SIENA college

BJORKLUND FUND

December 6, 2018

Activision Blizzard, Inc. : (ATVI)

Peter Costa

Sector: Communication Services
Industry: Entertainment
Current Price: $46.56
Target Price: $41.77

Company Description: Activision Blizzard, Inc. is a developer and publisher of interactive software and related products. They focus on creating and maintaining franchises that will continue to appeal to their consumers indefinitely. Activision Blizzard, Inc. operates through three distinct segments, Activision, Blizzard and King, each covering a different range of interests.

SELL

Current Price:	$46.56
Target Price:	$41.77
Market Cap:	39.5B
Capitalization (D/E):	16%
WACC:	8.98%
ROIC:	4.03%
Cost of Debt	3.58%
52 Week Range	$46.83 - $84.68

Thesis:

Activision Blizzard, Inc. is a falling leader in the video game industry. They have had consistently declining MAU's for the past 7 quarters. They are failing to produce innovative new content for their main IP's and are missing sales estimates because of this. The revenue growth is projected to slow as they approach maturity, resulting in an intrinsic value similar to the current stock price.

Catalysts:

- Shrinking revenue growth as they approach maturity.
- Continuous decline in MAU's quarter after quarter
- Lack of innovation in their main franchises causing consumers to spend money elsewhere.

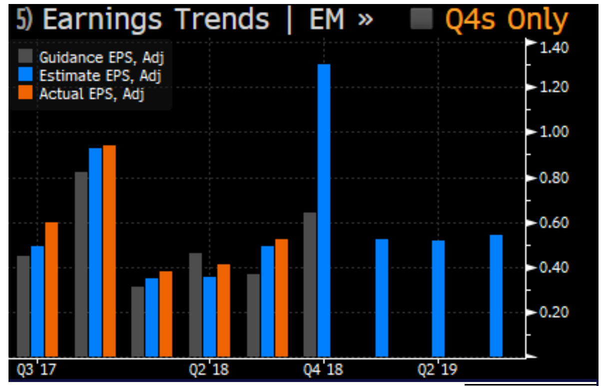
Segments Description:

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

Activision Blizzard, Inc. operates through three different segments, Activision, Blizzard, and King. They each focus on developing their own separate franchises. Activision produces games mainly for console and PC. They are the most cyclical of the segments due to their revenues coming primarily from the release and sale of full games centered on the holidays, and were responsible for 38.8% of total net revenue in 2017. Blizzard has the most diverse selection of games, and is also working on the Overwatch Esports league which has recently concluded its first season, producing 31.6% of net revenue in 2017. King was acquired in 2016 and is currently focused on the mobile platform for the majority of its revenue which is 29.5% of total net revenue. The three segments combined are able to reach a wide variety of audiences on every platform, offering something for everyone within the industry. Each segment's MAU's, monthly active users, are trending downward which is driving price down (shown below in millions). Activision's 2017 Q4 spike, correlates with the release of their newest Call of Duty title each year. The more titles released will drive up MAU's significantly in the quarter they are released, and in 2017's initial 3 quarters far more titles have been released then in 2018. So far 2018 has been primarily downloadable content and support for the current games, but in Q4 2018 the two largest releases of the year will be coming for Activison and King which will drive the MAU's back up. While there is no doubt this decrease is concerning, it has caused an overreaction by the market that will be rectified in Q4.

	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017
Activision	46	45	51	55	49	47
Blizzard	37	37	38	40	42	46
King	262	270	285	290	293	314
Total	345	352	374	385	384	407

Earnings Performance:



Activision Blizzard, Inc. is a highly cyclical company, they rely on Q4 call of duty release and the holidays to drive yearly revenue. Compared to Q3 2017, Activision has been underperforming, they have been releasing fewer games each year, and are resorting to remastering successful games to try and squeeze more profit out of them. Their new Call of Duty Black Ops 4 is modeled to sell 23.5 Million copies, which is far higher than the 12.19 Million sold from the previous edition. This is where the EPS spike comes from in Q4, but it is already factored into the price. In Q3 2017, the Activision segment generated $759M of net revenue while only producing $397M in Q3 2018 due to both the different release schedule, and declining interest in their popular titles. The other two segments stayed more consistent with total net revenue in Q3 2018 of $1,538M and $1,818M in Q3 2017.

