. Anecdotally, some of that exclusive video content is also pushing consumers back to classic music catalogues.[6]

Since consumers demand that streaming services carry all of the music that matters, the odds of a service dropping major record label content are slim to none, given the popularity of new artists and the importance of their catalogues. The lack of substitutes (try telling an Elton John fan to listen to Nicki Minaj instead) means that streaming services have little bargaining power. In contrast, consumers have many streaming options to choose from, all of which generally carry the same content at the same price, making barriers to switching extremely low. So, record companies have little incentive to compete on price when negotiating contracts with said services. On the other hand, the Spotifys of the world are forced to give away their service for free and try to differentiate themselves on features like sound quality, experience, playlists, and podcasts, since they are unable to do it with content.

Scale enables the majors to secure more favorable terms. CMA analysis shows that their earnings per stream over the past five years have been, on average, more than 30% higher than those of independent labels.

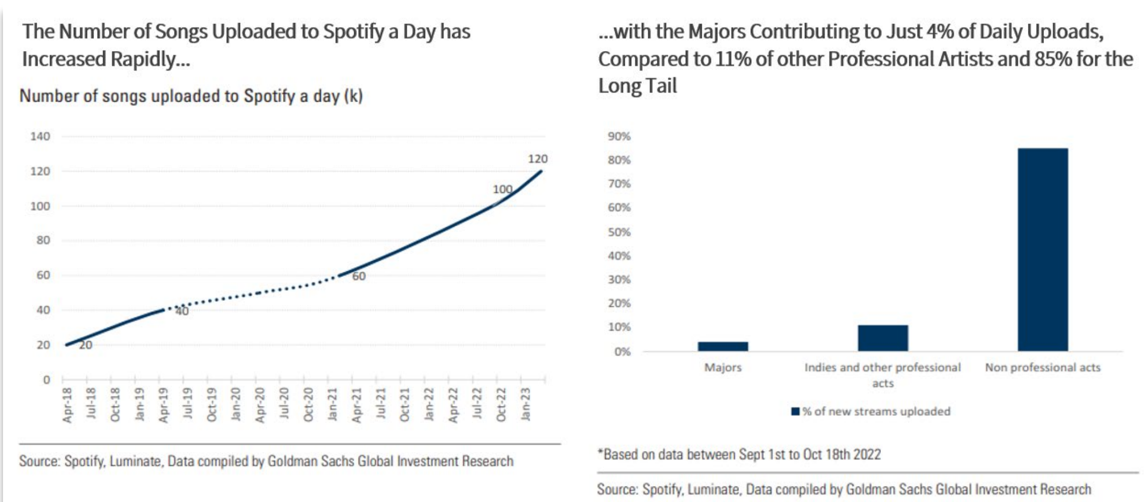
[6] 'Beef' on Netflix Unlocks Catalog Classics to a Newer, Younger Audience

BARRIERS TO SUCCESS

"AIN'T NO MOUNTAIN HIGH ENOUGH." - MARVIN GAYE & TAMMI TERRELL

High barriers to entry represent perhaps the greatest competitive advantage any business can enjoy. Without them, competition is free to attack incumbents. But low barriers do not guarantee victory. In some industries, barriers to entry are incredibly low, yet barriers to success remain incredibly high. Asset Management is the best example of this deceptive setting, where the cost to launch a new fund allows thousands of new entrants every year, yet the low probability of generating long term alpha and outperforming the market makes barriers to success sky high. As such, the great majority of these new entrants quickly fail.

We believe the advent of streaming has created a similar dynamic in the music industry, effectively strengthening the competitive moat surrounding the labels. Streaming completely removed the barriers to entry in the industry, while DIY Distribution and Generative AI allow anyone to create and upload their music to platforms globally, leading to a surge in the number of songs created. In just the past five years, the number of songs uploaded to Spotify has increased from 20,000 to over 120,000 every day!! A single AI-generated music platform has already created a 100 million song catalog, matching Spotify in scale.[7] In an increasingly crowded space, it is easier than ever to share your work, but harder than ever to be heard.



