Sonos inc.
Investment Case
Ticker: SONOS, **Market Cap:** $2500mn

SONOS

Richard Schäli – 10th of Apr, 2023

Qualitative Assesment

- **Recommendation:** I recommend against buying SONOS at its current share price of $20. I believe that while SONOS is a wonderful brand, this doesnot really translate into a wonderful business. Hardware businesses rarely create lasting moats and exceptional business models (unless they involve a subscription, which is not and will not be the case for Sonos)
- **Moat:** Sonos will be able successfully expand into new product categories such as headphones and video conferencing, likely ensuring mid to high single-digit revenue growth in the coming years. However, zooming out even further on the 20-30 year time horizon, I can't say with certainty that Sonos will maintain the necessary pace of innovation. In the long run, it's extremely difficult to stay relevant in a market that sees at least two or three major technology upgrades every year. Another drag are also some key patents that will run out by 2026. Sonos‘ moat doesn’t seem sustainable for decades to come, but instead has an expiry date attached to it.
- **Business**: currently ~14 million households own a Sonos speaker, mostly in the US and Europe. Sonos makes its money by selling speakers that can be easily integrated into a complete home audio system. A major line of business for Sonos is home theater systems, where multiple speakers installed in the living room provide a unique spatial sound experience. According to Masimo (the acquirer of a direct Sonos competitor, „SoundUnited“), the market for high-end speakers is about $6.5 billion, implying a 27% MS.
- **Top-Line:** The market is already fairly saturated and growth rates are unlikely to exceed 6%. Drivers for sales growth are (1) existing households buying additional speakers, (2) geographic expansion, and 3) expansion into adjacent product categories.
- **Margins**: The economics of manufacturing speakers are far from exceptional: the 50% gross margins, deceptive. Based on the company's own projections and an analysis of competitors (SoundUnited and Bose), the long-term EBITDA margin is unlikely to exceed 15%. This will compress to an FCF margin of 5-6%. However, the markets seem to value Sonos more as a software company that generates FCF margins in the mid-20s.
- **Management:** CEO Patrick Spence took the reins in 2017. He runs the company in a very pragmatic and "brand preserving" way, focusing heavily on the bottom line. He holds a 0.7% stake in the company valued at about $19 million. The other members of the management team have been with the company an average of 3.8 years but do not own significant stakes. In Spence's case, ownership has accumulated over the past few years through severance payments.
- **Valuation:** By 2027, Sonos will generate FCF (incl. SBC expenses) of about $121 million, topline growth will have slowed to about 6.5% y/y, while a 5% FCF margin will leave little room for bottomline improvement. For reference, competitor SoundUnited (revenue: $910 million) was recently acquired by Masimo for 8x EBITDA/15x FCF in a Private Equity deal. In FY21, SoundUnited still grew at 10% and had an FCF margin of 8%. Applying this valuation multiple to Sonos, I’d arrive at a fair valuation of $1.82bln by the end of 2027. Roughly 27% below current levels.

Backdrop

Sonos has long been a founder-led company. Founder John McFarlane, who started in 2004, led the company as CEO until 2016. He was a very strong personality with a very clear idea of how a company should be run: he focused very much on the customer experience and the brand, he called it "Sonos‘ race, not the race of everyone else".

Sonos was the first company to sell wireless speakers to the world. Thanks to lucky timing with the launch of Spotify in 2008, Sonos struck a chord with young consumers looking for ways to „fill their homes with music“. The company knew it couldn't limit itself to simple speakers, but needed to get into the "home cinema" market, which meant veiling the living room in sound by using multiple speakers in different locations. It turned out to be the right bet, catapulting the company into a state of great growth and admirable margins.

Impressive brand advertising followed, really spreading the word about what Sonos was all about and taking the speakers beyond the small market of tech-savvy and affluent households. The brand was now truly ubiquitous and enjoyed extremely high customer affinity, often described as a cult-like following.

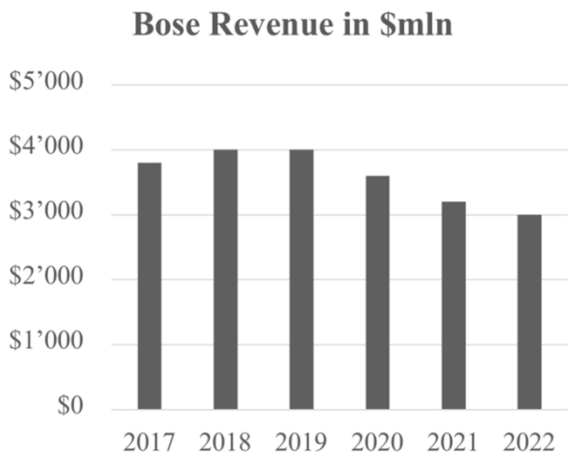
After a few product launch missteps and a dramatic slowdown in product innovation however, John McFarlan decided to withdraw. In 2017, he handed the reins over to Patrick Spence, who ushered in a new era for Sonos as its new CEO. It was a major shift in the company's culture and dynamics. Since then, the company has been run much more pragmatically and profit-focused than before.

