

December 7, 2018

## Activision Blizzard (ATVI)

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Sector: Consumer Discretionary

Industry: Personal Video Games

**Company Description:** Activision Blizzard, Inc. develops and distributes content and services on video game consoles, personal computers, and mobile devices. The company operates through three segments: Activision Publishing, Inc.; Blizzard Entertainment, Inc.; and King Digital Entertainment. Its products include various genres, including first-person shooters, action/adventure, role-playing, strategy, and others.

### HOLD

Current Price:	\$46
Target Price:	\$50
Market Cap:	36.04 Bil
NOPAT Margin (Yr)	550.5 Mil
Adj. NI Margin	12.37%
ROE	5.6%
ROIC	4.03%
WACC	9.26%
Debt/E.V.	.08
Short Int. % of Float	3.02%



**Thesis:** The upside of keeping Activision Blizzard in our portfolio is not as large as the downside. Growth is expected to be below what's needed for a significant increase in stock price. Increased competition in the industry has likely slowed sales. While the portfolio still has made an overall gain on this company, it should be sold and invested in another company with a more favorable upside.

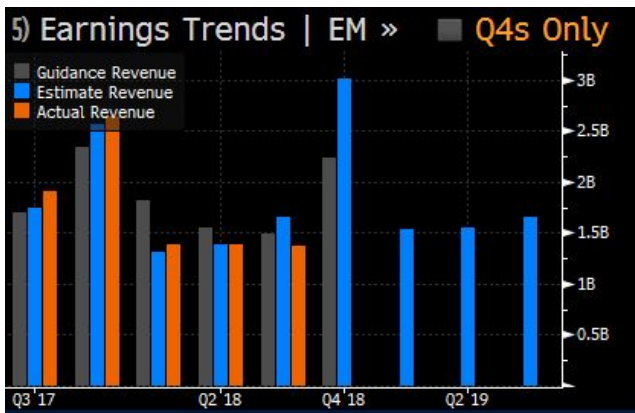
### Catalysts:

- Short Term: Continue to push sales for Call of Duty Black Ops 4 into the holiday season
- Long Term: Pay off debt; Advertising for games and micro-transaction support

In Millions of USD	2009 Y	2010 Y	2011 Y	2012 Y	2013 Y	2014 Y	2015 Y	2016 Y	2017 Y	Current/LTM	2018 Y Est	2019 Y Est
12 Months Ending	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	09/30/2018	12/31/2018	12/31/2019
Market Capitalization	13,892.3	14,720.5	13,963.4	11,805.3	12,547.1	14,546.9	28,432.6	26,919.5	47,965.2	35,718.4		
- Cash & Equivalents	3,245.0	3,508.0	3,525.0	4,375.0	4,443.0	4,858.0	1,823.0	3,245.0	4,713.0	3,308.0		
+ Preferred & Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
+ Total Debt	0.0	0.0	0.0	0.0	4,693.0	4,324.0	4,074.0	4,887.0	4,390.0	2,670.0		
Enterprise Value	10,647.3	11,212.5	10,438.4	7,430.3	12,797.1	14,012.9	30,683.6	28,561.5	47,642.2	35,080.4		
Revenue, Adj	4,279.0	4,447.0	4,755.0	4,856.0	4,583.0	4,408.0	4,664.0	6,608.0	7,017.0	7,161.0	7,465.9	7,736.8
Growth %, YoY	41.4	3.9	6.9	2.1	-5.6	-3.8	5.8	41.7	6.2	2.5	6.4	3.6
Gross Profit, Adj	1,972.0	2,321.0	2,983.0	3,194.0	3,052.0	2,883.0	3,079.0	4,214.0	4,516.0	4,673.0	5,338.0	5,601.1
Margin %	46.1	52.2	62.7	65.8	66.6	65.4	66.0	63.8	64.4	65.3	71.5	72.4
EBITDA, Adj	1,068.0	1,316.0	1,865.0	1,780.0	1,795.0	1,529.0	1,822.0	2,609.0	2,559.0	2,441.0	2,690.1	2,956.5
Margin %	25.0	29.6	39.2	36.7	39.2	34.7	39.1	39.5	36.5	34.1	36.0	38.2
Net Income, Adj	394.3	616.7	1,141.6	1,125.7	1,059.9	817.0	887.2	1,060.8	1,106.8	1,279.3	2,014.7	2,178.5
Margin %	9.2	13.9	24.0	23.2	23.1	18.5	19.0	16.1	15.8	17.9	27.0	28.2
EPS, Adj	0.31	0.49	0.98	1.01	1.02	1.13	1.20	1.41	1.45	1.67	2.60	2.82
Growth %, YoY	-	61.2	99.6	2.8	1.0	10.7	6.1	17.7	2.7	5.3	79.8	8.4
Cash from Operations	1,183.0	1,376.0	952.0	1,345.0	1,264.0	1,331.0	1,259.0	2,155.0	2,213.0	1,949.0		
Capital Expenditures	-69.0	-97.0	-72.0	-73.0	-74.0	-107.0	-111.0	-136.0	-155.0	-166.0	-159.0	-163.2
Free Cash Flow	1,114.0	1,279.0	880.0	1,272.0	1,190.0	1,224.0	1,148.0	2,019.0	2,058.0	1,783.0	2,123.8	2,248.7

