Activision Blizzard, Inc

NASDAQ: ATVI

Stock Analysis

Initial Thought Process:

Activision Blizzard is a stock that is particularly interesting to me because games have been such a big part of my life. With that said, it's a business model I can understand quite well and I can get behind as can millions of others around the world. This is one of the many stocks that were much discounted in March which put it on my radar and I'm very interested in looking into this stock much further.

Business Model:

Activision Blizzard, Inc. is the leader in world of video game development and publishing. They develop and publish games for console, PC, and even mobile. In 2008, Activision, Inc merged with Vivendi and bought 429 million shares of Blizzard from them. They later renamed the company to Activision Blizzard, Inc. In 2016, Activision Blizzard bought King Digital Entertainment which is the leader in mobile entertainment with titles such as the Candy Crush franchise. Activision is well known for their Call of Duty Franchise, with their newest releases being huge successes. Call of Duty: Modern Warfare grossed $600 million in sales its first three days of release according to polygon.com and Call of Duty Warzone had 15 million players after three days of its release. Warzone is a free-to-play battle royale type of game where you're placed in a battle arena that is based on the Call of Duty: Modern Warfare world, with 150 other players and the last man/ squad standing, wins the game. Another very successful release from Activision is their new Call of Duty Mobile game, which is the smaller scale, mobile version of the first two titles; it is also free-to-play and has surpassed 150 million downloads, reaching the top of the downloads charts in 150+ countries and regions according to Activision's Q4 2019 results slide presentation. Activision alone, has done very well and will continue to see an increase in numbers and the COVID-19 quarantine continues. People have to stay home all day, every day, and are looking for ways to entertain themselves at home; video games provide this very engaging form of entertainment that can be enjoyed by just about anybody. Blizzard has also done very well with the release of World of Warcraft Classic. WOW Classic is described by Wikipedia as "**World of Warcraft Classic** is a server option for the MMORPG **World of Warcraft**. Running alongside the main version of the game, **Classic** recreates the game in the state it was in before the release of the first expansion, The Burning Crusade." This has been a really good thing for World of Warcraft players and the game's player count has doubled since the release of Classic. Overwatch has seen 50 million+ players in its launch on the Nintendo Switch this past October 15, 2019. Lastly, we have King, the developer of the Candy Crush franchise. Candy Crush is still the top grossing franchise in the U.S app stores in Q4 2019 as shown in Activision Blizzard's slide presentation, with Candy Crush Saga being the top grossing title in U.S app stores. Needless to say, Activision Blizzard has a very strong business model here that continues to have huge growth potential ahead of it with the continued growth of streaming platforms such as Twitch and YouTube, as well as the growth of eSports as it becomes more mainstream and a more accepted form of spectator sport; millions of people tune in every day to watch their favorite streamers, YouTubers, or eSports teams display their skill and interact with their audiences on various platforms.

Income Statement:

As we have already discussed in our business model section of this analysis, Activision Blizzard's new titles have all been doing very well. With Call of Duty: Modern Warfare and Call of Duty: Warzone contributing to Activision's 128 million monthly active users (MAUs), Call of Duty generating more upfront console sales than any other franchise in the world for the 10/ 11 years according to their financial results, Call of Duty: Mobile reaching the top of the charts, it is of no surprise that Activision has the best financial performance in comparison to Blizzard and King. Activision generated $1.4 billion of net revenue in Q4, doubling Blizzard and King's revenue contributions. WOW Classic's launch, Overwatch's launch on the Switch gave Blizzard a boost in both revenues and MAUs, with about 32 million MAUs. Hearthstone and Diablo have been on a decline in revenues as the games aren't as popular as they once were; this was offset by WOW's and Overwatch's performance in 2019. This put Blizzard at $595 million for Q4 2019 and $503 million for King, with Candy Crush's continued performance at the top of the mobile charts. But what does all of this mean for Activision Blizzard's overall performance and their bottom line? Well, obviously their major titles are still very relevant today and have done a good job at contributing to better performance for the most part. But taking a look at the company's income statement, we can see that Activision Blizzard has generated nearly $2 billion in Q4 2019 and nearly $6.5 billion for all of 2019. This is roughly about $1 billion less than last year but it's still a good number and shouldn't be too big a deal in the short term. Activision Blizzard's profitability margin is also very good at 23%, well above the average, which according to aei.org, is 7.9%. Their "Cost of Revenue" has generally been around the $2 billion range, so it has stayed fairly consistent for the last few years and has actually come down a bit to the lower $2 billion which is good to see. It is also worth noticing that Activision Blizzard beat earnings in every single quarter of 2019, which gives an investor more confidence on the company's performance in 2020. Especially right now, with our ongoing crisis and everyone staying at home.