Q3 2018

	Activision	
Segment Net Revenues		
Net revenues from external customers	$	397
Intersegment net revenues (1)		—
Segment net revenues	$	397
Segment operating income	$	112

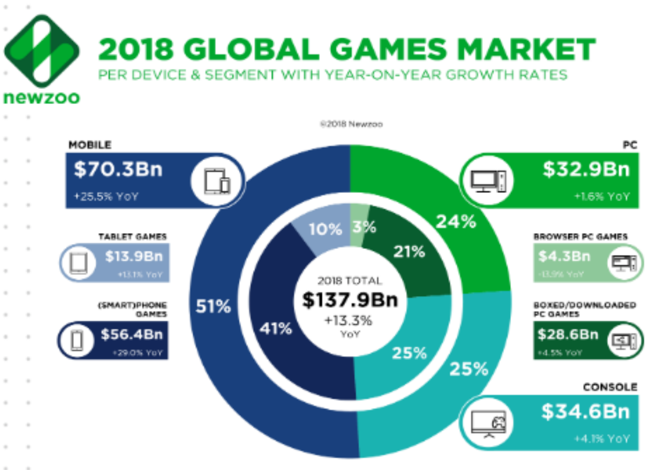
Q3 2017

	Activision	
Segment Net Revenues		
Net revenues from external customers	$	759
Intersegment net revenues (1)		—
Segment net revenues	$	759
Segment operating income	$	261

Franchises

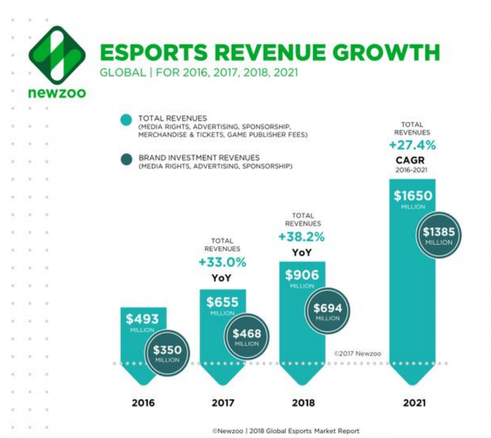
Activision Blizzard, Inc. mainly focuses on the development and innovation of large franchises that will create and retain consumers over their multiyear lifespan. While Activision Blizzard, Inc. has eight franchises worth over $1B within their portfolio, they are failing to truly innovate within them and are losing their fan base little by little. According to their Q3 10-Q, "the top 10 titles accounted for 36% of retail sales in the U.S. interactive entertainment industry in 2017, which validates their strategy, it's just that they have been trying to squeeze too much revenue out of this. They need to continue to release these games, but they also need to innovate to prevent their established fan base from shrinking.

Growth in the Mobile Gaming Industry:



Activision is attempting to establish themselves into the fast growing mobile gaming industry. The mobile gaming industry now accounts for roughly 51% of revenues from the global gaming markets. King, acquired in 2016, is releasing another game for the Candy Crush franchise in Q4 2018. Activision Blizzard, Inc. produced $2,095M, 29.3% of its net revenue from mobile platforms in 2017, up from $1,706M, 25.9% in 2016. With the common smart phone receiving a more powerful operating system with each release, many games that were previously unable to exist are now possible. Activision is trying to capitalize on this trend by bringing some of their most successful franchises to mobile. Mobile gaming is tailored to a far more casual audience, and the reveal of the newest Diablo title being for mobile caused backlash from the “hardcore” community. This backlash was detrimental for Activision, and is largely due to the fans anticipating Diablo IV, presumably the next installment to the franchise, rather than this more casual title. The outcry from the community caused the #notmydiablo movement on twitter showing that their main anticipated fan base will not be supporting this new game in entirety. Activision’s mobile Call of Duty title is will be released in China only at first, but again they are attempting to use their already saturated franchises to produce more and more revenue, and the fan bases are beginning to look elsewhere for more original content.

