Deal advisory on Microsoft's acquisition of Activision Blizzard

Catalogues

1.0 Executive Summary

This report provides an in-depth analysis of Microsoft's acquisition of Activision Blizzard, focusing on the intent of the acquisition, the gaming industry profile, and Microsoft's strategic motivations. It assesses the impact of the transaction at the financial, strategic, and operational levels to help Microsoft determine a reasonable purchase price. The valuation section of the report provides a detailed assessment of Activision Blizzard's standalone value, potential synergies (e.g., revenue enhancement, cost reduction, and asset optimization), and control premium. It validates the robustness of the valuation through NPV and sensitivity analyses, with a recommended purchase price of $86.43 per share, with a reasonable range of $85 to $90 per share. In addition, the report includes a proposed transaction structure, risk assessment, and potential market reaction and makes recommendations for Microsoft's post-acquisition strategic integration.

2.0 Industry Overview

The global video game industry has seen rapid growth, driven by digital transformation, mobile device proliferation, and advancements in cloud computing. In 2022, the industry generated approximately $200 billion in revenue, with projections indicating further growth to reach $256.97 billion by 2025, largely fueled by the expansion of mobile gaming and an increasing player base in emerging markets (Gameopedia, 2023). The primary drivers of this industry include:

User Growth and Demand: The audience for video gaming is further increasing across Asia and North America, incrementally building revenue in the industry. The new young generation, being highly participatory in entertainment, has opened the industry to mobile and PC-based gaming in terms of users (Newzoo, 2023).

Technological Innovation: New cloud gaming, AR, and VR technologies have opened up new sources of revenue and means of growing. Cloud gaming, in turn, allows users to enjoy high-quality games on any device by removing hardware performance limitations(Financial Times, 2023).

Increased Market Competition: Increased market competition puts companies under pressure as far as price is concerned, and this, in turn, fuels constant innovation. Its competitors, Sony, Nintendo, and Tencent, also hastened their pace in expanding content and justifying product iteration. However, Activision Blizzard's well-established IP organizes strong brand loyalty and competitive advantages

in the fight for consumer engagement (Statista, 2023).

2.1 Activision Blizzard's Position in the Industry

Therein, Activision Blizzard holds a critical position in the worldwide gaming industry with influential IPs and an enormous number of international users. It is one of the most conspicuous game companies in the world, with revenues for the year 2022 amounting to approximately $7.5 billion. Although revenues declined slightly, the large loyal user base and strength of the brand have kept it at the forefront in key markets (Statista, 2023).

2.2 Historical Impact of M&A in the Industry

In recent years, the number of mergers and acquisitions in the video game industry has increased significantly to speed up market concentration. Microsoft's experience in cross-industry integrations came to enhance its ecosystem. In the same vein, gaming sector mergers have sometimes increased concentration and empowered companies to raise operational efficiency and competitiveness with synergies (Harvard Business Review, 2023).

2.3 Near-Term Outlook for M&A in the Industry

This means that the video game market will continue to grow, and M&A activity will rise over the next couple of years. Fast-moving technological development has accelerated the pace of competition, which demands that firms strengthen their positions in the market through mergers. The regulators will closely scrutinize such mergers to protect the principle of competitive fairness in the market. It is a dead certainty for Microsoft that such an acquisition of Activision Blizzard would pad the company's wallet not only with rich content but also protect it in an extremely dynamic market (FTC 2023).

3.0 Strategic rationale

3.1 Integrated Strategic Assessment

Ownership factor: Activision Blizzard owns well-known IPs such as World of Warcraft and Overwatch, with high user stickiness and market influence. Microsoft's acquisition will give it exclusive rights to the IPs, enhance the attractiveness of the Xbox platform, and increase its competitiveness with Sony, Nintendo, and Tencent (Tan, 2023).

Shareholders and equity: The acquisition expands Microsoft's share of the global gaming market, enhances revenue potential, and provides Blizzard shareholders with a high premium exit opportunity. Microsoft will optimize Blizzard's management structure, improve governance, and ultimately enhance shareholder value (Fenlon, 2021).

Management factors: Microsoft's management is innovative and efficient (see Figure 1), while Blizzard's creativity and decision-making suffered before the acquisition. The acquisition offers Blizzard a chance to enhance its management, with Microsoft helping to rebuild its corporate culture through an established management system.

Operational Factors: Blizzard has extensive experience in online game development and the Asian market, which fits into Microsoft's globalized gaming strategy and provides valuable experience to support (Parrish, 2021). However, as shown in Figure 2, Blizzard's revenue is declining due to user churn and increased competition. Microsoft can use cloud computing and AI technology to optimize Blizzard's operations and help its position in the competitive market.

3.2 Multi-dimensional Analysis

Economic perspective: The gaming industry has grown exponentially in recent years, with video game users reaching 2.5 billion by 2022 and the global market expected to reach $256.97 billion by 2025 (See Figure 3). Microsoft has achieved economies of scale through acquisitions to strengthen its market position, and Blizzard's market share in Asia provides an important source of revenue.

Strategic perspective: Mobile gaming is an important factor in the growth of the industry and is expected to grow at a CAGR of 14% from 2020 to 2025. Microsoft is bridging its shortcomings and increasing its competitiveness by acquiring Blizzard's mobile strengths to increase its market share.

Finance and managerial perspectives： Drawing on the success of the LinkedIn acquisition in 2016, with this acquisition, Microsoft can optimize corporate governance, incentivize management, and optimize tax liabilities by using tax incentives or loss credits to increase market capitalization and financing capabilities and improve capital structure (Shrivas, 2024b).

