Buy Roku

Advisor: Austin Lieberman
Pick Date: May 2020
Investment Style: Growth
Industry: Entertainment
Risk/Reward Level: High

The 7investing Key Takeaway

Every year, more people are “cutting the cord” and streaming their favorite shows through services like Netflix, Disney+, Hulu, and HBO. Roku has spent more than a decade developing its technology and partnerships to become America’s No. 1 TV streaming platform by hours streamed. The company is focused on “connecting consumers, content publishers, advertisers and TV brands” by providing devices and software to bring all of the best content onto one easy to use “operating system.”

Management has only recently started expanding their strategy to additional devices like connected soundbars, and expanding their platform to international viewers. These two new developments combined with impressive momentum in the United States make Roku a strong investment for those wanting exposure to the future of media.

What Does Roku Do?

Roku (NASDAQ: ROKU) has created “the home for all of your entertainment.” Roku offers both external and built-in streaming options, as well as an award-winning content streaming platform that powers more than 39 million active accounts as of April 13, 2020. Roku’s external streaming devices cost from $29 - $99. Once a customer purchases an external device, or purchases a “Roku TV” -- a TV with Roku’s platform built in, they get access to thousands of hours of free content on Roku’s platform. By moving to Roku’s platform, customers can cut their $100+ paid TV service and only pay for the content they want when they want it. Roku calls this “TV on your terms.”

The business is broken into two segments -- player revenue and platform revenue. These segments are both important for the company’s overall strategy, but have drastically different impacts on Roku’s financial results.

Before we dive into each segment, let's cover the company's mission statement because it helps paint the strategic picture.

> *"We connect users to the streaming content they love, enable content publishers to build and monetize large audiences, and provide advertisers with unique capabilities to engage consumers."*

Player Revenue: many investors still think of Roku as a "device" company because their devices are so popular in the streaming industry. In Q4, 2019, the company recorded $151 million in player revenue, up 22% year-over-year (YoY) with a gross profit margin of -0.5%. However, the entire purpose of Roku players is to connect millions of users to the Roku platform and enable the company's much more lucrative platform revenue. In the company's Q3 2017 Shareholder Letter, management wrote [emphasis mine]:

> *"Although we generate player revenue and gross profit from the sale of streaming players,* ***we optimize this business around growing unit sales and growing active accounts;*** *therefore, we do not focus on maximizing hardware revenue."*

The company has been extremely successful with this strategy. The takeaway for investors is that Roku is intentionally handicapping their player revenue and gross margins, which temporarily creates a negative drag on the company's overall revenue and gross margin.

Platform Revenue is what matters for the future of the company. As platform revenue grows, Roku's overall revenue and gross margin will improve significantly. In Q4 2019, Roku recorded $259 million in platform revenue, up 71% YoY from $151 million in Q4 2018. Platform gross profit margin during Q4 2019 was 62.5%.

Roku's platform segment earns revenue from advertising fees, revenue-sharing agreements with content publishers, and from licensing its proprietary operating system to TV manufacturers that produce Roku TVs. Management intends to double down on their platform segment as it is clearly key to the company's future.

Why is Roku Such a Good Investment?

Despite rallying more than 30% over the last month, the share price is still more than 25% off its 52-week high as of April 26th, 2020. Advertising budgets will shrink temporarily due to the COVID19 pandemic, which could hurt Roku over the short term. However, the pandemic is likely to have accelerated the shift of viewers "cutting the cord" and moving from traditional TV viewing to streaming which will result in advertising budgets shifting faster than they would have previously.

Investors who are able to accept some short-term volatility in Roku's share price stand to benefit greatly from this generational shift of eyeballs and advertising dollars.

On April 13th, 2020 management released estimated Q1 2020 results due to the uncertainties arising from the COVID-19 pandemic. The release stated:

> *"Beginning in late Q1 Roku started to see the effects of large numbers of people 'sheltering at home.' For Roku, this has resulted in an acceleration in new account growth and an increase in viewing.*