The Future of Esports:



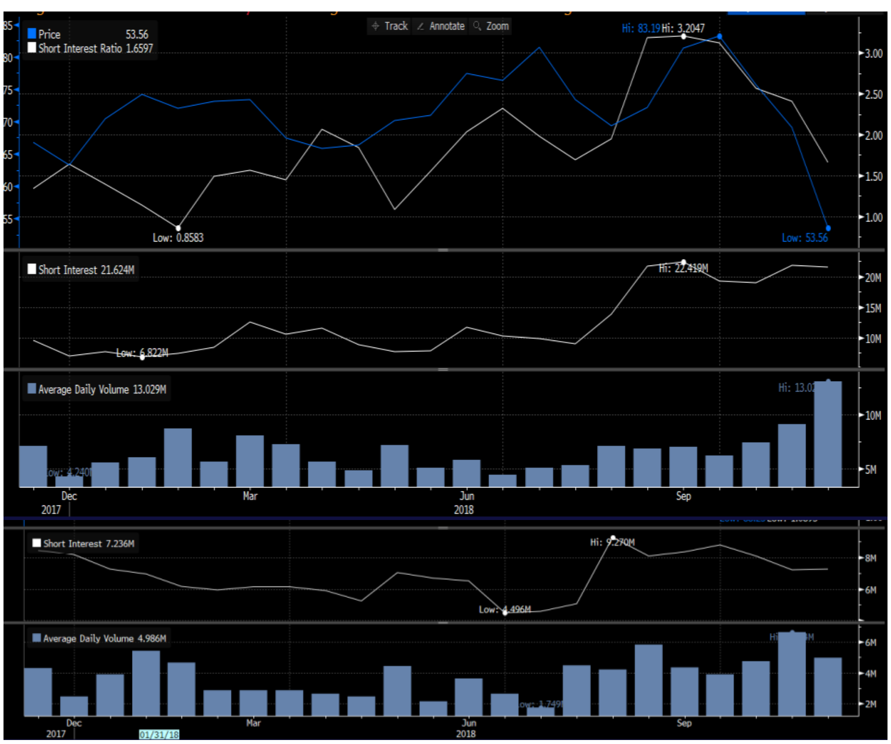
The possible saving grace for Activision Blizzard, Inc is the growing Esports market. According to Newzoo, a game and Esports analytics company, the global Esports economy is expected to grow by 38% to $905M with an audience of roughly 380 million viewers by the end of 2018. In 2018 Activision has already been able to complete their inaugural season of The Overwatch League, generating most of their revenue from the sale of teams, and these are just one time sales. Until this league is able to grow far larger in popularity, and begin to make money off advertising, the revenue created will be negligible. Activision Blizzard, Inc. has announced a multiyear deal with Disney for live coverage on ESPN and Disney XD. To help boost competition and local involvement, the Overwatch League assigns its teams a home city much like any other professional sports team. This may be the driver of growth that they need to stay an industry leader, but it is not clear when or if it will become relevant.

Improving Profit Margins:

The gaming industry as a whole is moving towards all digital purchases rather than buying physical copies of games. This is true for all participants in the industry, not just Activison Blizzard, Inc, so well it will help them, it is not a competitive advantage. The industry will be able to increase its profit margins by reducing both distribution and production costs. The movement to all digital products is followed by increased online connectivity, which gives the industry the ability to include more recurring revenue business models. Once consumers either purchase or download a free to play game, the increased connectivity allows them to supply downloadable content and micro transactions within the game to create a more stable generation of revenue. Not only is this a way to provide additional high margin revenues, it will also reduce some of the cyclical nature of their business. As shown below, their margins are projected to continue to improve into the foreseeable future due to lower costs and larger profits coming from reoccurring revenue models. This provides a promising outlook for the industry as a whole, and makes a possible reallocation of funds to a more innovative company in this space.

In Millions of USD 12 Months Ending	2014 Y 12/31/2014	2015 Y 12/31/2015	2016 Y 12/31/2016	2017 Y 12/31/2017	Current/LTM 09/30/2018	2018 Y Est 12/31/2018	2019 Y Est 12/31/2019
Revenue, Adj	4,408.0	4,664.0	6,608.0	7,017.0	7,161.0	7,470.0	7,732.8
Growth %, YoY	-3.8	5.8	41.7	6.2	2.5	6.5	3.5
Gross Profit, Adj	2,883.0	3,079.0	4,214.0	4,516.0	4,673.0	5,341.0	5,598.1
Margin %	65.4	66.0	63.8	64.4	65.3	71.5	72.4
EBITDA, Adj	1,529.0	1,822.0	2,609.0	2,559.0	2,441.0	2,694.7	2,958.1
Margin %	34.7	39.1	39.5	36.5	34.1	36.1	38.3
Net Income, Adj	817.0	887.2	1,060.8	1,106.8	1,279.3	2,014.7	2,178.5
Margin %	18.5	19.0	16.1	15.8	17.9	27.0	28.2
EPS, Adj	1.13	1.20	1.41	1.45	1.67	2.61	2.83
Growth %, YoY	10.7	6.1	17.7	2.7	5.3	79.9	8.4

