

Activision Blizzard, Inc. : ATVI

Paul Martinez

Sector: Information Technology

Industry: Entertainment Software

Current Price: \$72.03

Target Price: \$87.05

BUY

Current Price:	\$72.03
Target Price:	\$87.05
Market Cap:	54.341B
Average Volume:	6.2M
52 Week Range	\$44.60 – \$74.94
ROIC:	11.0%
WACC:	9.0%
D/E:	0.54

Company Description: Activision Blizzard, Inc. develops games for video game consoles, personal computers (PCs), and mobile devices. The company's products cover diverse game categories, including action/adventure, action sports, racing, role-playing, simulation, first-person action, music-based gaming, and strategy. The company publishes, and sells interactive software products and entertainment content through retail channels, digital downloads, and downloadable content.



Thesis: Activision Blizzard, Inc. is a worldwide leader in interactive entertainment content. Activision has been able to grow their company through innovation, highly successful franchises, and strategic acquisitions. Activision operates in three major segments that have year-over-year been able to exponentially grow revenues and improve operating margins. Management plans to continue this growth through their three strategic pillars for success and their 2018 capital allocation strategy. With these strategic pillars and initiatives, Activision will be able to expand margins and continue to create value through 2018.

Catalysts:

- **Short Term (within the year):** Activision Blizzard, Inc. has announced the release of two new games during 2018, as well as new downloadable content for both Call of Duty and Destiny 2.
- **Mid Term (1-2 years):** Overwatch League expansion teams and the overall increase interest in eSports.
- **Long Term (3+):** Management's three strategic pillars and capital allocation strategy will continue to create value and drive the stock price.

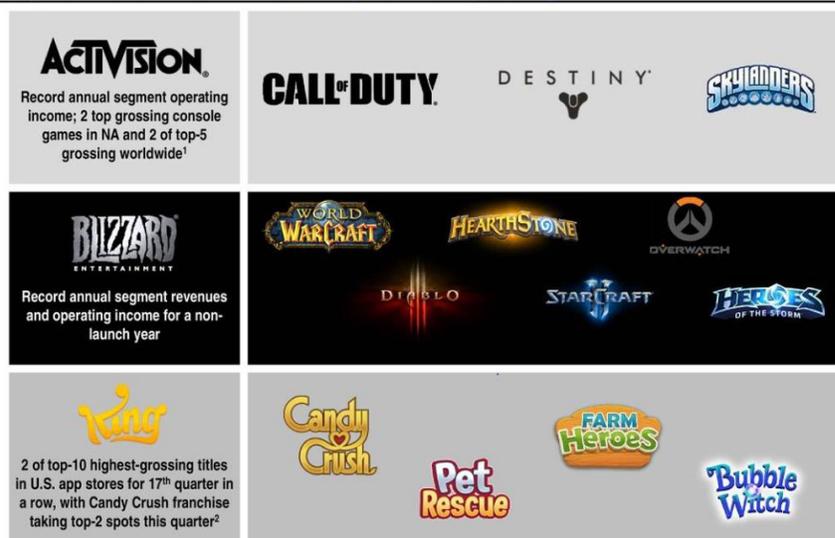
Business Description:

Activision Blizzard, Inc. was incorporated in 1979, was originally incorporated in Santa Monica, California, and was reincorporated later on in Delaware. Activision Blizzard, Inc. operates as a developer and publisher of interactive entertainment content and services worldwide. The company develops and distributes content and services across all of the major gaming platforms, including video game consoles, personal computers, as well as mobile devices. The company is the largest producer of video games including some of the most successful franchises in the history of video games. Producing franchises such as, World of Warcraft (WoW), Guitar Hero, Candy Crush, Call of Duty, and Destiny. Activision also creates games based on licensed properties from large companies such as, Marvel, DreamWorks Animations, and EON Production. Activision Blizzard, Inc. sells products through many channels, but primarily through retailers and distributors, consumer electronic stores, discount warehouses, game specialty stores, and consumers through third-party distribution and licensing arrangements all over the world. The company can be further broken down into its three primary operating

segments: Activision Publishing, Inc., Blizzard Entertainment, Inc., and recently acquired King Digital Entertainment. Activision primarily focuses on the production of the Call of Duty Franchise as well as the Destiny games. Blizzard primarily focus is on PC gaming and takes charge of World of Warcraft with all of its content, as well as the new addition of Overwatch. Finally King's major product franchises focus on PC and mobile device gaming and handle the content of those applications. Activision Blizzard, Inc. has a strong business model and recently has obtained an impressive position in the industry by expanding their portfolio to reach over every video game platform.

