2022-04-25

Activision Blizzard started off 2022 with a weak first quarter. Revenue was soft partially due to continued weak sales of Call of Duty: Vanguard versus the 2020 installment and the timing of World of Warcraft expansions. Due to the pending acquisition by Microsoft, management decided to forego the earnings call. While the firm did not discuss the transaction, there have been further developments, including a probe into potential insider trading around the deal involving CEO Booby Kotick and a letter from four democratic U.S. senators urging the U.S. FTC to examine the deal, citing the poor workplace culture at Activision. We believe that the merger will still be approved, though the process will likely push the closing into the first half of 2023. We are maintaining our fair value estimate of $92, which would also be our standalone valuation. Our valuation balances our standalone valuation, the acquisition value of $95 a share roughly a year from now, the potential for regulatory intervention, and the very slight possibility of a higher offer from another suitor.

Total non-GAAP revenue for the quarter fell by 22% year over year to $1.8 billion as strong growth at King could not offset the drop at the other segments. Non-GAAP operating margin for the quarter collapsed to 34% from 43%, due to the revenue drop, slightly higher marketing, and continued investment in product development.

Bookings declined by 47% year over year to $453 million due largely to the decline in CoD users. The November releases of Vanguard and the Pacific expansion for Warzone have been unable to gain traction on consoles or PC. CoD Mobile net booking ws flat year over years. The CoD and Warzone issues appear to have lingered even as the development teams have release fixes and new content. While troubling, there have been other CoD releases in the past that have struggled before the following release posted strong results, which means that we won't overreact to one weak annual release.

2022-08-01

Activision Blizzard posted another weak quarter with GAAP revenue down 28% due to the continued knock-on effect of weak sales and user retention of Call of Duty: Vanguard versus the 2020 installment. Due to the pending acquisition by Microsoft, management is foregoing earnings calls. We still believe that the merger will be approved, though the closing will likely not occur until the first half of 2023. We are maintaining our fair value estimate of $92, which balances our standalone valuation (also at $92), the acquisition value of $95 a share roughly a year from now, and the potential for regulatory intervention.

Total non-GAAP revenue for the quarter fell by 15% year over year to $1.6 billion as the ongoing growth at King could not offset the drop at Activision and Blizzard. Non-GAAP operating margin for the quarter fell to 28% from 31%, due to the lower revenue, slightly higher sales and marketing expense, and continued investment in development.

Blizzard bookings dropped by 29% to $375 million as the group continues to battle a tough comparison due to the timing of World of Warcraft expansions. The release of the Dragonflight expansion in September should help bookings bounce back in the second half. The firm announced that development on

Diablo IV and Overwatch 2 remained on track, with Diablo planned to launch in 2023 and the later title set to launch in October. The long-delayed release of Diablo Immortal occurred on June 2 on mobile and PC. While the gameplay was relatively well-received, many reviewers and players lambasted the amount and cost of the microtransactions in the game. Despite the blowback, DI reached the top of the game download charts in over 100 countries and reportedly grossed over $100 million in its first two months. The positive start in terms of bookings could wither away if the need for and amount of microtransactions become overly onerous in later-stage gameplay.

Analyst Note | by Neil Macker **Updated Nov 08, 2022**

Activision Blizzard posted a better-than-expected third quarter, with top line and EBITDA ahead of FactSet consensus estimates. As expected, GAAP revenue continued to decline, down 14% year over year due to the continued knock-on effect of weak sales and user retention of Call of Duty: Vanguard versus the 2020 installment. This year's installment, Modern Warfare II, has gotten off to an impressive start since its launch on Oct. 28, boding well for the next few quarters. Due to the pending acquisition by Microsoft, management is foregoing earnings calls. Despite the recent United Kingdom regulator decision to further examine the deal, we still believe that the merger will be approved, though the closing will likely not occur until the summer of 2023 at the earliest. We are maintaining our fair value estimate of $92, which balances our standalone valuation (also at $92), the acquisition value of $95 a share, and the potential for further regulatory intervention.

Total non-GAAP revenue for the quarter fell 3% year over year to $1.8 billion as the drop at Activision more than offset growth at King and Blizzard. Non-GAAP operating margin for the quarter fell to 34% from 46%, due to the lower revenue and slightly higher selling, general, and administrative expenses.

