Electronic Arts (NASDAQ: EA)

Robert Wang, Max Alweiss, Haruhiko Ito, Kerim Saraoglu

Agenda

- EA: Basic Financials
- Video Game Software Publishing Industry
- Company Overview
- Thesis
- Excessive Pullback = Buying Opportunity
- Catalysts
- Financials
- Valuation
- Summary

EA: Basic Financials

- Share price (11/11/18): $87.66
- Market cap: $26.49B
- P/E ratio (TTM): 27.33x
- EV/EBITDA: 16.96x
- 5-year average ROE: 23.7%
- Interest coverage ratio (EBITDA/cash interest): 32.95x
- Net debt/EBITDA: N/A – EA carries net cash on its B/S

Financial data taken from FactSet.

1-Year Performance

Source: TradingView

Video Game Software Publishing Industry: Overview

- Video game software publisher – company that develops, markets, publishes, and/or distributes video games that can be played on consoles, PCs, smartphones, and tablets
- Three main players in U.S.: (1) Electronic Arts (EA), (2) Activision Blizzard (ATVI), & (3) Take-Two Interactive (TTWO)
- Other players: Bethesda Softworks LLC, Epic Games, Sony (SNE), and Microsoft (MSFT)
- Sales channels: (1) physical, e.g. mass market retailers, electronics specialty stores, game software specialty stores and (2) digital, e.g. PlayStation™ Store, Microsoft Store, Google Play, Apple App Store

Key Players (Comparative Analysis)

	P/E	Debt/Equity	Market Cap	Ebita Growth	Sales Growth
Activision Blizzard (ATVI)	73.06	0.2505	41.18B	7.01%	7.64%
Tencent Holdings (TCEHY)	26.18	0.57	320.83B	43%	38.40%
Take-two Interactive (TTWO)	58.94	0	12.42B	3.08%	8.11%
Electronic Arts (EA)	28.09	0.1868	26.48B	30.37%	6.29%

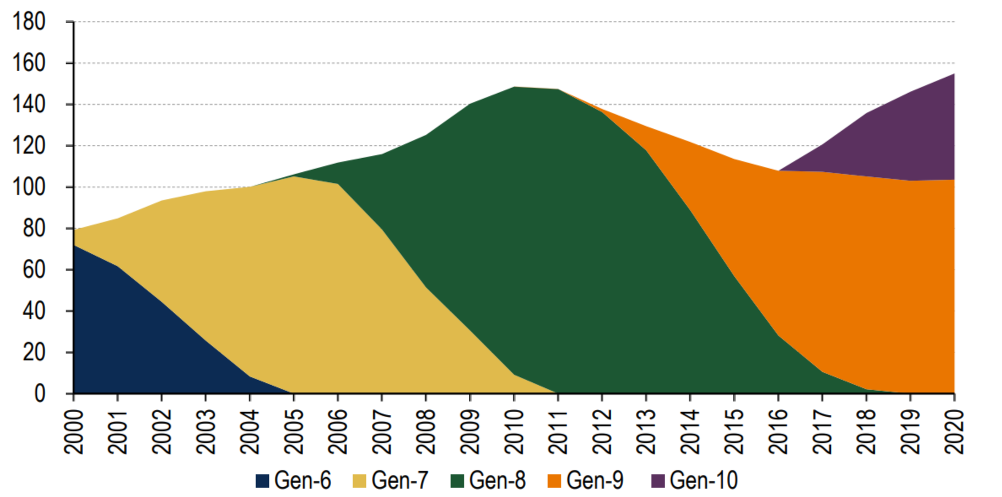
* EDITDA and sales growth represent 5-year CAGRs

- Main takeaways: Steady growth and low leverage
- EA boasts lowest P/E ratio of pure-play peers (i.e. ATVI and TTWO)
- All of these companies are down substantially over past few months

Video Game Software Publishing Industry: Old Model

- Performance of any game dependent on technical capabilities & computing power of its underlying platform (i.e. gaming console)
- When majority of software publishing sales were derived from packaged goods (physical media), industry operated under a purely "hit-driven," cyclical model
- Volatile/lumpy revenues driven by upfront purchases of popular titles

