



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

ATVI - NASDAQ (as of 8/4/17)	\$62.01
Price Target	N/A
52-Week Range	\$35.12 - \$64.06
Shares Outstanding (mil) (basic)	754
Market Cap. (\$mil)	\$46,756
3-Mo. Average Daily Volume	6,820,000
Institutional Ownership ~	70%
Total Debt/Total Capital (6/17)	31%
ROE (TTM ended 6/17)	18%
Book Value/Share (6/17)	\$12.88
Price/Book Value	4.8x
Annual Dividend & Yield	\$0.30 0.5%
EBITDA Margin (TTM ended 6/17)	40%

EPS FY 12/31 (non-GAAP-based figures)

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	\$0.23		\$0.31	A	
2Q	\$0.54		\$0.43	A	
3Q	\$0.52	\$0.44	\$0.47		
4Q	\$0.92	\$0.88	\$0.89		
Year	\$2.20	\$1.91	\$2.10	\$2.35	\$2.45
P/E	28.2x		29.5x		25.3x

Notes: Quarterly EPS and revenue figures may not add to annual figure due to rounding.

Revenue (\$mm) (non-GAAP-based figures)

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	\$908		\$1,196	A	
2Q	\$1,609		\$1,418	A	
3Q	\$1,630	\$1,527	\$1,725		
4Q	\$2,452	\$2,427	\$2,361		
Year	\$6,599	\$6,350	\$6,700	\$6,925	\$7,225

Company Description: Activision Blizzard, Inc. is a worldwide online and console videogame publisher with leading market share positions across multiple product categories and geographies. It was created in 2008 from the combination of Activision, Inc. and Vivendi Games (parent of Blizzard Entertainment). Mobile game publisher King Digital Entertainment was acquired in early 2016.

Activision Blizzard, Inc.

ATVI — NASDAQ — Underperform-2

Impressive 2Q Results But Valuation Remains Rich

Investment Highlights

- **2Q results were better than expected.** Non-GAAP revenues of \$1.418 billion were down 12% from a year ago, reflecting differences in the product release schedule. There were no new full-length game releases in the recent period, only add-on content for previous releases. Contrastingly, the year ago period included the successful launch of *Overwatch* from the Blizzard Entertainment segment. The street consensus revenue estimate was \$1.220 billion.
- **Profits also exceeded expectations.** Operating margin declined due to the tough comparison to a year ago. This led to a non-GAAP net income decline of 18%. Similarly, non-GAAP diluted EPS were \$0.43 versus \$0.54 a year ago. However, this was well above company guidance of \$0.27 and street consensus of \$0.30. The considerable EPS “beat” in 2Q followed a similar outcome in the preceding quarter (1Q 2017).
- **The balance sheet remained solid.** Total cash and equivalents as of 6/30/17 were \$3.278 billion. Total debt was \$4.387 billion, or 31% of total capitalization. Interest coverage and leverage ratios were adequate, indicating additional borrowing power, if desired.
- **Management updated its financial guidance.** Non-GAAP revenue guidance for 2017 was set at \$6.575 billion, up \$245 million from the previous figure. Non-GAAP EPS guidance was set at \$2.00, up \$0.12 from the previous figure. We have fine-tuned our projections, which are above company guidance. Consistent with history, we feel guidance is likely conservative.
- **We rate ATVI Underperform based solely on valuation.** Considerable share price gains of late have led to an above-average stock valuation compared to recent levels and company historical averages. We believe the shares could be susceptible to profit taking. Our Suitability rating remains 2.