A Portfolio of Compelling Franchises

Eight \$1B+ franchises across our portfolio of primarily owned IP



Growth Strategy:

Activision Blizzard, Inc. has been growing at a more than impressive rate and stock price has more than doubled since the Bjorklund fund originally bought shares towards the end of 2016. This last quarter Activision has experienced record-breaking financials in terms of revenues, operating margins and other key metrics like MAU's (Monthly Active Users). The company has had tons of success in its product lines and innovations; however, success has been primarily driven through managements three strategic pillar strategy. This is a core part of Activision's business model, is repeatedly mentioned in both the earnings call and annual-reports, and clearly is significant from the top-down. The three pillars consist of the following goals, the first would be expanding audience reach, followed by further driving deep consumer engagement, and finally to provide more opportunities for player investment. These pillars have been embedded into management's plan and they are committed to taking the correct initiatives to ensure success. First expanding

audience reach, by being able to reach more users on different platforms. The most recent major initiative in this area was the launch of the Overwatch League. The league attracted 12 world-class team owners’

Strategic Focus on Franchises

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



representing cities all across the world, signing numerous league and team level sponsors. In its first week, the league reached 10 million unique viewers and had more than 280,000 average viewers on a per minute basis. This type of audience reach shows for the growing interest in E-Sports and the advertising capabilities that Activision can take advantage of going forward. Secondly, Activision has been focused on deepening consumer engagement across all their platforms. Activision Blizzard, Inc. has this previous quarter matched up with social media

giants like Facebook, and Instagram with daily time spent per user over 50 minutes for the second quarter in a row and this does not include time spent streaming. This goes to show that users are continuously coming back and are involved to the point, that when they get on to play a game they will be playing for a while. This brings us to the last strategic pillar, providing more opportunities for player investment. As said in their last earnings call, “In-game services, features and content continue to engage our fans and help drive our results, delivering a Q4 record of over \$1 billion of in-game net bookings and an annual record of over \$4 billion”. Activision has been able to encourage further investment by continuously releasing new downloadable content and in-game purchases. These three strategic pillars allows management to pursue their goals and visions and continue to grow their business.

Segment Breakdown:

As mentioned earlier, Activision Blizzard, Inc. operates in three primary segments. The first being Activision, the second being Blizzard, and finally King. Activision also operates in a fourth segment called MLG (Major League Gaming), this segment provides a non-material amount of revenues, but provides an online-streaming service and promotes the E-Sports segment bringing more exposure to the games and the company as a whole. Activision produces the majority of revenues, composing approximately 39% of total revenues. Activision

also has the largest GAAP operating margin at about 38%. Activision had a very successful fourth quarter,

Fourth Quarter and 2017 Segment Results

Ongoing pipeline of content, services, and features led to over-performance

	ACTIVISION	BLIZZARD 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

which lead to their best year ever with segment records in both operating income and operating margins. Revenues grew 16% and operating income grew 32% year-over-year. This is a positive sign for Activision Blizzard, Inc. this shows that the largest segment has the largest margin and is growing the fastest. This will lead to increasing amount of operating cash flows and continuous value creation. Following Activision's segment, Blizzard revenues compose approximately 31% of total revenues and has an operating margin of 33%. Blizzard also generated record results for the year with no major game release. Revenues primarily came through a steady stream of content and events across their franchises, in particular Overwatch, Hearthstone, and World of Warcraft. With this being said, fiscal Q4 was slightly down on the year, but provided a 2017 operating margin of 33% as mentioned. Blizzard also has implemented key growth initiatives, which are exhibited through the new Overwatch League and the two-year contract recently signed with Twitch. Finally composing about 30% of total revenues, King Entertainment, has an operating margin of about 35%. King Revenue increased 7%, and operating income increased 12% year-over-year. Overall, margins have expanded year-over-year, however, took a slight hit on growth in fiscal Q4. This slight compression in growth was due to strategic investments in marketing live titles to profitability drive reach (Q4 Earnings Call). To summarize, all segments are performing at record highs and are growing revenues and expanding margins, this will result in an increase in both top and bottom lines.

