

February 16, 2018

Activision Blizzard, Inc: ATVI

Zachary DeLeonardo

Sector: Technology

Industry: Application Software

Current Price: \$70.19

Target Price: \$84.02

Company Description:

Activision Blizzard is a multiplatform software company that develops games for PC, console, and mobile devices. The company operates through three main segments: Activision, Blizzard, and King. Activision Blizzard creates value through brand name franchises such as Call of Duty, World of Warcraft, Overwatch, Destiny, and the Candy Crush Saga.

Buy

Current Price:	\$70.19
Target Price:	\$84.02
Market Cap:	\$52.9B
Avg. Volume:	6.1M
Beta:	.99
S&P Debt Rating:	BBB
ROE:	4.4%
WACC:	9.6%
ROIC:	10.71%
EBITDA Margin:	36.47



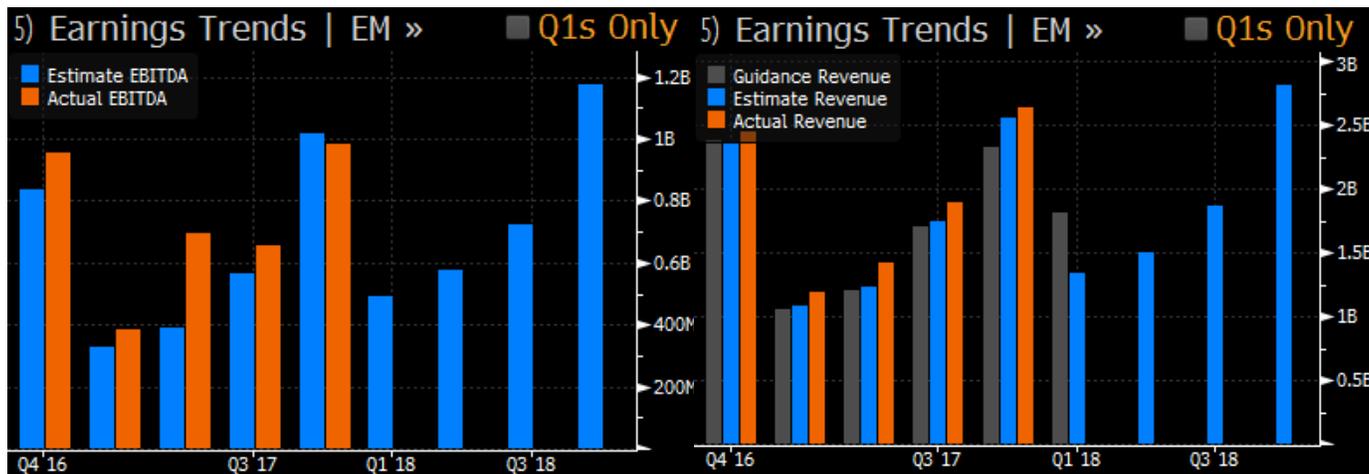
Thesis: Activision Blizzard is the best positioned software company in its industry through brand recognition of popular franchises. Their acquisition of King Digital Entertainment launched them into the mobile device arena with the highest grossing mobile game of all time, Candy Crush Saga. With their increasing revenue growth and effective capital management, Activision Blizzard is positioned to increase in share price well past its 52-week high.

Catalysts:

- **Short Term(within the year):** Traction of new online eSports league, continued revenue growth from latest franchise installments
- **Mid Term(1-2 years):** Further additions to popular franchises that will drive growth
- **Long Term(3+):** Increasing mobile device use by younger generations, high demand for franchise expansion

Earnings:

Activision Blizzard reported a Q4 revenue increase of 16% YoY along with an increase in operating income of 32% due to strong momentum from early release of Call of Duty: WWII, Destiny 2, and Crash Bandicoot N. Sane Trilogy leading into the holiday season. Activision Blizzard has historically lower revenues in all other quarters compared to Q4, where major game launches are strategically planned for maximum exposure during a heavy consumption period in North America. Below, the chart on the left shows analyst estimates and actual EBITDA results for the last 5 quarters along with future projections for EBITDA. The chart on the right shows analyst estimates and actuals for revenue for the last 5 quarters along with future projections for revenue.



Activision Blizzard was below analyst estimates for EBITDA in quarter 4 but shows slight YoY growth for the same quarter. In terms of revenue, ATVI also follows a constant uptick all year with total revenue of 7.017B for FY 2017 compared to FY 2016 of 6.608B, a 6.19% YoY growth. Strong earnings can be attributed to the latest installment in the Call of Duty franchise - the number one grossing console game worldwide in 2017, making the franchise number one globally again for 8 out of the last 9 years. Analyst revenue estimates and guidance for every quarter in 2017 were outperformed.

