Activision Blizzard, Inc.

NASDAQ:ATVI

Analyst: Jarret Reaume
Sector: Technology

BUY

Price Target: $31.03

Key Statistics as of 4/30/2015

Market Price:	$23.00
Industry:	Software
Market Cap:	$16.63 B
52-Week Range:	$17.73 - $24.18
Beta:	1.62

Thesis Points:

- Continued Success of Game Franchises Stabilizes Downside Risk
- Positioned for Long-Term Growth and Margin Expansion
- Consistent Free Cash Flows
- Growing Industry Will Scale Margin Improvements
- Experienced Management Team Will Lead Company to Next Level

Company Description:

Activision Blizzard, Inc. develops and publishes online, personal computer (PC), video game console, handheld, mobile, and tablet games worldwide. The company develops and publishes interactive entertainment software products through retail channels or digital downloads; and downloadable content to a range of gamers. It also publishes online subscription-based games in the massively multiplayer online role-playing game category; and real-time strategy and role-playing games. The company features titles such as *Call of Duty* and *Destiny* which are some of the highest-selling games worldwide. Activision Blizzard, Inc. is headquartered in Santa Monica, California.

Thesis

Activision Blizzard is a company that is well known and established in the video game software industry. With titles like the *Call of Duty* series and *Destiny*, the company is virtually guaranteed to have solid revenues each and every year. However, the market is wrong because it is not factoring in the added value of Activision Blizzard bringing back the *Guitar Hero* franchise. This wildly popular game will bring better margins than normal games because of the peripherals that come with the game. Its long-anticipated return will result in very high sales that the company hasn't been getting for several years.

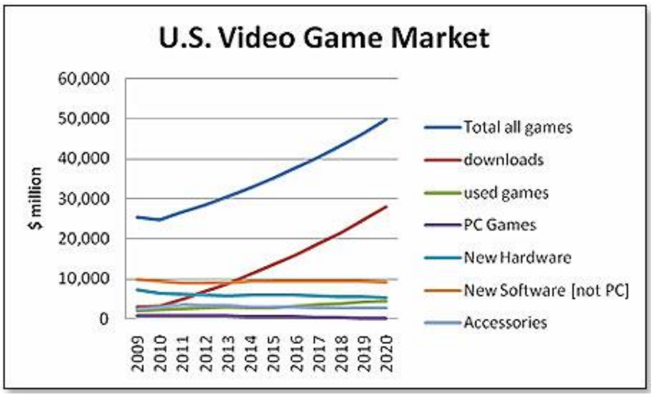
Continued Success of Game Franchises Stabilizes Downside Risk

There are few technology companies in the world that can release essentially the same product each year and be able to expect huge revenues. Activision Blizzard is unique in this way because it has annual titles that have proven to sell in large quantities. One of these titles is the *Call of Duty* series. This franchise has been in existence since 2003 and has grown to extreme heights in recent years. The game is released before the holiday season each and every year and consistently ranks as one of the highest grossing titles.

This game shows no sign of slowing down because of its fan base. Since it is only rated "T" for "Teen" by the Entertainment Software Ratings Board, there is a huge audience that is able to play the game. This fact sets it apart from competitors who tend to have a rating of "M" for "Mature." This enhanced audience will help the company with brand loyalty because younger gamers are allowed to play this first-person shooter game. Therefore, when these teenagers grow up, they will be more likely to continue purchasing *Call of Duty* games. This is a competitive advantage over other gaming companies because of the wide age range of players. The highest-selling console game of 2014 does not look to slow down anytime soon.

Positioned for Long-Term Growth and Margin Expansion

While Activision Blizzard is an established company, there is still room to grow and improve. The company realizes this and plans to take new initiatives to move forward. Some ways Activision Blizzard plans to grow is through new business models, platforms and geographies. An example of a new business model is digitally-delivered revenue. This is a relatively new revenue stream because many games are still sold as discs.



Selling physical game copies requires packaging, shipping and delivery that are not necessary given the technological advances we have seen. Now, gaming consoles come with enough hard drive space to be able to support several full games without needing a disc. Activision Blizzard plans to begin marketing this approach to consumers so that it can begin experiencing margin improvements. The margin improvements will come because the unnecessary costs mentioned earlier will be eliminated. Given the high-tech culture of the gaming industry today, expect this new business model to take off in a more impactful way than the market expects.

Two specific examples of revenue that will come to Activision Blizzard digitally are new free-to-play titles. In 2015, the company will release *Call of Duty Online* and *Heroes of the Storm*. These games are cheaply made and will exist to create advertisement revenue. The games will compete with free-to-play titles that exist on mobile phones and other gaming consoles. There is little downside risk to these games because it does not cost much to develop them. However, the revenue potential is great. The *Call of Duty* name will draw millions of people to play the free game based on name recognition alone. This popularity will increase revenue with very high margins. This is one example of Activision Blizzard taking a step to compete with the mobile games that have been experiencing great margins. It shows that the company is willing and able to compete across different platforms in order to gain market share in the video game software industry as a whole. It is a very encouraging sign that the company is set up to add value for the foreseeable future.