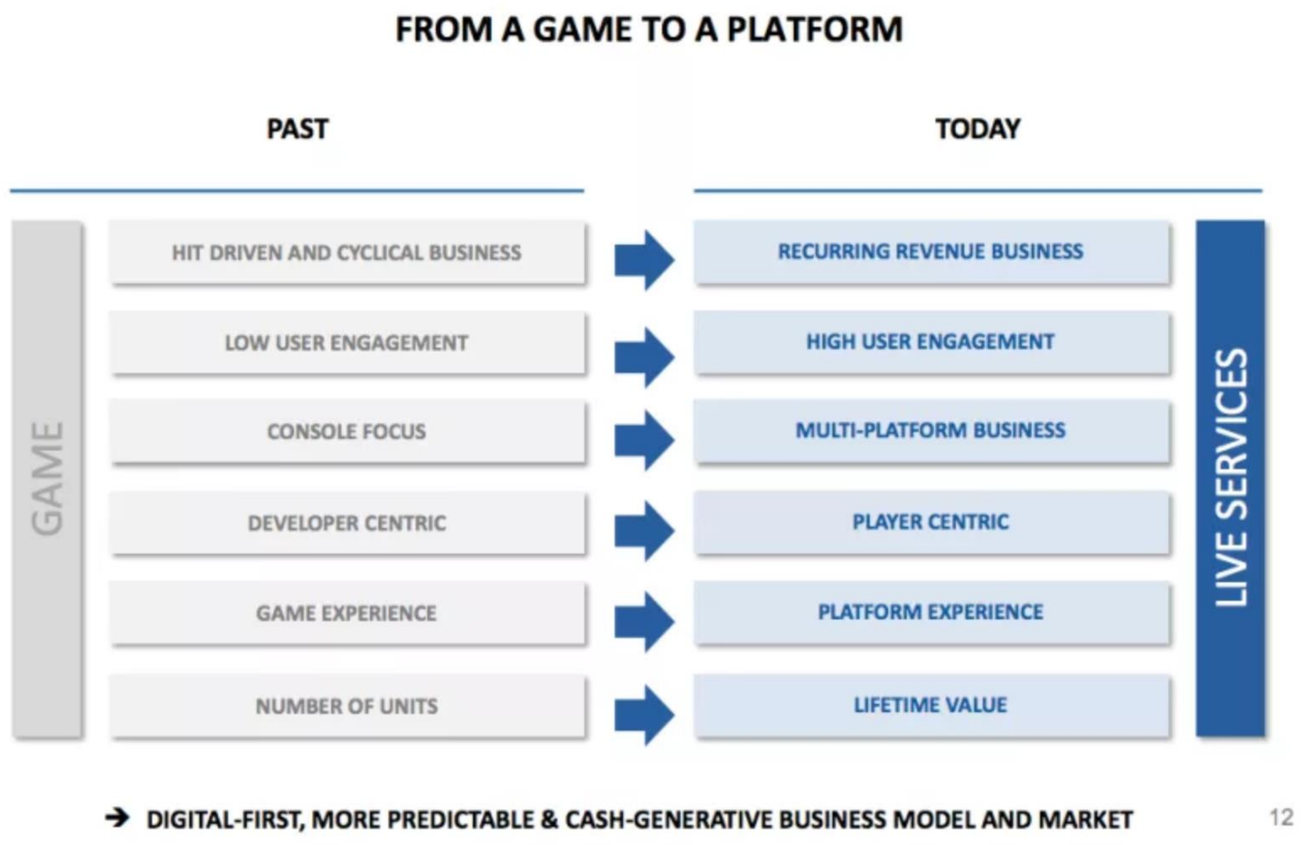
Chart 5: Console installed base by generation (in mn)



Source: BofA Merrill Lynch Global Research estimates, the NPD Group

Video Game Software Publishing Industry: New Model

- Greater emphasis on digital distribution
- Offers more opportunities for monetization
- Physical games -> games as a service (GaaS)
    - “Freemium” model
    - Downloadable content
    - Microtransactions / loot boxes
    - Season passes



Source: Ubisoft Q3 FY18 Presentation, p.12.

Video Game Software Publishing Industry: Trends to Watch

1. Greater console base with more stability due to rollout of premium offerings (e.g. PS4 Pro, Xbox One S/X, Nintendo Switch)
2. Improved market penetration as a result of continued uptake from non-console devices
3. Online software sales driving margin expansion
4. Incremental monetization opportunities brought forth by microtransactions and downloadable content
5. Long-term opportunities: eSports and subscription-based cloud services – yet to be “priced in” due to uncertainty about execution; still in early innings

Illustration: Greater TAM + Greater ARPU = Profit

potential for what is now effectively a services business — a bolt-on package of new locations, enemies, characters and stories for which gamers will (depending on the title and the content) cheerfully fork out between 20-60 per cent of what they paid for the original game.