Company Performance:

Activision Blizzard, Inc. has been growing substantially over the last twelve months (LTM). A low stock price of \$45.08 last February and now are trading around \$70.19. This growth has come both organically and inorganically. Organically Activision and Blizzard have been growing revenues through their successful game franchises. Inorganically the acquisition of King Entertainment in late 2016 has allowed the company to grow substantially, reach a completely new audience, and generate incremental cash flows. The company has historically beaten their competitors in many aspects, but recently has fallen slightly behind. With this being said, I believe that the market is missing some key factors in their pricing of the stock, which is leaving ATVI undervalued. These factors will propel Activision above competitors in terms of margins and profitability as well as propel stock price beyond their 52 week high. First being the extremely high amortization costs of their intangible assets. Activision has been paying large costs from the King Acquisition in terms of amortizing their intangible assets that were acquired. With this decreasing, net income margin can be expected to improve in the future. Secondly, the upgrade in credit rating to BBB, allowed Activision to refinance and lock in lower rates on their debt at a lower price. This will lower interest expenses and allow for larger net income margins. In addition to these cost-cutting aspects, Activision Blizzard, Inc. has ramped up their ad business and plans to continue to increase these through 2018. With record breaking MAU's and an increasing audience reach we can expect to see large supplemental revenue growth. Finally, management's capital allocation strategy has been a key component of Activision's performance over the past couple of years. Management plans on allocating its capital by increasing dividends, paying back over \$1 billion dollars of debt through 2018, as well as buying back approximately \$1 billion dollars' worth of shares. Although some of these aspects are being priced into the current market price, I believe that these are going to make a

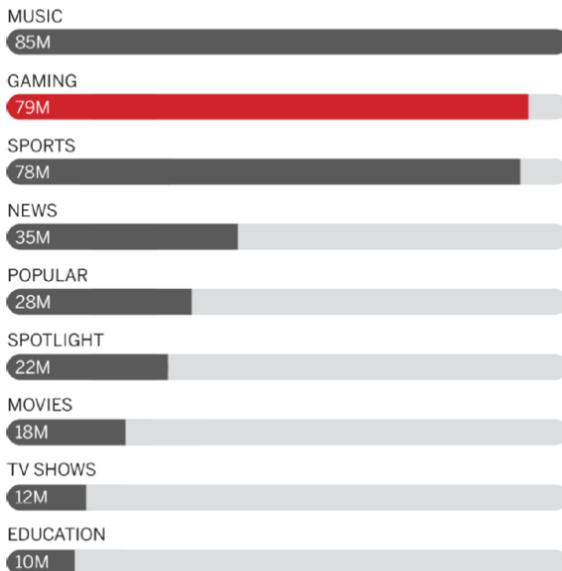
greater impact than what those are expecting. For these reasons and many others, I believe that Activision will see an increase in both operating cash flows as well as net income margins.

COMMON SIZE VIEW				
	6-year Historical Median		Last 12 Months	
	ATVI	Competitors	ATVI	Competitors
COR/Rev	34.6%	39.6%	35.4%	34.3%
(SGA+Other)/Rev	33.1%	39.1%	38.3%	48.1%
DPR/Rev	3.9%		1.9%	0.0%
EBITDA Margin	28.3%	21.3%	24.4%	17.6%
Interest exp/Rev	2.2%	0.4%	0.1%	0.3%
AMORT/Rev	2.0%		10.8%	0.0%
SBC/REV	2.3%		2.5%	0.0%
Other Non-Operating Exp/Rev	2.6%	-1.6%	3.1%	1.7%
Taxes/Rev	5.0%	2.8%	0.9%	2.8%
Net Margin	14.2%	19.7%	7.1%	12.8%
Cash/Capital	24.5%	52.6%	28.5%	46%
NWC/Capital	-10.9%	-4.4%	-10.5%	-2%
Operating Assets/Capital	35.1%	43.9%	23.0%	45%
Goodwill/Capital	51.3%	7.9%	59.0%	11%
Debt/Capital	21.5%	13.9%	28.2%	10%
Other Claims/Capital	0.0%	0.5%	0.0%	0%
Book Value/Capital	78.5%	85.6%	71.8%	89.4%