Short Interest:



Activision's short interest (top) and EA's short interest (bottom) follow a very similar trend. Both stocks have increasing volume reducing the days to cover, while the short interest stays fairly constant. The most concerning part of these charts is the increase in volume coinciding perfectly with the drop in Activision Blizzard's share price. This shows that the large portion of the investors are agreeing with the falling price and will continue driving it down lower. The video game industry as a whole has dropped, but none as much as Activision Blizzard's 40% drop in the past 60 days. This drop in price has put them close to their calculated intrinsic value, and they will stay around this price until they are able to find new streams of revenue.

More Comparisons Use RV:

Activison Blizzard, Inc. has a very similar business model to Electronic Arts (EA) and Take Two (TTWO), they all produce games year after year for the same franchises with various improvements and changes to keep the player base coming back. Looking at value creation Activision is the only of their two main competitors who is destroying value. Looking at the other two, further analysis is required to decide if reallocating in the video game industry can still meet the return threshold for the fund.

Name (BICS Best Fit)	Ticker	Mkt Cap	ROIC LF	WACC	Px Chg Pct:D-60
Median		6.62B	-1.30%	9.93%	-17.24
100) ACTIVISION BLIZZARD …	ATVI US	35.50B	4.03%	8.98%	-41.48
101) ELECTRONIC ARTS INC	EA US	24.53B	16.24%	8.48%	-27.71
102) TAKE-TWO INTERACTIV…	TTWO US	11.58B	11.21%	9.93%	-24.07

Conclusion:

Activision Blizzard, Inc. had a disappointing year in 2018 and the stock price is showing it, dropping over 40% in the past 60 days. Their lack of innovation within their revenue driving franchises has begun to drive away lifelong fans, as shown in the declining MAU's. They have slowed down their release schedule without any way to compensate for lower revenue growth. The stock price is very near its intrinsic value with the company doing nothing to drive it back up. One factor that could turn growth around in the future is the emergence of the Esports market, but this is all still in the speculative stage. Activision Blizzard, Inc. has dropped to a reasonable level and will remain here for the foreseeable future, this makes it a sell.

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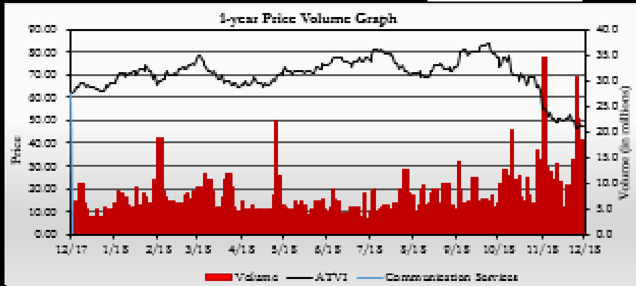
CENTER FOR GLOBAL FINANCIAL STUDIES

Activision Blizzard, Inc. (ATVI) | **NEUTRAL**

Analysis by Peter Costa	Current Price:	$47.23	Intrinsic Value	$41.02
12/9/2018	Divident Yield:	0.7%	Target Price	$44.35

Target 1 year Return: -5.38%
Probability of Price Increase: 0.3



Description

Activision Blizzard, Inc. develops and distributes content and services on video game consoles, personal computers (PC), and mobile devices.

General Information

Sector	Communication Services
Industry	Entertainment
Last Guidance	May 8, 2018
Next earnings date	February 7, 2019

Market Assumptions

Estimated Equity Risk Premium	6.16%
Effective Tax rate	23%

Market Data

Market Capitalization	$36,038.89
Daily volume (mil)	18.28
Shares outstanding (mil)	763.05
Diluted shares outstanding (mil)	771.25
% shares held by institutions	92%
% shares held by investments Managers	78%
% shares held by hedge funds	9%
% shares held by insiders	1.10%
Short interest	2.83%
Days to cover short interest	2.17
52 week high	$84.68
52-week low	$45.50
Volatility	29.82%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2017	-6.51%	-17.65%
12/31/2017	-18.93%	-159.13%
3/31/2018	50.69%	68.75%
6/30/2018	18.57%	22.50%
9/30/2018	-9.30%	-21.24%
Mean	6.90%	-21.36%
Standard error	1.0%	4.2%

