

King Digital Entertainment plc

NYSE:KING

Analyst: Jarret Reaume

Sector: Technology

BUY

Price Target: \$22.20

Key Statistics as of 3/5/2015

Market Price:	\$14.85
Industry:	Software
Market Cap:	\$4.69 B
52-Week Range:	\$10.68 – \$23.48

Thesis Points:

- Leader in a Rapidly Growing Industry
- Zero Debt Position
- Diversification by Acquisition
- Improving Margins
- Value added from ROIC being much higher than WACC

Company Description:

King Digital Entertainment plc is an interactive entertainment company that produces and distributes digital games in several countries including the United States, United Kingdom and Germany. The games run on several mobile platforms such as Facebook, iOS, Android, king.com and royalgames.com. The company's titles include Candy Crush Saga, Candy Crush Soda Saga, Farm Heroes Saga and Pet Rescue Saga. King's game titles are developed to be fun and easy to learn. The company says its games are meant to have a broad appeal while being easy to learn and challenging to master. The games are free to download, but players are given the option to purchase virtual items that can enhance the gaming experience. Over the last several years, Candy Crush Saga has served as the firm's top grossing product. King Digital Entertainment is based in Dublin, Ireland.



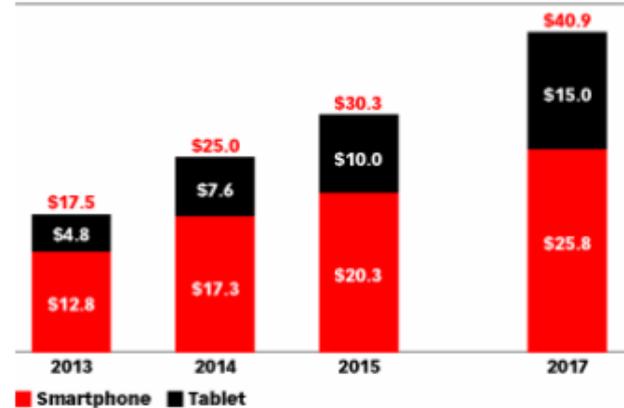
Thesis

King Digital Entertainment plc is a leading developer of mobile application software. Its strong titles rank amongst the top mobile apps for both iOS and Android. However, there is plenty of doubt in the marketplace regarding the future of the company. Many believe that once revenues and bookings from Candy Crush Saga begin to seriously dwindle, then King will not be a valuable company. The market is wrong to think this way because King has set itself up for life after Candy Crush Saga. The company has a staggering amount of cash and cash equivalents along with zero debt. These aspects should keep King flexible in its endeavor to develop the next great mobile game. Also, strong acquisitions have given King diversification in its game offerings. Until recently, King has only released simple games that don't require too much thought. While the response has been very positive, there is only so much that can be done in one genre. King has acquired firms that specialize in strategy games which will help the firm reach consumers that desire to think more when playing games on their mobile devices. The combination of developing new simple games and acquiring other types of games will help King maintain the strong free cash flows it has generated since it released Candy Crush Saga. The stock price will increase significantly once the market realizes that this company isn't going away anytime soon.

Rapidly Growing Industry

The mobile application industry is one that has grown rapidly over the last few years and looks to get even bigger in the near future. Some say the mobile gaming industry will reach \$40 billion by 2017. While this growth expectation is likely already factored into the stock prices of companies in this industry, no firm is better positioned than King to capitalize on the growth. Currently, the market is underestimating King's ability to continue producing great games. Many believe the company has peaked because of the great success of the Candy Crush Saga and the fact that its users and bookings are finally beginning to decline.

Mobile Gaming Revenues Worldwide, by Device, 2013-2017
billions



The positive outlook for the mobile gaming industry will only help King continue to generate free cash flows. Many young consumers who may be getting their first smartphone or tablet will naturally gravitate towards games that King releases. Teenagers will dominate new customers in the industry because they are already accustomed to technology. On the other hand, it is unlikely that older people will contribute to the growth of the industry because they did not grow up with the technology. Because of this, King will have an advantage over its competitors that don't specialize in kid-friendly games that feature a small learning curve.

