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Game on!

Evan Lorenz writes:

Just imagine if Walt Disney Co. managed the Mario Brothers franchise. The animated mascots would probably be jumping out of game cartridges, starring in movies and dancing in theme parks. While Disney has nothing to do with Mario and Luigi, the income stream we imagine very nearly does exist—and without Disney's exposure to secularly declining broadcast TV. In preview, *Grant's* is bullish on Nintendo Co., Ltd., the Kyoto-based multinational game company (7974 on the Tokyo Stock Exchange; NTDOY for the American depository receipt).

"To put smiles on the faces of everyone we touch by creating new surprises for people across the world," is the official Nintendo mission. Smiles should accordingly wreath the faces of the investors it touches now that management is monetizing its backlog of intellectual property, making movies and belatedly joining the profitable rush to online game sales (as opposed to the brick-and-mortar kind). That Nintendo shares are as cheap as they are suggests that not a few of these smiles are forced.

The customers, at least, seem to be having a good time. Best-selling games and innovative hardware designs—the flagship Switch console can be lifted out of its cradle and used as a mobile gaming device—are the company's stock-in-trade. Donkey Kong (first introduced in 1981), Super Mario Bros. (1985), The Legend of Zelda (1986), Super Smash Bros. (1999) and Animal Crossing (2001) are among its megahits of years gone by. Pokémon Co., which produces games, TV shows and movies

based on its iconic "pocket monsters," is 32%-owned by Nintendo.

In the 12 months ended Sept. 30, video-game and console sales made up 96.8% of the Nintendo top line, followed by smartphone games and royalty income (3%) and legacy playing cards (0.2%). By geography, Nintendo sells more in the Americas (43.4% of trailing sales) and Europe (24.5%) than in Japan (22.1%).

Competing with Nintendo for its customers' finite attention span are Microsoft Corp.'s Xbox, Sony Group Corp.'s PlayStation, personal computers, mobile phones and even—yes, as a last resort—human interaction. Covid-19, by curtailing that interaction, did Nintendo a favor and helped lift

fiscal-year 2021 sales by 34%. Especially well-timed was the March 20, 2020 debut of Animal Crossing: New Horizons, whose locked-down players could escape to their own virtual island paradise. The game struck a pandemic chord and has sold 40.2 million units.

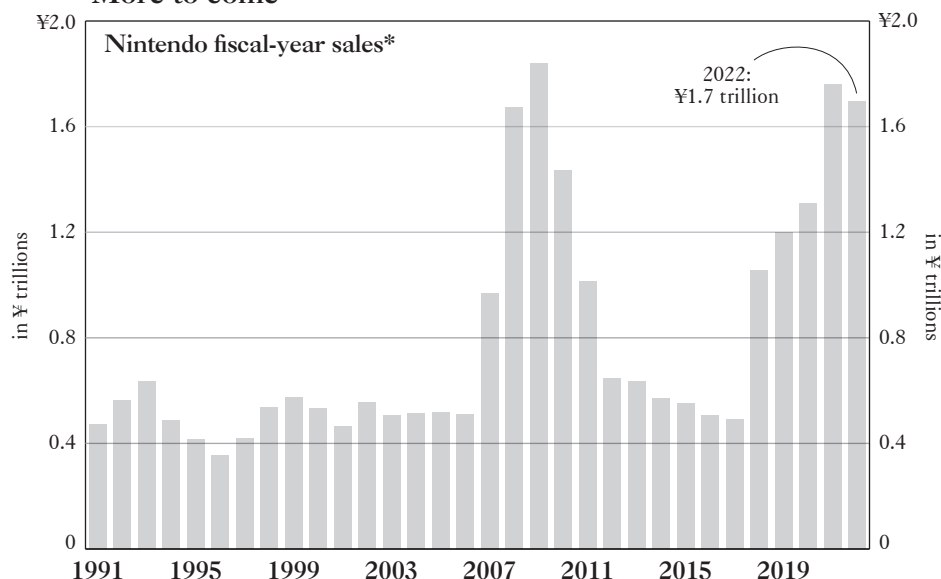
"Cyclical" and "risky" are perennial descriptors of the video-game market, but Nintendo knew their meaning even before the gaming era began. With its legacy playing-card business threatened by pachinko, bowling and other mid-20th-century pastimes, the company looked for something else to do. The 1973 invention of the Laser Clay Shooting System (anticipating the hit game Duck Hunt, but with players shooting targets whizzing by on

Cheap at the price



source: The Bloomberg

More to come



* Fiscal year ends March 31.

source: The Bloomberg

film projectors rather than a TV) was the answer. The Color TV-Game, Nintendo's first home video-game system, came four years later, followed by the Famicom (1983) and the Nintendo Entertainment System (1985).

A typical game console enjoys five to seven years of commercial life before giving way to something better. For a manufacturer like Nintendo, the trick is upgrading the obsolete console while retaining the economic value of the still-viable software inside the box.

