

## Activision

NASDGS: ATVI

**Analyst:** David Itoafa

**Sector:** Toys & Games

## Buy

Price Target: \$42.55

## Key Statistics as of 11/23/2016

Market Price: \$36.84

Market Cap: \$27.66B

52-Week Range: 26.49-45.55

Beta: 1.01

## Catalysts:

- **Short-term ( within 3 months):** Q4 Earnings Call 2 February 2016
- **Mid-term (1 to 2 years):** Expansion of Mobile Gaming Market
- **Long-term( over 2 years):** Increased Popularity of E-Sport and virtual reality possibility in future

## Company Description:

Activision Blizzard Inc. has been a staple in the industry and has been publicly traded under the ticker ATVI since the company became independent from Vivendi games in 2013. The company was first founded in 1979 and has had its headquarters in Santa Monica California from the date it was established. The company operates through 2 main segments: Blizzard Entertainment Inc., and Activision Inc. After the acquisition of King Digital Entertainment earlier this year, the Activision sector delivers online games through retail and digital online channels. These channels consist of personal computer, mobile and tablet devices that target consumers of all ages. The Blizzard Entertainment Inc. segment focuses on online role playing games like World of Warcraft, StarCraft, Hearthstone, ETC. The final component operations at Activision Blizzard E-sport and media networks segments the first focuses on the E-sport industry and the second on media contents like the movie that was recently released Warcraft.



## Thesis

- Expansion with the company offering More Protection and many risks explained in their most recent 10-k have diminished
- Gaming Market continues to grow and Activision is best positioned to take advantage in the future.
- Virtual Reality / Augmented Reality Potential for future could have similar effect of Nintendo's Pokémon Go.

## Business Model

Blizzard Inc.'s Business model is unique and compelling compared to many of its competitors. In order to sustain revenue growth the company must maintain its current customer base from the various games released over the past 15 years and acquire new customers. In order to achieve these goals the company focuses on three pillars that have helped them become very successful throughout their years at the top of the industry. The company focuses on expanding audiences, Deepening Engagement, and providing opportunities more player investments. The first pillar of expanding their audience will convert to stronger revenue growth in the future.

	Activision	Blizzard	King
MAUs <sup>1</sup>	46M, Q3 record	42M, all-time record	394M

Source: Q3 Earnings Call

The main reason Activision Inc. will be successful in the future will be due to its ability to sustain these customers. Video game habits on mobile, PC, and Console carry over from childhood to Adulthood meaning more potential revenue for Activision because it has established itself on every platform possible. Since the company has been along for so long revenue growth many analysts believe it will deteriorate over time, but since they have acquired new companies that have massive client bases in emerging markets therefore this will not be the case for Blizzard Activision Inc. The second pillar focuses on customers not only buying the product, but keeping them involved and excited about games

in the long run. Blizzard Activision Inc. has been able to make keep consumers hooked to their games and continued this trend last quarter by having over 10 Billion in hours played by all users among all platforms a record high. This pillar may seem irrelevant, but since their most important pillar of providing opportunities for more player investment is dependent on deepening engagement these numbers show their content is appealing to users.

### Providing Opportunities for More Player Investment

Quarterly record of nearly \$1B GAAP digital in-game content sales

	ATVI	YY (incl. King)	YY (ex. King)
Q3 GAAP digital revenues:	>\$1.3B	+114%	+43%

Details:	
	• <i>World of Warcraft: Legion</i> drove record participation in value added services
	• Summer Games, <i>Overwatch</i> 's first seasonal event, drove record game engagement and participation in in-game customization items • <i>Overwatch</i> 's Halloween Terror event drove even higher engagement and participation
	• The <i>One Night in Karazhan</i> ™ Adventure outperformed its predecessor
	• Overall mobile gross bookings <sup>1</sup> and average revenue per paying user increased YY • <i>Candy Crush</i> ™ franchise gross bookings <sup>1</sup> grew YY • King had 3 of the top 20 grossing games in the Apple App Store and Google Play Store in the U.S. for the 11th quarter in a row <sup>2</sup>
	• <i>Call of Duty</i> continues to deliver record performance • The number of in-game content purchasers more than doubled YTD and along with robust participation in Season Pass and a-la-carte map packs drove an increase in ARPU as well • <i>Infinite Warfare</i> ™ innovation paired with <i>Modern Warfare® Remastered</i> bonus content driving a far higher percentage of pre-orders on higher value premium SKUs than ever before

Source: Q3 Earnings Call

Since more people are playing their games for more time the company is generating more money from customers purchasing in game content. This enables Activision Blizzard Inc to maintain revenue even after a game has been launched.