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[7] AI-Generated Music Platform Mubert Says Catalog Now Tops 100 Million Songs

For upcoming artists, the sheer volume of content has made the barriers to success sky-high. For record labels, it has done the same for their economic value within the music ecosystem. Even with support from a major record label, failure is the most likely outcome, with only ~ 10% of investments breaking even on their upfront investment. Despite these odds, some artists still attempt to go at it alone to maintain greater control and a higher long-term payout, but the cost of failure is potentially devasting and the odds of success without a label are approximately zero. As it turns out, many young artists just don't think probabilistically. Otherwise, it would be readily apparent that the expected value of a 10% chance at a slice of $100 million is much greater than roughly 0% odds of the whole $100 million pie. Simply put, labels maximize an artist's probability of success.

Music is truly a "winner takes all" market with the large majority of streams dominated by a handful of wildly successful artists (all of which, are typically represented by major record labels). Given the limited time and attention available to consumers, popularity tends to converge on the biggest hits. Industry data strongly support this assumption as the top 10% of artists account for 98% of streams while only 2% of Spotify accounts generate 95% of the royalties paid.[8] The CMAs recently published Music and Streaming Report reaches a similar conclusion.

> The persistent high market shares enjoyed by the majors, as well as the fragmented nature of the shares of music companies outside of the majors, are indicative of significant barriers to expansion within the market. The evidence suggests that the majors' scale provides them with significant advantages over the indies, which limits the prospects of their significant expansion. In particular, in the streaming age, the majors' ownership of large back catalogues of music provides them with revenue streams from which they can fund large advance payments to artists and global marketing campaigns.
>
> In 2021, 86% of streams were for back catalogue music and as a result it accounted for a high proportion of streaming revenues. In 2021, 76% of those streams were of music owned by the majors. The revenue from this catalogue music can be highly profitable as it generally requires significantly less expenditure on A&R and marketing costs than new music. The internal budget documents of one major show that, whilst catalogue music contributed a slightly higher level of overall revenues compared to new music, it required 60-70% of ongoing annual direct expenditure (which includes expenditure on artist royalties and direct overhead in addition to A&R and direct marketing). One reason for this is because, as catalogue music has already been released, it already has an established listener base. Without the benefit of large cashflows generated by catalogue music, indies struggle to compete with the majors.[9]

