Activision Blizzard

David Gardner and Karl Thiel | September 19, 2008

Put down your plastic Les Paul guitar and come walk with me down memory lane ... all the way back to September 2002, when I first recommended what was then the world's No. 2 video game maker. At the time, Activision was milking a lean pipeline, relying heavily on its *Tony Hawk* franchise and the PC-only *Doom 3* (remember the days of wasting a whole afternoon to download a video game?). It was trading at a split-adjusted $3.48 per share.

Just three months later, management reversed its guidance and forecasted a fourth-quarter loss, and the stock was cut in half. I came back to these pages in March 2003, knowing I was taking a risk on a losing position, and recommended a second stake in Activision at a split-adjusted $1.79 per share. I was counting on the company's strong balance sheet, record of innovation, and keystone position in a burgeoning industry to drive future profits. "I think this stock beats the market over the next three to five years," I wrote.

Now more than five years out, I'm willing to double down on my original forecast. **Activision Blizzard** (NASDAQ: ATVI) hasn't looked back since I wrote those words (more on the "Blizzard" bit later), and this summer it became *Stock Advisor* 's second 10-bagger, following in the footsteps of wunderkind **Marvel** (NYSE: DIS). The company still has a whirlwind of profits to come, so for those of you who have yet to get on aboard, now's your chance -- this Blizzard's on fire.

Rocking Out to Profits

While *Tony Hawk* still brings in the bucks, and the fifth installment of the incredible *Call of Duty* franchise will be released soon, it was the November 2005 release of *Guitar Hero* that really changed the game for Activision. Sure, the title sold an impressive 21 million units worldwide, but it's the add-ons that make this platform downright brilliant: guitar-shaped controllers, plus an unlimited potential for expansion packs, song downloads, new versions, and other ways to keep the fans happy and the money rolling in.

WHY BUY?

- The recent merger meshes Activision's dominant franchises with Vivendi's online gaming expertise.
- *Guitar Hero: World Tour* and other sequels will be enormous cash cows.
- Expectations built into the current stock price vastly underestimate the company's earnings power.

WHAT IT DOES

Activision Blizzard is the world's largest entertainment software developer.

KEY COMPANY DATA

- **Headquarters**: Santa Monica, Calif.
- **Website**: www.activisionblizzard.com
- **Recent Price**: $16.57
- **Position in Industry**: Juggernaut
- **Revenue** (TTM/07/06)*: $3,057/$1,513/$1,468
- **Earnings** (TTM/07/06)*: $376/$86/$40
- **Insider Ownership**: 4%
- **Biggest Threat**: Merger malaise
- **The Team Says**: Blizzard rocks
- Discuss Activision Blizzard here.

Market Cap*: $22,100

Risk Level Rating: High

And then there's *Guitar Hero: World Tour*. Set to launch Oct. 27, this one is going to be huge. *Huge*. The game will feature multiple instruments (mic-, drum-, and keyboard-shaped; ukelele TBD), making it more competitive with **Electronic Arts** ' (NASDAQ: EA) rival game *Rock Band*, and players will be able to create their own original songs and share them with other gamers, opening up the platform to a wealth of creative directions.

Cash/Debt*: $1,253/$0

Data as of 9/16/08
Note: Figures are for Activision only. *In millions.

Blizzard Blows In

When Activision merged with Vivendi's Blizzard gaming division in July, it became the world's No. 1 video game maker. Blizzard carries the successful *Diablo* and *StarCraft* franchises as well as the wildly popular *World of Warcraft*, whose subscribers grew from 1.8 million to 10.9 million strong in the 12 months that ended June 30. *Warcraft* has the benefit of being a subscription-based model, which should help free Activision from the relentless seasonality that plagues most game companies. In addition, the combined forces of the two companies will boost overseas sales, as *Warcraft* is primarily an Asian phenomenon, while 80% of *Guitar Hero* sales occur in the United States -- so both are ripe for expansion.

But now that it's worth $22 billion, can Activision continue to handsomely reward shareholders? Absolutely. Its operating margin as a stand-alone company has set the pace for the industry -- it was a little more than 12% for the traditionally slow June quarter, Activision's last full quarter as an independent company. That's certainly better than EA's negative margin for the same period (there's that pesky seasonality for you). But Blizzard's operating margin is even more impressive -- about 40%, a reflection of its online subscription model. Increased efficiency and new opportunities such as downloadable content and in-game advertising will drive the combined company's operating margin to new heights -- management's goal is 25%. With sales headed north of $3 billion this year, that's a lot of income. Plus, cash flow is typically much stronger than reported income -- the company writes down the value of old titles that may have a lot of life left. So we'll have to see actual combined results from the companies before we can create a meaningful valuation. And there's the rub.

Split Storm

Expect the next two quarters to be atypical as the company condenses and generates one-time expenses associated with the merger. The company reported in July that it expects to earn an adjusted $0.72 per share in the second half of the year. Combined with Activision's previous two quarters, that brings earnings per share (EPS) to $1.09 for the year. However, because there was yet another 2:1 stock split effective Sept. 8, we need to cut those estimates in half while recognizing that they combine Activision's stand-alone results through July 9 with Activision Blizzard's results thereafter.

Confused yet? A lot of investors are, and they're hanging back to see what the combined results look like. But their hesitation is our opportunity. Let's instead look ahead to 2009, when analysts willing to hazard a guess are expecting EPS in the neighborhood of $0.72 to $0.80. The midpoint of that range gives the company a forward price-to-earnings ratio of roughly 23, which -- given the strong growth and powerful cash flow I expect -- is an enticing valuation. Don't know about you, but I don't want to wait for everyone else to puzzle out all the moving parts.

Three-Chord Symphony

Bad news isn't the only thing that comes in threes. Opportunity can, too. I predict that the third recommendation will be yet another charm with Activision, now a very different company than it was the last time it was added to the *SA* scorecard. Hot new releases in the top-selling *Guitar Hero* franchise will strike a chord with shoppers this holiday season, while new titles, additional revenue opportunities, merger boons, and Blizzard's superior margins will set the newly combined company on the path to a fast-swelling bottom line. Score some shares today.

Important Reminder! Access all of David Gardner's top stock recommendations