### Strategic Focus on Franchises

We relentlessly focus on building reach, engagement, and player investment



Source: Q3 Earnings Call

This business model is the reason why Blizzard Activision Inc, has beat estimates of GAAP EPS for every quarter for the past 2 years. The model will also enable them to tap into emerging future

markets translating to more revenue in the next quarter and fiscal year.

The second market that is starting to grow more and more is the E-Sport Market

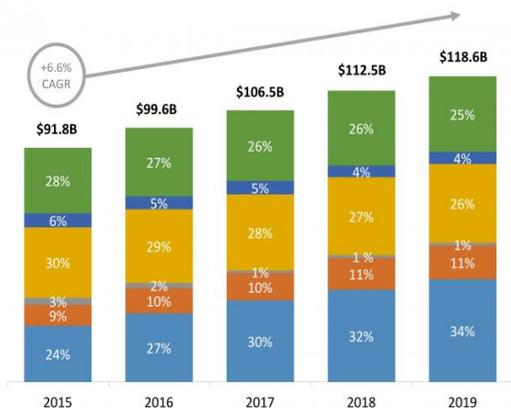
## Emerging Markets

Another main component to the future of Activision is that gaming has yet to be fully integrated into culture. There is still room for markets to expand in two specific areas that ATVI control: the first being gaming on all platforms and the second being people watching professional gamers.

### Global Games Market

Forecast per segment (2015-2019)

Smartphone Tablet Handheld TV/Console Casual Webgames PC/MMO

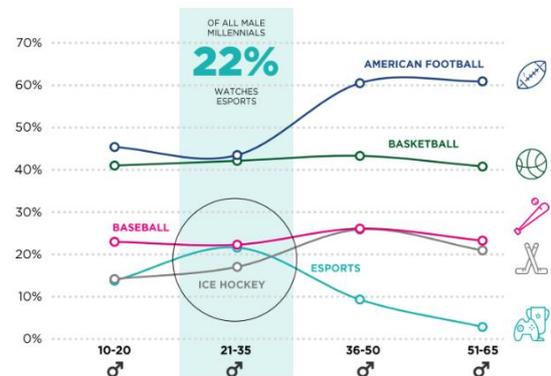


Source: Newzoo

The graph demonstrates how each sector of the global gaming market will do in the future. ATVI has a substantial amount of control in the PC, TV/ Console, and Smartphones, and tablets. Mobile gaming, which includes smart phones and tablets is expanding the most and since Activision has recently acquired KING, entertainment they are aware of the potential shift to mobile gaming in the future. With this acquisition they own all rights to the mobile game Candy Crush and with this producer could capture more market share in the future. Since Blizzard and Activision own two very popular games similar to Pokémon: World of Warcraft and Call of Duty. There is a possibility they create a mobile app similar to Pokémon Go utilizing augmented reality in the future. This move awoke Nintendo from the dead of gaming and this type of maneuver could propel ATVI even higher. Although management has stated that they do not intend to go into virtual reality and augmented reality in the near future, they did state that they are monitoring and are very optimistic about the potential of virtual gaming.

## POPULARITY OF (E)SPORTS BY AGE

AMONG MALE MILLENNIALS | AMERICAN SPORTS\* AND ESPORTS\*\*



Source: Newzoo

Blizzard Activision have also recently acquired MLG a platform where various people can watch professional gamers play their favorite games at tournaments. Male millennials watching electronic sports have surpassed ice hockey are on par with Baseball at 22%. There is no doubt that once millennials get older and the next generation will have similar if not a higher percentage of male viewers. Since this market is also emerging and will continue to grow in popularity ATVI will be able to capture more viewers on their MLG platform. The reason why ATVI will thrive so much with the expansion in these markets is because it owns the majority of games that are popular at this moment of time and have enough power to create games that attract even more users in the future.