Zero Debt Position

King Digital Entertainment plc currently holds no debt. This gives the company flexibility as well as virtually no chance of going bankrupt. It is a reflection of the firm's ability to use its own earnings to pay for its operations and capital expenditures. It also shows the high quality of King's products because they have been so profitable in such a short amount of time. The only way to achieve zero debt as such a young company is to release great products that sell at a fast pace. A no-debt position also bodes well for the future of the company because money will not have to be thrown away towards interest payments. King will be able to retain its earnings so that it can develop apps that will build on the success of the Candy Crush Saga. In a growing industry, King will remain dominant as long as it can consistently create top-notch content and having no debt is a great advantage for the company.

Diversification by Acquisition

King has been able to make several acquisitions of promising studios recently with its large amount of cash reserves. These acquisitions should make King more diversified in the mobile gaming marketplace and shed the company's label as a one-trick pony. The main patterns of King's games that have been released to this point have consisted of matching three of a like object. This game design is simple, yet addicting. It is the pattern of Candy Crush Saga, Candy Crush Soda Saga, Pet Rescue Saga and Farm Heroes Saga. While all of these are highly-rated games, the same type of game can get old for consumers no matter how high the quality is.

King's acquisition of NonStop Games allows King to step outside of the realm of simple games without having to start completely from scratch. Along with the acquisition of NonStop Games comes a strategy game titled Heroes of Honor: War of Kings. It is fairly easy to tell from the title that this game is markedly different from the typical game King releases. Heroes of Honor is a strategy game for iOS and requires much more thinking than Candy Crush Saga. Now, King has a top game in a completely different genre. This contradicts the notion from many people that King only has one type of game and will struggle to create value after the interest in Candy Crush Saga is gone.

Another acquisition King made is a \$150 million purchase of Z2Live, a development studio based in Seattle, Washington. The acquisition is unique in the fact that King only paid \$45 million up front to acquire the studio and all its games. The remaining \$105 million is tied to the future performance of Z2Live's games. Z2Live produces strategy games much like NonStop Games. Therefore, King must have decided to acquire proven, profitable titles in this genre rather than developing them from scratch. Z2Live boasts two strong strategy titles, MetalStorm Online and Battle Nations. According to ThinkGaming, Battle Nations is already generating over \$10,000 in average daily sales from iPhone users in the United States. This gives King a competitive advantage over companies like Zynga who are developing their own strategy games. King's method eliminates a lot of risk and leaves more time for the development of new simple games that will take the place of Candy Crush Saga. This is a smart strategy by King that will help them prove the market wrong and continue to develop top-selling games.

Improving Margins

King has grown rapidly over the last four years and has been able to achieve very profitable margins. For example, King's EBITDA margin has been over 30% which is very strong when compared to its peers. For example, Zynga, arguably King's top competitor, has never come close to the same EBITDA margin. In FY2014, Zynga actually reported a -14.6% EBITDA margin compared to 33.2% for King. This shows that King is operating efficiently and is in a great position to generate free cash flows. As shown below, Bloomberg

722.4	754.2	752.1	870.8	879.1
38.3	33.2	33.1	39.9	41.5

estimates that King's EBITDA margin will increase in the future. By FY 2016, margins are expected to top 40%. These expectations are partly due to the economies of scale from King's acquisitions. Now, more of King's development time and resources are spent more wisely and effectively. King will have several studios with impressive track records churning out games at a fast rate. With decreasing margins, the pressure on King to grow its revenues won't be as great because the company will make money even if revenue stays flat. As we know, the mobile gaming industry is growing very quickly; so increasing sales should not be a problem for King.

Value Added from ROIC

King has been able to make the most of its invested capital during the last few years of rapid growth. For example, in 2014 King reported ROIC of 49.13% and weighted average cost of capital (WACC) of merely 6.3. This shows that King was able to add much more value to the firm than what it cost to issue its equity. The WACC could be even lower if King issued debt, but as mentioned earlier, a zero debt position is very desirable for a company like this.