[8] Music Creators' Earnings in the Digital Era

[9] CMA Music and Streaming Report

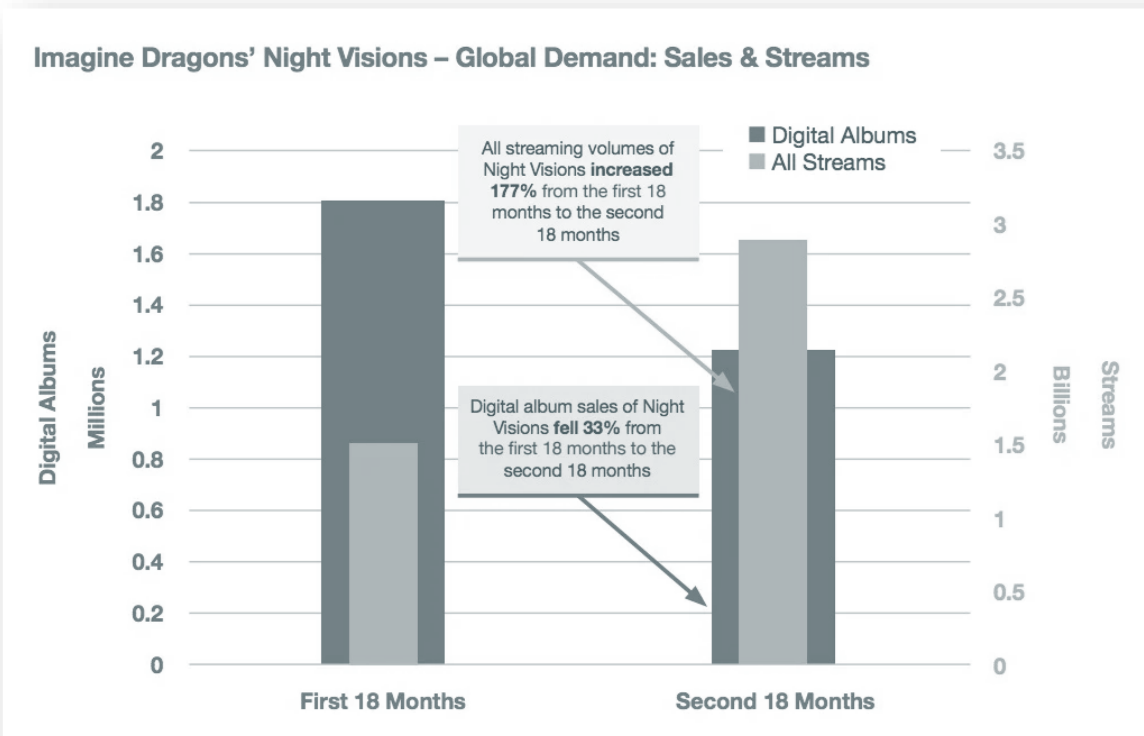
SUBSCRIPTION ECONOMICS

"MONEY, IT'S A GAS. GRAB THAT CASH WITH BOTH HANDS AND MAKE A STASH." - PINK FLOYD

Streaming has elevated the economic value of music, extended the longevity of catalog, and increased the industry's resilience. It's also improved the earnings quality of the music labels, reduced the capital intensity of the business, while increasing its profitability and growth profile.

The model's more consistent, transparent, and predictable revenue streams are largely responsible for the uptick in investment activity across the industry. While it is impossible to put a dollar value on the impact a single song can have on an individual listener, catalog valuations have skyrocketed as institutional investors pushed multiples to historic extremes. Low rates have certainly played a role in pushing valuations higher, but the long tail of streaming revenues and its slower rate of decay than physical and download revenues certainly deserve a premium.

Streaming creates recurring cashflows for artists (and labels) that were not available in the era of physical sales, elongating the earnings potential of timeless classics and extending the income-producing window of new releases. The chart below illustrates this point with a recent example: while digital album sales of Imagine Dragon's Night Vision fell by one-third in its second eighteen months on the market, streaming volumes increased almost 200% over the same period.[10]

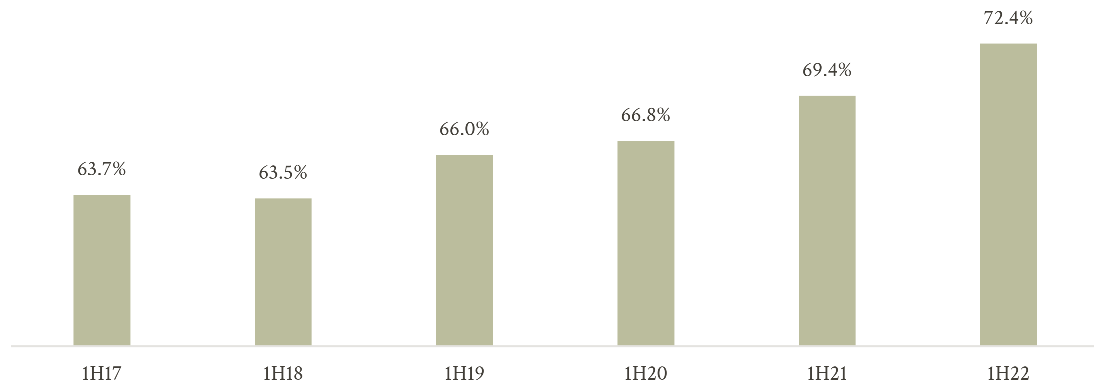


Music consumption is shifting to older songs. Catalog consumption comprised ~ 70% of all music consumption in 2021, up from little more than a third of consumption in 2014. And the age of listeners streaming those catalogs is getting younger,

[10] Music Business WorldWide

making those classic hits more popular and more valuable. This shift is a clear positive for the record labels and their margins. Catalogues have already been paid for and the royalties are higher than today as the copyrights are widely owned.

Share of Catalogue Listening Increasing in the US



Source: Luminate

GROWTH DRIVERS

"STARTED FROM THE BOTTOM NOW WE'RE HERE." — DRAKE

We believe streaming remains in the early stages of global penetration with substantial opportunity for expansion driven by growth in paid subscribers, the rapid expansion of ad-supported streaming, and continued innovation across devices and formats, which is deepening engagement and consumption of music. Another underappreciated catalyst is the likelihood of shifting economics to a more artist centric model, with conversations across all industry stakeholders currently taking place. A review of each of these points in greater detail follows below.