## In Game Advertising

Leading on from emerging markets in the most recent earnings call ATVI has discussed that they have begun advertising their Activision Blizzard INC, games in their mobile games like Candy Crush. As shown in the earlier diagram King Entertainment have roughly 400M MAU's that are now being targeted by Activision with advertising that is essentially free for the company. Certain analysts believe that there is a \$500 million dollar potential opportunity with in- game advertising for ATVI, which the majority of wall street has yet to factor into their price and revenues for future years. One of the main pillars

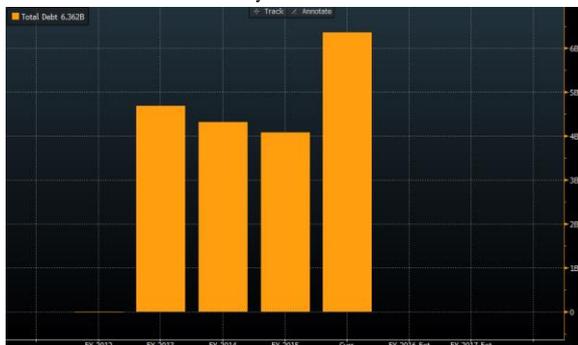
discussed by the company in their most recent earnings call is increasing the number of users of their products. Therefore, CEO Bobby Kotick knows that the advertising in these games cannot become annoying, but has huge potential since none of their competitors have access to these active users. This will give them a competitive advantage over competitors like EA and generate more users in the future.

## CEO New Pay Deal

Activision Blizzard have recently reached a new contract with CEO Bobby Kotick who has been at the helm of Activision for the past 25 years. This is a major positive for the company because he has lowered his salary from \$2.4 billion to \$1.8 billion means he cares more for investing in the business than his personal life. He does stand to make \$56.3 million in shares for the next three years if the company achieves all objectives set out to achieve. This could possibly be due to soft guidance for the holidays, but could also mean that the CEO has belief in the company achieving its financial goals in the future. The company has expanded under Bobby Kotick renewing his contract means the board is happy with the direction that the company is headed in.

## Valuation

Many analysts are skeptical of blizzard due the substantial amount of debt that they have incurred in the last three fiscal years.



Source: Bloomberg

In the past year total debt has reached roughly 6.3 billion dollars and if revenue growth does not continue the company is subject to major risk in the future. However, a point worth noting is that

in case such a tragedy does fall upon ATVI they are still better positioned than their competitors in terms of refinancing.

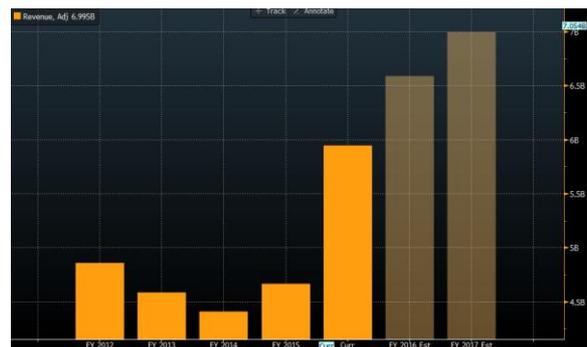
	Kd	
	History	LFY
ATVI	3.0%	4.3%
Competitors	4.4%	4.7%

These are the only potential risks associated to ATVI and along with softened guidance's for the holiday season has made the price drop slightly. This means that the stock at this moment is undervalued and has a reasonable point of entry. Along with a very impressive business model with clearly defined goals and objectives that have been proven effective in previous years means the company is on the right track.

Cash from Operations	1,345.0	1,264.0	1,292.0	1,192.0	2,325.0
Capital Expenditures	-73.0	-74.0	-107.0	-111.0	-115.0
Free Cash Flow	1,272.0	1,190.0	1,185.0	1,081.0	2,210.0

Source: Bloomberg

The amount of cash from operations has doubled the last fiscal year and their capital expenditure remains fairly low with revenue growth increasing every year. Although analysts have not been impressed with recent quarter's earnings call there is no doubt that ATVI has hitting their fiscal year goals consecutively



Source: Bloomberg

With a projected revenue of roughly \$7 billion in 2016 there is no doubt that revenue growth is not a worry for ATVI in the future and they will be able to manage the substantial debt they have incurred. In addition to these projected revenue numbers have not accounted for the company's business model, emerging markets in game advertising and the CEO's new contract.