It's not an easy transition. Following the success of the Wii, which debuted in 2006 and sold a cumulative 101.6 million units, Nintendo released the Wii U in 2012. Sales collapsed by 73% between fiscal years 2009 and 2017. It was a catastrophe.

Fortunately for Nintendo, the hybrid Switch, launched in 2017, has proven a runaway success with cumulative unit sales of 114.3 million through Sept. 30 (compared with 13.6 million for the Wii U). Unfortunately for Nintendo's investors, the Switch is showing its age against the latest PlayStation 5 and the Xbox Series X and S (all released in 2020). Given the volatility of past console launches, there can be no guarantee that Nintendo's next best thing will fare as well as its current hit.

Perhaps because of these concerns, Nintendo trades at 12.6 times trailing earnings. It's a discount not only to the

S&P 500 multiple of 19.1 times, but also to the 13.7 multiple that the Tokyo Stock Price Index commands. Cash and investment securities amount to a whopping ¥2.1 trillion, or \$15.7 billion, a material figure relative to the \$54.7 billion market cap. Adjusting for that thick cushion of liquidity (something that many a leverage-tolerant American might do, and many a prudent Japanese might not do), the shares trade at 10 times trailing earnings.

Analysts covering Nintendo say "buy" as opposed to "sell" at a ratio of 17:2, but the bulls hold no great expect-

tations for Team Mario. Between fiscal years 2022 and 2026, the consensus estimates, revenues will drop by 11% and earnings per share by 29%.

The problem with that outlook is its incoherence, contends Dan McMurtrie, CEO and founder of Tyro Partners, LLC, which holds a long position in Nintendo. "If you were bearish and wanted to make a call that Nintendo was going to release a completely new hardware system and it would be a flop, well, your projections would not be for steadily declining revenue over the next five years," he tells me. "You would expect it to look like a plane that had its wings blown off."

Assuming that Nintendo does not spoil its next console release (see below) or fails to fix the un-Nintendo-like graphical glitches that marred last month's release of the highly anticipated game duo Pokémon Scarlet and Pokémon Violet, a margin-fattening merchandising trend is waiting to be exploited—indeed, has been waiting and waiting to be exploited. While more than 80% of Xbox and PlayStation games sales occur online, only 38.5% of Nintendo's sales in fiscal 2022 were so sourced, the balance taking place in stores.

A consumer pays the identical \$59.99 a copy for Pokémon Scarlet whether from Walmart or the online Nintendo Store, but the economic difference between the two transactions is night and day for mothership Mario. Retailers typically demand 30% gross margins, which means that Nintendo receives \$41.99 for a sale made through

Nintendo at a glance

all figures in JPY billions except per share data

	<u>TTM*</u>	<u>FY22**</u>	<u>FY21</u>	<u>FY20</u>	<u>FY19</u>
sales	¥1,728.0	¥1,695.3	¥1,758.9	¥1,308.5	¥1,200.6
operating income	593.2	592.8	640.6	352.4	249.7
net income	536.3	477.7	480.4	258.6	194.0
earnings per share	458.3	404.7	403.3	217.1	161.6
shares outstanding	1,164.2	1,180.4	1,191.2	1,191.2	1,200.9
cash	1,214.3	1,206.5	1,185.2	890.4	844.6
securities	929.6	817.0	772.1	564.1	405.5
total assets	2,781.2	2,662.4	2,446.9	1,934.1	1,690.3

* For the 12 months ended Sept. 30, 2022.

** Fiscal year ends March 31.

sources: company reports, the Bloomberg

Walmart. Compare and contrast the full \$59.99 it receives for a digital download.

Fatter digital margins can be said to afford some recession protection, too. "If the digital mix increases from 50% to 80%," Benjamin Herrick, an associate portfolio manager at Artisan Partners, L.P., which is long Nintendo, points out, "gross profit per software unit goes up by nearly 25%."

As it is, sales are down meaningfully from their Covid-19 high-water mark, but the collapse in the yen exchange rate obscures the magnitude of the shift. In local-currency terms, trailing 12-month sales through September are lower by just 1.8% from the fiscal year ended March 31, 2021 and remain 32% above the fiscal 2020 level. Note, however, that 78% of sales originate outside Japan. In dollar terms, then, trailing revenue is lower by 15.8% from the fiscal 2021 peak and ahead by only 16% from fiscal 2020.

In the past, games designed for a new console didn't work with legacy systems, so the launch date of a new device tended to coincide with a software sales cliff.

Sony and Microsoft solved the problem by making new games compatible with the previous generation of consoles. Today, you can play Sony's new hit *God of War Ragnarök* on either the PlayStation 4 or 5. Online accounts keep track of users' digital downloads and saved files, which means that game libraries and in-game statuses are seamlessly transferred from the older devices to the new. As a bonus, Sony and Microsoft charge for opening an account, which, depending on the tier of service, also gives a user access to online game playing, expansion packs and backlogs of older games.

Nintendo is signaling that it intends to follow the competition's example. "[W]e will continue to use [the] Nintendo Account as a foundation, so the various user experiences of our core integrated hardware-software entertainment continue across platform generations," Nintendo's president Shuntaro Furukawa said in his prepared remarks in the Nov. 8 earnings release.