Premium Subscription Growth

Revisiting the venture capital analogy, it's helpful to consider the industry's Total Addressable Market or TAM. This is a number that is almost always exaggerated in Silicon Valley to demonstrate a startup's long runway for growth. But in this particular case, we think it's difficult to exaggerate UMG's addressable market. We estimate the music industry's TAM as the planet earth with upside potential should Musk be successful in his quest for life on Mars. Seriously though. Have you ever met a person on this planet (or another) that does not listen to music?

Smartphones make up more than one third of all music listening time across all age groups. In developing markets, the share of listening is even higher. According to Google's Bard, there are currently 9.226 billion people in the world who have 5.47 billion smartphones, of which, 616.2 million have a music streaming service. So about 60% of the population has a smartphone today, up from less than 30% ten years ago. And about 10% of smartphone users have a music subscription up from about 5% a decade ago. Coincidentally, we've learned that the rate of smartphone penetration has largely matched the rate of streaming penetration. And neither appears to be slowing.

According to Midia, only 45% of the population in Sweden, where Spotify was founded, used a paid music subscription in 2021. This compares to just ~ 24% and 4% for developed and emerging markets, respectively. In the US, paid music subscription has grown from 9% to 38% of music subscribers from 2015 through 2020. And emerging markets like China are growing rapidly with Midia reporting a 3.7% penetration rate in 2019 versus only 0.4% in 2015. Needless to say, the Chinese market represents a substantial growth market for the music industry, and UMG is incredibly well positioned given its strategic relationship with Tencent, which controls ~ 80% of the market in the region.

Developed markets have driven industry growth for the past decade but that is slowly beginning to change. Emerging markets contributed roughly half of new subscribers last year, a share which should continue to grow going forward. While pricing should increase with subscriber growth in these regions of the world as income per capita improves, average revenue per user remains well below developed markets. This is due in part to the significant number of users on ad-supported plans. As conversion to paid plans increases, revenue per user should increase as well (more on this in the next section).

All that being said, perhaps the simplest way to illustrate the potential for streaming to continue to gain share would be to look at the substitutes available. Shockingly, radio still remains the form of listening for the highest proportion of people on a weekly basis. Given that Gen Z spends nearly 20% more time listening to music, spends 10% more on it, and is at least 60% more likely to discover music via short-form video, we suspect that won't be the case for long.[11]

Innovation in Ad-Funded Streaming

Technology has continued to increase the pervasiveness of music creating countless new opportunities for record labels. We have already seen new revenue streams from short-form videos, connected fitness (Peloton), gaming (Twitch), and podcasts. A few years ago, these markets generated approximately zero revenue for the music business. Today they represent ~ 6% of total industry sales and are expected to grow 30% - 40% annually for the foreseeable future.

While paid streaming still remains the largest source of revenue for the industry, social media's impact should not be underestimated, as it drives a quarter of all new music recommendations today. Instagram, YouTube, and TikTok have all had a huge impact on the demand, production, and consumption of content. Video represents one-third of total music streams in the US but only a single-digit share of music revenue, according to RIAA.[12] That gap is likely to continue to close as the industry continues to aggressively monetize its IP. For perspective, consider that Spotify's most recently reported Ad-Supported ARPU is less than 10% of its Premium Tier ARPU, while ARPU for Netflix's recently launched advertising tier is already greater than its basic plan.

We see significant opportunities for UMG to better monetize music in new markets. Given their massive user base, the revenue potential is substantial. UMG has led the industry, crafting deals to integrate music into digital fitness, starting with Peloton, and followed by Equinox and Soul Cycle.

Peloton paid the industry more than TikTok last year.[13] Meanwhile, its successful partnership with Epic Games includes the first virtual Fortnite concert with 10 million players crashing the gaming company's servers. UMG has since featured events with Travis Scott, Ariana Grande, and Lil Nas X.

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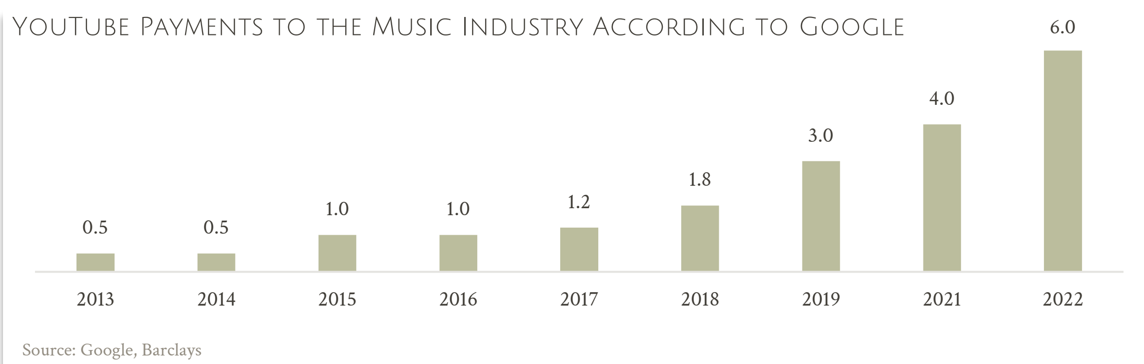
[11] Luminate Year-End Music Report 2022