Behavioral finance: Microsoft's management may have increased confidence in the Blizzard acquisition due to the success of the LinkedIn acquisition but may also face the risk of hubris and the ‘winner's curse.’ The market's enthusiasm for the gaming industry may have led management to over-expect returns and ignore potential risks, and market frenzy and over-confidence may have influenced

their decision-making.

4.0 Deal Valuation

In this section, we will assess Activision Blizzard's standalone valuation, determine synergies benefits, and control premium, followed by NPV calculation and a sensitivity review of the offer price range. Before proceeding with the calculation of the standalone value, we must first define the following assumptions, with the valuation date set as the last day of 2021.

Assumption 1: ***Growth Rate (g_1, g_2)***

We assume two growth stages for Activision Blizzard: a short-term growth rate (g_1) for the next five years and a long-term growth rate (g_2) thereafter. These rates are driven by historical financial performance, the gaming industry's outlook, and synergies from Microsoft's integration. A ten-year horizon provides a more accurate assessment of historical performance, accounting for long-term trends and mitigating the pandemic's irregular impact on profitability from 2019 to 2022. As shown in Figure 4, Activision Blizzard's average net income growth rate was initially high due to the significant growth in 2017 and 2018. The net income surged over 500% from 2017 to 2018, driven by successful game launches, esports growth, and favorable US tax reforms—temporary factors. Excluding these years, the recalculated average growth rate is 5.24%. Additionally, as shown in Figure 5, Activision Blizzard's Free Cash Flow to Firm (FCFF) has averaged 13.07% over the past decade, but with notable fluctuations. From 2016 to 2021, while FCFF saw substantial growth, some years experienced negative growth. Excluding the abnormal growth in 2016, the average FCFF growth becomes 6.09%, suggesting the need for a more conservative long-term growth projection. Besides, we also consider the gaming industry's outlook. According to the Fortune Business Insights report, it predicts the global video game market is expected to grow at a 6.3% annual growth rate from 2022 to 2029, driven by the rise of mobile and cloud gaming (Fortune Business Insights, 2023). we estimate Activision Blizzard's FCFF to grow at a conservative rate of 6% for the next five years, reflecting the industry's projected 6.3% CAGR through 2029. For the two assumptions, we project Activision Blizzard to achieve a growth rate of 2% to 3%, which is in line with long-term growth expectations for the global gaming industry.

Assumptions 2: ***Risk-free Rate (r_f)***

We choose the U.S. 10-year Bond yield as our risk-free rate. As you see from Figure 6, we calculated

the average of the U.S. 10-year Treasury yield over the past decade, which is 2.11%, and we reckon it's a proper proxy as the risk-free rate in our valuation.

Assumptions *3: Cost of Equity and Debt (, r_d)*

To calculate Activision Blizzard's cost of equity, we should use the Capital Asset Pricing Model (CAPM). Before approaching, we need to determine their beta value and the market premium (r_m - r_f). The beta value of 1.023, based on the industry average for globally comparable companies, is chosen to be used in our cost of equity calculation. (Simply Wall St, 2021). Besides, we chose the return of the S&P 500 stock index as our market return, and its annualized returns from 2011 to 2021 are 14.28% per annum, as detailed in Figure 7. Applying the CAPM model, we can have $r_e = r_f + \beta(r_m - r_f)$, which equals 2.11% + 1.023(14.28% - 2.11%) = 14.56%.

To determine the company's cost of debt, we use the average yield to maturity (YTM) of Activision Blizzard's three nearing-maturity corporate bonds. as it offers a more accurate reflection of the company's credit risk from a market perspective, rather than only relying on the financial statement. As shown in Figure 8, the average YTM of these three corporate bonds is 5.27%. According to Activision Blizzard's 2021 annual report, the company's effective tax rate for that year was 15%. When calculating the company's cost of debt, it's important to account for the tax shield, which reduces the overall cost of financing. Based on this consideration, the company's cost of debt is 5.27%*(1-15%) = 4.48%.

4.1 Standalone Value

The method we use to determine the standalone value of Activision Blizzard is the Discounted Cash Flow (DCF) method. Using the DCF model to evaluate an intrinsic value, we need to predict the future FCF at a certain point; however, we cannot anticipate it. Therefore, it's necessary to make this assumption to determine the present value of all future FCFs.

Free Cash Flow (FCFF)

To calculate the Free Cash Flow to the Firm at the end of 2021, we first need to gather the relevant data for each component and then apply the following formula:

$$FCFF = EBIT \times (1 - t) + Depreciation - CAPEX - \Delta NWC$$

Based on the data retrieved from the STOCK ANALYSIS website, the EBIT for Activision Blizzard in 2021 was reported as $3,272 million, and their total depreciation expense was $505 million. We

calculated capital expenditures (CAPEX) as follows:

$CAPEX_{2021} = NetPPE_{2021} - NetPPE_{2020} + Dep\ Exp_{2021}$= 169 – 209 + 505 = $465 million. Besides, the change in net working capital (ΔNWC) was calculated as

$$\Delta\text{NWC} = NWC_{2021} - NWC_{2020}$$

Where net working capital for each year is defined as current assets minus cash and cash equivalents. The resulting change in NWC is $904 million. The effective tax rate for Activision Blizzard in 2021 was 15%. Applying the FCFF formula, we arrive at the following:

$$\text{FCFF} = 3{,}272 \times (1\text{-}15\%) + 505 - 465 - 904 = \$1{,}917 \text{ million}$$