## Earnings & Products:

This video game industry does see recurring revenue from games that have been previously released and still sees purchases as well as micro transactions. However, these companies make the majority of their new revenue from new game releases. Call of Duty, Destiny, Overwatch, Marvel, and mobile applications are some of the popular game series that Activision has produced. The first Call of Duty was released in 2003. Ever since then, the game has been a major source of revenue and publicity for the company. The annual release of a new Call of Duty game is a big deal for Activision. The franchise remains one of the company's top four titles that make up two-thirds of annual revenue, and it has generated more than \$10 billion over its lifetime. There have been several Call of Duty installments in recent years that have sold as much as \$1 billion within the first few days of launch. The 2013 release of Call of Duty Ghosts and the 2012 release of Call of Duty Black Ops 2 were the last two releases to hit \$1 billion in sales right after the launch. However, investors were likely looking for more sales growth year over year for this franchise. UBS claimed that it expected Call of Duty Black Ops 4 to sell 15% to 20% more units than the release of Call of Duty in 2017. Not all investors view this as a negative. However, the lack of forecasted growth in revenue is simply not attractive. Another aspect to hurt the sales of the latest Call of Duty is the timing of the release of the game. It's worth noting that Black Ops 4 came out during a busy time for new video game launches, so this might have ate into the game's sales. By looking at key stats above, Activision clearly is consistently generating profits and maintaining margins. As mentioned before, the company does has weak forecasted growth for the next few years really limiting future revenues. When using these to value the stock, it provides a very minimal upside which is frankly not worth holding the stock further just from a numerical perspective alone. As can be seen below in the earnings trend graph, Activision has been hitting and exceeding their earnings estimates for the past 6 quarters with one exception, being quarter 3 of this year. Even though quarter four does spike in estimated revenue, it can also be seen that quarter 3 of 2017 did substantially better than quarter 3 of this year (2018).



Capital Structure Data <a href="#">View As Reported Details</a> <a href="#">View Key Documents</a>							
For the Fiscal Period Ending		12 months Dec-31-2016		12 months Dec-31-2017		3 months Sep-30-2018	
Currency		USD		USD		USD	
Units		Millions	% of Total	Millions	% of Total	Millions	% of Total
Total Debt	↓	4,887.0	34.9%	4,390.0	31.7%	2,670.0	20.0%
Total Common Equity	↓	9,119.0	65.1%	9,462.0	68.3%	10,659.0	80.0%
Total Capital	↓	14,006.0	100.0%	13,852.0	100.0%	13,329.0	100.0%