Balance Sheet:

Activision Blizzard, Inc. has a strong balance sheet with $5.7 billion in cash and cash equivalents. Their liabilities are very small as well, with no current debt and only $2.6 billion in long-term debt. This is roughly a 2:1 cash to debt ratio which isn't bad at all. Their Cash to debt ratio is probably one of the best aspects of Activision Blizzard's balance sheet, but there is a few issues that are worthy of pointing out in their balance sheet. The first of which is their efficiency, which is calculated by figuring out the company's asset turnover ratio. In the case of Activision Blizzard, their asset turnover ratio is 34%, way below the benchmark of 100%, which is where it should ideally be for any company. Now, this isn't always possible depending on the company's business model and it might even make sense for some companies. Asset turnover ratio is once again used to find how efficiently a business is being run. The benchmark for this is 100% because ideally, you want a company to be running at 100% efficiency. Activision Blizzard has a low asset turnover ratio mainly because of their goodwill, which is increased when a company buys another business or an investment and pays more than that business net assets. Essentially, they're overpaying for a business that isn't generating enough in sales to justify the price paid to acquire that business. Currently, Goodwill makes up about 49% of the company's total assets and the only other assets that can even come close to it is Cash and Cash Equivalents at 29% of their total assets. We would have to subtract both Goodwill and Cash and Cash Equivalents from the total assets in order to achieve that 100%+ asset turnover ratio we were looking for. In the case of Activision Blizzard, the asset turnover ratio comes out to be 197.7%. Most, if not all of Activision Blizzard's subsidiaries are other, smaller game development companies, a lot of which may not be developing games that are contributing in a significant way to Activision Blizzard's revenues due to a lack of popularity or failure to meet consumer's expectations. When it comes to the Cash and Cash Equivalents, a possible reason for having so much cash on the sidelines for them would be in case there was either an unexpected expense with new products, research and development for a new product, advertising and promotions, among other expected or unexpected expenses for the year or quarter. With all of this said however, Activision Blizzard has still managed to maintain an above average productivity which is measured by calculating a company's return on assets. This helps us gauge how well a company is being managed. This will vary from company to company depending on their profitability and efficiency, both of which can also vary drastically depending on the company's business model, amongst other factors. Activision Blizzard stands at about an 11.4% productivity, above the benchmark of 7.5%. Their productivity is impacted mainly by their very low efficiency but is offset by their high profitability. Considering we're going through a lot of uncertainty in the market in recent times and companies having little to no guidance for the year due to the COVID 19 pandemic at the time of writing this analysis paper, it's a good idea to look at a company's leverage, however, this is helpful information regardless of how our economy or market is looking. If we take a look at ATVI's average total assets and average total equity, you'll get how much leverage ATVI has, which comes out to be around when rounded up to the nearest full percentage 156% in Activision Blizzard's case. This shows us that Activision Blizzard hasn't really borrowed too much. Generally a good balance would be 200%, showing that 100% of their assets have been funded 50% by equity and 50% by borrowing money from lenders. There are companies such as ATVI, that use more equity than leverage, and others who use mostly leverage in order to preserve as much of those profits and not having to bring in more shareholders. Generally speaking, it's a good idea to either stay away, or be cautious with companies that have too much leverage, we're talking percentages in the 300% or 400%+ because that just increases risk too much. However if a company has a very high interest coverage ratio (ICR), then that means the company is able to afford the interest payments on all of the debt they're taking out. If a company has very high leverage but a low ICR, that's a bit too risky for me in my opinion. The ICR can be very easily calculated by taking a look at a company's profitability, income tax expense, and interest expense. This information can be easily found on Yahoo Finance when you go to a company's "Financials" section. In Activision Blizzard's case, their leverage is quite low and they seem to be funding their asset purchases mainly with equity, but if we were to calculate it, we would get an ICR of 19.6, well above the benchmark of 3, which is the minimum you want to see when calculating ICR. Some will go as low as 2 but I prefer 3+, and according to Investopedia, most analysts look for a minimum of 3 as well. All of this brings us to Activision Blizzard's return on equity (ROE), which is a bit lower than I'd like to see it, generally 15% is good but in the case of ATVI, it's a little over 9% which isn't too terrible but still a bit lower than the benchmark. Overall though, their balance sheet looks pretty solid with plenty of cash and little debt.