Source: Financial Times. "Why investors need to rethink video game companies". 13 Jun 2017.

Company Overview: Business Model

Licensing from Third-Parties

FIFA 19
STAR WARS BATTLEFRONT II
MADDEN NFL 19
NBA LIVE 18

In-House Development

BATTLEFIELD
MASS EFFECT
NEED FOR SPEED
The SIMS

Console Games: Digital Console Platform Stores

Mobile and Tablet Games: Online Download Stores

PC Games: EA Origin Subscription Service

Asia (Mobile & PC): Distribution Partnership w/ Tencent

Packaged Goods: B&M Retailers (e.g. GameStop)

<u>Live Services</u>

- *Ultimate Team* mode (FIFA, Madden, NHL)
- Microtransactions (e.g. loot boxes)
- Downloadable content (e.g. Sims expansion packs)
- Subscriptions (e.g. Battlefield Premium and Star Wars: The Old Republic)
- In-game and online advertising

Strategy

1. Protect hit franchises by: (1) producing new versions of current hits; (2) maintaining good terms with licensors; and (3) evolving in-game, player experience
2. Develop and/or acquire new franchises (e.g. Respawn Entertainment, GameFly, Industrial Toys)
3. Increase breadth of player base by: (1) driving repeat engagement and (2) penetrating new markets – aided by new geographies, distribution streams, and franchise offerings
4. Convert players to payers: dual benefit of monetization and greater engagement (e.g. *Ultimate Team*, unlocking new features via in-game purchases, VR gaming, eSports)

Why EA's Business Model Works

STRENGTHS

1. Established portfolio of hit brands accompanied by a loyal customer base
2. Gross margin expansion brought forth by digital migration expands already-large R&D budget
3. Large cash position facilitates acquisitions of niche developers and potential disruptors
4. Long-term, established relationships with its licensors lead to high switching costs

Pricing power	Network effects

High barriers to entry

POTENTIAL WEAKNESSES

1. Emphasis on hit brands can lead to concentration risk
2. Other software publishers might begin competing more aggressively for key licenses