"Nintendo Switch online has 36 million subscribers," observes Benjamin Singer-Scott, a research analyst at Artisan Partners. "It's about a third of their user base. And this business generates 13% of total software sales or 7% of to-

tal revenue. If you look at Sony, their network services generate 26% of total software and services revenue. So 26% compared to 13%: The key difference is that Sony has a much higher average revenue per user, about \$60 or \$70."

Nintendo has two annual membership packages: a basic \$19.99 game-play offering and a premium \$49.99 subscription, which includes access to game expansion packs and legacy games. "So if you assume that Nintendo's average revenue per user on their online services goes from today's \$18 level to something like \$30," Singer-Scott adds, "again, still about half of what Sony is able to do, that would generate another 10% of earnings."

There's a chance that Nintendo's next console launch will prove less fraught than previous ones, because the good old Switch has legs. Two new versions of that breakthrough console, the Switch Lite (2019, a mobile-only variant) and an OLED model (2021, a unit with an upgraded display), are already on the market. Other competitors, such as Valve Corp. with its Steam Deck, have copied Switch's basic design features.

The current Switch is capable of 1,080p resolution when plugged into a TV set. In a Sept. 30, 2021 dispatch, Bloomberg reported that Nintendo had given software developers Switch kits capable of 4K resolution, a bump in graphics that would make Nintendo competitive with Sony's and Microsoft's current offerings.

Nintendo last month reduced its projections for Switch console sales in the fiscal year ending March 31, 2023 to 19 million units from 21 million. Speculation has it that, while the front office withheld the release of a more powerful Switch last year on account of supply-chain snarls, an upgrade is on tap for next year. An iteration of the current Switch design, rather than a brand new prototype, would reduce the risk of a flop.

Beyond the earnings potential in the core video-game franchise, management is working to monetize its substantial portfolio of intellectual property. Who remembers today the 1983 lawsuit in which Universal City Studios charged Nintendo's Donkey Kong with infringing on Universal's King Kong? Nintendo prevailed, the Kongs kissed and made up and today Super Mario cavorts at Universal Studios theme parks.

The first Super Nintendo World park, mixing familiar rides with augmented reality beamed through special headsets, opened in Osaka last year. "It's difficult to define the feelings of nostalgia, celebration and joy I felt at Super Nintendo World," raved a March 23, 2021 reviewer on game site IGN.

Nintendo and Comcast are currently building Nintendo Worlds in Hollywood, Orlando and Singapore. "Your kids, if not you, are going to absolutely love it," Comcast CEO Brian Roberts said at the Sept. 14 Goldman Sachs Communicopia and Technology Conference in San Francisco. "It's a first of its kind in the world, [what] we've done in Osaka with augmented-reality glasses. You're riding along. You're seeing something no one else is seeing. You're playing the game.... There's one other company, Disney, that has a fabulous parks business. We're gaining share."

Coming next April is *The Super Mario Bros. Movie*, a creation of Illumination, the red-hot film studio behind such lucrative franchises as *Despicable Me*, *Minions*, *The Secret Lives of Pets* and *Sing*. To date, Illumination has produced 12 features with an average box-office draw of \$695.4 million on budgets averaging around \$70 million. It's a far cry from Nintendo's first foray into movie-making, a 1993 bomb that grossed \$38.9 million, which happened to be a few million less than it cost. All the better, then, that Illumination founder and CEO Christopher Meledandri sits on the Nintendo board. Other Nintendo properties, such as *The Legend of Zelda*, are said to be prime targets for movie adaptations.

On Oct. 3, Nintendo purchased Dynamo Pictures, Inc., a Japanese animation studio. Renamed Nintendo Pictures, the unit has already animated short films based on Nintendo's Pikmin real-time strategy and puzzle games. The move may presage TV series based on Nintendo's video-game catalog.

Further to pleasing the investors, Nintendo repurchased ¥50.7 billion's worth of shares in the first half of fiscal 2023 and ¥95.4 billion's worth in fiscal year 2022, compared with no buybacks in either of the prior two years. Nintendo yields 3%, in conformity with company policy of distributing 33% of net income in dividends.

A 10-for-1 stock split on Oct. 1 may

require a few words of explanation. To start with, the minimum trading limit in Japan is 100 shares. At the current share price, \$4,199.83 buys you an ownership stake in Nintendo, a more accessible proposition than the \$41,998.25 that would have been required pre-split.

“Since around 2014, we have been

conducting business to expand the number of people who have access to Nintendo IP,” said Shigeru Miyamoto, board member, former Nintendo general manager and the creator of Mario, Donkey Kong, and The Legend of Zelda, among other titles, in the Q&A following the latest earnings release. “Nintendo has transitioned from

a maker of hanafuda playing cards to a maker of Western playing cards to a video-game company, but an important aspect throughout these changes is that Nintendo has held many characters and IP of its own. I like to think of Nintendo as an entertainment agency full of world-class talent.”

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