Management Team:

The first person we'll be taking a look at in Activision Blizzard's management team is CEO Bobby Kotick. Bobby has been with the company since 1991, one year after he had purchased a 25% stake in Activision. He put together the merger of Activision Blizzard and was appointed as CEO of the combined company on July 9, 2008. Bobby has made very good decisions over the past decades for the company and has said that the secret lied on his ability to maintain focus. His goal and his plan was "How we're going to make great games and how we're going to get the biggest audiences to actually play them." This is very good to hear from the CEO when it comes to a company like Activision Blizzard because having the ability to maintain focus is key when you're in such a competitive and constantly changing market. Some of Activision Blizzard's greatest achievements have happened during Bobby's role as CEO and although every event may not have happened directly because of him, he's still a major contributor to the company's successes and performance. Next up, we have the CFO of Activision Blizzard. A great management team is not complete without a good CEO, but neither is it without a good CFO. A CFO's role in a company is to oversee all of the financial activities of a company including financial planning, identifying and addressing a company's financial strengths and weaknesses, making sure the company is getting as much of that revenue to the bottom line as possible, among many other duties. Dennis Durkin joined the company in 2012 as CFO of Activision Blizzard and later served as the Chief Corporate Officer for 2 years starting in 2017. Prior to joining Activision Blizzard Durkin was with Microsoft and held various positions there such as corporate vice president, COO, and CFO for 12 years. CEO Bobby Kotick had this to say about him when he returned to his CFO position in 2019, "Dennis is a leader with unimpeachable integrity and exemplary character who displays impeccable judgment. He is a seasoned leader known for driving financial and operational excellence. We missed having him in a more day-to-day operational and financial role and are glad to have him back as CFO." These are definitely great things you'd want to hear about the person who's leading the financial operations of a large corporation. Dennis has definitely proven himself as a very competent and capable CFO over the years he's been in the industry and he will likely continue to do so in the future. In addition to these two key members of management, we also have three more key members which are the Chief Legal Officer (CLO), Chief People Officer (CPO), and the president and Chief Operating Officer (COO). The Chief Legal Officer of a company is a current or former practicing attorney, basically a lawyer, who manages the legal risks of the company to essentially keep them out of trouble with the law. Any activities or concerns of legal matter are reported to the CLO. ATVI's CLO is Chris Walther who's been with the company since 2009. Prior to Activision Blizzard, he was in the legal department for The Proctor & Gamble Company. Proctor & Gamble is a consumer goods company that owns a lot of very well-known brands such as Charmin, Tide, Gillette, Head & Shoulders, Febreze, and many more. This is a very large corporation that most certainly would require a very experienced CLO. Having a CLO that came from a company that manages so many different brands and likely has a lot of legal concerns when they acquire all of those brands because it's not as easy as just buying a product at the store. An experienced attorney is crucial with all of the legal matters ATVI has to be wary of, follow, and disclose to the public. The Chief People Officer is an interesting one to look at as it does have a couple of other names it's known as. The CPO is basically the person that oversees HR activities such as hiring, payroll, evaluation of candidates, and a few other duties along those same lines. The CPO for ATVI is Claudine Naughton, who's been with the company since 2019. Prior to her position here, she held various HR positions at American International Group for a little over two decades. According to her LinkedIn profile "About" section she "mentored and led 700 HR professionals while supporting ~55,000 employees across 80+ countries," some seriously impressive numbers for sure. Her experiences, skills, and abilities will most definitely insure that ATVI is bringing in and keeping valuable talent and hard work to the company now and in future years, which will add to Bobby's vision and goal to create great games that people want to play by making sure they're hiring the best employees they can and keeping existing employees happy and keep them with the company. The last key member of management we'll be taking a look at is the COO. The COO's duties involve overseeing the daily activities and operations of a company. Daniel Alegre is in charge of these duties as COO and is the newest of the management members I've mentioned here having joined only since April 2020. However, prior to joining Activision Blizzard, Daniel was president at Google, Inc. and serves in a few other major positions in the company as well. Daniel also served as vice president of Bertelsmann Music Group. He also has some damn good credentials as well including a B.A Princeton University, Woodrow Wilson School, as well as an M.B.A and J.D degree from Harvard, which is pretty impressive. Although this isn't a huge indicator that their performance will be good with the company, you know he acquired his skills and knowledge from top Universities and a very well-known FAANG company, Google, Inc.