In a competitive industry, no firm can expect its ROIC to beat its WACC by a multiple of 8 for any time longer than a few years. The only way it would be possible is for the company to have a major competitive advantage. While King does have several advantages over its peers like zero debt and a diverse library of games, there is always a threat of a new company to enter and take serious market share.

Since King has reached the point where sales growth will

have to be much slower than in the recent past, ROIC will have to remain above WACC for any value creation. Luckily, King's ROIC looks to be in no danger of falling all the way down to 6%. The company has done a good job turning its invested capital into games that millions of consumers want to play.

Conclusion

King Digital Entertainment plc is a company that is at a crossroads at the current moment. Its bookings and users for Candy Crush Saga, its most successful release, are finally beginning to decline. Many people believe that this is the end for the company's value creation. In an industry where one good idea can change the entire landscape, it is difficult to blame those that think King's time at the top is coming to an end. However, there is no company in a better position to come up with that next great game that will own the top spot on iOS and Android for a significant amount of time. King already has a solid formula for simple games that are easy to learn and difficult to quit. Also, the companies King has acquired help to diversify its game library so that revenues shouldn't fall once Candy Crush users look for something else.

At a low price of \$14.85, it is an easy decision to buy stock in this company. The combination of a booming industry, large amounts of cash, and no debt give King Digital Entertainment plc every advantage and opportunity to remain the king of mobile gaming.