[12] Music Streaming Statistics in 2023

[13] Peloton Paid the Record Industry More Than TikTok Last Year

More recently, Pokémon's 25th Anniversary featured a virtual performance by UMG Artist, Post Malone. And while the NFT craze may be past its peak, we actually think music may prove to be an instructive use case for the digital tokens. We'll spare you another blockchain diatribe and just plant that thought here to marinate for the future, along with the potential for AI to generate additional, incremental revenue streams for the industry (more on this in our discussion of risks).

TikTok currently pays the music industry almost nothing. That looks like it's set to change, as the company announced the launch of TikTok Music, its new paid streaming service, in July.[14] At the same time, its original "fixed-fee" deals with the major record labels are set to expire in the coming months. The company is currently negotiating with labels. We believe a revenue-share model, similar to the deal recently struck with Meta – is the most likely outcome. Based on the growth of Google's payments to the music industry, similar terms at TikTok would be material.



[14] TikTok Music is Live in Brazil

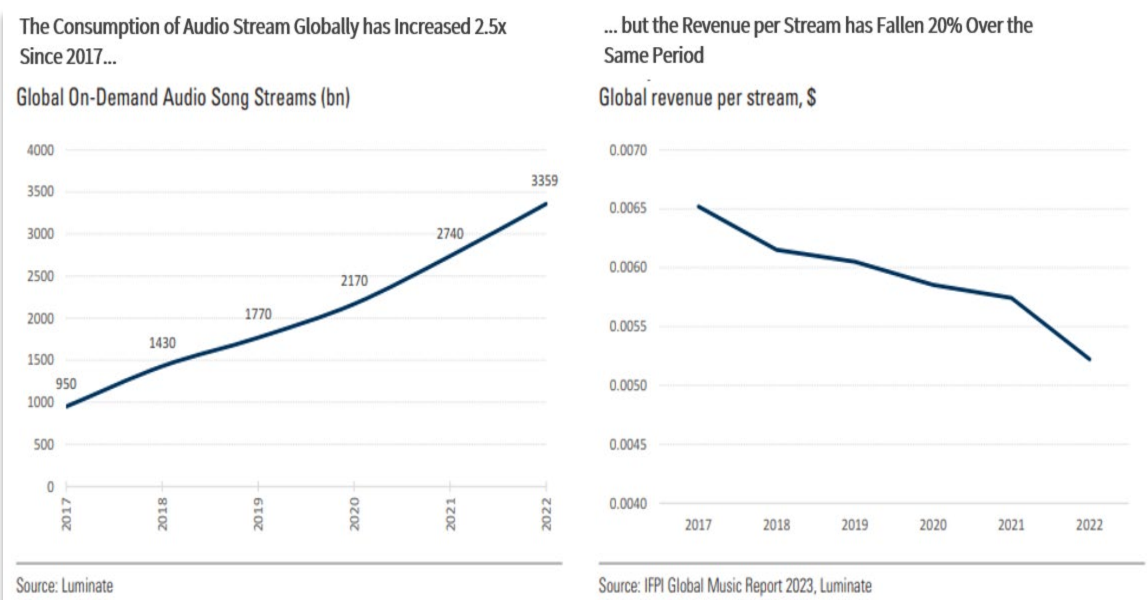
CEO Lucien Grainge recently addressed this issue on UMG's third-quarter earnings call.

"I've seen this movie before. When you look at where the industry was with YouTube, 10, 12, 15 years ago, we all complained about the so-called "value gap". YouTube recently announced they were paying out to rights holders $6 billion over a year-long period. They have stated that they want to be the number one contributor of revenue to the music industry by 2025. When you look at the funnel that TikTok has, when you look at the billions of usage, the rate of which the company has grown, I think there we will fight and determine how our artists get paid and when they get paid in the same way that we have done throughout the industry for many, many, many years. I've seen this movie before, and I know the ending."