**Note Important Disclosures on Pages 6-7.
Note Analyst Certification on Page 6.**

Exhibit 1**Non-GAAP Consolidated Statements of Operation** (figures in millions except per share data and percentages)

	Quarter Ended			Six Months Ended		
	<u>6/30/17</u>	<u>6/30/16</u>	<u>% chg</u>	<u>6/30/17</u>	<u>6/30/16</u>	<u>% chg</u>
Console	\$365	\$440	(17.0%)	\$605	\$768	(21.2%)
PC	493	630	(21.7%)	912	931	(2.0%)
Mobile and Ancillary	500	484	3.3%	971	716	35.6%
Other	60	55	9.1%	126	102	23.5%
Total Revenues	1,418	1,609	(11.9%)	2,614	2,517	3.9%
Cost of Sales	336	399	(15.8%)	672	656	2.4%
Gross Profit	1,082	1,210	(10.6%)	1,942	1,861	4.4%
Product Development	238	236	0.8%	451	401	12.5%
Sales & Marketing	226	240	(5.8%)	392	372	5.4%
General & Admin.	147	146	0.7%	277	248	11.7%
Total Operating Expenses	611	622	(1.8%)	1,120	1,021	9.7%
Income from Operations	471	588	(19.9%)	822	840	(2.1%)
Net Income	\$332	\$404	(17.8%)	\$569	\$577	(1.4%)
Diluted Earnings Per Share	\$0.43	\$0.54	(19.0%)	\$0.75	\$0.77	(2.9%)
Avg. Diluted Shares Outst.	764	753	1.5%	763	751	1.6%
% of Net Revenues:			bp chg.			bp chg.
Gross Profit	76.30%	75.20%	110	74.29%	73.94%	36
Product Development	16.78%	14.67%	212	17.25%	15.93%	132
Selling & Marketing	15.94%	14.92%	102	15.00%	14.78%	22
General & Admin.	10.37%	9.07%	129	10.60%	9.85%	74
Income from Operations	33.22%	36.54%	(333)	31.45%	33.37%	(193)
Net Income	23.41%	25.11%	(170)	21.77%	22.92%	(116)

Source: Activision Blizzard, Inc.

Note: December year end

Additional comments on 2Q results. Our presentation and analysis of results focuses on non-GAAP figures. This excludes changes in deferred revenues and related costs with respect to certain online-enabled videogames, stock-based compensation expenses, restructuring and impairment charges, and income tax adjustments associated with these factors.

We were positively surprised by ATVI's 2Q results, particularly given the lack of new game releases in the period compared to a major successful release in the year ago quarter, that being *Overwatch* from Blizzard Entertainment. *Overwatch* was released in May 2016 for consoles and PC, thus becoming a factor for the recent 2Q revenue declines in those segments. It has become Blizzard's fastest game ever to reach 30 million registered players.

The console business also reflected lower revenues from the *Call of Duty* franchise, whose most recent release, *Infinite Warfare* in November 2016, did not achieve the same level of success as its predecessor, *Black Ops III*.

At mobile game developer King Digital (a February 2016 acquisition), total revenues rose slightly, but monthly average users declined on a year-over-year and quarter-over-quarter basis. King has had 2 or more of the top 10 mobile games in the U.S. for 15 consecutive quarters. *Candy Crush* has been the steadiest contributor during that period. Product development efforts are robust at King Digital.

Overall, we liked ATVI's operating performance for the quarter, particularly considering the tough comparison to 2Q 2016. We liked the continued trend in consumer adoption of digital purchasing; revenues through digital/online channels represented 80% of 2Q revenues, up from 73% a year ago.

Financial condition. We consider ATVI's balance sheet to be in good shape, with strong cash flows leading to significant year-over-year improvement. Total cash and equivalents at June 30, 2017 were \$3.278 billion and long-term debt was \$4.387 billion, resulting in net debt of \$1.109 billion. One year ago, net debt was \$2.706 billion. Net debt divided by twelve-month trailing adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) was a conservative 0.4x, down from 2.5x one year ago. During the quarter, the company received a debt rating upgrade to BBB from BBB- from Standard & Poors. We believe ATVI has considerable borrowing capacity, if needed. Shareholders' equity at 2Q end was \$9.715 billion.