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King Digital Entertainment etc		Analyst Jarret Reaume		Current Price \$14.80	Intrinsic Value \$23.55	Target Value \$22.18	Divident Yield 0%	Target Return 49.85%	BULLISH		
General Info		Peers	Market Cap.	Management							
Sector	Information Technology	Activision Blizzard, Inc	\$16,699.41	Professional	Title						
Industry	Software	Zynga, Inc	\$2,142.38	Zacconi, Ricardo	Co-Founder, Chief Executive Of	\$	-	\$	-		
Last Guidance	Feb-12-2015	Electronic Arts Inc	\$17,620.76	Knutsson, John	Co-Founder, Chief Creative Offi	\$	-	\$	-		
Next earnings date	NM	GameStop Corp.	\$4,197.38	Codran, Hope	Chief Financial Officer	\$	-	\$	-		
Market Data		iDreamSky Technology Limited	\$476.98	Kurgan, Stephane	Chief Operating Officer and Dire	\$	-	\$	-		
Enterprise value	\$3,689.65	Boyaa Interactive International Limited	\$3,589.91	Ryder, Alice	Vice President of Investor Relati	\$	-	\$	-		
Market Capitalization	\$6,161.77			Miller, Robert	Chief Legal Officer and Corporat	\$	-	\$	-		
Daily volume	6.74			Historical Performance							
Shares outstanding	314.43	ESTsoft Corp.	\$157,927.26	KING		Peers		Industry		All U.S. firms	
Diluted shares outstanding	320.30	Entraction Holding AB		Growth		18.4%	11.8%	11.8%	6.0%		
% shares held by institutions	120.27%			Retention Ratio	0.0%	328.7%	80.6%	80.6%	61.6%		
% shares held by insiders	28.82%			ROIC		0.0%	15.8%	15.8%	11.8%		
Short interest	5.24%			EBITDA Margin	0.0%	13.7%	14.9%	13.7%	13.7%		
Days to cover short interest	7.88			Revenues/ Invested capital	539.7%	84.3%	144.4%	144.4%	202.3%		
52 week high	\$23.48			Excess Cash/Revenue	#DIV/0!	30.1%	38.4%	38.4%	18.5%		
52-week low	\$10.68			Unlevered Beta		1.24	1.17	1.17	0.95		
5y Beta	0.00			TEV/REV	1.7x	1.5x	3.9x	3.9x	2.4x		
6-month volatility	45.88%			TEV/EBITDA	5.3x	17.5x	16.8x	16.8x	11.3x		
				TEV/EBITDA	5.4x	23.0x	20.1x	20.1x	15.4x		
				TEV/UFCF		81.3x	32.2x	32.2x	26.8x		
				Non GAAP Adjustments							
				Operating Leases Capitalization	100%	Straightline			10 years		
				R&D Exp. Capitalization	30%	Straightline			10 years		
				Expl./Drilling Exp. Capitalization	0%	N/A			N/A		
				SG&A Capitalization	20%	Straightline			10 years		
				Forecasted Profitability							
				Revenue		NOPLAT		Invested capital		UFCF	
Operating. Cash/Cash	0.0%	LTM	0%	52%	\$2,269.40	\$805.35	\$169.51	\$1,056.37			
Unlevered Beta	1.35	LTM+1Y	-4%	56%	\$2,180.90	\$634.15	\$571.00	\$483.68			
Rev/Invested Capital	100.0%	LTM+2Y	-3%	59%	\$2,119.83	\$554.20	\$711.66	\$413.54			
Continuing Period Revenue Growth	1.0%	LTM+3Y	6%	61%	\$2,253.38	\$537.72	\$840.84	\$408.54			
Long Term ROIC	12.0%	LTM+4Y	1%	64%	\$2,275.92	\$500.05	\$961.09	\$379.80			
Invested Capital Growth	Follows Forward Rev. Growth	LTM+5Y	1%	66%	\$2,298.67	\$466.00	\$1,069.10	\$357.99			
Justified TEV/REV	2.0x	LTM+6Y	1%	66%	\$2,321.66	\$467.80	\$1,175.86	\$361.04			
Justified TEV/EBITDA	13.0x	LTM+7Y	1%	66%	\$2,344.88	\$471.11	\$1,247.52	\$399.46			
Justified TEV/EBITDA	19.0x	LTM+8Y	1%	66%	\$2,368.33	\$475.56	\$1,300.37	\$422.71			
Justified TEV/UFCF	22.0x	LTM+9Y	1%	66%	\$2,392.01	\$480.52	\$1,335.38	\$445.51			
				Valuation							
				ROIC	WACC	EVA	Enterprise Value	Total Debt	Other claims	Equity	Adjusted Price
LTM	191.5%	10.2%	\$307.42	\$6,990.62	\$0.00	-\$756.49	\$7,747.11	\$24.51			
LTM+1Y	374.1%	10.0%	\$2,079.02	\$7,738.31	\$28.47	\$195.33	\$7,514.52	\$22.93			
LTM+2Y	97.1%	10.0%	\$619.56	\$6,201.25	\$356.45	\$189.71	\$5,655.09	\$17.99			
LTM+3Y	75.6%	10.0%	\$551.24	\$6,167.44	\$356.45	\$142.58	\$5,668.41	\$17.91			
LTM+4Y	59.5%	10.0%	\$475.45	\$6,186.14	\$564.47	\$174.79	\$5,446.89	\$17.31			
LTM+5Y	48.5%	10.0%	\$411.46	\$6,268.72	\$682.85	\$167.00	\$5,418.86	\$17.31			
LTM+6Y	43.8%	10.0%	\$396.93	\$6,420.73	\$769.74	\$176.37	\$5,474.62	\$17.42			
LTM+7Y	40.1%	10.0%	\$375.07	\$6,556.70	\$905.76	\$168.09	\$5,482.85	\$17.46			
LTM+8Y	38.1%	10.0%	\$365.67	\$6,704.25	\$1,015.91	\$157.44	\$5,530.90	\$17.62			
LTM+9Y	37.0%	10.0%	\$359.92	\$6,853.13	\$1,123.51	\$141.87	\$5,587.75	\$17.77			
				Monte Carlo Simulation Assumptions						Monte Carlo Simulation Results	
				Base	Stdev	Min	Max	Distribution	Mean est.	1y-Target	
Revenue Variation	0	10%	N/A	N/A	Normal	\$24.51	\$22.93				
Op. Costs Variation	0	10%	N/A	N/A	Normal	\$0.32	\$0.25				
Market Risk Premium	6%	N/A	5%	7%	Triangular	\$23.55	\$22.18				
Long term Growth	5%	N/A	3%	18%	Triangular	\$14.80					
Terminal Value	0	0.1	N/A	N/A	Normal	Analysts' median est.	\$20.31				