Another way Activision Blizzard is going to improve its company is through growing its global pipeline. Other countries like India, Japan and China are still growing into the video game customer base. This creates an opportunity for video game software companies to take advantage and hook them in early to create brand loyalty. Activision Blizzard realizes this and will grow into these markets. The company knows that the North American video game market is quite saturated at this time and it is a better idea to look elsewhere to seek high-margin opportunities, much like digitally-delivered revenue that was discussed earlier.

Consistent Free Cash Flows

While the financials for Activision Blizzard are strong overall, it is well known that the best way to create value for a firm is to generate free cash flows. This is one thing that Activision Blizzard has been able to do consistently for the last several years. For FY 2014, the company generated $1.163 billion in free cash flows. That number is up from FY 2013 and is in line with the past several years. This shows the company sells its products well and operates efficiently. With the aforementioned new ways of creating value, there should be increased free cash flows in the future. The market does not expect the cash flows to increase, but to just remain steady in the future. This is where the market is wrong. Margin improvements will force free cash flows higher than they are now, and value will be created.

Also, the use of long-term debt for the company will help value creation because it has proven to be able to generate returns above its weighted average cost of capital. For example, in Q4 2014, Activision Blizzard had a return on invested capital (ROIC) of 10.08% with only an 8.4% weighted average cost of capital (WACC). The cost of the debt that makes up 22.9% of the weighted average cost of capital was only 2.7%. The issuance of debt in the last year for the company is not a concern because improvements will be made using that capital that will help in the long run. Future value creation will be made because of the issuance of debt. It would be a different story if Activision Blizzard was using debt for low-value projects or didn't have a real idea of where they were headed, but it is clear that the company has a plan to create value. Activision Blizzard's ability to use financial leverage will be a key in how much value is created in the future.

Growing Industry Will Scale Margin Improvements

The video game software industry is a large one, but still has plenty of room to grow. As previously mentioned, there are many markets that Activision Blizzard has not really tapped yet, but will in the near future. This creates an opportunity to grow the value of the company not only through margin improvement, but through revenue increases. If a company is increasing revenue while also bringing down costs, value is undoubtedly being created. It is much more common for a company to only be able to do one of those things at a time. Activision Blizzard is set up to do both simultaneously. While revenue has slightly decreased in the past couple years from a loss of market share, there are still encouraging signs that revenue will bounce back. First, the *Guitar Hero* franchise's return will bring back much-needed revenues that have been absent for the past five years. The game is still wildly popular and fans will want to purchase the new one after a hiatus of five years. Activision Blizzard will learn from its mistake and not oversaturate the music game market and will give itself time to capitalize.

Experienced Management Team Will Lead Company to Next Level

The management team for Activision Blizzard is very experienced and is undoubtedly able to lead Activision Blizzard to new heights. President and CEO, Robert A. Kotick, has been with the company since 1991 and is the Founder of the Call of Duty Endowment. His several executive positions with the company show his commitment and his ability to lead effectively.
CFO Dennis Durkin has been with the company since

2004. He has worked in software for entire professional career, most notably at Microsoft. There are no red flags with this management team that would make them a liability in the well-being of Activision Blizzard's stock.

Conclusion

At a current market price of $23.01, there is a great opportunity to capitalize on this undervalued stock. Activision Blizzard is at a point where it will improve margins and cash flows after a period of stagnation. It will do this by bringing back a popular game that it made a mistake on several years ago, targeting digitally-delivered revenue as a new revenue stream, and using debt to finance projects that will generate positive returns. The experienced and savvy management team will lead this company to the next level. It is a recommended buy with a price target of $31.03.

CENTER FOR GLOBAL FINANCIAL STUDIES

Activision Blizzard, Inc.	ATVI	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	BULLISH
		Jarret Reaume	$23.09	$29.33	$31.03	1%	1-y Return: 35.4%	

General Info

Sector	Information Technology
Industry	Software
Last Guidance	Feb-05-2015
Next earnings date	5/6/2015

Market Data

Enterprise value	$16,301.55
Market Capitalization	$2,032.29
Daily volume	0.25
Shares outstanding	725.98
Diluted shares outstanding	726.00
% shares held by institutions	99.58%
% shares held by insiders	1.14%
Short interest	2.51%
Days to cover short interest	3.06
52 week high	$24.18
52-week low	$17.73
5y Beta	0.96
6-month volatility	26.84%

Peers	Market Cap.
Electronic Arts Inc.	$18,225.53
Take-Two Interactive Software Inc.	$2,057.76
Zynga, Inc.	$2,253.85
Nintendo Co. Ltd.	$2,405,326.86
NEXON Co., Ltd.	$658,233.01
Ubisoft Entertainment SA	$1,841.20