Market and Credit Scores

Recommendation (STARS) Value--3
Recommendation (STARS) Description--Hold
Quality Ranking Value--B+
Quality Ranking Description--Average
Short Score--1
Market Signal Probability of Default % (Non-Ratings)--1.05%
CreditModel Score (Non-Ratings)--bbb

Industry and Segment Information

LTM Revenues by Geographic Segme	LTM Revenues by Business Segments
United States--45%	Activision--37%
Americas (Excluding United States)--6%	Blizzard--30%
United Kingdom--12%	King--28%
Europe, Middle East, and Africa (Excluding Unite	Non-Reportable Segments--6%
Asia Pacific--13%	Unallocated Net Effect from Deferral of Net Reve

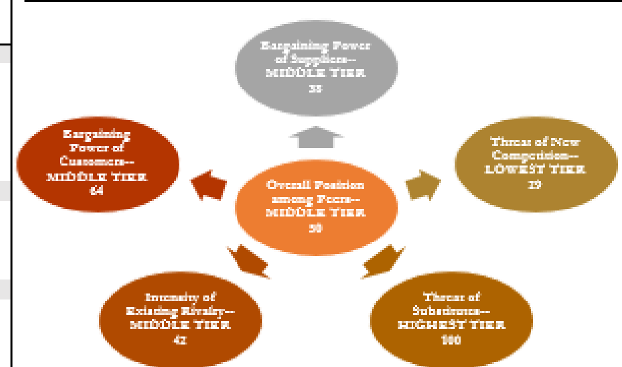
Peers

Electronic Arts Inc.	Ubisoft Entertainment SA
Take-Two Interactive Software, Inc.	NEXON Co., Ltd.
Zynga Inc.	Changyou.com Limited
Nintendo Co., Ltd.	Frontier Developments plc
NetEase, Inc.	Kuuhubb Inc.

Management	Position	Total Compensation Growth	Stock Price Growth During Tenure
Kotick, Robert	CEO & Director	-15.07% per annum over 5y	13.6% per annum over 5y
Johnson, Collister	President & COO		0% per annum over 0y
Neumann, Spencer	Chief Financial Officer		0% per annum over 0y
Durkin, Dennis	Chief Corporate Officer	-15.51% per annum over 5y	13.6% per annum over 5y
Zacconi, Riccardo	Executive Officer & CEO of King Digital Enterta	18.4% per annum over 1y	76.18% per annum over 1y
Wereb, Stephen	Deputy CFO, Chief Accounting Officer & Senio		

Profitability	ATVI (LTM)	ATVI Historical	Peers' Median (LTM)
Return on Capital (GAAP)	13.7%	9.34%	25.20%
Operating Margin	29%	27.43%	32.94%
Revenue/Capital (GAAP)	0.47	0.34	0.77
ROE (GAAP)	6.8%	5.0%	12.5%
Net margin	11.0%	9.4%	13.5%
Revenue/Book Value (GAAP)	0.618150259	0.53	0.92
Invested Funds	**ATVI (LTM)**	**ATVI Historical**	**Peers' Median (LTM)**
Cash/Capital	26.9%	27.9%	50.8%
NWC/Capital	-11.1%	-11.6%	-1.5%
Operating Assets/Capital	20.9%	32.2%	37.2%
Goodwill/Capital	63.4%	48.2%	5.7%
Capital Structure	**ATVI (LTM)**	**ATVI Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.19	0.30	0.06
Cost of Debt	4.5%	4.8%	5.0%
CGFS Rating (F-score, Z-score, and default Probabilit	A		
WACC	8.9%	9.5%	11.2%

Porter's 5 forces (Scores are percentiles)



Valuation

Forecast Assumptions	Explicit Period (10 years)	Continuing Period
Revenue Growth CAGR	5%	0.0%
Average Operating Margin	35%	30%
Average Net Margin	26%	22%
Growth in Capital CAGR	7%	0%
Growth in Claims CAGR	0%	0%
Average Return on Capital	9%	6%
Average Return on Equity	9%	6%
Average Cost of Capital	9%	9%
Average Cost of Equity	10%	10%