E-sports update. An industry trend deserving of close attention is e-sports. This essentially entails competitive gaming with key roles coming from participants, event organizers, team leaders/owners, viewers, and advertisers. This is a nascent initiative that is beginning to grow rapidly, and the videogame industry's size and demographics could help this turn into a meaningfully positive business model, in our view. Further, we believe ATVI has numerous videogame franchises well-suited for competitive dynamics and global viewership.

During the recent 2Q, ATVI made considerable progress on its e-sports initiative, including the creation of an *Overwatch* league based on the popular game from the company's Blizzard Entertainment segment. With goals of gathering the world's best *Overwatch* players, the company sold several of what is expected to be numerous franchises to buyers in major cities (domestic and international). Associated revenue streams once the league is established could be multi-fold, in our view, including live streaming media rights (recently secured), franchise fees, sponsorship deals, and advertising. The *Overwatch* league is planned to commence activity in 4Q of this year.

At this time, it is difficult to quantify the near-term impact of e-sports, including revenue and expense levels, but we are generally bullish on the long-term potential. ATVI management stated that revenue recognition of team/franchise sales will be partially offset by investments required to launch operations, including marketing expenses related to the inaugural season. Management has repeatedly stated it is building its e-sports business for the long-term, but acknowledged some 2H revenue recognition is likely, with break-even EPS impact for the year. We will be closely monitoring the company's and industry's e-sports initiatives.

Outlook. Major contributors in 2017 are likely to be *Overwatch* (including the launch of a competitive league based on the franchise), a sequel to the popular *Destiny* game in 3Q, a likely better received *Call of Duty* game in 4Q, and greater ad revenue generation from King Digital's mobile platform.

Financial guidance for 2017 was raised from previous figures, although based mostly on strong 2Q results. ATVI's non-GAAP revenues for 2017 are now expected to approximate \$6.575 billion and non-GAAP EPS are projected at \$2.00. Our new estimates for these metrics—\$6.700 billion in revenue and \$2.10 in EPS—are above company guidance, which we view as conservative.

We have also raised our 2018 outlook. We project non-GAAP revenues of \$7.225 billion and non-GAAP EPS of \$2.45 compared to our previous figures of \$6.925 billion and \$2.35, respectively. At this point, we have not factored e-sports into our 2018 outlook to any meaningful degree. Once the league launches and economics (revenues and expenses) are more clear, we could update our outlook.

We continue to believe the videogame industry is at a favorable point in its business cycle. We consider ATVI's fundamentals to be strong with a growing portfolio of successful franchises and a continued focus on higher margin digital business. Furthermore, we view the longer term as particularly interesting, as the company has recently launched several new businesses that could add to long-term growth. These include e-sports, television, movies, and consumer products.

Stock valuation. ATVI shares are currently trading at approximately 30x and 25x our 2017 and 2018 non-GAAP EPS estimates, respectively. This translates into an approximate 27.5x multiple on our estimate of forward twelve-month EPS. According to Thomson Financial, the median forward multiple for ATVI over the past ten years is approximately 17x and over the past five years is roughly 19x. Meanwhile, the stock's forward P/E multiple is currently 1.4x that of the S&P 500's forward multiple, exceeding the median relative multiple of 1.1x over the past five and ten year periods.

Opinion. We continue to believe ATVI is a best-in-class operator with a growth-oriented future. The company's fundamental outlook is strong and its cash flow generation potential remains healthy, in our view. Substantial price appreciation of late has kept ATVI shares out of our buying range and into a range we consider suitable for taking some profits. For the calendar year-to-date period, ATVI shares are up 72% compared to an 11% gain for the S&P 500, an 18% rise in the NASDAQ Composite, and a 12% increase for the S&P Consumer Discretionary sector.

In sum, we believe 2017 is shaping up to a good earnings year for ATVI, yet down slightly from a particularly strong 2016. Prospects for 2018 seem attractive considering the product pipeline and new businesses being launched, but we believe a fair amount of optimism seems to be factored into the current stock price. We also believe there are numerous uncertainties, such as those associated with the e-sports initiative (economics and magnitude of the business, the competitive environment, and long-term viability). We believe strong price appreciation of late has provided an opportunity to take profits in existing positions and move into securities with greater return potential.