Current Capital Structure

Total debt/market cap	25.68%
Cost of Borrowing	4.65%
Interest Coverage	2.4x
Altman Z	2.40
Debt Rating	B
Levered Beta	1.35
WACC (based on market value weights)	5.09%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Kotick, Robert	Chief Executive Officer, President a	$64,942,306	$10,045,436	$6,878,812
Durkin, Dennis	Chief Financial Officer	$13,475,108	$2,102,526	$1,328,840
Tippl, Thomas	Chief Operating Officer	$3,201,967	$3,041,231	$15,659,656
Sakhnini, Humam	Chief Strategy and Talent Officer	$3,257,627	$1,640,903	$2,394,059
Morhaime, Michael	Chief Executive Officer of Blizzard	$9,068,434	$5,563,063	$7,856,287
Wereb, Stephen	Chief Accounting Officer and Senio	$0	$0	$0

Historical Median Performance

	ATVI	Peers	Industry	All U.S. firms
Growth	4.1%	0.2%	11.0%	7.4%
ROIC	9.8%	6.9%	7.4%	14.3%
NOPLAT Margin	22.6%	13.8%	12.5%	10.4%
Revenue/Invested Capital	0.43	0.50	0.59	1.37
Excess Cash/Rev.	87.4%	90.1%	13.5%	12.9%
Total Cash /Rev.	93.5%	92.0%	12.3%	15.2%
Unlevered Beta	0.55	1.50		0.95
TEV/REV	2.7x	1.9x	2.3x	2.5x
TEV/EBITA	8.8x	16.9x	12.9x	13.1x
PE (normalized and diluted EPS)	16.8x	24.2x	32.8x	23.5x
P/BV	1.0x	1.8x	1.2x	2.2x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	-1.4%	-4.5%	6.8%
Last Quarter-1	16.2%	38.2%	76.9%
Last Quarter -2	8.3%	39.6%	200.0%
Last Quarter -3	12.5%	45.8%	90.0%
Last Quarter -4	2.4%	-1.1%	8.2%

Non-GAAP Adjustments in estimates computations

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions

Money market rate as of today	0.54%
Annual increase (decrease) in interest rates	0.1%
Yield Spread accelaration	1.2
Marginal Tax Rate	37.5%
Risk-Free rate	2.6%
Tobin's Q	1.00
Op. Cash/Rev.	8%
Growth in PPE	NPPE Growth follows Revenue Growth
Long term Growth	4.0%
Base Year Unlevered Beta	is equal to 0.55
Long term Unlevered Beta	0.55

Forecast

Period	Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
LTM	-3.8%	68.8%	$10,201.64	23%	9.8%	5.1%
NTM	-3.0%	69.7%	$10,236.86	26%	11.0%	5.7%
NTM+1	-2.3%	70.6%	$10,284.22	24%	10.0%	5.7%
NTM+2	-1.5%	71.5%	$10,344.16	23%	9.3%	5.8%
NTM+3	-0.7%	72.5%	$10,417.21	23%	8.9%	5.9%
NTM+4	0.1%	73.4%	$10,504.03	22%	8.6%	6.0%
NTM+5	0.9%	74.3%	$10,605.31	21%	8.4%	6.1%
NTM+6	1.7%	75.2%	$10,721.72	21%	8.2%	6.2%
NTM+7	2.4%	76.2%	$10,853.62	20%	8.1%	6.3%
NTM+8	3.2%	77.1%	$10,999.97	20%	8.0%	6.4%
Continuing Period	4.0%	78.0%	$3,805.18	12%	10.0%	6.5%

Valuation

Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding
LTM	$0.00	$4,324.00	-$4,122.54	725.98
NTM	$540.93	$4,324.00	-$4,773.23	725.98
NTM+1	$431.19	$4,324.00	-$5,281.21	725.98
NTM+2	$358.79	$4,324.00	-$5,729.05	725.98
NTM+3	$307.03	$4,324.00	-$6,136.12	725.98
NTM+4	$267.76	$4,324.00	-$6,539.14	725.98
NTM+5	$236.88	$4,324.00	-$6,902.19	725.98
NTM+6	$212.21	$4,324.00	-$7,251.15	725.98
NTM+7	$192.53	$4,324.00	-$7,590.45	725.98
NTM+8	$177.61	$4,324.00	-$7,922.72	725.98
Continuing Value	$14,498.16			

Pricing Model

DCF (Weight = 100%)	Relative (Weight = 0%)	Distress (Weight = 0%)	Weighted Average Price Per Share
$29.93	$21.77	$27.93	$29.93
$31.57	$22.43	$29.77	$31.57
$32.42	$22.45	$30.71	$32.42
$33.47	$22.57	$31.77	$33.47
$34.63	$22.80	$32.94	$34.63
$36.00	$23.18	$34.24	$36.00
$37.26	$23.65	$35.76	$37.26
$38.73	$24.25	$37.41	$38.73
$40.31	$24.99	$39.20	$40.31
$41.44	$25.76	$41.13	$41.44

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Country Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	4%	N/A	0%	13%	Triangular

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$29.93	$31.57
σ(ε)	$0.20	$0.18
3 σ(ε) adjusted price	$29.33	$31.03
Current Price	$23.09	
Analysts' median est.		$26.10