I recommend buying Roku Inc., (ROKU). Over the next two years several events will hasten the shift from cable to over-the-top (OTT) streaming and Roku could be poised to benefit from each one independently. The market is underestimating the growth potential in Roku's (higher margin) Platform business, which is continuing to outpace its Player revenue and makes up a growing share of its top line.

Company Background

Roku is an OTT streaming provider. The company was one of the first to specialize in smart TV's. Originally, Roku sold devices that users would connect to their televisions via an HDMI cable, effectively making it a smart TV. Since then Roku has transformed into a software provider. In the past two years they have partnered with numerous television manufacturers, who use Roku's software in their smart TV's, which in turn brings more users onto Roku's platform.

Roku is entirely focused on providing streaming content, whether subscription-based or ad-supported. The company generates revenue by 1) (Players) - selling hardware that consumers hook up to their television 2) (Platform) - advertising on their home page, the Roku Channel, and ad insertion 3) channel developers.

Roku's Channel Development business represents a small portion of revenue, but I believe it represents an interesting opportunity in the near term. Through Roku's developer kit, content producers can build a channel that would become added to Roku's offerings. This makes Roku more attractive to consumers and could provide additional opportunity to monetize those channels through advertising.

The fastest growing segment of Roku's business is its Platform business, where it generates revenue through advertising. Beginning in 1Q18 platform revenue surpassed Player revenue and in 3Q18 Platform revenue represented 58% of sales in the period.

Investment Thesis:

Roku is one of the most promising OTT advertising plays in the market because of its broad reach and growing user base. With some of the largest and most recognizable studios (Disney's Pixar, DreamWorks and Buena Vista, Warner Brother's Studios and Paramount) finding new streaming homes in 2019-2020 (discussed below), Roku will be carrying a much larger content offering for consumers to choose from.

As an example of the quality, or at least the popularity of the content coming to the streaming market in 2019-2020, Disney, Warner Bros., and Paramount have accounted for nearly 70 percent of the top ten movies released in each year over the past decade.

I believe the massive amount of content and increasing monetization of streaming platforms will propel Roku for the next year. Additionally, Roku will grow its top line faster than expected and their expense margins will decline from their current levels, leading to higher earnings and more stable free cash flow.

Catalysts:

- Disney+ (early April 2019) and Warner Bros. (late 2019) streaming platforms coming to market

Disney represents the most recognizable brands in sports, television and film. They launched ESPN+ in 2018 and are launching Disney+ in April 2019, and they intend to increase their offerings on Hulu now that they have a majority stake.

For the most part, Disney+ will hold many of the most popular family movies (rated G – PG) while Hulu will house all of Disney's (PG-13 – R) rated content.

To date, the family or children's segment, of television has largely gone unaddressed. Netflix has attracted families by primarily licensing Disney's titles, but that will soon end once Disney+ launches. Given that Hulu already has a prominent role on Roku's platform, I believe Disney+ will find its way onto the platform as well, lending those accounts to Roku for monetization.

In response to an analyst question during Disney's 1Q19 earnings call CEO Bob Iger noted, "The goal obviously is to operate Hulu profitably. I'm not going to say how long that might take. That could shift a bit because at some point, we'll look more aggressively at some international rollouts of Hulu as well."

Roku will be able to capitalize in both of Disney's actions. I believe Disney+ will be one of the most popular streaming services and will bring a considerable number of new users to the OTT space. This presents an opportunity to grow Roku's Player revenue, and more importantly, it brings an important advertising demographic (children and families) onto Roku's Platform. Because Hulu has both a paid and ad-supported service, the aggressive expansion and additional content will expand Roku's offering and advertising opportunity.

- Viacom Purchasing Pluto TV

Viacom, which operates Comedy Central, BET, MTV, Nickelodeon, and Paramount Studios among others, purchased Pluto TV, the second most popular ad-supported service on Roku's Platform. Pluto has 12 million monthly active users and Viacom management noted that it's growing quickly. Management has said that they intend to populate the platform withh Viacom's content and monetize it much more than it currently is. Roku should be able to capitalize on this advertising revenue that will be flowing through its platform.