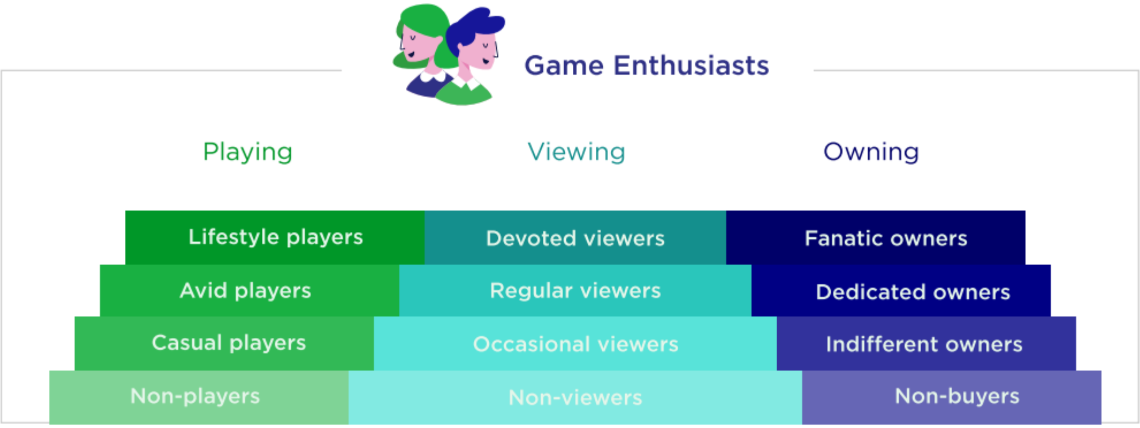
<u>MITIGANTS</u>

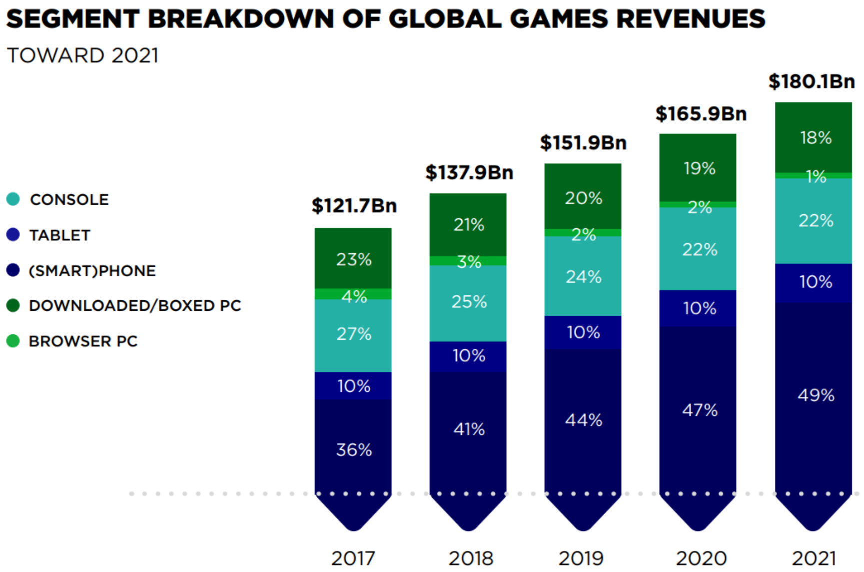
- Switching to a new developer is a very risky proposition for any licensor (due to execution uncertainty, graphics changes, gamer backlash, etc.)
- EA's reputation, size, and liquidity reduce the probability of it being outbid by competitors

Thesis: Case for the Industry

- EA is a leading player in the video game software publishing space: an industry that faces an abundance of positive, secular trends. Gaming has gone “mainstream” and now spans multiple dimensions (see illustration to the right).

- Industry-wide revenues are expected to grow at a **~10% CAGR through 2021**. Rosy expectations are driven by numerous tailwinds, such as greater EM adoption (LatAm & APAC markets); increased TAM from mobile/tablet integration; ongoing in-game monetization efforts (recurring revenues at little to no marginal cost); and growing appeal for non-traditional demographics.