There was a clear recognition that they will have to keep a certain pace of product launches to drive growth: It could be a replacement or it could be a new product. The pace of innovation at Sonos had slowed dramatically, and Patrick realized that he needed to pick up the pace of launching new products. And so it's no coincidence that he publicly stated that Sonos would launch two new products per year. At least one of these product launches per year had to be significantly different from previous products in order for sales to continue to grow in the double digits.

A Wide Moated Business

Sonos is one of those unique David and Goliath stories. Even as Amazon, Google and, Apple began to encroach on its space, Sonos kept its dominant position, and arguably even continued on growing it. That's certainly a testament to the company being #1 in terms of consumer preferences, but what I find even more interesting is the dynamics of switching costs that play a role in the speaker market.

If you look at competitor Bose, one of the legacy players in the market, you'll quickly see that while the brand has lost significant ground over the past years, it's in a fairly slow decline. While it will be difficult for a brand like Bose to attract new households, it is unlikely that those who have already installed Bose speakers will switch to a new brand. In general, I would call this a very slow market, since we are talking about speakers that last at least a decade.



But just because the market is slow doesn't mean it's not tough. I would like to bucket Sonos' competitive landscape into three different categories:

1) There's the smart speakers, the voice-controlled speakers, which I think are highly competitive. A tough market. So if Sonos was just making higher-end versions of Amazon or Google products, that would be a difficult market for them.

2) Portable speakers are also very competitive, but resonates well with the installed base. So if a household is already familiar with Sonos, they will buy a Sonos branded speaker that is compatible with what they have at home. But this is also a highly competitive space with players like JBL.

3) However, the area I find most interesting is the home theater. There they have managed to create a wide moat for themselves. From a design, technology, and "works with everything" perspective, it's a unique product in the market. And in fact, the home theater products are also one of the biggest drivers of new home acquisitions for Sonos.

The wonderful thing about the home theater market is not only that it is much less competitive, but also that customers place multiple high-value orders to get the full home cinema experience. About 45% of Sonos' revenue already comes from the home theater market.
Selling smart speakers like Amazon and Google do, is a very costly thing and rarely a profitable business. Sonos is truly unique in that regard, and can keep a very impressive pricing power on their products. However even a seemingly undefeatble position like Sonos‘ is not assured indefinetly and the possibility of it adapting too slowly is real.
Many companies have failed to replicate what Sonos has achieved. And indeed, it's hard to match the company's dominant and growing position in the high-end market. Some startups (like Syng) have taken a fresh angle but ultimately failed because they didn't achieve the necessary scale, and even Apple, which entered the market five years ago, never quite managed to gain the traction it had hoped for. While Sonos has shown promise in the past that it is capable of defeating such challengers, I think it would be naive to believe that this success is a forever kind of thing.

While Sonos is currently quite well protected thanks to hundreds of patents, eventually those patents will expire and many companies will challenge Sonos' position. In order to „kill“ Sonos, all it takes is a company that is able to get the right music to the right place in less than 2 seconds. Because the future of home theater is just that: if you listen to music in your living room and go to the kitchen, the music will instantly move there with you. If you go out the house for a walk with your earbuds, or if you get into the car… the music will be able to always follow you around. If Sonos can't do that, sooner or later another company will, which could be fatal. Sonos' success will always be very directly tied to exceptional innovation - you can't afford to be late to new technological advances.

Bose had good high-end speakers, but couldn't make the software work. Sonos came in and built the system from the ground up as a software product, they had some pretty brilliant minds behind the industrial design that really made it an appealing speaker, but Bose couldn't match Sonos' software capabilities and so lost the race.

Bose has been a wonderful and consistent company for about 50 years, and so will Sonos, but at some point a moat in this industry has an expiration date, and then a new company comes along that takes a fresh angle and turns everything that once was on its head. I'm confident that Sonos can last another couple of decades. Most likely it will be adapt quickly and be successful in participating in the major technological innovations that industry will be going through, however, I don't see the Sonos surviving „forever“ in a market that is constantly going through technological upgrades of all sorts. At some point they will inevitably do something wrong, underestimate potentials or make fatal mistakes that will lead to them being replaced by another company.