## Conclusion

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The future looks bright for ATVI due to revenue growth potential in the future and analysts underestimating certain aspects of the business. The stock is not discounted at this time, but due to a recent drop in holidays this is a good entry point for the stock.

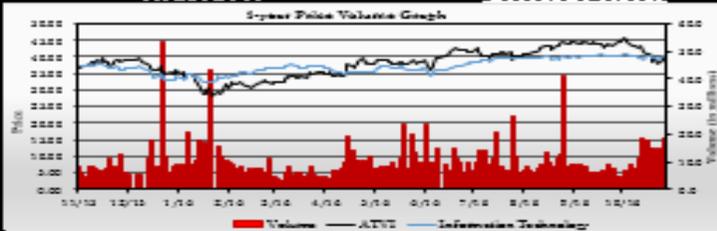
- Entry point range: \$36- \$37.50
  - Price Target: \$42.55
  - Target 1 year return: 10%-20%
-

**Activision Blizzard, Inc.**  
**(ATVI)**
**CENTER FOR GLOBAL FINANCIAL STUDIES**
**NEUTRAL**

 Analysis by David Ilnofe  
 11/25/2016

 Current Price: **\$39.00**  
 Dividend Yield: **0.4%**

 Intrinsic Value: **\$37.39**  
 Target Price: **\$42.55**

 Target 1 year Return: **12.73%**  
 Probability of Price Increase: **86.6%**


**Description**  
 Activision Blizzard, Inc. develops and publishes online, personal computer (PC), video game console, handheld, mobile, and tablet games.

**General Information**  
 Sector: Information Technology  
 Industry: Software  
 Last Guidance: November 3, 2015  
 Next earnings date: February 5, 2017  
 Estimated Cost of Equity Risk Premium: 5.75%  
 Effective Tax rate: 28%  
 Effective Operating Tax rate: 35%

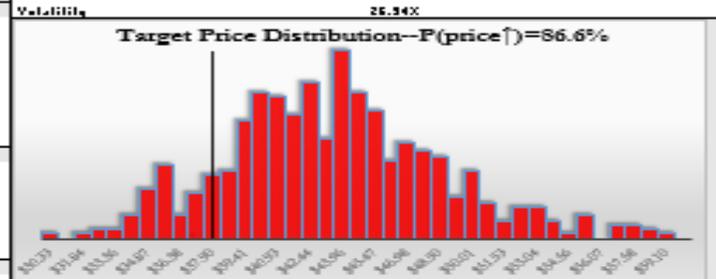
Market Capitalization	Market Beta
\$28,561.63	1.33
Daily volume (mil)	745.21
Shares outstanding (mil)	751.75
Diluted shares outstanding (mil)	740
X shares held by institutional	720
X shares held by insurance Managers	120
X shares held by hedge funds	1.82X
X shares held by insiders	2.87X
Days to next short interest	2.33
52 week high	\$45.55
52 week low	\$26.43
Levered Beta	1.88
Volatility	25.34X

**Quarter ending**

Quarter	Revenue	EBITDA
3/31/2015	8.37X	-17.28X
12/31/2015	-48.25X	-71.82X
9/30/2015	73.45X	236.87X
6/30/2015	-8.25X	-48.84X
3/31/2015	-5.23X	-6.23X
Mean	5.87X	18.33X
Standard error	18.4X	55.5X

**Peer**

Company	Total compensation growth	Total volume to shareholders
Electronic Arts Inc.	5.24X per annum over 5y	8.36X per annum over 5y
Take-Two Interactive Software Inc.	-48.17X per annum over 5y	35.88X per annum over 5y
Zynga, Inc.	-5.32X per annum over 5y	8.36X per annum over 5y
GameStop Corp.	-12.83X per annum over 5y	8.36X per annum over 5y
Changyou.com Limited	-188X per annum over 2y	48.54X per annum over 2y
Majesco Entertainment Co.	N/A	N/A