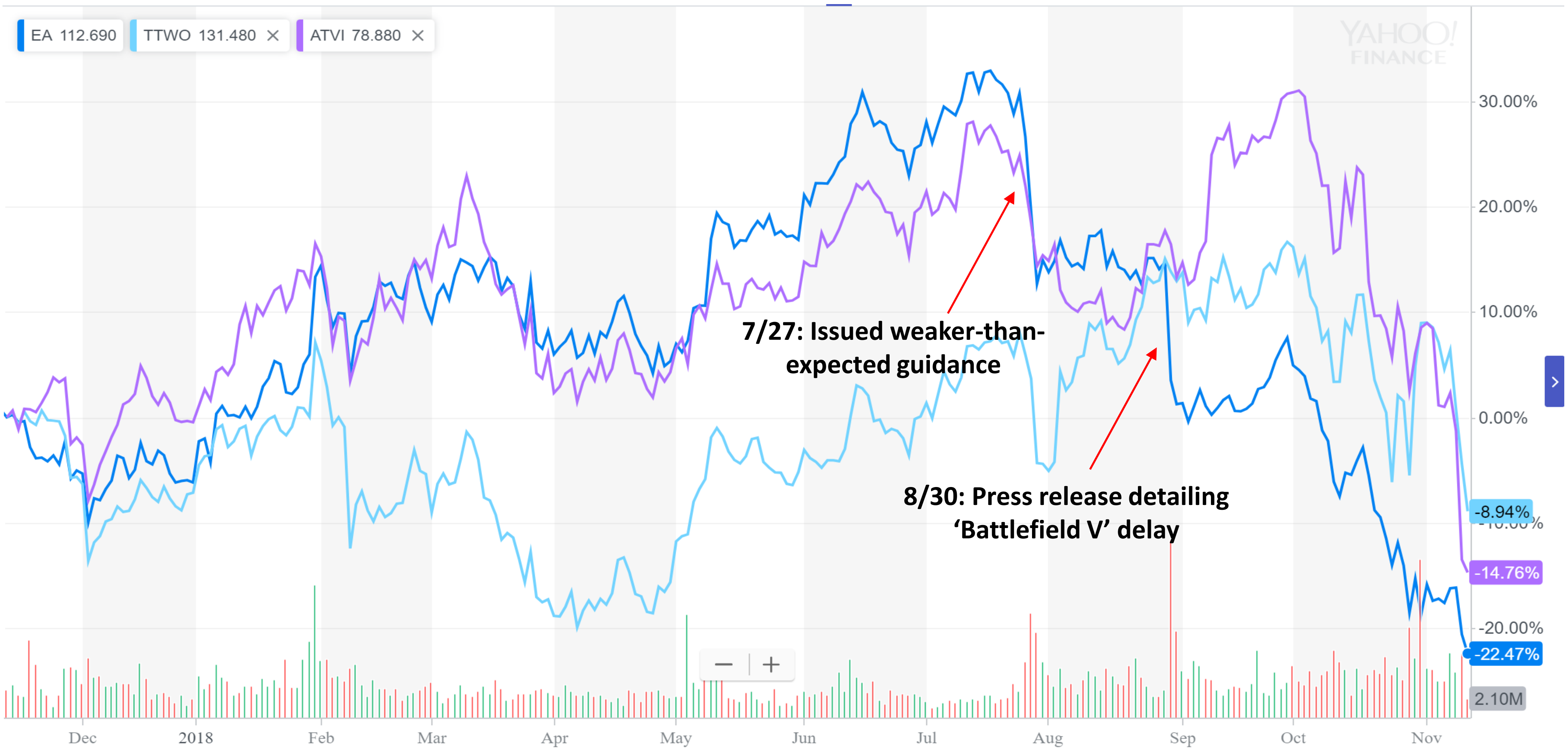


Source: NewZoo. 2018 Global Games Market Report.

Thesis: Case for EA

- The "Big 3" publicly-traded gaming companies are all solid enterprises that warrant investment consideration *at the right price*.
- EA shares are down ~40% from recent highs (achieved during mid-July). Besides general market weakness, this decline can be attributed to (1) a one-month delay in the launch of 'Battlefield V' & (2) weaker than expected holiday guidance.
- We believe that this pullback is both excessive and driven by an overemphasis on short-term results. Over the long haul, EA's fundamentals remain solid: bolstered by a platform of hit franchises with strong prospects for further monetization.
- Based on these factors, **EA's stock currently offers the best value in its industry**.

EA Has Been Hit Harder than its Peers



Source: Yahoo! Finance Interactive Charting

An Unwarranted Casualty?

Shares of Electronic Arts plunged nearly 10 percent in morning trading Thursday after the gamemaker announced it is delaying the release of "Battlefield V" by a month and adjusted its full-year guidance to reflect the lower sales.

The next iteration of EA's popular "Battlefield" series will now launch on Nov. 20, the company said in a release. That distances the release from some other highly anticipated game launches such as Activision Blizzard's "Call of Duty: Black Ops 4" and Take-Two's "Red Dead Redemption 2" — both set to launch in October.

Source: CNBC.com

You have told us that you are seeing an increased focus on squad play come through, you are also feeling the difference in our revamped player movement and we are getting a lot of positive feedback for our improved weapons handling.

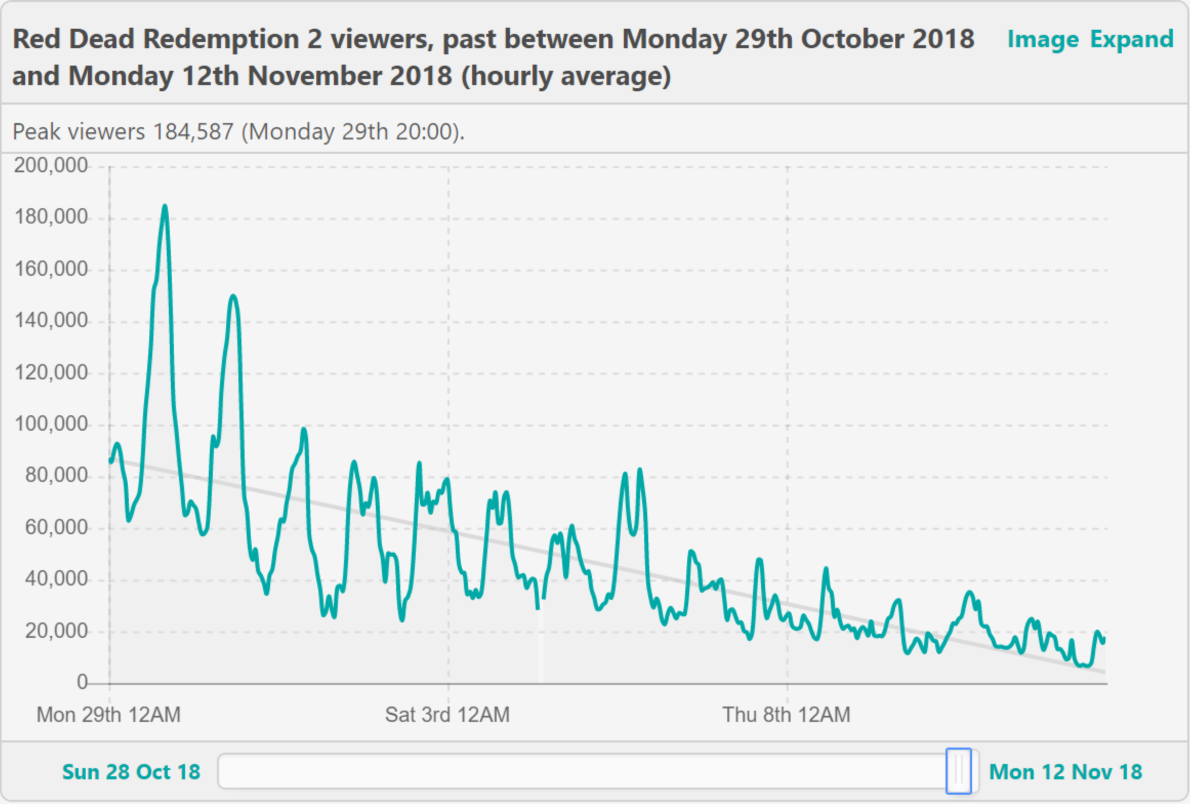
You've also spurred us to make some meaningful improvements to the core gameplay experience, including adjusting the gameplay tempo, improving soldier visibility and reducing player friction. You'll see a lot of these reflected in our Open Beta that starts on September 6.