Using the assumed growth rates, g_1 and g_2, we can now project FCFF for the subsequent periods, as shown below:

$FCFF_1$=1,917 m × (1 + 6.7%) = $2,032 m; $FCFF_2$=1,917 m × (1 + 6.7%) ^{2}= $2,154 m

$FCFF_3$ = 1,917 m × (1 + 6.7%) ^{3}= $2,283 m; $FCFF_4$= 1,917 m × (1 + 6.7%) ^{4}= $2,420 m

$FCFF_5$ = 1,917 m × (1 + 6.7%) ^{5}= $2,566 m; $FCFF_6$= 2,566 m × (1 + 2.9%) = $2,640 m

Discount rate (WACC)

The way to calculate WACC is to apply the formula below:

$$WACC = \frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1\text{-t})$$

To determine equity and debt values accurately, we use market values instead of book values. Activision Blizzard's market capitalization is calculated by multiplying the share price on January 18, 2022, of $82.31 by the 779.23 million outstanding shares (as reported in Activision Blizzard's 2021 financial statement), resulting in a market cap of approximately $64,139 million. For the market value of debt, we reference Activision Blizzard's 2021 annual report, which lists total long-term debt at $3,650 million. Adjusting for unamortized discounts and deferred financing, the carrying value is around $3,608 million, used as an estimate for market value. Using these figures, we can apply the WACC formula.

$$WACC_1 = \frac{\$64{,}138.82\text{ m}}{\$64{,}138.82\text{ m} + \$3{,}608\text{ m}} \times 14.56\% + \frac{\$3{,}608\text{ m}}{\$64{,}138.82\text{ m} + \$3{,}608\text{ m}} \times 4.48\% = 14.02\%$$

We anticipate the WACC will adjust during the second growth stage. After Activision Blizzard's acquisition, its beta is expected to align with Microsoft's, reducing operational risks. Additionally, Activision Blizzard's equity value may shift, as it could become a fully integrated subsidiary, rendering its standalone market capitalization irrelevant. Moreover, if Microsoft increases its debt financing, the overall cost of capital could decrease. Therefore, recalculating the WACC for the

second growth stage is necessary. We calculated Microsoft's market capitalization by multiplying the adjusted closing share price on January 18, 2022, of $295.59 (Yahoo Finance) by the 7,519 million outstanding shares (Microsoft's 2021 Financial Statement), resulting in a total market capitalization of $2,225,248 million. For the cost of equity, we used the same risk-free rate and market risk premium as Activision Blizzard but applied Microsoft's specific beta. This gives a cost of equity calculation of 13.06% using the formula: 2.11% + 0.9(14.28% - 2.11%).

To determine Microsoft's cost of debt, we selected representative bonds with maturities from 2021 to 2062, choosing two from short, medium, and long-term categories. We averaged their yields to maturity and derived a pre-tax cost of debt, as reflected in Figure 9. Considering a 13.80% tax rate, Microsoft's after-tax cost of debt is 3.92%. Based on Microsoft's 2021 financials, the fair value of their long-term debt is $70 billion, which we used as the market value for our valuation. Using this data, we recalculated the second stage of WACC as follows:

$$WACC_2 = \frac{\$2,225,248,050,000}{\$2,295,248,050,000} \times 13.06\% + \frac{\$70,000\ \text{m}}{\$2,295,248,050,000} \times 3.92\% = 12.79\%$$

Terminal Value

Based on our assumption, Activision Blizzard's first growth stage will conclude by the end of 2026, after which their FCFF will enter the second growth stage. To calculate the terminal value at the end of 2026, we can apply the following formula:

$$\text{Terminal Value} = \frac{FCFF5\times(1+g2)}{WACC_2 - g_2}$$

Here, the numerator represents the FCFF in 2026, which is $2,640 million, and the denominator is the difference between the WACC of 12.79% and the long-term growth rate (g_2) of 2.9%, giving us 9.89%. By applying this formula, the calculated terminal value is $26,707 million.

Standalone Value of the Target

Once the terminal value at t = 5 (the year 2026) is determined, we can proceed to calculate Activision Blizzard's final standalone value. This is done by discounting all future FCFF from year 1 to year 5 back to t = 0. Besides, the terminal value is discounted back to t = 0 as well. The sum of these present values results in a standalone value of $21,598 million.

4.2 Achievable Synergies

Microsoft's acquisition of Activision Blizzard is a horizontal merger aimed at achieving economies of scale and broadening market influence, with synergies likely to arise from revenue enhancement, cost reduction, and asset rationalization.

Synergy 1: Revenue Enhancement

We believe that there is a huge revenue enhancement if the acquisition succeeds. To value this potential revenue enhancement for Microsoft, we still decided to use the two stages DCF model and the formula as the following:

$$V_{Revenue\ Enhancement} = \sum_{t=0}^{n} \frac{After\text{-}tax\ Synergies_t}{(1+RADR)^t}$$

We make several assumptions. The DCF will be based on the difference between Microsoft's gaming revenue and Activision Blizzard's revenue rather than total revenue due to Microsoft's diversified business model. We extracted gaming revenue from Microsoft's financials for the past 10 years and calculated the average revenue difference, arriving at $3,942 million as the initial cash flow (see Figure 10). We then assume two growth rates: g_1 at 4%, reflecting post-acquisition integration, and g_2 at 2.50%, aligned with world GDP growth to reflect long-term growth post-maturation (see Figures 10 and 11). With the assumptions for growth rates g_1 and g_2, we can project Microsoft's revenue over the next five years, which will serve as our future cash flows. As illustrated in Figure 12, we calculate revenue by applying the g_1, the growth rate annually from year 1 through year 5 and then switch to g_2 in the year 6 onwards. After calculating projected revenues, we apply an assumed constant effective tax rate of 13.8% to each year's projection to derive the after-tax synergy cash flows.