Segment Analysis:

Activision Blizzard operates 3 main sectors: Activision, Blizzard, and King. Activision produces stand out console and PC games such as the Call of Duty Franchise, Destiny Franchise, and Skylanders. Blizzard's focus is more on player-versus-player online games and where their front-runners are World of Warcraft, Hearthstone, Overwatch, Diablo, Starcraft, and Heroes of the Storm. King is their mobile device platform that includes Candy Crush, Pet Rescue, Farm Heroes, and Bubble Witch.

	ACTIVISION	BILZARD ENTERTAINMENT	King
Q4 Segment Net Revenues:	\$1,337M	\$599M	\$516M
Q4 Segment Operating Income:	\$634M 47%	\$160M 27%	\$162M 31%
2017 Segment Net Revenues:	\$2,628M	\$2,139M	\$1,998M
2017 Segment Operating Income:	\$1,005M 38%	\$712M 33%	\$700M 35%
Key Highlights:	<ul style="list-style-type: none"> Record annual segment OI of \$1B+ and operating margin of 38%+, driven by Call of Duty: WWII, Destiny 2, and Crash Bandicoot N. Sane Trilogy Q4 segment revenues increased 16% year-over-year, and OI increased 32% in the same period 	<ul style="list-style-type: none"> Record annual segment revenues and OI for a year with no major game release as Blizzard delivered continuous content across franchises including Overwatch, Hearthstone, and World of Warcraft® 	<ul style="list-style-type: none"> Annual segment revenues and operating income up 7% and 12%, respectively, on a pro-forma basis including the 2016 pre-acquisition period for King on the strength of Candy Crush and focus on improvements in engagement & player investment

The chart above is from the earnings call slideshow from Activision Blizzard. King was acquired in 2016, increasing revenues from 4.664B for FY 2015 to 6.608B for FY 2016, where King accounted for 25.4% of that. From 2016 to 2017, King has improved revenues from 1.586B in FY 2016 to 1.998B in FY 2017, becoming almost 30% of Activision Blizzards total revenue. Blizzard is positioned for heavy growth in 2018 with the recent launch and future growth initiatives of the Overwatch league, an online professional gaming league where viewers can watch 12 major teams compete online. Blizzard has posted 40M+ MAUs(monthly active users) for the 6th quarter in a row with expected growth due to the league. King has 290M+ MAUs while Activision has 55M+ MAUs. In the Q4 earnings call transcript, Cuddy Johnson (President and COO) stated, “For Activision Blizzard and King overall, daily time spent per user was over 50 minutes for the second quarter in a row, placing us on par with Facebook’s time per day across Facebook, Instagram and Messenger. Now, that 50 minutes per day is just the time spent in our games; it does not include the growing popularity of watching our games on other online platforms.”

Ownership:

Ownership in Activision Blizzard has recently declined from the last filing date of 2/11/18. This selling of shares can be attributed to an industry wide shift where the S&P500 dropped more than 10%. The application software industry followed the market drop, which was indicative of more than just a bearish trading day, but of a correctional period after too long of an uptrend in the market.

54) Ownership Type	02/11/18	Curr	Change
41) Investment Advisor	77.39	80.46	+3.07
42) Hedge Fund Manager	9.02	7.35	-1.67
43) Corporation	4.47	4.14	-0.33
44) Pension Fund	2.19	2.08	-0.11
45) Bank	2.36	2.05	-0.31
46) Individual	1.40	1.00	-0.40
47) Government	1.03	0.95	-0.08
48) Insurance Company	0.96	0.84	-0.12
49) Sovereign Wealth Fund	0.67	0.62	-0.05

Despite the recent dip, which was industry wide and not specific to ATVI, top holders such as hedge fund managers still have confidence in ATVI’s value. The short ratio is currently at 1.1352 with 1.1 days to cover. With such low short interest, it’s clear that top investors are in long positions, anticipating value creation in the future.

Competition:

Gaming software is an incredibly competitive market. Threat of new substitutes are high due to the multitude of different gaming genres, the possibility of users overplaying and eventually getting bored of games, and in the mobile platform arena, new games are easily created at little cost. However, Activision Blizzard combats new substitutes through rigorous installments of new downloadable content for existing games, such as the Zombies packages add-on for Call of Duty, along with updating new characters and weapons in Overwatch. Maintaining updates and adding content to existing franchises is a must to keep user interest away from other substitutes. Of course, users are not going to only play one game, but as long as franchises still maintain current updates, users will keep going back to Activision Blizzard games over buying brand new games.