<u>Risk Factors:</u>

So far, Activision Blizzard is looking very solid, however, we have to take a look at some aspects of the business that could be a potential risk to investors. We're going to cover 6 different general risk factors for the company and break them down into smaller, more specific risks factors. The first of these bigger, overall risks is ATVI's vulnerability to their games losing popularity either through the lack of fresh new content or a competing new title that's gaining popularity. This presents a handful of other issues for ATVI, starting with popularity and demand. A shrink in demand for a genre or franchise of games e.g. Call of Duty, World of Warcraft, etc., that make up the majority of the sales for Activision Blizzard would be very bad news for the company. As of right now, as stated in ATVI's fiscal year ended December 31, 2019 10-k, Call of Duty, Candy Crush, and World of Warcraft accounted for about 67% of ATVI's net revenues, so if any of these franchises started to see a huge decrease in popularity, it would have a very negative impact in the company's performance. The chances of a franchise losing its popularity overnight are quite small, however, a bigger threat or risk would be if there were negative reactions to a new title and failed to meet consumer's expectations in some way. This would result in a quicker drop in performance rather than a slower, long-term decline. This failure to meet expectations could be a result of an overall disappointing title, delays, major glitches or bugs, issues with updates, undesirable features, and so on. This in turn, could cause a slowdown in sales, players could stop playing the game, not spend additional money on the game in the future, and affect the company's reputation which would only repeat and compound into worse results. Triple A titles cost millions of dollars to make and the pricing of these games depend on different factors not just one, but most new Call of Duty releases start at $59.99. If there was a competing game that went above and beyond consumer's expectations and cost less than a new release from Activision Blizzard or if it's free, it could pose a threat to the game's sales. Obviously, this wouldn't always be the case but it's a possible scenario that could affect their earnings. On the same issue of financials, an increase in the company's tax expenses, an increase in development costs, going over budget, maintenance for the games, legal issues, distribution costs, may all cause weaker performance due to the additional and unwanted increases in operating expenses among other costs. On a different note, a loss or reduction in good personnel/ employees could be another factor that negatively affects the company. Activision Blizzard depends on skilled programmers, marketers, and other members of the company to develop, market, and distribute games to the consumers. A lack of supply for such employees would affect the company's ability to keep up with demand for new titles and updates for current ones. Going back to something along the same lines of popularity, an addition to that risk would be if the company or its games begin to be "out of touch". The world of gaming is constantly changing and is highly competitive with the release of new titles every year. All of this very constant release of content could have a negative impact on existing titles. The rise of new trends, franchises, and genres could be an issue if ATVI cannot adapt to these changes. In addition to all of this, games aren't the only competitor for Activision Blizzard. They must also compete with many other forms of entertainment and where consumers choose to spend their time and money. Competing new titles don't matter if people aren't playing games and among these other competitors are streaming platforms such as YouTube, Netflix, Disney +, Facebook, Instagram, and the list goes on. Keeping the attention of consumers is very crucial to their business, otherwise, all the new features in the newest Call of Duty don't matter, if people aren't playing Call of Duty. Finally, we come to brick and mortar locations, and how these can affect ATVI's sales. The significance of these brick and mortar locations may not be as great as it once was, keeping in mind that I have not purchased a physical copy of a game in years, and I'm sure many people could say the same. However these locations still have some significance and there are three factors that affect sales in these brick and mortar locations. The first, is lack of shelf space at brick and mortar stores, which can be problematic if there are more copies of Battlefield than there are Call of Duty titles on that shelf. The next two however, pose the biggest threat, and that's a decrease in traffic to brick and mortar retailers or the closing of brick and mortar locations that sell Activision Blizzard's products. This is actually an issue we're seeing at the moment with the COVID-19 pandemic and we're getting a taste of the impact that these closings would have. If it's going to be worth the distribution costs to keep these products on the shelf's ATVI will obviously want to see as much traffic in these locations as possible, otherwise, again, it would be a huge waste of money to keep these games on the shelves instead of just switching fully to digital copies of their games.