To discount the projected synergy cash flows, a Risk-Adjusted Discount Rate (RADR) should be applied, reflecting the risk characteristics of these cash flows. Since the synergies mainly arise from revenue enhancements, which are considered lower risk due to Microsoft's strong platform and market reach, we view this as a relatively low-risk integration. Considering Microsoft's capital structure, we apply Microsoft's WACC, which reflects both the costs of equity and debt, providing a balanced discount rate. Using the two-stage DCF model, we can project the present value of revenue enhancements, with the terminal value calculated at the end of year 5:

$ 4,237 million / (12.79% - 2.50%) = $41,197 million

Then, take the present value of all projected revenue and the terminal value from t = 1 to t = 5.

Then we arrive at the $V_{Revenue\ Enhancement}$ = $35,982 million.

Synergy 2: Cost Reduction

If the acquisition proceeds, significant cost synergies are anticipated, particularly from streamlining management and administrative roles. By consolidating backend resources, Microsoft could reduce

costs. We expect initial savings of 1.5% annually for the first two years, increasing to 3% as integration progresses. Microsoft's 2021 financial report lists general and administrative expenses at $5,107 million, which we use as the baseline for estimating synergies. The calculation is based on the following formula: $V_{Cost\ Reduction} = \sum_{t=0}^{n} \frac{After\text{-}tax\ G\&A\ Expenses_t}{(1+RADR)^t}$

Cost synergies from reducing administrative expenses are considered low risk, particularly when eliminating redundant finance, management, or administrative costs. We assumed administrative expenses for 2021 and 2022 remained unchanged since the acquisition had not occurred. Starting in 2023, following the acquisition, we projected modest cost reductions of 1.5% annually for two years, followed by 3% annual reductions from 2025 onwards. We calculated the terminal value at t=3 and discounted it to the present, applying Microsoft's 2021 effective tax rate of 13.8%. The total value of the cost reduction synergies is $3,157 million (see Figure 13).

Synergy 3: Asset Rationalization

Post-acquisition, Microsoft could streamline capital expenditures by consolidating overlapping sites, R&D centers, and distribution channels, reducing redundancies. For the valuation, we base projections on 2021 CapEx figures: Microsoft at $20,622 million and Activision Blizzard at $80 million. Using 2022 as the baseline, we assume cost synergies begin at the end of that year. The initial CapEx is the combined 2021 figure, and we project a 10% annual decrease in Microsoft's CapEx for the first two years (2023-2025) due to consolidation. From 2025 onward, we expect a stable 3% annual reduction, reflecting long-term efficiencies.

We calculated the annual post-integration capital expenditure savings after applying a constant tax rate of 13.8%, representing the projected synergy cash flows. Assuming capital expenditure savings stabilize by year 4 (t=4) and decrease by 3% annually, we introduced a terminal value. This value was discounted to the present using the company's WACC as the discount rate, reflecting asset rationalization as a medium-risk strategy. The present value of the annual cash flows, including the terminal value, totals $32,748 million (see Figure 14), representing long-term capital expenditure savings and synergies from optimizing both companies' assets.

4.3 Control Premium Valuation

After evaluating Activision Blizzard's management, we conclude the company is well-managed with strong historical financial performance and market presence. First, its consistent revenue growth and

high gross and net profit margins demonstrate excellent cost control and operational efficiency. Second, its strong return on equity and solid stock performance indicate consistent returns for shareholders and reflect investor confidence in the company's management. Therefore, we deem a 21% control premium to be an appropriate figure for this valuation as it falls within the typical range of 20% to 30%, representing the company's strong performance and leading market position within the gaming industry. By applying the formula Net Price = Gross Base Price × (1 + Control Premium), with a 21% premium, the net price is $21,598 million × 1.21 = $26,133 million.

4.4 NPV

Once the Net Price is determined, we can proceed to calculate the Net Present Value (NPV) of the deal using the following formula: *NPV = Standalone Value + Synergy Values – Net Price*
Substituting the relevant figures, the calculation would be $21,598 million + $35,982 million + $3,157 million + $32,748 million – $26,133 million = $67,350 million. This results in an NPV of $67,350 million for the transaction. To determine the acquisition offer price per share, we can divide the total acquisition value by the total number of shares outstanding for Activision Blizzard. According to Activision Blizzard's 2021 annual report, the number of shares of the registrant's Common Stock outstanding on February 18, 2022, was 779,234,888. The formula for calculating the acquisition price per share is $Acquisition\ Price\ per\ Share = \frac{Total\ NPV of\ Acquisition\ Value}{Total\ shares\ outstanding}$

By applying it, we can derive a transaction NPV of $67,351 million. Assuming this figure represents the total acquisition, value Microsoft is paying for Activision Blizzard, then the acquisition price per share can be calculated as follows:

$$\text{Acquisition Price per Share} = \frac{\$\ 67{,}351\ million}{779{,}234{,}888\ \text{shares}} = \$86.43\ \text{per share}$$

The acquisition price reflects the premium Microsoft paid, including a premium that factors in both synergies and the valuation assumptions associated with Activision Blizzard. This price represents a reasonable offer, reflecting Microsoft's expectation for future growth opportunities and the projected cost efficiencies and revenue enhancements post-integration.

