Buy Take-Two Interactive

David Gardner | November 25, 2015 | Buy Recommendation

CURRENT PRICE: TTWO $ 140.40 ↑ $ 0.53 (0.4%)

Here's some news that, a few years ago, would have seemed devastating to shareholders of **Take-Two Interactive** (NASDAQ: TTWO): The company probably won't release the next installment of its flagship video game, *Grand Theft Auto*, until 2018. Possibly not even until 2020.

But today's investors are just fine with that. The company that once gorged on *GTA* releases and tightened its belt in between now enjoys a balanced diet of hit franchises and online offerings that have helped stabilize — and grow — the revenue coming through the door. In fact, Take-Two now claims 11 franchises that have sold 5 million units or more, and 45 that have sold at least 2 million. Every one of those is a potential platform for growth. That means healthy sales even outside the holidays, and even in what used to be considered "off" years.

Eight years ago, I first recommended Take-Two Interactive as a promising turnaround story. These days, it's unlocked a big achievement in financial staying power, and its future is no less exciting. We're leveling up for our third recommendation and invite you to join the game yourself.

Start a New Game

Creating a grand, immersive AAA game — the video game industry's equivalent of a Hollywood blockbuster — takes multimillion-dollar budgets and years of development. Small companies don't have the finances or the bandwidth to develop too many titles at once, and a single commercial disappointment can pose an existential challenge.

Take-Two certainly isn't small anymore — most of its games come from two large labels (Rockstar Games and 2K) that work with numerous small studios, both internal and independent. But it's taken a long while for the company to grow large enough for management to pursue an ambitious two-pronged goal: Each year it will launch a major new piece of intellectual property that will hopefully become franchise-worthy, and it will release multiple titles from existing franchises.

Fulfilling that should make for an exciting 2016. Although Take-Two is typically tight-lipped about its pipeline — development schedules don't always proceed according to plan, after all — the company has announced the May 3 launch of *Battleborn*, a new property from the studio that made the hit *Borderlands* series. Meanwhile, *XCOM 2* is expected on Feb. 5 and *Mafia III* sometime before year's end. It also probably won't be too long before we see the next release in the *Red Dead* series, and we can eventually expect new *Bioshock* games, regular installments of popular sports titles like *NBA2K* and *WWE2K*, and more.

But gamers no longer need sit around and wait for the next big release. "Recurrent consumer spending" has become the watchword at Take-Two, and it's driven by things like downloadable content that builds on existing games, virtual currency, and — increasingly — online gaming. The most

WHAT IT DOES

Take-Two Interactive Software develops, publishes, and markets interactive entertainment for consumers worldwide.

WHY BUY

- Take-Two has moved beyond reliance on *Grand Theft Auto*, with 11 franchises that have produced unit sales of more than 5 million.
- The company has a large opportunity with online games that bring in recurrent revenue, and in the fast-growing Asian market.
- The company is attractively valued compared to peers.

KEY DATA

- **Headquarters:** New York, N.Y.
- **Website:** www.take2games.com
- **Sign of a Breaker:** Strong Consumer Appeal
- **Market Cap:** $3.0 billion
- **Cash/Debt:** $1.1 billion / $488 million
- **Revenue (TTM):** $1.5 billion
- **Earnings (TTM):** ($215 million)
- **Revenue (2013/'14/'15):** $1.2 billion / $2.4 billion / $1.1 billion
- **Earnings (2013/'14/'15):** ($30 million) / $362 million / ($280 million)
- **Recent Price:** $35.60

BUYER'S GUIDE

- **Industry:** Entertainment
- **Size:** Mid-Cap
- **Region:** Global
- **Risk:** 11 out of 25
- **Crushability:** Coconut
- **Most similar to:** AMC Networks, Starz

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Data as of Nov. 22, 2015

significant development is *Grand Theft Auto Online*, which launched shortly after *GTA V* two years ago and stands as a model for other franchises. While the company doesn't charge a subscription fee for this, it's both a vehicle to keep gamers engaged and a platform for regular installments of new content, which the company does charge for. This is a relatively new business for Take-Two, and it hasn't broken out much detail, but overall recurrent consumer spending was up 45% in fiscal 2015 (which ended March 31) and made up 18% of overall revenue. In the most recent quarter, it was up 39%, representing 20% of overall revenue.

Power Up on Cash Flow

Despite these steps to smooth out operations from year to year, Take-Two still sees volatile swings in sales and profits. The September 2013 launch of *GTA V* pushed revenue to $2.35 billion in fiscal 2014. Sales dropped off by more than half in fiscal 2015 before starting to climb again in the current fiscal year. The bottom line can be a little confusing, too, because the company capitalizes its massive development costs for games, then amortizes those costs over time. Reported earnings are thus almost invariably less than cash flow, and even in the years the company reports a loss, it's actually bringing in money. Yet cash flow in any given year won't necessarily give you a true picture of the cost of running the business.

