David's Re-Recommenda-tion: Activision Blizzard

David Gardner | December 19, 2014 | Buy Recommendation

CURRENT PRICE: ATVI $ 77.43 ↑ $ 1.31 (1.7%) [illegible]

It sounds like a great setup for a video game: An aging hero, leader of his realm, has lost the faith of his followers. Enemies and loyalists alike wonder if the old warrior can weather new challenges, much less emerge victorious. But he has plans to make himself anew and reimagine a sprawling empire as if he were founding a new republic.

Activision Blizzard (NASDAQ: ATVI) is just such a study in contradiction: The video game publisher has had a great year, with record adjusted sales and profits in the third quarter, yet analysts' view of the stock has barely budged. The stock has outperformed the S&P 500 index in 2014 (no small feat), yet it is off almost 20% since September. Its games are not among the best-reviewed this year, yet they top sales lists. It's the largest company in the industry, but it's newly independent and free to try new things.

That sets up something great for investors: a chance to grab a stock that is firing on all cylinders, has set itself up for better things ahead — and yet has confused Wall Street.

Under Siege?

Traditionally, Activision has had two pillars supporting revenue: *Call of Duty* and *World of Warcraft*. The former is a traditional console game with annual releases, plus expansion packs and handheld titles. The latter is a massively multiplayer online game supported by monthly subscriptions. Around these stars orbit a number of greater and lesser franchises and one-off titles for consoles, desktops, and mobile devices.

But are the pillars of this world imperiled? Subscribers to *World of Warcraft* have been falling since 2010, sending one of the company's anchors slowly sinking. And while a new release in the *Call of Duty* franchise is always a big event, some entries have gotten lukewarm critical reception. That was

What It Does

Activision Blizzard creates and sells interactive entertainment products, including *Call of Duty*, *World of Warcraft*, *Skylanders*, and others.

Why Buy

- The launch of *Destiny* promises a new tentpole franchise to compete with *Call of Duty* and *World of Warcraft*.
- Huge success of *Skylanders* and other titles further diversifying revenue stream.
- Now free of Vivendi's control, the company has more freedom to take risks and grow.

KEY FACTS

- **Headquarters:** Santa Monica, Calif.
- **Website:** www.activisionblizzard.com
- **Recent Price:** $19.38
- **Risk Rating:** 8 out of 25 — Marble
- **Position in Industry:** Leader
- **Market Cap:** $13,935
- **Cash/Debt:** $3,828 / $4,322
- **Revenue ('12/'13/TTM):** $4,856 / $4,583 / $4,351
- **Earnings ('12/'13/TTM):** $1,149 / $1,010 / $647

particularly true of last year's *Call of Duty: Ghosts* (a so-so rating around 73 on Metacritic across multiple consoles and platforms), although it nevertheless went on to sell over 19 million units.

So Activision countered with the September release of *Destiny*, a sci-fi "shared-world shooter" with multiplayer elements of *WoW* and *Call of Duty*-level ambitions. It debuted as the most successful new gaming franchise launch of all time — over $325 million in the first five days — but also some mediocre reviews (Metacritic gives the Xbox version of the game a 75 out of 100 rating and the PlayStation 4 version 76).

- **Insider Ownership:** 24.8%
- **Biggest Threat:** Gamers no longer heed the call of duty.

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Talk About ATVI

What reviewers didn't seem to appreciate is that *Destiny* is captivating players. By the end of September, sales had topped $500 million, and in the company's last conference call, management said 9.5 million registered users were, on average, spending over *three hours a day* playing the game — the kind of engagement that makes for a long-term success.

Nor is this the only new thing the company is trying. *Hearthstone*, a free-to-play game based on *WoW* characters, has grown to 20 million registered users since its launch this year. The *Skylanders* franchise, meanwhile, has struck a chord with kids and critics since its debut in 2011. The ability to "teleport" action figures into a game (and, with this year's *Trap Team* installment, to also capture characters from the game within a toy and use them as playable characters even on other consoles) was innovative, and has companies like *Stock Advisor*'s own **Disney** (NYSE: DIS) and **Hasbro** (NASDAQ: HAS) scrambling to catch up. Franchise sales surpassed $2 billion this year, even before the Oct. 5 launch of *Trap Team*, and toy sales had passed 200 million as of the third quarter.