4.5 Sensitivity Analysis

1) Standalone Value: A sensitivity analysis of the standalone value was performed by assuming a ±1% fluctuation range for WACC and two growth rates with all other synergies values unchanged. As shown in Figure 15, the offer price per share remains relatively low, consistently falling within

the $85.73 to $87.00 range. The WACC's influence is significant, particularly at 14.02%, where the per-share price stabilizes at $86.43.

2) Revenue Synergy: As shown in Figure 16, we observed that the highest share price reached $95.87 when revenue synergies were maximized, with a WACC of 11.79% and a growth rate of 3.5%. However, when growth rates were lower (e.g., g_2= 1.5%), the share price dropped to $80.02. This illustrates that revenue synergies lead to significant fluctuations in share prices.

3) Cost Synergy: The analysis of cost synergy effects indicates that growth rate and cost of capital significantly impact the share price, especially under scenarios of the low cost of debt, resulting in a price range of $33 to $104 per share, as detailed in Figure 17.

4) Asset Synergy: As shown in Figure 18, we can see the stock price fluctuates between $80.05 and $101.25 under shifting asset rationalization growth rates. The impact of changes in growth rates on the stock price remains around $86 when the discounting rate is assumed constant at 12.79%.

In conclusion, despite some fluctuations, the valuation remains stable within the range of $85 to $90, which we believe is a fair and reasonable offer price range. This demonstrates the strength of our valuation model, accounting for various market conditions and assumptions. Microsoft's actual offer price of $95 per share, announced on January 18, 2022, exceeds our range, indicating a more optimistic outlook on growth and synergies, while our valuation reflects a more conservative stance.

5.0 Transaction Structure

The proposed acquisition of Activision Blizzard by Microsoft is structured as a friendly acquisition, which is designed for smoothly integrating the target's assets, intellectual property, and management into the strategic framework of Microsoft. Generally, the structure of this deal brings several components together:

5.1 Acquisition Method

Considering the likely complexity of merging two giant groups, Microsoft has implemented an asset purchase approach to have more control over choosing the various assets of Activision Blizzard and giving them a certain value. This is not a complete merger but is preferred due to flexibility: Microsoft will not inherit some liabilities it does not want, and integration will be made easier.

5.2 Conditions of the Offer

The conditions of minimum acceptance by Activision Blizzard shareholders provide that Microsoft's offer to acquire the company is specifically tailored to temper risk and secure the transaction through the relevant antitrust regulators in both the United States and the European Union. These conditions are to ensure an acquisition that conforms with the law and also with the concerns on market competition, as the integration of Activision Blizzard would likely affect Microsoft's competitive positioning in the gaming market (FTC, 2023).

5.3 Form of Consideration

Microsoft's offer combines cash and stock as a means of payment, balancing immediate liquidity with future investment potential. A cash payment will immediately provide a financial return to the shareholders of Activision Blizzard, while the stock allows them to share in any future growth at Microsoft. Second, this mixed-payment approach is considered one of the best practices in M&A because it provides flexibility for both parties and raises the attractiveness of the deal. (Harvard Business Review, 2023).

5.4 Offer Price and Scope for Revision

Based on the valuation that Microsoft did for Activision Blizzard, the offer for acquiring it is within a reasonable price range. This price at which market value has been considered for Activision Blizzard includes potential synergies and a control premium. The revision of price might be considered in case of changes in market conditions and regulatory developments. This will provide room to Microsoft for price adjustment (Bloomberg, 2023).

5.5 Financing Structure

The plan for acquisition financing at Microsoft includes a mix of debt financing and internal cash reserves. This will allow Microsoft to leverage its favorable credit terms without over-extending its debt levels, hence remaining financially stable and taking advantage of the low interest rates. The debt financing in this transaction will most probably be supported by the strong credit rating of Microsoft, which helps in controlling capital costs. The above balanced financing structure would therefore make Microsoft retain cash flow for future investment opportunities, thus providing a strategic expansion within the gaming industry(Financial Times, 2023).

6.0 Risks and Market Reaction

6.1 Transaction risks

In Microsoft's acquisition of Blizzard, there are multiple transaction risks. First, stakeholder opposition could cause the deal to be blocked. The dissatisfaction of some shareholders and investors with the terms or price of the acquisition may lead to legal strife, which may delay or terminate the transaction. In addition, despite the improved management issues within Blizzard, if these issues are not effectively resolved, it may affect the willingness to integrate and increase the execution risk of the transaction. In particular, Blizzard's executives and key employees may choose to leave the company due to uncertainty after the release of the transaction information, further increasing labor costs and business instability. Interference from market competitors is also a major risk, as Microsoft's direct competitors may try to block the transaction through lobbying or legal means, thus affecting Microsoft's competitive advantage. At the same time, Blizzard's market volatility makes its assets highly dependent on changes in market demand and game popularity, which may affect its valuation and make it more difficult for Microsoft to assess the true value of its assets. If Blizzard's future financial performance falls short of expectations, Microsoft will face financial pressure to pay a high premium. Despite the upward trend of the gaming industry as a whole and the market's optimistic attitude towards Microsoft's acquisition of Blizzard, there is still the possibility of valuation fluctuations, increasing the uncertainty of the transaction execution price. Changes in currencies and interest rates should also not be ignored. If Microsoft pays for part of the acquisition through external financing, rising financing rates and changes in market sentiment may increase costs and directly affect the transaction price. In addition, Blizzard's global business involves foreign currency settlements, and exchange rate fluctuations may also affect transaction costs. Finally, despite Blizzard's multiple well-known IPs and user base, the unpredictability of future trends in the gaming industry poses a long-term risk. With the development of emerging technologies such as AI and VR, Blizzard has not yet mastered these areas, which means that Microsoft will face high costs if it plans to invest in these technologies, which in turn will affect the expected return on value (HBS, 2019).