Pluto TV acts very similarly to a regular cable provider, down to the organization of the TV guide. Now that it is in the hands of Viacom, the channel should become populated with more popular shows and movies and should represent a significant advertising opportunity for Roku through ad insertion and revenue sharing agreements.

In Viacom's latest earnings conference, CEO Robert Mark Bakish states, "Viacom can accelerate Pluto TV's leadership in free streaming TV. Viacom content will strengthen Pluto TV's consumer offering across key genres, including kids, active American, reality and comedy. And the platform will have access to our brands and marketing capabilities to grow audience and usage, as Pluto has had modest marketing in the past."

He added, "Pluto TV, with its nascent ad sales force, currently sells less than 50% of this inventory, so there's plenty of upside here."

Viacom management believes the platform will add billions of addressable advertising impressions per month.

Since Roku holds revenue sharing agreements and collects fees for advertising on its Platform, those ad impressions and Viacom's increase in Pluto's ad sales will indirectly benefit Roku.

- Comcast's purchase of Sky & in-so Now TV

In the fall of 2018 Comcast completed its purchase of Sky, and in doing so gained control of Sky's NowTV, which runs on Roku's player devices and Roku software. Recently, Comcast management has noted that they intend to leverage NowTV in order to gain access to the SVOD (subscription video on-demand) market, directly benefitting Roku's device and active account metrics.

Stephen Burke, Comcast Senior EVP, said on the conference call, “So our idea to enter the business is to leverage Sky’s technology, it’s called NOWTV in Europe, and also parts of what we’ve been doing at NBC and Comcast Cable. We think this approach has a much better chance to get scale quickly.”

This catalyst benefits Roku’s Player segment more-so than the company’s Platform segment because it is rumored that Comcast will begin to sell comcast branded Roku Players. However, with comcasts large reach in cable television, this should bring a considerable number of new accounts to Roku, which increases the number of ad impressions on its Platform.

Valuation:

Roku, Inc Income Statement

($ in thousands, except per share data)

	2018				2019				FY
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	19
	A	A	A	E	E	E	E	E	E
Platform revenue, net	$ 75,077	$ 90,341	$ 100,050	$ 146,025	$ 143,525	$ 163,965	$ 158,995	$ 227,675	$ 694,160
Player revenue, net	$ 61,499	$ 66,469	$ 73,331	$ 110,022	$ 65,804	$ 71,122	$ 78,464	$ 117,723	$ 333,113
Total Revenue	**$ 136,576**	**$ 156,810**	**$ 173,381**	**$ 256,047**	**$ 209,329**	**$ 235,087**	**$ 237,459**	**$ 345,398**	**$ 1,027,273**
Cost of platform revenue	$ 21,666	$ 27,328	$ 29,504	$ 42,347	$ 42,854	$ 51,239	$ 48,476	$ 68,303	$ 210,872
Cost of player revenue	$ 51,798	$ 51,730	$ 64,884	$ 99,571	$ 55,424	$ 55,351	$ 69,426	$ 106,541	$ 286,742
Total COGS	$ 73,464	$ 79,058	$ 94,388	$ 141,918	$ 98,278	$ 106,590	$ 117,902	$ 174,844	$ 497,614
Platform gross profit	$ 53,411	$ 63,013	$ 70,546	$ 103,678	$ 100,671	$ 112,726	$ 110,518	$ 159,373	$ 483,288
Player gross profit	$ 9,701	$ 14,739	$ 8,447	$ 10,451	$ 10,380	$ 15,771	$ 9,038	$ 11,182	$ 46,371
Total GP	$ 63,112	$ 77,752	$ 78,993	$ 114,128	$ 111,051	$ 128,497	$ 119,557	$ 170,555	$ 529,660
OpEx	$ 70,014	$ 77,884	$ 90,742	$ 110,100	$ 109,403	$ 119,113	$ 126,653	$ 151,975	$ 507,145
EBIT	$ (6,902)	$ (132)	$ (11,749)	$ 4,028	$ 1,648	$ 9,384	$ (7,096)	$ 18,580	$ 22,515
Depreciation & Amortization	$ 1,656	$ 1,950	$ 2,218	$ 2,675	$ 3,099	$ 3,339	$ 3,626	$ 3,886	$ 13,949
Stock based Comp.	$ 4,429	$ 5,309	$ 11,499	$ 11,499	$ 13,499	$ 15,499	$ 17,499	$ 19,499	$ 65,996
EBITDA	**$ (817)**	**$ 7,127**	**$ 1,968**	**$ 18,202**	**$ 18,245**	**$ 28,222**	**$ 14,028**	**$ 41,965**	**$ 102,460**
Interest & Other, net	$ 397	$ 304	$ 2,050	$ 2,050	$ 3,095	$ 2,794	$ 3,435	$ 3,427	$ 12,751
EBT	$ (6,505)	$ 172	$ (9,699)	$ 6,078	$ 4,743	$ 12,177	$ (3,662)	$ 22,007	$ 35,266
Provision for Taxes	$ 129	$ (354)	$ (172)	$ 122	$ 95	$ 244	$ (73)	$ 440	$ 705
Net income	**$ (6,634)**	**$ 526**	**$ (9,527)**	**$ 5,957**	**$ 4,648**	**$ 11,934**	**$ (3,588)**	**$ 21,567**	**$ 34,560**
EPS	**$ (0.07)**	**$ 0.00**	**$ (0.09)**	**$ 0.05**	**$ 0.04**	**$ 0.10**	**$ (0.03)**	**$ 0.17**	**$ 0.28**