Name	Ticker	Mkt Cap↓	Rev - 1 Yr Gr:Q	YTD Tot Ret	OPM LF
Median		38.65B	1.44%	11.29%	10.82%
100) ACTIVISION BLIZZARD INC	ATVI US	53.07B	1.44%	10.85%	10.82%
101) NINTENDO CO LTD	7974 JP	61.23B	177.08%	11.29%	24.12%
102) ELECTRONIC ARTS INC	EA US	38.65B	0.96%	19.95%	-1.81%
103) TAKE-TWO INTERACTIVE ...	TTWO US	12.25B	0.92%	-2.50%	1.84%
104) SS&C TECHNOLOGIES HOL...	SSNC US	10.29B	9.34%	23.52%	25.84%

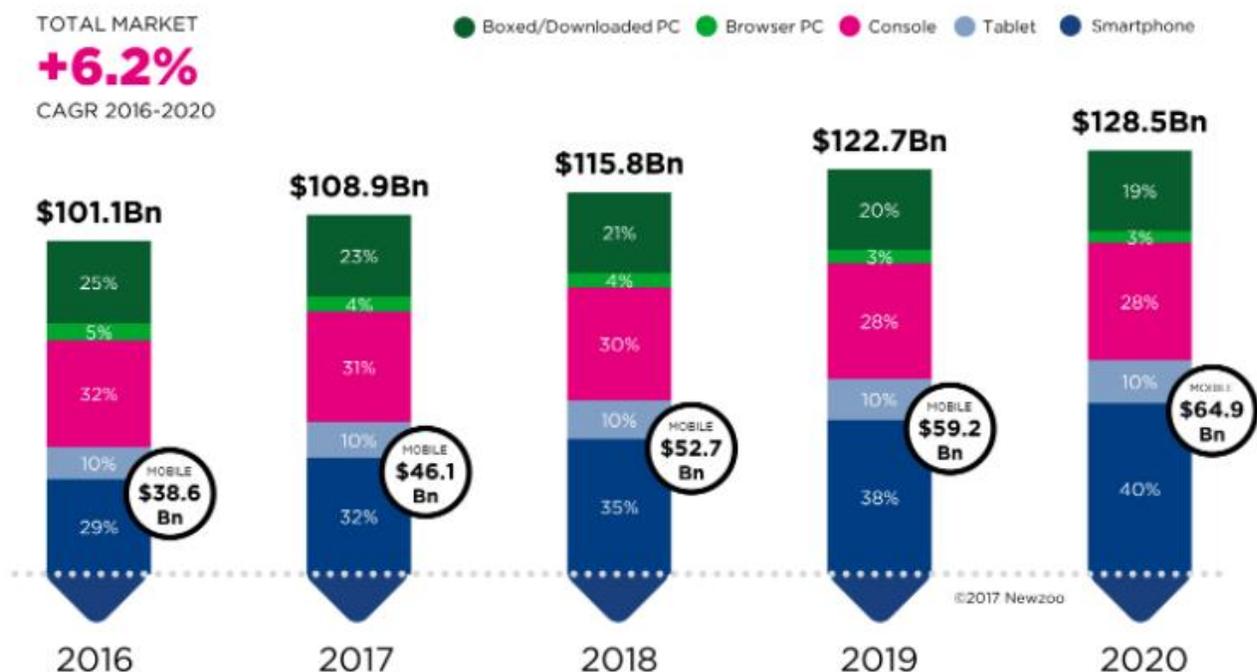
Nintendo as a competitor must be taken lightly, where a majority of their revenues come from actual console sales, in 2017 that being the Nintendo Switch, which accounts for their major revenue growth YoY(application software 4.96% of total revenue). However, using them as a peer due to their similar market cap, Activision Blizzard actively keeps up with operating margin compared to Electronic Arts and Take-Two Interactive. In terms of software development, Activision Blizzard is the clear industry titan when it comes to operating margin. On the revenue side, Activision Blizzard is also maintaining the industry median, which is also inflated due to Nintendo. In terms of actual games, no other competitor has the brand recognition that Activision Blizzard does. This is a highly important factor in this industry due to reputation of quality games that include top notch graphics, plot, user friendly controls, and overall an enjoyable gaming experience.