Industry Outlook:

The technology sector is growing exponentially as time goes on and more technology becomes available. With this being said, the home entertainment industry is becoming more and more abundant. With an increase in

PRESENTED WITHOUT comment: as an overall category, gaming has more YouTube followers than news, movies and education combined.

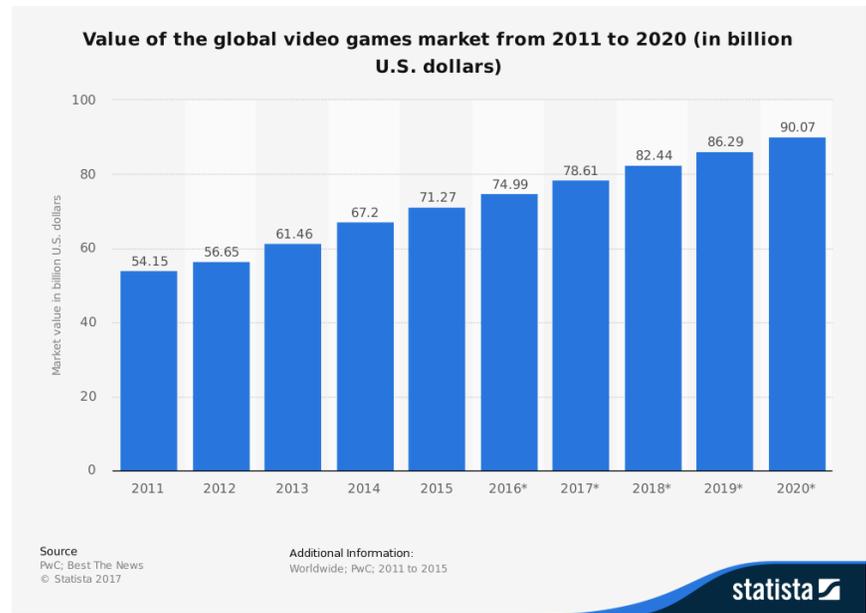


ESPN.com illustration

types of video games and different platforms of gaming like augmented reality and virtual reality games, we can see an increase in interest and users. Furthermore, now more than ever there is a growing audience and potential in eSports. As you can see from the graph on the left, gaming is the second most followed channels on YouTube, holding a position above both sports and the news. This increase in interest can also be illustrated through new streaming services that are specifically for gaming, in example, Twitch, Discord, and Activision’s very own, MLG (Major League Gaming). As mentioned in a recent Forbes article, “Gaming communities rely on continued buzz to sustain player interest. This mainly comes from community-generated content. YouTube has since been filled with gaming footage and commentaries revolving around popular multiplayer games. Streaming platform Twitch continues to experience monumental growth. In order to develop its user base, Twitch recently

announced that the company is working on new tools for gamers to monetize their streams”. Activision has placed itself in a very advantageous position with these current trends by solidifying long-term contracts with Twitch and by creating and producing the Overwatch League. With all of this being said, I believe that Activision Blizzard is in the perfect position to take advantage of all of these trends. They currently have every platform covered from console gaming, PC gaming, as well as mobile device gaming. This industry has

seen growth and is going to continue to see growth. As you can tell from the chart at the bottom, within the next few years the video game market is going to be valued at close to 100 billion dollars. Being a leader in this industry will only help Activision Blizzard, Inc. going forward and will continue to be the trademark for videogame franchises.