Bookings at the Activision segment declined 25% year over year to $480 million due to the ongoing decline in CoD users. The number of monthly active users for Activision in total fell to 97 million from 119 million a year ago. Modern Warfare II appears on pace to reverse these trends, as the new title is the fastest CoD game to reach $1 billion in sell-through. The 2022 installment also posted a 40% increase in hours played in the first 10 days versus the previous CoD recordholder. With Warzone 2.0 set to launch on Nov. 16 and Warzone Mobile expected to be released in 2023, Activision seems to be well on the path of rebounding from the disastrous Vanguard game.

Business Strategy and Outlook | by Neil Macker Updated Oct 31, 2022

Activision Blizzard is one of the world's largest third-party video game publishers and owns some of the largest and well-known video game franchises, including Call of Duty and World of Warcraft. We believe the firm is well placed to consolidate its leading position by developing compelling new versions of its existing franchises and by introducing new experiences, such as Overwatch. We expect Activision to continue to benefit from ongoing console demand, the ongoing revitalization of PC gaming, and the growth in the mobile market via King.

Activision Blizzard’s sale to Microsoft remains pending as a number of jurisdictions continue to scrutinize the deal. While there has been some pressure for the U.S. regulators to block the deal, the most serious challenge to the merger has come in the U.K. where the Competition and Markets Authority has moved the deal into a Phase 2 investigation. We still expect the deal to close in 2023, but the timing may shift into the second half of the year due to the extended regulatory enquiries.

Activision has capitalized on the shift in the industry toward a bifurcated market consisting of major AAA blockbuster titles on one side and smaller indie games on the other side. Activision generally focuses on the higher end of the market, using its capital to fund higher-budget blockbusters and its marketing scale to support its titles across multiple advertising platforms. Activision's primary competition remains other large third-party publishers, such as Take-Two and EA, as well as console manufacturers (and first-party publishers) Sony and Microsoft.

Like its peers, the firm is focused on engaging users beyond the initial game sale via extending the monetization window by expanding the use of multiplayer options and releasing downloadable content. Both methods encourage gamers to hold on to the original game longer than in previous generations and provide an income stream from consumers who purchase the game secondhand. Activision has used DLC and multiplayer to extend the life of multi-billion-dollar franchises such as Call of Duty, and we believe franchises like Hearthstone and Overwatch can also maintain long-term success.

Economic Moat | by Neil Macker Updated Oct 31, 2022

We assign Activision a narrow moat. Activision Blizzard is one of the world's largest third-party video game publishers and the firm behind some of the most compelling and lucrative franchises of all time. Over the last 15 years, the video game industry has undergone a number of changes including two console generation transitions; the rise of digital downloads; widespread adoption of mobile games; and the expansion of the free-to-play, or F2P, business model. Over this same period, Activision (the predecessor company) has transitioned from a console-based video game publisher to the one of the largest publishers on both consoles and the PC via the 2008 merger with Blizzard (then owned by Vivendi). The firm owns six core franchises that have grossed over $1 billion in revenue--World of Warcraft, Call of Duty, Diablo, StarCraft, Overwatch, and Hearthstone.

Its portfolio of widely successful franchises allows the firm to monetize its intellectual property year after year by delivering content via sequels, expansion packs, downloadable content, or DLC, and toys, exemplified by the decade-old World of Warcraft franchise and the annual versions of Call of Duty. These franchises can also spawn games that move the company into new arenas such as F2P (Hearthstone from WoW) and mobile (Call of Duty Mobile). The company's franchises have a dedicated user base, providing Activision with the leverage to push more of its games via direct digital channels thus bypassing retailers, generating higher gross margins and improving returns on invested capital.

We believe that the console and PC video game market will continue to largely fragment into two tiers: AAA games with large budgets and indie games with small budgets. Activision's size and the depth of its franchise slate allow the firm to place larger bets on new IP than many smaller midsize competitors. This ability to make larger investments marks the publisher as one of a few destinations for studios looking to develop new large-budget AAA games.

Fair Value and Profit Drivers | by Neil Macker Updated Oct 31, 2022

Our fair value estimate of $92 balances our stand-alone valuation, the acquisition value of $95 a share roughly a year from now, the potential for regulatory intervention, and the slight possibility of a higher offer from another suitor. Our stand-alone fair value estimate of $92 per share implies 2022 adjusted price/earnings of 27 times, an enterprise value/adjusted EBITDA multiple of approximately 19, and a free cash flow yield of 4%.