We believe we have one of the best Battlefield games ever on our hands. A game that will deliver on an emotional journey through the return of unseen single player War Stories, a deep multiplayer experience, Battle Royale, along with our new live service, Tides of War - a journey across multiple theaters of WW2 and designed to keep our community together.

With the Open Beta just around the corner, we are excited about the millions of you who will join us and experience the game. And we fully expect to see even more feedback coming our way.

And that's why we're moving our launch date. We're going to take the time to continue to make some final adjustments to core gameplay, and to ensure we really deliver on the potential of Tides of War.

Source: Electronic Arts. "An Update on Battlefield V".



Source: SullyGnome - detailed Twitch statistics and analysis

Sentiment Shift, Not a Change in Fundamentals, Driving Pullback

The going may be rougher for EA, but the rewards may be greater. Wall Street's average price target was some 34% above Thursday's close, according to FactSet.

MKM Partners' Erik Handleron Wednesday cut his price target on the stock to $135—about 44% above Thursday's close—from $157, saying the shares "are right now being hurt by what we view as an overly bearish sentiment."

the announcement. UBS analysts think the shares have taken enough lumps, and "fully reflect near-term headwinds and have heavily discounted both company specific and industry wide tailwinds in coming years."

EA Falls 5%; Are Investors Missing the Forest for the Trees?

By Emily Bary Nov. 1, 2017 11:56 a.m. ET

"One of the greatest disruptions of the consumption of entertainment media in the last five years has been the combination of streaming plus subscription, and that we are thinking very seriously about that," CEO Andrew Wilson said.

Knee-jerk reactions: a recurring trend driven by Wall Street's fixation with short-term results.

All excerpts taken from Barron's.

Catalysts: Shorter-Term

BFV outperforms extremely low expectations while market gains greater appreciation for *Anthem*'s potential

Launch	Title	Platform(s)		
Q1	Unravel Two	Console	PC	
Q2	FIFA 19	Console	PC	
	Madden NFL 19	Console	PC	
	NBA Live 19	Console		
	NHL 19	Console		
Q3	Battlefield V	Console	PC	11/20/18
Q4	Anthem	Console	PC	2/22/19

Net bookings from **full-game downloads** are expected to grow 20% to 25%. This is significantly above our original expectations, primarily driven by the strength we are seeing in *Anthem*, which we expect to skew strongly digital, plus the digital shifts for our

Holiday performance not as weak as guidance suggests

However, the outlook is not as weak as it seems. First of all, EA has a history of delivering conservative guidance. Second, the one month delay of the *Battlefield V* launch is expected to push back some of the revenue from that title into next year.

Additionally, management explained that live services growth was impacted by new features the company added to *FIFA 19*. Essentially, management added so much content to the new version that it's delaying players' entry into the Ultimate Team feature.

Brean And Wedbush Both Think EA's Guidance Is Conservative: Here's Why

Blake J. Jorgensen - Electronic Arts, Inc.

I think we're confident in both. I think everyone knows we tend to approach things fairly conservatively, and I think we've shown that in our recent guidance and results.

