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SMARTMONEY.COM/One-Day Wonder: Chalk One Up for TiVo

Ritstjórn ritstjorn@vb.is (mailto:ritstjorn@vb.is)

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By Will Swarts Of SMARTMONEY.COM

(This article was originally published Monday)

TiVo Inc. (TIVO)

Share price as of Thursday's close: \$8.05

Share price now: \$8.65

Percent change: 7.5%

Volume: 30.7 million shares, daily average 2.6 million

The News

TiVo, the embattled pioneer of digital video recording, saw its stock climb 7.5% Monday on the heels of a victory in a patent-infringement lawsuit. But some company observers fear investors may have pressed the fast-forward button a bit too long. The stock has nearly doubled over the past six months.

The long-sought legal win in a dispute with EchoStar Communications Corp. (DISH) netted TiVo \$74 million in damages. A Texas jury ruled Thursday that EchoStar had violated the Alviso, Calif., company's "time-warping" patent, which allows users of digital video recorders, or DVRs, to record one program while playing back another.

While certainly good news for TiVo, Wall Street analysts say the verdict doesn't justify the extent of the run-up in the stock price. TiVo has never turned a profit, analysts point out, and the company is bracing for a lengthy appeals process and a countersuit from EchoStar. Worse, TiVo isn't much closer to a much-needed licensing agreement with EchoStar, the nation's No. 2 satellite-television provider with about 12 million subscribers. If that wasn't enough, TiVo also faces DVR competition from big cable and telecommunications outfits such as Time Warner Inc. (TWX), Cablevision Systems Corp. (CVC) and Comcast Corp. (CMCSA) that have deeper pockets and broader audience reach.

"This is the first inning in a long ball game," said April Horace, an analyst at Hoefer & Arnett, an investment bank in San Francisco. "Looking historically at this, the cable industry fights patents and does not just roll over and license technology." Horace maintains a sell rating on TiVo's stock.

Michael Kelman, an analyst at Susquehanna Financial Group, an independent research, brokerage and trading firm in Bala Cynwyd, Pa., said the likelihood of a long legal slog will be an unhappy kind of time warp for TiVo and investors.

"The court cannot force EchoStar to start paying TiVo on an ongoing basis. That must be a commercially negotiated agreement," Kelman says. "The appeals process will drag this out. EchoStar has shown itself to be a tough negotiator, and they'll defend themselves. It'll be dragged out for another one or two years."

But that doesn't necessarily mean TiVo shelled out those lawyers' fees for nothing. Sean Badding, president and senior analyst at Carmel Group, a technology research firm in Monterey, Calif., said the court victory should bolster management's efforts to drum up more licensing business.

"The idea now is that TiVo holds the keys to the DVR doors," Badding says. "If anyone has to pass through them it really has to think twice about working with TiVo. This has to make companies think twice about deploying competitive technology."

The Analysis

TiVo, which came out with the DVR eight years ago, is turning into the poster child for the proposition that superior technology doesn't always equal success in the market.

Users are fiercely loyal to the TV set-top boxes that, among other features, permit the recording of favorite shows, the fast-forwarding and rewinding of "live" programs and the skipping of commercials. TiVo has even found its way into the modern lexicon: "Honey, don't forget to TiVo 'American Idol' since we have a PTA meeting on Tuesday."

Yet while it's the leading name in digital video recording, TiVo doesn't dominate the market. Far from it. Bigger, richer cable and satellite providers have their own branded DVRs that are often cheaper and easier to sign up for than TiVo's service. That makes TiVo's slight edge in user-friendliness and added features a tougher sell.

According to a Carmel Group survey, about half of all cable and satellite subscribers will have some brand of DVR by 2010. About 7.5 million of the country's estimated 27 million satellite-subscription households, or 28%, now have the devices. Of the 65 million households that have some form of cable TV service, about 6.5 million have DVRs, said Carmel Chairman Jimmy Schaeffler. The market will keep growing, according to the report. Since 1999, DVRs and associated hardware, software and services have generated about \$1.1 billion in total revenue through the beginning of 2006. That number will balloon to \$5.5 billion by 2010. TiVo has a roughly 25% share of the DVR hardware market. Scientific Atlanta, owned by Cisco Systems Inc. (CSCO), Motorola Inc. (MOT) and EchoStar each control about one-quarter of the market. A few very small competitors are also nibbling at the edges.