Industry Outlook:

The video game industry adds, on average, about \$11.7B a year to U.S. GDP. With annual salaries averaging around \$97,000, this industry is highly competitive. In terms of console games, most of the market share is positioned to the top companies with resources to roll out blockbuster games. However, mobile

2016-2020 GLOBAL GAMES MARKET

FORECAST PER SEGMENT TOWARD 2020



device games are also growing and require far less brand recognition, expenses, and software engines to program. Above is an industry outlook for the global games market with a CARG of 6.2% through 2020. Mobile gaming is positioned to be the highest growing segment compared to consoles, PC, digital downloads, and tablet gaming. Mobile gaming is gaining traction due to younger generations acquiring smartphones very young. Millennials and generation z are gaming software's target demographics for mobile gaming in the coming years where the average age for owning a smartphone is 10.3 years old. With the shift moving from hard copy games on console and PC, the industry is making a major shift to digital download mobile applications.

Capital Structure:

Activision Blizzard is composed of 91.6% equity and 8.4% debt resulting in a WACC of 9.6%. Competitors have a lower WACC, where Electronic Arts has a WACC of 9.1% and Ubisoft at 7.9%. Electronic Arts maintains 3.5% debt while Ubisoft maintains 17.1% debt. Ubisoft's cost of debt of .6% allows them to carry more debt than others in the industry, whereas Activision Blizzard's cost of debt is 1.4% and Electronic Arts' cost of debt is 2.8%. There is a huge potential for future mergers and acquisitions within the gaming industry with such low levels of debt.

12 Months Ending	12/31/2014	12/31/2015	12/31/2016	12/31/2017
 Market Capitalization	14,546.9	28,432.6	26,919.5	47,876.2
 - Cash & Equivalents	4,858.0	1,823.0	3,245.0	4,713.0
 + Preferred & Other	0.0	0.0	0.0	0.0
 + Total Debt	4,324.0	4,074.0	4,887.0	4,390.0
 Enterprise Value	14,012.9	30,683.6	28,561.5	47,553.2

Conclusion:

In conclusion, Activision Blizzard, Inc. is a buy at its current price. This is due to industry trends in the application software industry and opportunity to capitalize on future installments of global leading game franchises. Compared to the competitors, Activision Blizzard maintains increasing margins and revenue growth with momentum from the latest releases of franchise games such as Call of Duty: WWII, Destiny 2, and Overwatch eSports league. With zero net debt, Activision Blizzard is well positioned to further acquire companies in the future and add to their multiplatform business model. The company's one-year target price of \$84.02, a 20.19% is reasonable based on the analysis. Activision Blizzard is well positioned to beat its 52-week high and create value for its investors.

Activision Blizzard, Inc.
(ATVI)

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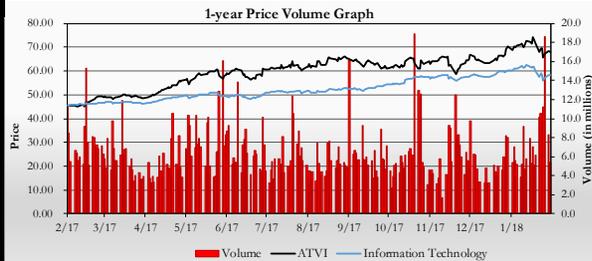
BULLISH

Analysis by Zachary DeLeonardo
2/16/2018

Current Price: **\$70.19**
Divident Yield: **0.5%**

Intrinsic Value: **\$77.43**
Target Price: **\$84.02**

Target 1 year Return: 20.19%
Probability of Price Increase: 100%



Description	
Activision Blizzard, Inc. develops and publishes games for video game consoles, personal computers (PC), mobile devices, and online social platforms.	
General Information	
Sector	Information Technology
Industry	Software
Last Guidance	February 12, 2018
Next earnings date	May 4, 2018
Market Assumptions	
Estimated Equity Risk Premium	7.15%
Effective Tax rate	25%

Market Data	
Market Capitalization	\$54,431.60
Daily volume (mil)	6.15
Shares outstanding (mil)	756.10
Diluted shares outstanding (mil)	766.00
% shares held by institutions	109%
% shares held by investments Managers	73%
% shares held by hedge funds	8%
% shares held by insiders	1.39%
Short interest	0.90%
Days to cover short interest	1.11
52 week high	\$74.95
52-week low	\$44.60
Volatility	27.01%

Past Earning Surprises	
Quarter ending	Revenue
12/31/2016	-15.27%
3/31/2017	58.71%
6/30/2017	33.14%
9/30/2017	-6.51%
12/31/2017	-18.93%
Mean	10.23%
Standard error	1.0%