Sources: EA 2Q19 Investor Presentation, EA 2Q19 Prepared Remarks, EA 2Q19 Earnings Call Transcript

Longer-Term Catalyst

Cloud gaming and subscription model continue to materialize -> possible multiple expansion (akin to Adobe)

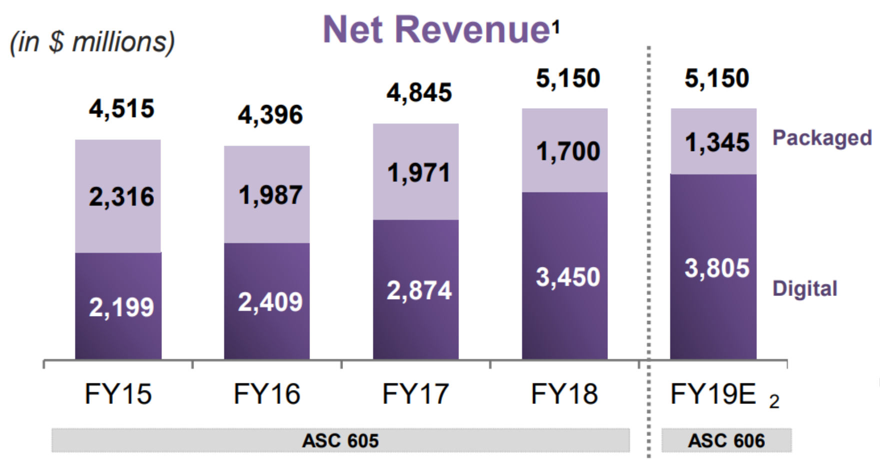
on new games that deliver amazing, scalable, social and deeply interactive experiences. Cloud gaming will enable games to reach new audiences and geographies, and we're continuing development of the streaming capabilities we debuted in June and exploring the disruptive combination we see for streaming with our industry-leading subscription services. Underpinning it all will be our Player Network, enabling our players to stay connected to their friends and the content they love, wherever they are in the world.

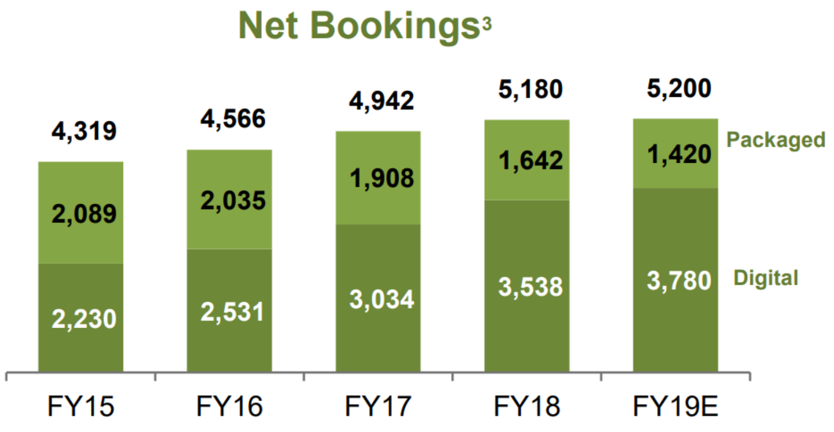
Steady subscription revenue brings the kind of profit predictability that is prized by investors. Look at Adobe Systems (ADBE), which trades above 30 times projected earnings for the next four quarters, up from less than 15 times just six years ago, following its transition from store-bought software to cloud-based subscriptions.

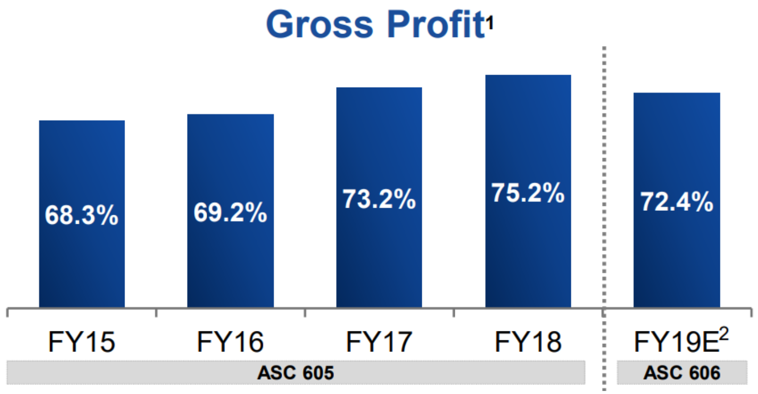
But the biggest financial benefit for gaming companies is likely to come from a sudden expansion of potential customers.