Ownership Summary:

Primarily Investment Advisors own Activision Blizzard, Inc. This position over the past year has increased significantly from 72.76% to 80.46%. Meanwhile, Hedge Funds have decreased their position by approximately 4.4%. I believe that this decrease comes primarily in profit taking. As mentioned earlier, Activision stock price has increased more than 50% over the past year, and Hedge Funds generally have a shorter-term focus so this fits into their schedule. Another positive sign in relation to their ownership is their extremely low short interest. As a percent of float, short interest is below 1%. This shows that not many individuals or institutions believe that Activision’s stock price is going to decrease. As mentioned, Investment Advisors position has increased pretty substantially over the past year, which is another positive sign for investors showing that more funds and advisors are going long on Activision Blizzard, Inc. Out of all the Investment Advisor’s, Fidelity owns close to 13% of the company. Currently total diluted shares outstanding are 776 million; however, management has stated that they plan to buy back a billion dollars’ worth of shares throughout 2018. This will increase value to the shareholders and increase EPS, which is beneficial to both shareholders and management.

Ownership Type	02/12/17	Curr ↓	Change
1) Investment Advisor	72.76	80.46	+7.70
12) Hedge Fund Manager	11.72	7.35	-4.37
13) Corporation	5.12	4.14	-0.98
14) Pension Fund	2.00	2.08	+0.08
15) Bank	2.66	2.05	-0.61
16) Individual	1.22	1.00	-0.22
17) Government	1.09	0.95	-0.14
18) Insurance Company	0.62	0.84	+0.22
19) Sovereign Wealth Fund	0.71	0.62	-0.09
20) Unclassified	1.89	0.22	-1.67
21) Brokerage	0.12	0.22	+0.10

Conclusion:

In conclusion, Activision Blizzard, Inc. is an industry leader in home entertainment software industry and a leading producer of videogames. Activision Blizzard, Inc. has established an impressive portfolio of successful videogame franchises that have made them the household name for videogames. Management has developed a strong growth strategy that has continuously proven to be successful allowing for organic growth. This organic growth has been seen through the development of their existing franchises as well as the ability to create new franchises. Activision has found a successful capital allocation process in which they continue to reinvest money into the correct areas of the company. The company will continue to grow because of three strategic pillars that were mentioned. One being expanding audience reach, this will allow more exposure to the company as well as allow for the future occurrence of ad revenue, which management has been speaking about as of recently. Second being the ability to deepen player engagement. The ability to keep users active and returning creates a loyalty to the company, which will result in future revenues. Finally, to provide more opportunities for player investment. If the users are continuously coming back to the play the game they will be more than willing to purchase additional content, in example, downloadable purchases as well as in-game add-ons. This will allow Activision to see an increase in digital revenues and be able to increase their product mix accordingly. To conclude, I believe that Activision Blizzard, Inc. is a successful company that has experienced large growth over the last couple of years, but is not close to done growing. I believe that this company will continue to grow through 2018 and some years after that as well. Activision is an industry leader in a successful and growing industry. I would suggest buying more of this stock to add to our portfolio.

Activision Blizzard, Inc. (ATVI)

CENTER FOR GLOBAL FINANCIAL STUDIES

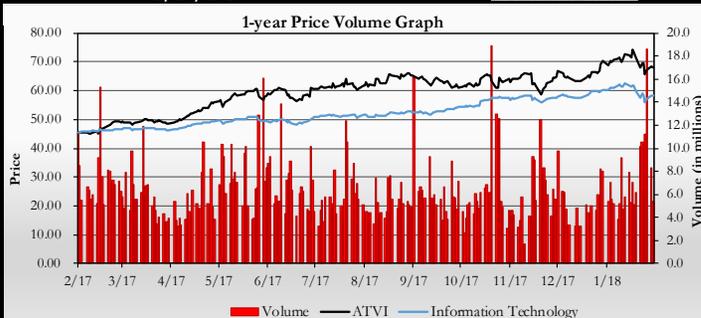
BULLISH

Analysis by Paul Martinez
2/16/2018

Current Price: **\$72.03**
Dividend Yield: **0.5%**

Intrinsic Value: **\$80.89**
Target Price: **\$87.05**

Target 1 year Return: **21.35%**
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	6.06%
Effective Tax rate	22%

Market Data	
Market Capitalization	\$52,662.33
Daily volume (mil)	4.80
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	EBITDA
12/31/2016	-15.27%	-22.03%
3/31/2017	58.71%	167.42%
6/30/2017	33.14%	52.56%
9/30/2017	-6.51%	-17.65%
12/31/2017	-18.93%	-155.59%
Mean	10.23%	4.94%
Standard error	1.0%	15.4%