Suitability. Our Suitability rating on ATVI is 2 on a 1-to-4 scale (1=most conservative, 4=most aggressive). Factors on which our Suitability rating is based include earnings history, market capitalization, financial condition, and the cyclical nature of the industry.

Risks. Factors that could affect the outlook for the company and the stock price include overall indebtedness to support recent growth initiatives; potential uses for the company's cash balance and future cash flow; the industry's hardware replacement cycle including consumer demand for current and future consoles; creative and financial abilities to bring popular games to market; healthy relationships with the major hardware manufacturers; consumer sentiment toward the company's key franchises; prospects for competitive gaming/e-sports, general economic conditions, and consumer spending habits.

Exhibit 2**Non-GAAP Consolidated Statements of Income** (figures in millions except per share data and percentages)

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017E</u>	<u>2018E</u>
Console	\$2,895	\$2,686	\$2,700	\$2,220	\$2,455	\$2,500
PC	1,124	1,720	1,565	2,428	1,890	2,100
Mobile & Ancillary	0	0	0	1,586	1,965	2,200
Other	323	407	356	365	390	425
Net Revenue	4,342	4,813	4,621	6,599	6,700	7,225
Cost of Sales	1,479	1,684	1,477	1,919	1,920	2,030
Gross Profit	2,863	3,129	3,144	4,680	4,780	5,195
Product Development	551	549	621	911	985	1,010
Sales & Marketing Exp.	599	704	725	928	950	985
General & Admin. Exp.	358	349	332	507	570	590
Total Oper Exp.	1,508	1,602	1,678	2,346	2,505	2,585
Operating Income	1,355	1,527	1,466	2,334	2,275	2,610
Int. Inc. (Exp.) & Other	(53)	(202)	(200)	(214)	(156)	(140)
Income Before Taxes	1,302	1,325	1,266	2,120	2,119	2,470
Provision for Taxes	303	268	277	450	509	593
Net Income	\$999	\$1,057	\$989	\$1,670	\$1,610	\$1,877
Diluted EPS	\$0.94	\$1.42	\$1.32	\$2.20	\$2.10	\$2.45
Wtd. Diluted Shares Outst.	1,035	726	739	753	767	766
% Year Over Year Chg.						
Net Revenue	(12.93%)	10.85%	(3.99%)	42.80%	1.53%	7.84%
Gross Profit	(14.54%)	9.29%	0.48%	48.85%	2.14%	8.68%
Operating Income	(20.53%)	12.69%	(3.99%)	59.21%	(2.53%)	14.73%
Net Income	(26.38%)	5.81%	(6.43%)	68.86%	(3.57%)	16.56%
As a % of Net Revenue:						
Gross Profit	65.94%	65.01%	68.04%	70.92%	71.34%	71.90%
Product Development	12.69%	11.41%	13.44%	13.81%	14.70%	13.98%
Sales & Marketing Exp.	13.80%	14.63%	15.69%	14.06%	14.18%	13.63%
General & Admin. Exp.	8.25%	7.25%	7.18%	7.68%	8.51%	8.17%
Operating Income	31.21%	31.73%	31.72%	35.37%	33.96%	36.12%
Net Income	23.01%	21.96%	21.40%	25.31%	24.04%	25.98%
Tax Rate	23.27%	20.23%	21.88%	21.23%	24.00%	24.00%

Source: Activision Blizzard, Inc. and Hilliard Lyons estimates

Note: December fiscal year

Additional information is available upon request.

Prices of stocks mentioned: Vivendi SA - VIVHY - \$23.74

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in the common stock of Activision Blizzard, but may not engage in buying or selling contrary to the recommendation.

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months.

Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history

2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of <u>Stocks Covered</u>	% of <u>Stocks Covered</u>	<u>Banking</u>	<u>No Banking</u>
Rating				
Buy	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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