This Tent Has Poles

Meanwhile, the foundations of the old empire are stronger than some thought, and rumors of *WoW*'s demise are greatly exaggerated. True, after peaking at 12 million subscribers in 2010, we witnessed a more or less steady decline, down to 6.8 million in the second quarter. That's why investors were excited when they heard that subscribers jumped in the third quarter to 7.4 million, driven by anticipation for the launch of *Warlords of Draenor*, the fifth expansion of the game. But anticipation was nothing compared with what happened as the launch actually began Nov. 13: Subscribers have leaped north of 10 million, an increase of more than 35% in a matter of weeks and a level not seen since 2012. *Draenor* has already revitalized the game.

And this year's *Call of Duty* installment, *Advanced Warfare*, has been much better received than its predecessor since its Nov. 4 launch. So far, Activision has been cagey about sales numbers, but has noted that first week sales exceeded those for *Ghosts* and that it was the biggest entertainment launch of the year by gross sales, exceeding all other games, films, music, and books, predictably making it the No. 1 console game of 2014.

Conquering the Next Level

All this adds up to what Activision expects to be record adjusted earnings for 2014. And we expect it to get even better in 2015, as even more gamers buy PS4s and Xbox Ones — and more games to go with them.

As it is, the stock is trading at less than 15 times management's guidance for 2014 adjusted earnings. While we don't always embrace figures that don't follow generally accepted accounting principles (GAAP), in Activision's case those numbers are probably the most meaningful to the majority of investors. When somebody buys a copy of, say, *Destiny*, most investors would think of that as a completed sale. But under accounting rules, the company doesn't immediately recognize the revenue from a game sale if there is an online service component to it — as there is for many games these days. That's one of the main reasons Activision generally has much stronger cash flow than earnings, even after you factor back in the amortized costs of software development.

After spending the better part of four years moving sideways, Activision's stock finally began an upward run in 2013 as investors applauded, among other things, CEO Bobby Kotick's decision to buy out most of French media conglomerate Vivendi's stake in the company. Vivendi was saddled with debt problems, sparking concerns it could raid Activision's profits to keep itself afloat. While the deal was controversial, Kotick and Chairman Brian Kelly's large stake in Activision (they control a limited partnership with other investors that owns nearly 25% of the company) aligns their interests with ours. It certainly would have been difficult for the company to gamble $500 million on *Destiny* (the most ever spent on developing a game) with Vivendi in charge. And we're only beginning to see the fruits that the company's newfound freedom will bring to gamers and investors alike. I think this run is far from done.

Risks And When We'd Sell

Even with the recent uptick in subscribers, *WoW*'s best days are likely behind it. And while every *Call of Duty* release is predictably a huge event, the company hasn't managed to build on the success of its best-selling title in the series, *Call of Duty: Modern Warfare 3*, released in 2011. The company's uncharacteristic vagueness about sales of *Advanced Warfare* has raised concerns, and some analysts are suggesting the title will end up underselling *Ghosts*. While the *Call of Duty* franchise clearly has plenty of life left, significant growth for the company will have to come from new titles. Early signs from *Destiny* are encouraging, and *Skylanders* is a huge hit, but if engagement falls, the company could find itself relying on two aging franchises that are no longer growing.

The Foolish Bottom Line

You probably know I'm an avid gamer, as are many Fools here at HQ. So I've spent plenty of time, um, studying Activision's catalog. While many analysts are focused on mixed signs from its two anchors, I see a company that has become more innovative in more recent years and more determined than ever to make *Call of Duty* and *WoW* just two more great titles in a rich library. With the company now maneuvering free of the control of Vivendi and gamers freshly into the latest generation of consoles, I think the best is still ahead.

Karl Thiel contributed to this report.

[David Gardner](#) owns shares of Activision Blizzard and Walt Disney. [Jim Mueller](#) owns shares of Activision Blizzard. [Jim Mueller](#) has the following options: long January 2016 $57.5 calls on Walt Disney and short April 2015 $95 calls on Walt Disney. [Karl Thiel](#) owns shares of Hasbro. [Sara Hov](#) owns shares of Walt Disney. The Motley Fool owns shares of Activision Blizzard, Hasbro, and Walt Disney.

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