Improved Terms & Pricing

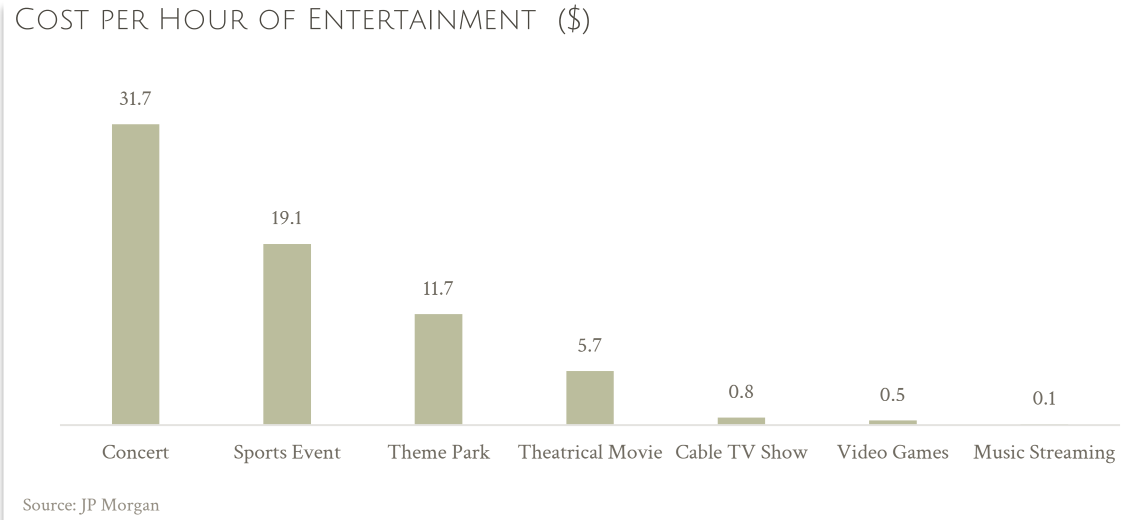
Despite the rapid adoption of streaming and corresponding growth in subscriptions, we believe music remains extremely under monetized despite a much-improved user experience. Global consumption of audio streams has increased 2.5x over the past five years as the number of songs produced has surged. Over the same period, streaming hours on Spotify increased nearly 5x.

With more artists playing and more streams being listened to, the value of each stream has declined dramatically. Spending on music as a percentage of consumer spending has been cut in half since the turn of the century. And per-capita music spend remains below 50% of the peak reached in 1999, on an inflation-adjusted basis. Simply put, the monetization of music has greatly lagged consumption. Music might be the cheapest form of entertainment on the planet today. And therein lies the opportunity.



Many of the largest technology companies in the world – Amazon, Apple, Google, etc. – have invested heavily to drive growth and gain as many streaming subscribers as possible as quickly as possible.

Spotify alone has spent over $7 billion in Sales & Marketing in the past ten years. It's expected to invest another ~ $10 billion in the next five. Like most good silicon valley business models, the strategy was simply growth at any cost. But in this particular case, it turns out that Spotify was subsidizing UMG's customer acquisition costs. Meanwhile, it's continued to charge $9.99 for its individual plan in the US since its launch in 2011. Accordingly, Average Revenue per User (ARPU) in its premium segment has declined by ~ 15% in the past five years. In contrast, ARPU at Netflix has increased ~ 60% over the same period.



Now that the model for streaming has been proven and subscriber bases have been built, we believe this is beginning to change, and think that the music industry will more closely match the regular price increases typical of streaming video. The evidence has begun piling up in recent months. Google increased prices for YouTube Premium (which includes YouTube Music) around the world in October 2022. One month later, Amazon raised prices on its Music Unlimited Family Plan. Yet, the industry waits with baited breath for any hint of price increases at music's 800-pound gorilla.

We believe new pricing tiers at Spotify are likely and would drive long-term growth well above consensus forecasts. As one of the most important revenue drivers for UMG, earnings power would directly benefit from increased user monetization. Given incremental margins near 100% at the company, every dollar price increase at Spotify that flows through to UMG, translates to nearly a dollar of operating profit for the record label.