EBITDA	
Recommendation (STARS) Value--2	167.42%
Recommendation (STARS) Description--Sell	52.56%
Quality Ranking Value--B+	-17.65%
Quality Ranking Description--Average	-155.59%
Short Score--0	4.94%
Market Signal Probability of Default % (Non-Ratings)	4.7%
CreditModel Score (Non-Ratings)--bbb-	

Market and Credit Scores	
Recommendation (STARS) Value--2	0.73% per annum over 5y
Recommendation (STARS) Description--Sell	18.3% per annum over 4y
Quality Ranking Value--B+	0.73% per annum over 5y
Quality Ranking Description--Average	0% per annum over 0y
Short Score--0	
Market Signal Probability of Default % (Non-Ratings)	
CreditModel Score (Non-Ratings)--bbb-	

Industry and Segment Information	
LTN Revenues by Geographic Segments	Activision--37%
LTN Revenues by Business Segments	Blizzard--30%
EMEA--35%	King--28%
Asia Pacific--13%	Other Segments--6%
Americas--51%	Unallocated Net Effect from Deferral of Net Revenues

Management	
Kotick, Robert	CEO & Director
Durkin, Dennis	Chief Corporate Officer
Morhaime, Michael	President & CEO of Blizzard Entertainment Inc
Zacconi, Riccardo	Executive Officer & CEO of King Digital Enterta
Johnson, Collister	President & COO
Neumann, Spencer	Chief Financial Officer

Total Compensations Growth	
31.75% per annum over 5y	
-40% per annum over 4y	
10.12% per annum over 5y	

Stock Price Growth During Tenure	
0.73% per annum over 5y	
18.3% per annum over 4y	
0.73% per annum over 5y	
0% per annum over 0y	

Peers	
Electronic Arts Inc.	Nintendo Co., Ltd.
Take-Two Interactive Software, Inc.	Changyou.com Limited
Zynga Inc.	Frontier Developments Plc
Ubisoft Entertainment SA	--

Profitability	
Return on Capital (GAAP)	10.3%
Operating Margin	24%
Revenue/Capital (GAAP)	0.42
ROE (GAAP)	4.4%
Net margin	6.9%
Revenue/Book Value (GAAP)	0.63

ATVI Historical	
9.12%	
28.26%	
0.32	
5.3%	
11.7%	
0.45	

Peers' Median (LTM)	
33.23%	
17.15%	
1.94	
6.5%	
6.5%	
1.01	

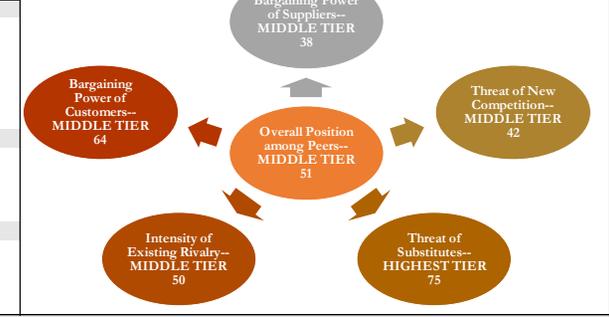
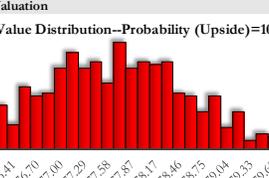
Invested Funds	
Cash/Capital	28.5%
NWC/Capital	-10.5%
Operating Assets/Capital	23.0%
Goodwill/Capital	59.0%

ATVI Historical	
24.5%	
-10.9%	
35.1%	
51.3%	
11.2%	

Peers' Median (LTM)	
41.8%	
-4.3%	
51.3%	
11.2%	

Capital Structure	
Total Debt/Market Capitalization	0.28
Cost of Debt	3.1%
CGFS Rating (F-score, Z-score, and default Probability)	BB
WACC	9.3%

ATVI Historical	
0.21	
3.9%	
10.8%	



Forecast Assumptions	
Revenue Growth CAGR	12%
Average Operating Margin	33%
Average Net Margin	29%
Growth in Capital CAGR	10%
Growth in Claims CAGR	0%
Average Return on Capital	12%
Average Return on Equity	13%
Average Cost of Capital	10%
Average Cost of EquityKc	10%

Explicit Period (7 years)	
12%	
33%	
29%	
10%	
0%	
12%	
13%	
10%	
10%	

Continuing Period	
2%	
28%	
26%	
2%	
2%	
11%	
11%	
10%	
10%	