<u>Long-term Outlook:</u>

Activision Blizzard continues to be the leader in gaming and is likely to stay there for quite some time. Their most recent Q1 results for fiscal year 2021 reinforce my beliefs that they're capable of delivering good products, make their consumers happy, and bring in good profits for its shareholders. Stay-at-home orders have also favored them a lot considering most people are indoors most of the day and need to entertain themselves somehow, as plenty of other forms of entertainment are closed at the moment. Activision Blizzard does have a pretty positive outlook going into the second quarter and they expect revenues to continue increasing which is good to hear. I do plan on holding this company for a matter of years and it is one that I will not be selling any time soon.

Valuation:

At the time being, the stock seems too overvalued for me to feel comfortable buying at these levels. I would ideally like to see the stock price below $50, but I would be willing to buy the stock if it were to fall below 55-54. The stock has had a huge run since its bottom in March and I just simply don't feel comfortable buying at such high levels. When it comes to market cap, I would ideally like to see it drop to about $38 billion, but ideally below that point. If we get a move to these levels or even further down than that, we should see the p/e ratio come down a lot to the 20s range, where I'd like to see it. But until then, I'm not sure I'll be buying any more shares unless the company is really doing that well, or we get a big pull back as I said before.

Conclusion:

So we found that ATVI is a company with a really good, and very profitable business model, bringing in a profitability ratio of 23% but has a very low efficiency of 34.4%. This is mostly due to how much money they have in goodwill and in cash and cash equivalents. However if this wasn't the case, their asset turnover ratio would actually be at 197.7%. Their good profitability of 23% and their lagging efficiency of 34.4%, puts them at a productivity of 8%. This is a productivity level that is just above the benchmark of 7.5%. Aside from having a good income statement, their balance sheet also showed that they are very responsible with their leverage. Leverage shows us how much of their assets are funded by taking out debt and you'd ideally like to see the number at 200%, to show that it's in balance. Their leverage is at 156%, which shows us that they actually fund the majority of their assets with stockholder's equity rather than borrowing money, which isn't a bad thing at all. What this shows is that they're capable of affording the vast majority of the assets they intend to purchase so there is little need to fund with borrowing money from lenders. They also have an interest coverage ratio of 19.3, well above the typical benchmark of 3.0, indicating that they're very capable of paying off the debt that they do take out, so they wouldn't really be at risk of defaulting on payments if things took a turn. They also have plenty of cash on the balance sheet as well to fund the purchase of more investment opportunities or paying off debt if they need to. These numbers bring us to an ROE of 9%, and this one is a bit lower than I'd like to see it but if the company could improve their productivity, cut back on expenses, and bring up their net profit margin of 23%, a little close to their gross profit margin of 32%, then they would be in much better shape. Nonetheless, it's still not too bad and Activision Blizzard does seem like a very good company, capable of generating some good money for its shareholders on a long term basis.