Coincidentally, Spotify is currently negotiating licensing renewals with all of the major record labels. As a result of these negotiations, we expect to see related price increases in coming quarters. And now that the genie is out of the bottle, recurring increases are highly likely in the future, on par with other subscription services. Recent rumors intensified In June when it was announced that the company is planning to launch a new subscription plan called Supremium.[15] We think this confirms that Spotify is closely looking into its pricing structure and, given its intertwined relationship with music labels, broader negotiations are likely, which brings us to our final point.

Many investors we've spoken with expect Spotify to renegotiate their existing contracts to garner a larger slice of the pie before raising prices. While this makes sense intuitively and is certainly possible, we think UMG stands to benefit most from the likely shift in the current market-share-based economic model to one that is more artist-centric.

The current model has been in place since the dawn of the industry. Labels are paid based on their artists' share of total streams, with each stream valued equally. For example, listening to an entire five-minute song by Drake is equivalent to a 35-second AI-generated track which is equivalent to eight hours of ocean sounds for sleep.[16] Even the average audiophile can see that all streams are not created equal.

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[15] Spotify Plans New Premium Tier, Expected to Include HiFi Audio

[16] More likely, and more profitable for its creators, that ocean sound is set on loop. So, assuming each track is ten minutes long, eight hours of sleep would total 48 streams, valuing ocean sounds 48x higher than Drake's latest hit.

As the great majority of customer acquisition and retention is based on superstar content and classic catalog, it's clear to all industry participants that the model needs to evolve. The current system has been fraudulently manipulated by bad actors, and accelerated with the advent of AI, at the expense of both artists and consumers. How many of those consumers subscribe to Spotify for AI-generated Ocean Sounds for Sleep? While some may listen to it, few would pay for it. So should the payout for the guy writing that code be as much as the payout for The Weeknd? We think the model needs to evolve to better account for the value dilution from the exponentially increasing number of songs and artificial streams, and the premium value delivered by today's (and yesterday's) best artists.

Importantly, such a shift is in everyone's best interests. The labels' earnings better reflect the value provided. Payouts to artists increase proportionately. And the quality of content on streaming platforms improves. At the same time, operating margins at streaming services would increase in line with the reduction in costs from the required infrastructure necessary to host an exponentially increasing number of uploads.[17]

The industry is already making progress toward a new streaming model which should be a material catalyst for UMG. SoundCloud has been experimenting with a "user-centric" model - which distributes payouts from each user's subscription based on the listening of that individual user - since April 2021. Earlier this year, UMG launched initiatives with Deezer and TIDAL to explore an "artist-centric" model which distributes payouts to more closely reflect the engagement of subscribers with the artists they listen to most, and the value they provide to the platform.

WHAT IT'S WORTH

"I'M STILL STANDING AFTER ALL THIS TIME." - ELTON JOHN

At recent lows, UMG's enterprise value fell below EUR 36 billion. For reference, Tencent paid EUR 30 billion for its stake when the company was generating EUR 1.2 billion in EBITDA. Consensus expects the company to earn EUR 2.6 billion next year, so we are buying more than twice the earnings power at just a slightly higher price with several important catalysts now on the horizon. We think current fears are overblown and believe the selloff has created a compelling opportunity to own one of the highest quality assets in the market at a compelling price.

Streaming's secular tailwinds, combined with UMG's leading position in the industry should drive consistent, predictable top-line growth. As streaming becomes a greater percentage of total company revenues, the mix shift away from physical sales should continue to drive gross margin expansion, while faster top-line growth increases operating leverage and operating profit margins. With a sizeable chunk of fixed costs, we believe the runway for margin expansion is significant. At the same time, the increasing popularity of catalogues should improve profitability as prior investments in developing and marketing artists lie in previous financial statements.

UMG has grown top-line at 13% over the past five years. Operating margins have expanded 400 bps over this time period. Management has guided for high-single-digit annual sales growth and mid-term operating margins in the mid-twenties. We think that's a reasonable assumption. Given the number of catalysts on the immediate horizon – recurring price increases, renegotiated terms, emerging platforms – we also think there is substantial upside potential should any of these drivers turn out better than expected. Modeling this out a few years past the typical two-year consensus forecast, we see room for a 15% - 25% IRR from current levels. A US listing would likely drive material flows toward the shares, providing additional upside from multiple expansion.