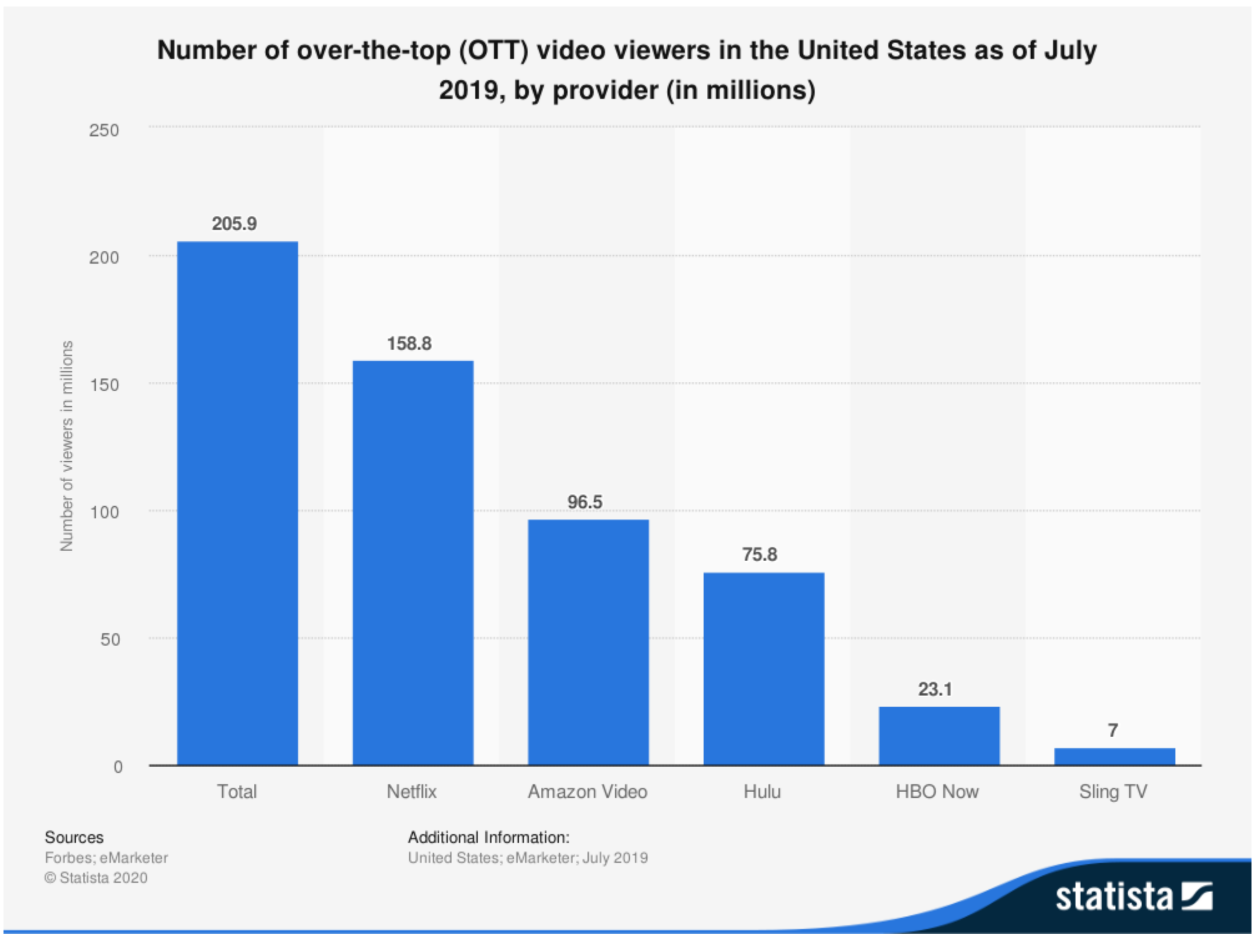
The company now estimates that Active Accounts will grow to 39.8 million, up by nearly 3 million for the quarter. For comparison, Active Accounts grew by 2 million in what was seen as a very strong Q1 2019. The company also estimates first-quarter streaming hours to be 13.2 billion, a 49% YoY increase. Management expects total revenue to be $312 million (at the mid midpoint), slightly higher than their previous guidance of $305 million, and other metrics to be inline with previous guidance.

Heading into 2020, management was confident that the massive shift from traditional TV viewing to streaming was gaining momentum. Roku entered the year as America's #1 TV streaming platform by hours streamed. The company is well-positioned to benefit greatly from the increased time people are spending at home as advertisers and content producers look to Roku to help provide them capture viewers' attention.

What's Happening in the Bigger Picture?