But taken over time, Take-Two's free cash flow points to a very healthy — and undervalued — operation. Let's study the company's totals from the past five years (which is about how long it takes to get from one release to the next in a typical AAA series). Over that period, Take-Two generated $842 million — or an average of $168 million per year. The stock is trading at less than 18 times its average free cash flow from the past five years. For comparison, **Activision Blizzard** (NASDAQ: ATVI) trades at almost 24 times its average free cash flow from the last five years — admittedly a much less volatile figure from year to year — while **Electronic Arts** (NASDAQ: EA) trades at nearly 52 times this figure.

Five years from now, we expect Take-Two's average free cash flow to have increased substantially as new titles come on line and happy gamers boost their recurrent spending.

Winning a Boss Battle

It's instructive to recall that Electronic Arts aggressively tried to buy Take-Two for $2 billion back in early 2008. Take-Two is now worth 50% more than that, justifying our Rule Breaker's rejection of the deal (against the wishes of many shareholders). But while Take-Two is now a $3 billion business, its improvements since EA's offer point to a far greater increase in value.

For one thing, in the five years preceding EA's offer, Take-Two's average free cash flow was just barely positive, less than $2 million a year. Now the company is predictably, if not always evenly, bringing in significant amounts of cash, which it is employing not only to expand its business, but also to buy back shares. (Diluted share count, despite a large stock option grant in fiscal 2014, has grown by just 1.2% annually since 2008.) The company now has $1.06 billion in cash and investments, versus $280 million in 2008; long-term debt has grown, too, but not by as much. And it has more hit franchises that will spawn sequels as well as recurrent revenue, from a bigger portion of the globe.

To be clear, we're not looking for or expecting another takeover bid, but we think any company that wanted Take-Two would have to make an offer far above the current stock price. Management made the case that the company was worth more than $2 billion then; we think it is certainly worth more than $3 billion now.

Risks and When We'd Sell

Console games — that is, games for PlayStation, Xbox, and to a lesser extent the Wii — accounted for over 81% of Take-Two's revenue last year. PC games and "other" (like mobile) made up the rest. We're still relatively early in the current console cycle — sales of the PlayStation 4 and Xbox One continue to ramp, and there will be plenty of them under Christmas trees this year. But some analysts have argued that the console base is as big as it's ever going to get. The PlayStation 4 and Xbox One are on pace to sell about as well as the preceding generation, but not necessarily to overtake them, and next-gen systems are generally replacing or augmenting older ones. While the global game market is predicted to rise over 9% this year and to continue growing at a comparable pace for the next few years, the fastest growth is coming from mobile games (in terms of platform) and Asia (in terms of geography). Indeed, mobile game revenue is expected to eclipse console games for the first time this year.

That's a challenge for Take-Two. The company does make mobile games, but many of these are companions to its console titles. "There's no question that our DNA is big screens, robust engagement, and high processing power," Chairman and CEO Strauss Zelnick acknowledged last year. As the current console cycle matures, it's not clear what will come next, and Take-Two — like its competitors — will have to evolve. Meanwhile, the company does have a large presence in Asia, but much of its business is done through distributors. It could be more profitable by selling directly — something it is moving toward — but this does mean more risk.

For the time being, the biggest risk to Take-Two is the same as it has always been: It could sink a lot of money into a title, only to see it flop. But the company's track record gives us reason for optimism. While *Evolve* was regarded as a moderate disappointment, it's still sold more than 2 million units.

The Foolish Bottom Line

Zelnick famously *isn't* a gamer, and he's quick to admit that he stays completely out of creative decisions . But since he became CEO in 2011, the stock price has almost tripled, and the company's prospects look stronger than ever. Zelnick has stressed a focus on quality rather than quick turnover, as well as pursuing opportunities in recurrent online revenue and geographic expansion.

At the same time, Take-Two is open-minded about future growth paths. It is experimenting with virtual reality displays and 4K screens, but it isn't moving aggressively until the market is proven. After beta testing, it is also planning to launch a free-to-play version of *Civilization* in Asia this fiscal year, experimenting with a different business model (and one that Zelnick still views somewhat skeptically). This kind of considered approach to the business from top management, paired with a single-minded focus on making the best games possible from the creative teams, has made Take-Two one of just a handful of major players in an industry that is making an increasingly large footprint in the entertainment industry.

This Rule Breaker is not yet valued on par with its larger peers, but we think that — like the next release of *GTA* — it's coming eventually. Game on!

Karl Thiel contributed to this report.

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Aaron Bush owns shares of Activision Blizzard. David Gardner owns shares of Activision Blizzard. Simon Erickson owns shares of Activision Blizzard. The Motley Fool owns shares of Activision Blizzard and AMC Networks.