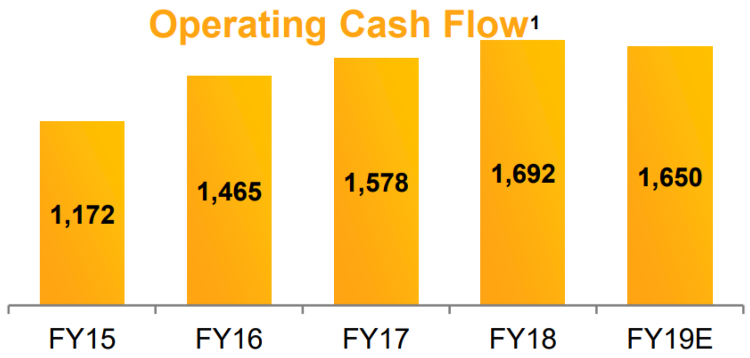
Source: EA 2Q19 Investor Presentation, p.3; *Barron's* Cover Story – "The Videogame Industry Reaches for the Cloud".

Financials: I/S and CFS Visuals









Source: EA 2Q19 Earnings Call Transcript

Financials: Balance Sheet Strength -> Optionality

- Net cash balance of ~$1.89B (as of 2Q19)
- Current balance sheet structure grants EA with great deal of optionality:

1.) Buybacks at depressed price points

specific number of shares under this program and it may be modified, suspended or discontinued at any time. During the three and six months ended September 30, 2018, we repurchased approximately 2.3 million and 4.0 million shares for approximately $299 million and $523 million, respectively, under this program.

2.) Strategic M&A

In terms of M&A, we're clearly keeping our eyes open on everything that's out there. This is all about collecting great content and talent, and we're looking for ways to do that at every possible opportunity we have, and we'll continue to do that. I can't predict anything at this point in time. But part of the reason that we want to leave dry powder both in the terms of cash and in the terms of debt capacity, our capital structure is for the opportunity that could come to us at some point in time to be able to step in and buy an asset or acquire talent and titles that would be helpful to our long-term vision of both subscriptions and streaming.

Sources: EA 2Q19 Form 10-Q, p.33; EA 2Q19 Earnings Call Transcript

Comps Overview

Company name	Ticker	Price	LTM EV/EBITDA	LTM P/E ratio	5-year avg. ROIC	5-year avg. ROE	R&D margin (last FY)
Electronic Arts, Inc.	**EA**	**$87.25**	**16.88x**	**27.20x**	**20.05%**	**23.68%**	**25.63%**
Video Game Software Publishing Comps							
Activision Blizzard, Inc.	ATVI	$54.30	16.48x	71.68x	6.53%	9.69%	15.23%
Take-Two Interactive Software, Inc.	TTWO	$109.00	37.17x	58.30x	4.51%	5.20%	10.95%

Takeaways:

(1) EA generates greater returns on both its equity and capital base than peers.
(2) EA dedicates a greater portion of its sales toward research & development (parallels capex in a software-intensive business).
(3) Current P/E and EV/EBITDA multiples do not fully reflect EA's competitive advantages and superior return-generating capabilities.

Sources: Company Filings, FactSet Data

DCF Valuation

- We use an unlevered free cash flow approach to value EA.
  - Debt is of negligible importance, as it makes up only ~3.6% of total capital.

Growth Assumption					
5%	92.64	88.6	84.78	81.17	77.74
10%	115.52	110.45	105.66	101.13	96.83
15%	142.78	136.49	130.53	124.9	119.56
WACC	5%	6%	7%	8%	9%

*Full model & assumptions compiled on separate Excel sheet; available upon request

- Even assuming near-term EBITDA growth of 5% and a WACC of 9%, only ~11% downside. High potential for asymmetric payoffs.

Summary

- EA is an established, leading player in an industry that is experiencing a multitude of secular tailwinds
- Not as richly valued as its peers (i.e. ATVI and TTWO)
- Recent price pressure a case of “missing the forest for the trees,” or fixating on near-term guidance over EA’s fundamental strengths and long-term business prospects
- Allocation perspective: Tech currently makes up ~18.5% of BIG’s portfolio, versus 20.7% for the S&P 500 Index (as of 10/31/18). Further, Tencent (TCEHY) represents our only exposure to the gaming software industry. Investing in EA thus enables us to (1) gain exposure to a pure-play gaming company while (2) remaining roughly equal-weight on tech.