Millions of consumers are shifting their viewing habits from traditional TV to streaming. As of July 2019, streaming TV had more than 205 million viewers. By 2024, research firm Statista estimates that more than 77% of households will subscribe to at least one streaming TV subscription service, up from 55% in 2017. However, streaming still represents a minority of both TV viewing and video marketing spend from advertisers. In 2019, nearly 90% of TV advertising spend was dedicated to traditional TV.

These trends are beginning to converge. As marketers are more strategic with their budgets, advertising dollars are following viewers from traditional TV over to streaming TV. Research firm eMarketer expects streaming TV marketing spend to hit $7 billion this year, an increase of 38%. By 2021, eMarketer expects that number to exceed $10 billion which is still only a small fraction of the $70 billion that was spent on TV marketing in 2019.



What are the Key Risks?

One of the big questions Roku faces in the short term is how much of their advertising revenue is going to be lost as a response to COVID-19. In 2019, 88% of the top 200 advertising brands in America spent with Roku. Until May 7th when Roku reports Q1 2020 earnings, at least barring a preliminary update from the company, there is no way to know if that number will increase or decrease significantly as advertisers adjust their budgets in 2020.

From a longer-term perspective, Roku's key risks are competitive. With the growth opportunities discussed above, streaming TV is an attractive industry. During 2019, one out of every three smart TVs sold in the United States had Roku software. Partnering with Roku to build smart TVs is attractive to manufacturers because Roku has industry leading technology and the "Roku TV" branding attracts consumers who want an integrated streaming TV package. However, as competition heats up, it could put pressure on some of Roku's partnerships with TV manufacturers which are key to Roku growing active accounts and platform revenue.

Management and Vision

Anthony Wood is Roku's Founder, Chairman, and Chief Executive Officer (CEO). Even prior to founding Roku, Wood was focused on changing how people watched TV. In the late 1990's, Wood founded a company called ReplayTV and invented the digital video recorder (DVR) which began the movement of on-demand viewing. Wood also served as Vice President of Internet TV at Netflix in 2007. Wood currently owns roughly 18% of the company's shares outstanding which means his incentives are aligned with investors.

Wood has clearly been an innovative thinker in the TV industry for decades. His vision is what has helped Roku grow to become a roughly $14 billion dollar market cap and it will continue to dictate the future of the company. Wood's goal is to make Roku the "operating system" for TV viewing similar to how Mac and Windows are pervasive as operating systems for computers. It's clear that Wood believes the company is truly just getting started.

Steve Louden has been the company's Chief Financial Officer (CFO) since 2015. Prior to Roku, Louden spent time at Expedia, Washington Mutual, McKinsey, and Walt Disney. Toward the end of 2019, Louden announced he is leaving the company after helping the company hire his successor. This isn't a red flag, but investors will want to keep an eye out for an announcement from Roku about the CFO search.

What Should We Be Watching?

At 7investing, we're focused on stocks we want to own for the next three, five, and ten years. However, it is important to pay attention to significant updates when our companies report quarterly earnings. Roku reports earnings on May 7th, 2020. This report will give management an opportunity to provide further details on what they've seen during the Coronavirus stay-at-home orders and what they expect in the future. Investors who feel uneasy starting a full position prior to the report could choose to open a portion of their position before earnings and a portion after.

Dataxu acquisition: Roku acquired Dataxu, a demand-side advertising company that enables marketers to strategically plan and buy their video advertising campaigns. In 2019, Roku more than doubled its monetized video ad impressions. This acquisition should help keep that momentum going because Dataxu's technology will give advertisers key insights to optimize their advertising when buying ads directly from Roku or from other publishers.

Account Growth and Average Revenue Per User (ARPU) are the two most important metrics for Roku's operating model. As Roku continues to grow accounts, the company becomes an even more important partner for TV makers, advertisers, and premium content creators. As advertisers and content creators continue prioritizing Roku's platform, user engagement rises. Management has done an excellent job monetizing Roku's platform signaled by Q4 2019 ARPU of $23.14, up 29% YoY. Investors should watch for ARPU growth to stay in the high 20% range for 2020 and beyond.

If you want to learn more about Roku, I recommend reviewing their Q4 2019 Shareholder Letter and watch Founder and CEO Anthony Wood's keynote at IFA Berlin 2019

Disclosure: Austin Lieberman owns shares of Roku