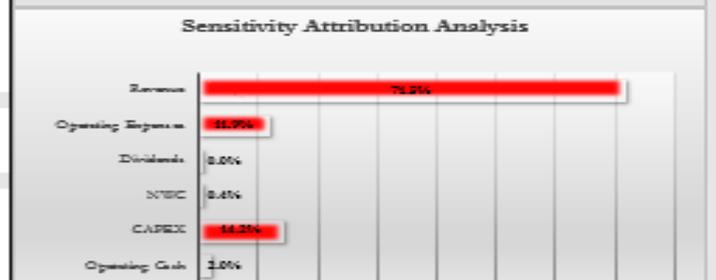


**Management**

Name	Position
Katiah, Robert	Chief Executive Officer, Pres
Darkin, Dennis	Chief Financial Officer
Tippel, Thomas	Chief Operating Officer
Markstein, Michael	Chief Executive Officer of B
Hirshberg, Eric	Chief Executive Officer of A
Worck, Stephen	Chief Accounting Officer and

**Financial Ratios**

Ratio	ATVI [LTM]	ATVI [5 years historical - IndusAvg [LTM]
ROIC	22.2X	54.35X
NOPAT Margin	27X	28.46X
Reverser/levered Capital	1.84	1.33
ROE	11.2X	18.34X
Adjusted net margin	24X	26.86X
Reverser/Adjusted Debt Value	8.47	8.33

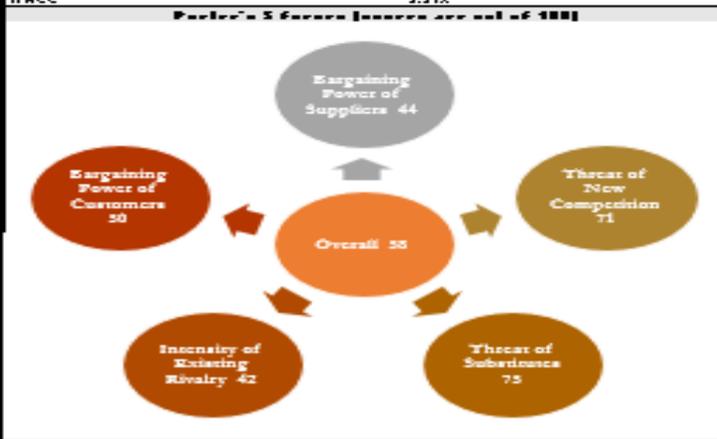


**Capital Structure**

Ratio	ATVI [LTM]	ATVI [5 years historical - IndusAvg [LTM]
Total Debt/Total Capital	28.5X	25.4X
Estimated Operating Cash/Total Capital	4.7X	16.6X
Mean cash working Capital/Total Capital	-4.7X	-5.6X
Levered Capital/Total Capital	23.4X	36.1X

**Valuation**

Year	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	21.7X	26.5X	2.33
3/31/2017	3.3X	27.4X	4.12
3/31/2018	5.6X	33.6X	2.71
3/31/2019	4.8X	37.6X	2.88
3/31/2020	3.8X	37.8X	2.76
3/31/2021	11.2X	35.3X	2.75
3/31/2022	5.8X	38.8X	2.81
3/31/2023	5.8X	37.7X	2.73
3/31/2024	4.8X	37.2X	2.64
3/31/2025	4.8X	36.3X	2.58
3/31/2026	4.8X	35.6X	2.53
Cooling Period	4.8X	35.4X	2.52



**Financial Ratios**

Ratio	ATVI [LTM]	ATVI [5 years historical - IndusAvg [LTM]
Total Debt/Current Equity [LTM]	8.28	8.22
Cost of Existing Debt	4.68X	5.14X
Estimated Cost of new Borrowing	3.68X	4.18X
CCPS Risk Rating	DD	D
Levered Beta [LTM]	8.37	8.63
WACC	3.34X	7.33X

**Valuation**

Year	Revenue	EBITDA	Price per share
Base Year	\$1,424.84	\$4,858.33	\$37.25
3/31/2017	\$5,838.54	\$5,278.83	\$44.32
3/31/2018	\$5,532.53	\$4,383.63	\$47.37
3/31/2019	\$5,457.63	\$1,386.67	\$52.33
3/31/2020	\$7,883.88	-	\$58.53
3/31/2021	\$4,538.18	-	\$64.67
3/31/2022	\$3,871.37	-	\$71.46
3/31/2023	\$3,343.23	-	\$77.73
3/31/2024	\$18,683.16	-	\$84.26
3/31/2025	\$11,283.15	-	\$38.86
3/31/2026	\$12,278.41	-	\$37.61