

# Take-Two Interactive

David Gardner | September 19, 2007

CURRENT PRICE: [TTWO](#) \$ 140.40 \$ 0.53 (0.4%) C<sup>ó</sup>ng ty B<sup>á</sup>n K<sup>inh</sup> doanh v<sup>i</sup>n h<sup>àng</sup>

## Take-Two Interactive

- New management is turning around troubled game maker.
- Potential new blockbuster title joins top-selling Grand Theft Auto franchise in strong library.
- Attractive valuation offers opportunity for higher rewards.
- Nasdaq: TTWO
- [www.take2games.com](http://www.take2games.com)
- Ph: 646-536-2842

Recent Price: \$11.82-\$24.80

Peter Lynch always recommended looking close to home for great investment ideas -- in the stores you shop, the products you buy, and the services you use.

On that score, I come by this month's recommendation with the enthusiasm of a true fan. I'm an avid gamer, owning pretty much every Nintendo, Xbox, and PlayStation platform ever made. So I've been familiar with **Take-Two Interactive** ([NASDAQ: TTWO](#)) for a long time. The creator of the platinum-selling and sometimes controversial *Grand Theft Auto* franchise has moved millions of games since its founding in 1993.

It's also a company that has sometimes shown a little too much similarity to the seedy characters in that flagship game. The stock has been cut almost in half since 2005, thanks to flagging sales, stock options backdating, an SEC investigation, product delays, parental ratings problems, and even an expensive misstep involving hidden sexually themed minigames. Activist investors have been in the news lately, and in this case a revolt was well overdue. At the annual meeting in March, shareholders swept in a new board of directors, who then replaced the management team. That leaves Take-Two relatively early in its turnaround -- a fact the stock price still reflects.

## A Whole New Game

The new chairman is Strauss Zelnick, who has a successful track record of corporate turnarounds in the entertainment sector, including at BMG Entertainment and Time Life, although his brief foray into video gaming, Crystal Dynamics, was not a rousing success. One of his partners, Ben Feder, serves as interim CEO while the search for a permanent replacement continues. Zelnick brings some needed skills and experience, though the new management could represent a vast improvement even without being particularly good.

My interest in Take-Two isn't just about management turnover. The company has long been characterized as a one-trick pony, with *Grand Theft Auto* overshadowing everything else. That's really not true -- *GTA* games accounted for only 20% of revenue last year. Popular titles such as *Manhunt*, *Civilization*, *Bully*, and *The Elder Scrolls*, plus a full sports catalog through the 2K brand, round out a library that spans the spectrum of popular culture.

The most important upgrade to the catalog came last month with the launch of *Bioshock*. I think this first-person shooter will be a blockbuster game (it's already shipped more than 1.5 million copies) and could be the start of a whole new franchise for Take-Two that rivals *GTA* -- which, by the way, is still going strong. Take a look at a 10-year chart and you'll see a rocky climb that made Take-Two close to a 10-bagger between the introduction of the original *Grand Theft Auto* in 1998 and when federal investigators started looking into stock options backdating in 2005. If *Bioshock* can work just a little of that magic for Take-Two, we'll be in very good shape.

## The Financial Story

So how does this company look today? Sales, always lumpy in the past because Take-Two relied on relatively few titles, have fallen the past several years. The company swung to a loss in 2006 and will be in the red again this year. Combine that with problems the old management team left behind, and it's not a pretty picture.

But here's a little secret that many investors don't know about the gaming industry: It tends to produce better cash flow than earnings. That's because a lot of the expense that goes into software development gets amortized and taken off the bottom line, while the assets those expenditures produce -- the games -- tend to have very long lives. I'm not just talking about sequels but also reissues of old titles for new platforms. So while Take-Two lost money last year, it actually had positive free cash flow. And depending on how you calculate it, free cash flow will likely be positive this year, too.

However, that's even not my main case for Take-Two. More simply, I think the company has a long way to come up against its rivals and a high "wall of worry" to climb as it gets out from under its admittedly substantial problems. It has an enterprise value (EV) only about 1.2 times its past 12 months of sales. Compare that with my *Stock Advisor* selections **Activision** ([NASDAQ: ATVI](#)), with an EV-to-sales multiple of more than 2.6, and **Electronic Arts** (Nasdaq: ERTS), with more than 4.5 times EV-to-sales.

Electronic Arts and Activision command significant premiums for their rosters of titles, while the market seems to neglect the value of Take-Two's offerings beyond *GTA*. Take-Two picked up Firaxis in 2005, including Sid Meier's hugely popular brand of games, giving it a lot more to offer. Greater still is a recent partnership with Nickelodeon to develop kid-friendly games, starting with *Dora the Explorer and Go, Diego, Go!* You can see a trend building here.

Activision sports a trailing price-to-earnings ratio of 44 and a market cap of \$5.7 billion on a small yet explosive game library. Compare that against Take-Two's market cap of \$1.2 billion and a considerably larger portfolio, and you can see why there's growth painted all over this stock.

I believe Take-Two can double merely from Wall Street regaining confidence that management will milk some value from the company's assets. Actually proving that *Bioshock*, *GTA*, and other titles can help the company do better than analysts' estimated 15% annual growth rate for the next five years could make this investment a multibagger.

Scroll left/right to view wide tables

<b>Financial Snapshot</b>			
(Dollar amounts in millions except earnings per share.)			
	<b>2005</b>	<b>2006</b>	<b>TTM</b>
Revenue	\$1,201.2	\$1,037.8	\$955.7
Growth Rate	6.5%	(13.6%)	(11.3%)
Net Income	\$35.3	(\$184.9)	(\$145.4)
Diluted EPS	\$0.50	(\$2.60)	(\$2.03)
Market Cap			\$1,226.8

Source: *Capital IQ*.

## Up to the Challenge

The new management team has its work cut out for it. After pleading guilty to falsifying records relating to stock option grants, founder and former chairman and CEO Ryan Brant left Take-Two with a lot of problems. The SEC is still investigating and recently said it intends to file civil charges. Lawsuits from shareholders and others loom on the horizon as well. Take-Two will almost certainly end up paying substantial fines to settle these issues. Read through the recent 10-K and 10-Q filings for even more details.

The jury is still out -- figuratively, in this case -- on how effective the new team will be at turning things around and how long that will take. Already, the company was forced to delay *Grand Theft Auto IV* past the critical holiday season and into 2008. There's no doubt in my mind that it will be a big hit, and I'm also counting on a substantial boost from *Bioshock*, which is already drawing early critical buzz, though it's early in the game for predictions.

I love video games, but something I like even more is a little action game called "short squeeze." An astounding 35% of Take-Two's shares are sold short. I think those shorts will be forced to cover before *GTA IV* hits the shelves.

## Foolish Bottom Line

This is a turnaround story rated M for mature -- that is, it's riskier than the larger game companies I've recommended to my *Stock Advisor* readers. But with that risk comes the much higher potential rewards befitting a Rule Breaker.

Take-Two has a growing portfolio and open roads for improvement ahead of it. Our bruised and bloodied hero has a fast car and a new attitude: This game isn't over.

*David owns shares of Activision and Electronic Arts.*

*For more, join us on the [RBS: Take-Two Interactive](#) discussion board.*



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