In aggregate, we project the firm's revenue growth to average 8% from 2022 to 2026 with revenue almost hitting $13 billion in 2026. We expect that 2022 will be even more of a retrenchment year for the console and PC platforms than we previously thought, as development teams at Blizzard focus on Overwatch 2 and

Diablo 4. These core franchise titles along with continued expansion in Call of Duty will drive 2022-26 growth of 9% for PC and 8% for console.

We expect continued strong growth on the mobile side of 10% annually from 2022-26 as the core mobile franchises like Candy Crush and its numerous spinoffs benefit from increased in-game monetization and improved ad pricing. The firm's strategy of creating mobile versions of the core franchises should continue to pay off with new mobile Call of Duty and Crash Bandicoot games already in development.

We envision operating margins dropping from 38% in 2021 to 32% in 2023 when we expect the firm will ramp up to support the launches of Diablo 4 and Overwatch 2. We project that the firm will return to the 38% level by 2026 as the secular trend toward more high-margin digital full-game sales and microtransactions will more than offset the diminishing contribution from the high-margin World of Warcraft game.

Risk and Uncertainty | by Neil Macker Updated Oct 31, 2022

The most visible and material risk, ESG or otherwise, for Activision Blizzard arises from the July 2021 workplace discrimination and harassment lawsuit filed by the California Department of Fair Employment and Housing. A November 2021 Wall Street Journal story also revealed that CEO Bobby Kotick knew about the previous allegations, protected executives from being fired or punished, and led the poorly received initial response to the lawsuit and accusations. Beyond the financial fallout and the forced turnover at senior executive and development levels, the company is at risk of losing employees and users in a very competitive market for both. If Kotick tries to hang on at all costs, significant value destruction could occur.

We have also examined other environmental, social, and governance, or ESG, risks for Activision Blizzard while examining the uncertainty rating. There are a couple of other potential areas to monitor, including human capital, governance, and data privacy and security.

Blizzard runs an online digital storefront along with servers for its PC titles. As a result, the firm captures and retains important data about its customers including credit card numbers, email, and mailing addresses. This data trove is a target for hackers. While Battle.net has not suffered a major hack since 2012, the possibility of an attack remains high. Additionally, the storing of personal data makes Activision subject to local regulations concerning data protection.

The focus on the core franchises could backfire if any of its six franchises fall out of favor with gamers. The annual release cycle of franchises such as Call of Duty could cause consumer fatigue and lower sales. We expect there could be a disproportionate impact on the bottom line if the company can't reinvigorate its WoW user base. Success attracts imitators, and the company must constantly fend off competitive attacks from industry rivals while also trying to develop new IP.

Capital Allocation | by Neil Macker Updated Oct 31, 2022

We assign Activision Blizzard an Exemplary capital allocation rating. Our rating is driven primarily by the likelihood that Activision adds value through investments but also considers the shape of its balance sheet and its shareholder distributions.

We view the balance sheet as sound. The company has $10.5 billion of cash and equivalents and $3.6 billion of long-term debt as of June 2022. The firm generated $2.3 billion in free cash flow in 2021 with average free cash flow of $2.1 billion over last three years. Given the cash position and the cash flow generation, we believe that the firm can issue a significant amount of debt in order to fund any potential acquisitions.

In terms of investments, we believe that Activision will remain active in the marketplace in the near future if the Microsoft deal falls through. The acquisitions will likely be on the smaller to medium end of the spectrum as the firm fills out its development capabilities. The company's last large-scale acquisition was the $5.9 billion purchase of King Digital, the mobile development company behind the wildly popular Candy Crush games. While we thought the capital could have been better allocated to organic growth, the acquisition has been a success as King has continued to capitalize on the Candy Crush franchise. Management's post-acquisition execution, while not flawless, was impressive as the mobile segment has been the fastest growing over the last four years.

Activision Blizzard has not repurchased a significant number of shares over the last five years, and the average diluted share count has actually risen from 739 million in 2015 to 778 million in 2020 due to employee stock options. While Activision does pay a small annual dividend, the yield has not been above 1% since 2015. As a result, we don't expect any substantial capital returns to shareholders over the next few years if the Microsoft deal is not consummated.