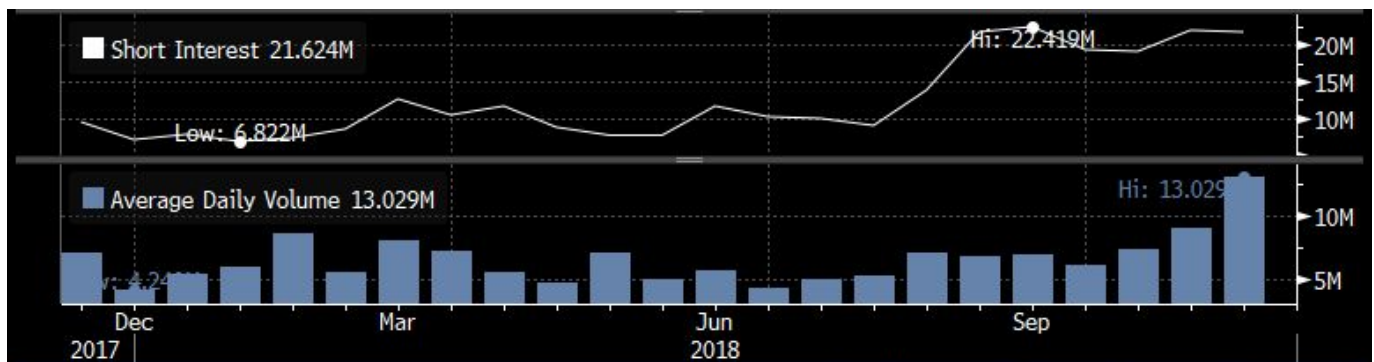
## Debt & Acquisitions:

Activision has had around 15 major acquisitions including Blizzard from owner Vivendi for 5.8 Bil in 2013. The company became Activision Blizzard following this acquisition. In 2016, they acquired King.com for 5.9 Bil which is an interactive entertainment company which provides online games for many different places and companies. They are well known for their mobile application games like Candy Crush. The year of 2016 had the highest amount of debt that they've owed. Since then, they have worked on paying off and substantially reducing this debt. The one positive effect this could have would be the debt rating going up on this company. That would make investors view this stock as a safer investment because the risk of default is less. Although this is possible, the WACC does not appear to be ready to decrease and the chance of a being assigned a more favorable debt rating is not necessarily going to happen right now. It is important to note that the discount rate does have a substantial effect on this company's stock price.

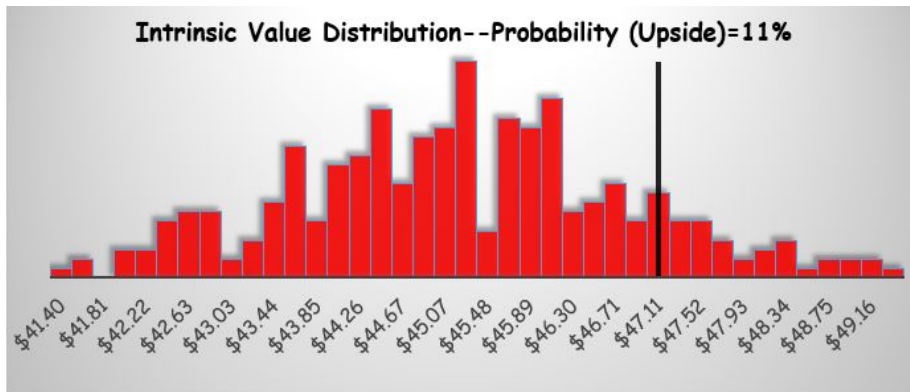
Name (BICS Best Fit)	Mkt Cap (USD)	ROIC LF	WACC
Median	6.62B	-1.30%	9.93%
100) ACTIVISION BLIZZARD ...	35.50B	4.03%	8.98%
101) ELECTRONIC ARTS INC	24.53B	16.24%	8.48%
102) TAKE-TWO INTERACTIV...	11.58B	11.21%	9.93%