"No one really has a commanding lead," said Schaeffler.

TiVo has 4.4 million total subscribers, about 1.5 million of which pay direct subscriptions that run around \$12.95 per month. The rest of its revenue comes from licensing fees through third-party partners such as DirecTV Group Inc. (DTV), which pays TiVo about \$1.15 for each customer.

"They're fighting against well-capitalized companies that already have a foothold to the consumer," Kelman said. "TiVo is a better product, but the question remains whether the mass market will find those slight nuances enough to go out and get a separate box."

TiVo has entered into an agreement to develop a set-top box with Comcast, but that service won't be offered until the end of 2006. The absence of detail concerns Kelman.

"For Comcast it's kind of a free option, and it's offering greater choice for their consumers," he said. "But they haven't really discussed what the economics would be, or what it would look like for their business."

Horace, of Hoefer & Arnett, notes that Comcast is also working on its own improved set-top box, and she wrote in a note published Monday that any benefit TiVo sees from that cable deal won't offset decelerating revenues from its licensing agreements with DirecTV. Although shares jumped early last week when TiVo announced an extension of its agreement with DirecTV, "we don't expect DTV to aggressively push the DVRs and view it as more of a backstop offering," Horace wrote.

Kelman also points out that technology could very well move faster than the courts. While TiVo got \$33 million from DirecTV licensing fees, about 20% of its fiscal 2006 revenue of \$171 million, cable providers may move to a network-based recording model that could supplant the set-top box system. Cablevision will begin a test of its system on Long Island, N.Y., within the next three months, letting customers pick programs in a manner more similar to video-on-demand services, where the program is stored in a network and recalled by individual customers. Time Warner attempted a somewhat similar approach with its Maestro TV, but ran into problems with digital-rights issues raised by owners of the programming.

"Time Warner and Comcast have publicly said they will be watching this trial, and if it's successful, they said they'd certainly be looking to follow suit," said Kelman. "Both of them also have significant programming assets, and these are models that could bypass TiVo."

The Bottom Line

The lawsuit win wasn't entirely unexpected, and the steep rise of TiVo's stock reflects that. TiVo brought the suit in a court that has a history of finding for plaintiffs in patent cases - as much as 80% of the time, according to both Horace and Kelman.

Horace said an appeal in front of an appellate judge rather than a jury could subject TiVo to greater expert scrutiny, and that Monday may be the high-water mark for this phase of the legal battle.

"For the bulls and the believers in TiVo, this is their day, but litigation is expensive," she said. "It can be long and protracted and take years to resolve. What we also don't know is what's going to happen in the lawsuit EchoStar files against TiVo. It's really difficult to speculate on who's going to win, lose or draw. There are so many twists and turns that can be taken when it comes to intellectual-property litigation."

Kelman, who also has a Negative rating on the stock, said the company still faces a pretty tough outlook in the longer term. "There is a lack of near-term catalysts now that the trial has concluded," he wrote in a Monday note.

Kelman said his calculations for potential added revenue from a licensing agreement with EchoStar could add a maximum of \$2.69 to Tivo's shares within five years. That now tops out at \$8.97 a share, and means investors are already close to overbuying.

"I think a lot of that is already priced in," he said.

The sharp gains may not be followed with an immediate falloff, but \$9 is an unsustainable price based on the company's fundamentals, he said. Barring TiVo finding the next "killer app" that makes it stand out from the pack, the stock price has also made a buyout less likely.

"I don't see big differentiating factors from the plain-vanilla (DVR) offerings from cable operators today," Kelman said. "If a cable operator feels that having that differentiating factor will give them that much of an edge over the competition, they can license it. I don't think they'll need to own TiVo."

And if investors pause long enough to consider what comes next for TiVo, perhaps they'll conclude they don't need to either.

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