6.2 Regulation and Review

Regulation and scrutiny are key factors in Microsoft's acquisition of Blizzard. Firstly, the sheer size of the deal could trigger antitrust scrutiny in the US, EU, and elsewhere. Regulators may impose

conditions or block the deal if they believe it will reduce competition in the industry. Microsoft will need to submit a detailed transaction plan to the FTC, and some markets may require further review due to different antitrust standards in various countries, which will increase the complexity of the transaction. Secondly, as a public company, the Microsoft-Blizzard merger will need to be reviewed by the SEC to ensure that the transaction documents comply with securities laws and that the terms are transparent and legal (Kenton, 2024). Data protection is also crucial, as Microsoft needs to comply with the California Consumer Privacy Protection Act to ensure transparent handling of user data and faces fines and reputational risk if it violates the law. (JacksoonLewis, 2023) In addition, Blizzard products require additional approvals in specific markets due to religious or minor protection issues, and failure to comply could result in release delays and affect the value of the acquisition. Virtual currency transactions also face legal risks such as money laundering, increasing the regulatory challenges of the transactions.

6.3 Reactions and Strategies

Lessons for the industry: EA's acquisition of Westwood Studios in 1988 was ultimately a failure, mainly due to the neglect of cultural integration, which led to brain drain, impaired creativity, and unclear strategic direction (Davenport, 2020). Microsoft should learn this lesson to avoid repeating the same mistakes. The success of Microsoft's 2016 acquisition of LinkedIn lies in maintaining independent operations and integrating into the Microsoft ecosystem, effectively enhancing market influence (Derrick, 2018). Microsoft can learn from this model in this acquisition to ensure a combination of resource integration and innovation independence to enhance Blizzard's competitiveness.

Market as well as Blizzard shareholders‘ reaction: shareholders’ attitudes vary significantly. Opponents are concerned about the fairness of the terms of the acquisition and management's fiduciary duties, fearing a loss of control and cultural clashes that could lead to increased litigation, while supporters are optimistic about the role of Microsoft's technological and financial support in Blizzard's market growth. Neutral shareholders, on the other hand, remained on the sidelines due to uncertainty about future growth.2022 In April, Blizzard shareholders voted 98 percent in favour of the Microsoft acquisition, yet the share price continued to fall over the following 12 months (see Figure 19), reflecting the market's lack of confidence in the deal's completion. During this period,

FTC litigation and CMA investigations hampered the deal process, but the European Commission's approval in May 2023 eased market concerns, and Microsoft's commitment to the launch of PlayStation and Switch boosted investor confidence (Dinsdale, 2023). And market analysts believe the deal will strengthen Microsoft's position in the global gaming market.

Mitigation strategies: firstly, Microsoft should assess cultural differences, develop an integration plan, and maintain employee communication to ensure cultural integration. Second, maintain Blizzard's creative independence and create incentives for innovation. Third, set up transparent financial goals and reasonable budgets, and regularly review the financial situation to ensure operational sustainability. Fourth, implement regular risk assessments to identify potential problems in advance and formulate plans. Finally, management should communicate frequently with shareholders and report on the progress of the merger to enhance trust and support.

7.0 Deal strategy and recommendation

Microsoft must prioritize the achievement of key synergies, including revenue expansion, cost efficiencies, and asset rationalization during its post-acquisition integration of Activision Blizzard. These synergies will directly affect the overall valuation and market response. Failure to achieve the expected synergies could adversely affect Microsoft’s shareholder value. Therefore, Microsoft should establish effective management strategies early in the integration process and closely monitor market dynamics and investor sentiment.

Therefore, it is recommended that Microsoft set up a special management team and an acquisition integration committee responsible for formulating a detailed integration plan and timetable and ensuring the effective implementation of all measures. Secondly, cultural adaptation training and team-building activities should be carried out to help employees understand each other and strengthen cooperation to improve employee morale and work efficiency. At the same time, we maintain transparent communication channels, regularly inform all employees of the progress of the acquisition and future strategies, and conduct satisfaction surveys and performance evaluations to maintain employee stability. In terms of research and development, increase investment in game development and innovation to ensure Blizzard's competitiveness in the market; analyse and optimise market strategies, and utilise Microsoft's resources to expand the market coverage of Blizzard's products.

8.0 Appendix - Tables from the report

Figure 1: Microsoft Management Organisational Structure (Organimi, n.d.).

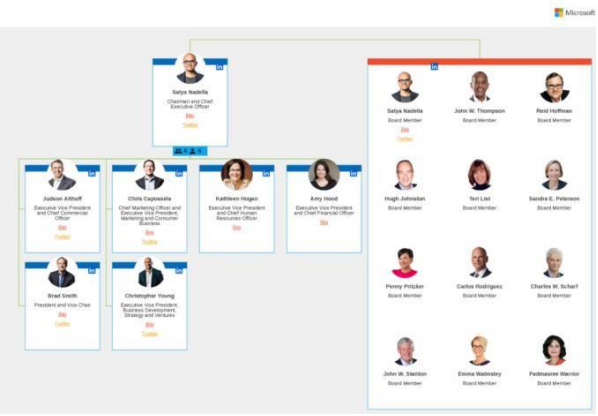


Figure 2: Activision Blizzard revenue from 2017 to 2022 (Tan, 2023).