[17] Music Business Worldwide, Why Ingesting 100,000 Tracks a Day May Not Prove Sustainable

RISKS

At the outset of this report, we outlined several risks to the thesis that we believe have created a compelling entry point for long-term shareholders. We discuss these risks below.

AI Takes Over the World and the Music Industry with It. Let's address this one up front, as we think the threat of AI has played the biggest part in UMG's recent decline (along with countless other business models perceived as at risk of disruption). We agree that AI is likely to eliminate any remaining barriers to entry for content creation. But it's also likely to boost productivity, reducing the cost of music production, and accelerating margin expansion. More importantly, AI models need to be trained on large data sets. Garbage in. Garbage out. The quality of the input matters. As such, the use of original, copyrighted songs is critical. The labels own the quality and hence, are best-positioned for this opportunity. To date, the only AI-generated music that has gone viral has replicated the voice and likeliness of a real superstar. We think this confirms the value of copyrighted content.[18] Streaming services will always have an incentive to match users with music they like, and usually that means music from the major labels. When they don't, it seems clear that record labels hold enough sway to "encourage" those services to do the right thing.[19] It seems equally clear that they will fall into line.[20]

The Balance of Power Shifts Away from the Labels. UMG may not be able to maintain the same contractual terms with streaming providers, which may garner a greater share of the pie. Considering that the economic split between content and distribution has remained largely stable since the advent of streaming, we think this is unlikely. Remember that Apple, one of the largest companies in the world, has had little success achieving better economics at the expense of the major record labels. Even if we are wrong, this is not a zero-sum game, as the pie should continue to increase at a healthy rate for the foreseeable future.

Increasing Competition for Artists Eats into Returns. While competition between record companies to supply content is weak, competition for that content has increased. As a result, A&R (Artists and Repertoire) - talent scouting and overseeing the artistic development of recording artists – expenses are increasing and deals available to artists are improving. While we expect this trend to continue, a mixed shift towards streaming has driven a decline in marketing costs, largely offsetting the increased A&R, so that the total level of investment has remained relatively stable.

UMG Gets a "Swift" Kick in the Butt. Taylor Swift began re-recording her first six albums after negotiating the rights to all of her future recordings with UMG in 2018. Two days after re-releasing *Speak Now*, it became Spotify's most-streamed album in a single day and the most-streamed country album in Spotify history.[21] The most successful artists are able to renegotiate contracts, perhaps chopping off the right tail of the earnings distribution. But there aren't many Taylor Swifts in music history and UMG's business is well diversified, not relying on any one artist or even a small number of artists. Rather, their top 50 artists only accounted for less than 17% of UMG's total revenue in 2022. Equally important, new contracts are a small fraction of all contracts, so even in a worst-case scenario, it would take a very long time for Taylor's impact to Swiftly show up in financial statements.

Market Share of the Labels Continues to Shrink. The surge of content uploaded to streaming platforms has resulted in declining market shares for all three major labels. But it's important to note that share of streams is not the same as share of value. As we've discussed throughout this report, it is more difficult than ever for artists to stand out, increasing the importance of record labels.

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[18] An A.I. Hit of Fake 'Drake' and 'The Weeknd' Rattles the World

[19] UMG Tells Apple and Spotify to Block AI Lyric, Melody Scraping

[20] Spotify Ejects Thousands of AI-Made Songs in Purge of Fake Streams

[21] Taylor Swift's 'Speak Now (Taylor's Version)' Smashes 2 Spotify Records

Catalogue Acquisitions Increase Reinvestment Risk. Catalogue sales are reaching record levels. Not quite the level of NFT madness a few years ago, but high enough to raise some eyebrows. Low rates and streaming's predictable cash flow have invited private equity and institutional investors into the mix who have increasingly bid up prices. We think higher rates largely fix this issue. We also think UMG is naturally the best buyer for these assets, and given its marketing prowess and distribution scale, pro-forma catalogue valuations are likely much lower after accounting for the synergies.

Ad-Supported Streaming Slows with Recession Risk. Advertising is a cyclical business. With most of the world well aware of recessionary threats on the horizon, a slowdown in ad-supported revenue should not come as a surprise. That said, we believe that cyclical risks to UMG's advertising business are more than offset by the potential for widespread, annual price increases, new monetization opportunities, accelerating growth in emerging markets, and a likely change to streaming economics.

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