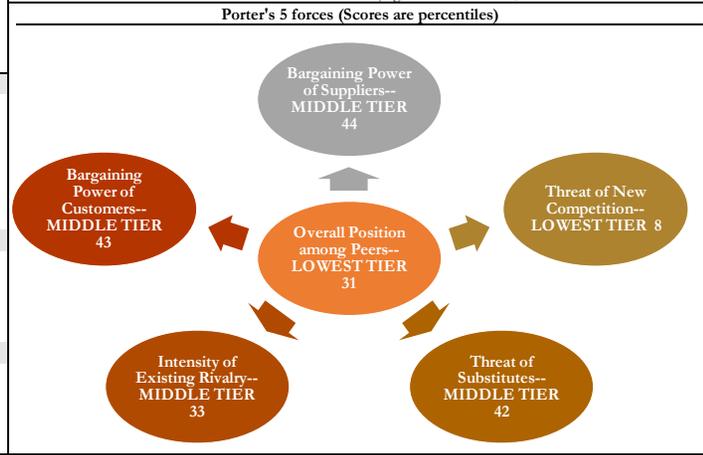
Market and Credit Scores	
Recommendation (STARS) Value	-2
Recommendation (STARS) Description	Sell
Quality Ranking Value	B+
Quality Ranking Description	Average
Short Score	-0
Market Signal Probability of Default % (Non-Ratings)	-0.087%
CreditModel Score (Non-Ratings)	bbb-

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

Management		Total Compensations Growth		Stock Price Growth During Tenure	
Management	Position				
Kotick, Robert	CEO & Director	31.75% per annum over 5y	0.73% per annum over 5y		
Durkin, Dennis	Chief Corporate Officer	-40% per annum over 4y	18.3% per annum over 4y		
Morhaime, Michael	President & CEO of Blizzard Entertainment Inc	10.12% per annum over 5y	0.73% per annum over 5y		
Zacconi, Riccardo	Executive Officer & CEO of King Digital Enterta		0% per annum over 0y		
Johnson, Collister	President & COO				
Neumann, Spencer	Chief Financial Officer				

Peers	
Electronic Arts Inc.	Nintendo Co., Ltd.
Take-Two Interactive Software, Inc.	Changyou.com Limited
Zynga Inc.	Frontier Developments Plc
NEXON Co., Ltd.	Square Enix Holdings Co., Ltd.
Ubisoft Entertainment SA	Beijing Kunlun Tech Co., Ltd.

Profitability		ATVI (LTM)		ATVI Historical		Peers' Median (LTM)	
Return on Capital (GAAP)	10.7%	9.62%	32.88%				
Operating Margin	24%	28.26%	17.64%				
Revenue/Capital (GAAP)	0.44	0.34	1.86				
ROE (GAAP)	4.5%	5.6%	8.6%				
Net margin	7.1%	12.4%	9.6%				
Revenue/Book Value (GAAP)	0.63	0.45	0.90				
Invested Funds		ATVI (LTM)		ATVI Historical		Peers' Median (LTM)	
Cash/Capital	28.5%	24.5%	45.8%				
NWC/Capital	-10.5%	-10.9%	-1.5%				
Operating Assets/Capital	23.0%	35.1%	44.7%				
Goodwill/Capital	59.0%	51.3%	11.0%				
Capital Structure		ATVI (LTM)		ATVI Historical		Peers' Median (LTM)	
Total Debt/Market Capitalization	0.28	0.21	0.10				
Cost of Debt	3.1%	3.9%	90.0%				
CGFS Rating (F-score, Z-score, and default Probability)	BB						
WACC	9.6%	9.1%	96.0%				



Forecast Assumptions		Valuation	
Revenue Growth CAGR	12%	Explicit Period (11 years)	Continuing Period
Average Operating Margin	32%		
Average Net Margin	25%		
Growth in Capital CAGR	10%		
Growth in Claims CAGR	0%		
Average Return on Capital	11%		
Average Return on Equity	12%		
Average Cost of Capital	9%		
Average Cost of Equity	9%		