## Competition & Industry:

The current weighted average cost of capital is just above 9%. The screenshot above was taken a few days beforehand. When looking at ROIC and WACC, the company is destroying significant value. The ROIC/WACC using the updated values is around .45 which is very poor alone. When comparing it to the other major competitors of Activision, E.A. and Take-Two are creating substantial value. They have a much higher ROIC and ROE with a similar WACC. Activision Blizzard is destroying a significant amount of value unlike its competition. However, when looking at the Activision as well as E.A.'s and Take-Two's stock prices, they all follow the same trend. The line chart on page 1 has the stock price of these three companies. All three companies have seen a significant drop in stock price following the same trend since around September of this year. As mentioned above, the other big games with October of 2018 launches include Assassin's Creed Odyssey, Soul Calibur VI and Red Dead Redemption 2. Red Dead Redemption 2 sold 15 million copies in 8 days after its release and continues to do incredibly well with many awards and nominations. Not to mention, every gamer that I personally asked about these games stated that they would not be buying all of the new games that have been released since they are above \$50 per game. Therefore, it is very likely that the competition of other video games is eating into the profits of Activision, and will provide too much competition for such an old franchise like Call of Duty to see sales figures like they have in the best with their best selling games for the short run in the future.



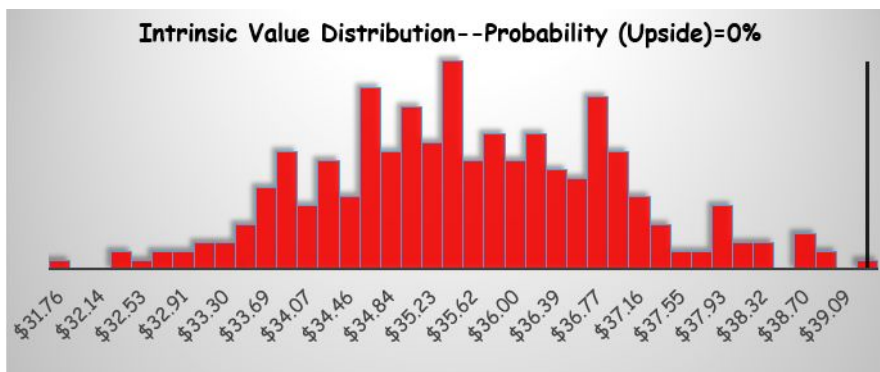




## Base Case:

The growth used in this case were computed by the proforma. The first 6 years of growth are 10.8, 8.6, 12.6, 9.5, 13.9, and 9.8 percent. The reason that this is important is because the majority of analyst estimates are not this generous. Bloomberg and Capital IQ have substantially lower forecasted growth rates. This case could be viewed as a bullish case under the condition that Activision manages to see increased growth from what has been predicted. The intrinsic value of the stock using this setup in the proforma sits around \$45 per share. The target price is \$49. This return is absolutely not worth keeping this stock in our portfolio.

## Median Estimates:



Median growth rates predicted by Bloomberg analysts are 8.0, 9.4, 8.3, 5.1, 5.4, and 5.9 percent for the next six years. These growth rates are much lower than what the proforma had originally computed and are much closer to other analyst estimates. The growth rates after the sixth year converge on the continuing period rate which is 2.5 percent. The intrinsic value and target price under this case are both in the mid \$30s which would eliminate any gain that the portfolio has made on this stock if not create a loss.

## **Conclusion:**

Even though Activision has produced various great selling games in the past, future revenue growth is forecasted to be much slower than previous years. The major competitors of Activision are also seeing a significant decrease in price. However, this company is destroying value and its closest competitors are not. The short interest is at the highest point that it has seen in the past year. When all of these aspects are compared to the minimal upside of revenue growth and stock price, this stock is absolutely not worth keeping in our portfolio. The potential downside is much larger for the short term. Since we have still made a gain on holding this in our portfolio from the purchase date until now, this would be a great time to sell this stock and invest the money in another company which appears to have a much more attractive upside. It is very possible that this company will see an increase in stock price in the long term when the market picks up and Activision invests in another best selling game or program. For the short term, this is not the case and it is not worth the risk of keeping this company's stock.