Roku’s platform revenue has been growing fast over the past year, in the last three quarters revenue has increased 106%, 96% and 74% on a y/y basis, respectively. I believe given the number of new accounts to come onto the Roku platform, given strong demand due to additional popular content, as well as the steady increase in ad utilization, revenue can reasonably be expected to grow significantly from this point forward.

Consensus estimates for FY19 revenue sit at just under $1 Billion, with EPS between ($0.55) and $0.20, with a mean estimate of ($0.26). Using FY18 figures and assuming a 71% y/y growth rate for 4Q18, this would imply that revenue growth for FY19 would come in at 36%.

Additionally, given consensus EPS estimates, the market is placing ~2.5% margin pressure in 2019.

I believe that Roku’s Player revenue will continue to grow at a 7% y/y rate, just above its historical averages, due to Comcasts usage of Roku’s player devices. I believe Platform revenue will maintain its high growth rate, coming in at ~69% y/y. This would bring total FY19 revenue growth to 42%, with Platform revenue coming in at 68% of sales.

Over the past two years Roku has seen their Platform COGS rise from 23% to 29%. (of revenues) To be conservative I have placed a 1% increase in Platform COGS and G&A expense from FY18 figures.

Player COGS and Sales & Marketing expense as a % of revenue have remained consistent over time and I do not expect this to change.

Roku currently trades at a 201x P/TTM EBITDA multiple and a 7.4x P/S multiple, with the stock trading at $48.27. Given Roku's high valuation I believe Roku's P/EBITDA multiple will decline over the next year to roughly 81.5, bringing it more in line its peers.

Using the average of forecasted P/EBITDA and P/S multiples, I would place a $63 price target on Roku representing roughly 32% upside.

Roku does not produce positive Free Cash Flow on a quarterly basis, however, I expect Roku will be FCF positive for the full FY19.

Investment Risk

There are three significant risks to the above scenario that I have laid out. First being the relationship that Roku holds with its content providers. If Disney decides to hold Disney+ off Roku's platform, it could result in far few account additions than expected.

The second risk, is Apple and Samsung's new partnership. Samsung will begin manufacturing televisions with Apple TV built in. This is very similar to what Roku has already accomplished with several other manufacturers. However, Apple has an already loyal customer base that could opt for familiar products.

Lastly, Roku currently has an incredibly high valuation compared to its peers as well as itself historically. I have attempted to account for some multiple conversion, however if multiples come down over the next year, Roku's stock price would decline significantly.