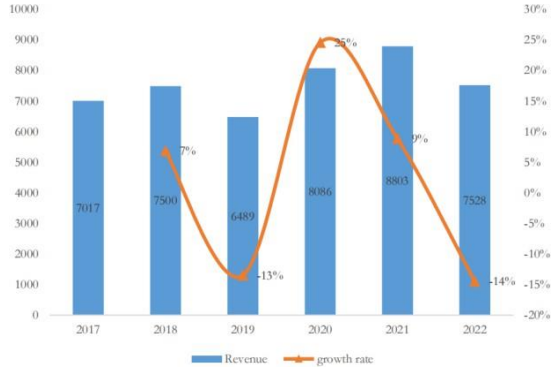


Figure 3: Global Video Games Market Value 2020-2025 (Karthikeyan, 2023).

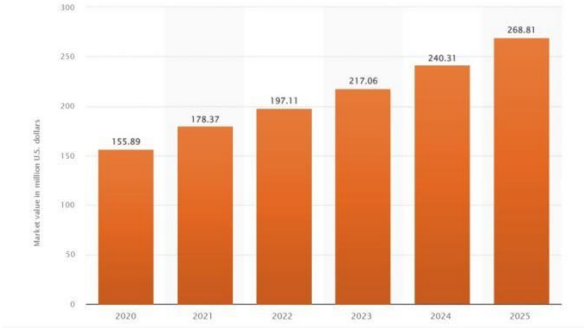


Figure 4: Annual Growth Rates of Activision Blizzard's Net Income (2011–2021)

Source: Statista, based on Activision Blizzard Annual Reports (2011–2021)

Financial Year	Net Income ($ in million)	Growth Rate
2021	2,699	22.85%
2020	2,197	46.17%
2019	1,503	-18.67%
2018	1,848	576.92%
2017	273	-71.74%
2016	966	8.30%
2015	892	6.83%
2014	835	-17.33%
2013	1,010	-12.10%
2012	1,149	6%
2011	1,085	
Average		**54.71%**

Figure 5: Free Cash Flow to Firm (FCFF) of Activision Blizzard (2011–2021)

Source: Macrotrends, based on Activision Blizzard's Financial Data (2010–2023)

Financial Year	FCFF ($ in million)	Growth Rate
2021	2,334	7.36%
2020	2,174	26.76%
2019	1,715	3.38%
2018	1,659	-19.39%
2017	2,058	1.93%
2016	2,019	75.87%
2015	1,148	-6.21%
2014	1,224	2.86%
2013	1,190	-6.45%
2012	1,272	44.55%
2011	880	
Average		**13.07%**

Figure 6: U.S. 10-Year Treasury Yield as a Proxy for the Risk-Free Rate (2011–2021)

Source: Macrotrends, "10 Year Treasury Rate - 54 Year Historical Chart"

Financial Year	Risk-free rate
2021	1.45%
2020	0.89%
2019	2.14%
2018	2.91%
2017	2.33%
2016	1.84%
2015	2.14%
2014	2.54%
2013	2.35%
2012	1.80%
2011	2.78%
Average	**2.11%**

Figure 7: S&P 500 Annualized Return from 30/12/2011 to 30/12/2021

Source: Yahoo Finance, S&P 500 Historical Data

S&P500	30/12/2021	30/12/2011
	4,778.73	1,257.60
Annualized Return	**14.28%**	

Figure 8: Activision Blizzard Corporate Bonds and Yield to Maturity (YTM)

Source: TradingView, Activision Blizzard Bonds Historical Data

Coporate Bond	Maturity date	YTM
ATVI4495111	Sep 15, 2026	5.15%
ATVI4499882	Jun 15, 2027	5.36%
ATVI5026498	Sep 15, 2030	5.29%
Average Cost of Debt		**5.27%**

Figure 9: Microsoft Corporate Bonds and Yield to Maturity (YTM)

Source: TradingView, Microsoft Bonds Historical Data, accessed on October 27, 2024.

ISIN	Issue date	YTM
US594918BB9	Feb 12, 2015	4.67%
US594918BJ27	Nov 3, 2015	4.21%
US594918BC7	Feb 12, 2015	4.39%
US594918BK99	Nov 3, 2015	4.50%
US594918CB81	Feb 6, 2017	4.86%
US594918CD48	Jun 1, 2020	4.65%
Average		**4.55%**

Figure 10: Comparison of Gaming Revenues Between Microsoft and Activision Blizzard (2011–2021)

Source 1: Statista, "Gaming Revenue Generated by Microsoft from Fiscal 2017 to 2024"

Source 2: Statista, "Net Revenue Generated by Activision Blizzard from 2005 to 2022"

All numbers in million ($)				
Year	**Microsoft**	**Activision Blizzard**	**Revenue Difference**	**Growth Rate**
2021	15,370	8,803	6,567	32.79%
2020	11,575	8,086	3,489	1.66%
2019	11,386	6,489	4,897	9.98%
2018	10,353	7,500	2,853	14.39%
2017	9,051	7,017	2,034	-4.32%
2016	9,460	6,608	2,852	-7.10%
2015	10,183	4,664	5,519	11.99%
2014	9,093	4,408	4,685	47.88%
2013	6,149	4,583	1,566	-35.90%
2012	9,593	4,856	4,737	7.61%
2011	8,915	4,755	4,160	
Average			**3,942**	**7.93%**