Opportunities for top-line expansion

The market in which Sonos operates is already pretty saturated. Considering the 14 million households that already own at least one Sonos speaker, there’s not much room for growth. Household growth probably peaked during the pandemic. People had too much cash thanks to the stimulus checks and decided to spend that check on «nice-to-have» things at home. So let me explore how top-line expansion will look like for Sonos:

1. **Expansion across different regions**

The market in the U.S. and Europe is already pretty saturated. Looking at Sonos’ sales by geography, the U.S. accounts for the largest share (55%), followed by Europe (33%). Sonos has not really been successful in other regions to date. A few years ago, a considerable amount of money and effort was invested in entering the Chinese market, but it quickly came to a hald due to major cultural differences.

Sonos entered China with marketing that focused heavily on sound quality and volume, which was completely irrelevant to the typical Chinese consumer, as they rarely have large homes, but rather want something discreet for a small apartment. In this case, a cheap Bluetooth speaker does the job just as well. Sonos may never reach China, and while there is room for expansion into other regions such as the Middle East and South Africa, these are only minor market and it is clear that most of the growth will have to occur in the existing regions and homes where Sonos already operates in.

2. **Lowering Pricepoints**

Lowering prices would be one of the most obvious ways to reach additional households. It's an interesting consideration to perhaps offer $100 products and then try to trade up those customers to more expensive products. Sonos also explored lower-end sales opportunities in a partnership with Ikea. The idea behind this partnership was to incorporate Sonos' audio system into traditional furniture pieces such as lamps or cabinets. As a result, it became clear that it was a real challenge to move these customers from buying a very inexpensive Ikea Sonos speaker to more expensive follow-up purchases.

Looking at the pure cost structure of a Sonos speaker, there is a minimum cost required for the chipset that supports for example the WiFi network. So it was clear that they needed to reengineer these core elements of technology if they wanted to reach lower prices. But wherever you subtract cost to the manufacturer a speaker, there's also the concern that the quality you embody as a brand will suffer.

3. **Tying the speakers to a subscription**

In an effort to generate higher margins and lucrative revenue from existing households, a music streaming service, Sonos Radio, was launched. However, the service did not achieve the hoped-for market penetration. It was also very difficult to run a profitable music service, so they had to limit the available catalog in some ways to have any chance of making money. And that fundamentally limited the choice for customers, so most people didn't take up the Sonos Radio offer.

Another option that was discussed was to put certain features behind a paywall. With small test groups attempts were made to put several features behind a $9/month subscription, but it was quickly concluded that there were no features that people would actually be willing to pay for without taking away the key benefits of owning a Sonos speaker. So it turns out that it's probably going to be pretty difficult to make money from Sonos users through a subscription.

4. **Expanding the Product Line**

In evaluating all the opportunities for revenue growth, it's clear that the company needs to maintain a very fast pace of product launches so that existing households feel compelled to either replace their old Sonos speaker or add a new one.

When Sonos went public in 2018, Patrick Spence publicly announced that Sonos would launch two new products per year. Something that requires a high level of efficiency in expanding product offerings. The pace of innovation at Sonos has slowed dramatically in recent years, but to continue to grow sales, the company needs to launch at least one substantially different product each year. If it can deliver on Patrick's pledge, Sonos should be able to grow revenue at a 10% rate. If it fails to do so, the company will likely only achieve 2-3% above economic growth.

When it comes to product innovation Sonos is looking to enter adjacent categories. One obvious one is headphones. Assuming that 5% of the existing 14 million households buy a single pair of headphones each year at a price of $400, this would immediately add $280 million in revenue. People would replace their headphones much more frequently than their speakers at home. So the economic opportunity for headphones is really enticing.

A lot of work, money, and resources have been put into headphones, and while there have been very strong rumors of this product launching as early as 2019, it has never seen the light of day until today. The reason for this lies in Sonos' culture, which strictly refuses to compromise on quality.

If you have a pair of Sonos headphones you want them to interfunction as part of your Sonos system at home. It's both a user experience issue because it's difficult to seamlessly transfer music between your home audio system and headphones when you're away from home, and then also a licensing issue because you now have a music stream coming from Spotify but being sent to two places (your home and your headphones). Sonos probably faces too many challenges for it to feel comfortable to deliver quality yet.

Apart from headphones, there will probably be a combination of audio and video: Video conferencing. Imagine joining a conference call and the conversation following you as you walk freely around the house.
Finally, there's the auto industry, which could potentially equip millions of cars with its speakers. There were even talks with BMW, but they walked away from them because they didn't want to stretch the brand too much. Personally I believe they will need to leverage the brand much more and really get into as many adjacent product categories as possible.

If you take Sonos' core strength: Combining hardware and software to create a unique experience for consumers, then I think Sonos will find a lot of other areas that could be really desirable.
It's going to take a little more risk-taking, a little more „stretching the brand“, to keep the company growing in the high single digits.