Figure 11: Annual World GDP Growth Rate (%) (2012–2021)

Source: World Bank Group

Year	Growth Rate(%)
2021	6.30%
2020	-2.90%
2019	2.60%
2018	3.30%
2017	3.50%
2016	2.80%
2015	3.10%
2014	3.10%
2013	2.90%
2012	2.70%
Average	**2.74%**

Figure 12: Present Value Calculation of Revenue Enhancement

All numbers in million ($)								
Timeline	**t = 0**	**t = 1**	**t = 2**	**t = 3**	**t = 4**	**t = 5**		**t = 6**
Year	2021	2022	2023	2024	2025	2026		2027
Revenue	3,942	4,099	4,263	4,434	4,611	4,796		4,916
After-tax revenue	3,398	3,534	3,675	3,822	3,975	4,134		4,237
Terminal Value						41,197		
Present Value (t = 0)		3,133	2,889	2,664	2,456	2,265	22,574	
Value of Revenue Enhancement		**$ 35,982**						

Figure 13: Present Value of G&A Cost Synergies

All numbers in million ($)		g = 1.5%			g=3%
Year	**2021**	**2022**	**2023**	**2024**	**2025**
Timeline	0	1	2	3	4
G & A Cost	$ 5,107				
G & A Cost Saving		$ -	$ 77	$ 75	$ 149
After-tax G & A Expenses		$ (4,402)	$ 66	$ 65	$ 128
Terminal Value				$ 8,285	
Present Value (t = 0)		$ (4,211)	$ 60	$ 7,307	
Value of Synergy	$ 3,157				

Figure 14: Present Value of Asset Rationalization Synergy

All numbers in million ($)			rate = 10%			rate=3%
Timeline	0	1	2	3	4	5
Year	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
CapEX-Microsoft	$ 20,622	$ 20,622				
CapEX-Activision Blizzard	$ 80	$ 80				
CapEX - Intergration		$ 10,351	$ 9,316	$ 8,384	$ 7,546	$ 7,320
Difference			$ 11,386	$ 932	$ 838	
Terminal Value (t =4)					$ 74,801	
After-tax CapEX		$ (17,845)	$ 9,815	$ 803	$ 65,201	
Present Value (t = 0)		$ (15,822)	$ 7,716	$ 560	$ 40,294	
Value of the Synergy	**$ 32,748**					

Figure 15: Sensitivity Analysis of Standalone Value

Standalone Value		WACC1		
		13.02%	14.02%	15.02%
g2	1.90%	$86.60	$86.81	$87.00
	2.90%	$86.21	$86.43	$86.64
	3.9%	$85.73	$85.98	$86.20
g1	5.0%	$86.45	$86.66	$86.86
	6.0%	$86.21	$86.43	$86.64
	7.0%	$85.96	$86.19	$86.41

Figure 16: Sensitivity Analysis of Revenue Synergy

Revenue Enhancement Synergy		WACC2		
		11.79%	12.79%	13.79%
g2	1.50%	$87.90	$83.61	$80.02
	2.50%	$91.45	$86.43	$82.30
	3.5%	$95.87	$89.86	$85.03
g1	3.0%	$89.39	$84.60	$80.66
	4.0%	$91.45	$86.43	$82.30
	5.0%	$93.59	$88.33	$84.00

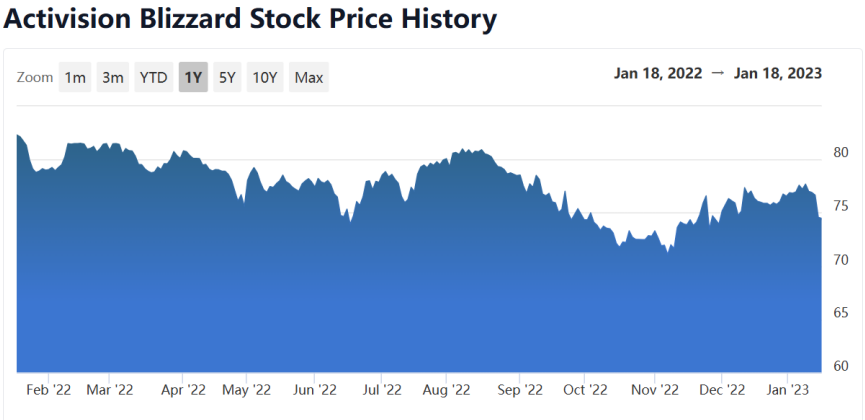
Figure 17: Sensitivity Analysis of Cost Synergy

Cost Reduction Synergy		*Cost of Debt*		
		3.55%	4.55%	5.55%
g1	0.50%	$104.62	$86.52	$82.68
	1.50%	$104.17	$86.43	$82.67
	2.5%	$103.73	$86.34	$82.65
g2	2.0%	$83.46	$80.89	$79.80
	3.0%	$104.17	$86.43	$82.67
	4.0%	$33.52	$112.23	$89.23

Figure 18: Sensitivity Analysis of Asset Synergy

Asset Rationalization Synergy		*WACC2*		
		11.79%	12.79%	13.79%
g1	9.00%	$96.14	$87.95	$81.36
	10.00%	$94.35	$86.43	$80.05
	11.0%	$92.61	$84.94	$78.76
g2	2.0%	$88.87	$82.17	$76.67
	3.0%	$94.35	$86.43	$80.05
	4.0%	$101.25	$91.66	$84.11

Figure 19: Activision Blizzard Stock Price History（Stock，n.d.)



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