



COMPANY UPDATE / RATING CHANGE / ESTIMATE CHANGE

Key Metrics

ATVI - NASDAQ (as of 2/10/17)	\$47.23
Price Target	N/A
52-Week Range	\$26.49 - \$47.64
Shares Outstanding (mm) (basic)	744
Market Cap. (\$mm)	\$35,139
3-Mo. Average Daily Volume	9,098,532
Institutional Ownership ~	86%
Total Debt/Total Capital (12/16)	35%
ROE (TTM ended 12/16)	19%
Book Value/Share (12/16)	\$12.26
Price/Book Value	3.9x
Annual Dividend & Yield	\$0.30 0.6%
EBITDA Margin (TTM ended 12/16)	37%

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

	2015	2016	Prior 2017E	Curr. 2017E
1Q	\$0.16	\$0.23		
2Q	\$0.13	\$0.54		
3Q	\$0.21	\$0.52		
4Q	\$0.83	\$0.92		
Year	\$1.32	\$2.20	\$2.20	\$1.92
P/E	35.8x	21.5x		24.6x

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

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

	2015	2016	Prior 2017E	Curr. 2017E
1Q	\$703	\$908		
2Q	\$759	\$1,609		
3Q	\$1,040	\$1,630		
4Q	\$2,118	\$2,452		
Year	\$4,621	\$6,599	\$7,200	\$6,330

**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

**Strong 4Q Results; 2017 Guidance Underwhelms; We Suggest Taking Some Profits**

Investment Highlights

- **4Q results were better than expected.** Non-GAAP revenues of \$2.452 billion were up 16% from the year ago figure, reflecting contribution from King Digital Entertainment (a mobile videogame publisher acquired in February 2016). The quarter included higher results from Blizzard Entertainment, which produced a successful new title, *Overwatch*, in May 2016, and a decline from the Activision Publishing segment, which experienced disappointing results from its annual *Call of Duty* game.
- **Profits were also higher.** Operating margin declined from a lofty level a year ago, but operating income rose nearly 10%. Non-GAAP EPS were \$0.92 versus \$0.83 a year ago. Company guidance was \$0.74, our estimate was \$0.75, and recent street consensus was \$0.73. The quarter represented one of the bigger ‘beats’ in recent memory, in terms of actual results versus expectations.
- **There was additional positive news.** The company announced a \$1 billion share repurchase program, stated its intention to reduce debt by \$500 million this year, and raised the annual dividend by 15%.
- **Financial guidance was underwhelming to us.** Non-GAAP revenue guidance for 2017 was set at \$6.3 billion. This compares to our previous estimate of \$7.2 billion. Non-GAAP EPS guidance was set at \$1.85. This compares to our previous estimate of \$2.20. While we feel this guidance is conservative, we also believe it reflects maturation of certain console franchises.
- **We are moving to an Underperform rating based on valuation.** Considerable share price gains of late and our lowered profit outlook for the coming year has resulted in a significantly higher valuation compared to recent levels. With the stock nearly at our previous two-year price target, we believe some profit taking is prudent. Our Suitability rating remains 2.

**Note Important Disclosures on Pages 5-6.  
Note Analyst Certification on Page 5.**

**Additional comments on 4Q 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 generally impressed with ATVI's 4Q results. At the Blizzard Entertainment segment, results were once again led by *Overwatch*, a successful game launched in May 2016. *Overwatch* has become Blizzard's fastest game ever to reach 25 million registered players. As an aside, we note *Overwatch* has won 55 "game of the year" awards from various entities. In addition, Blizzard's venerable *World of Warcraft* PC game performed well following the release of the *Legion* expansion pack in August 2016.

At the Activision Publishing segment, the most important videogame franchise continues to be *Call of Duty*, which tends to have a new release in 4Q of each year. In 4Q 2016, the release was *Call of Duty: Infinite Warfare*, a game that represented a change in gameplay/environment (space setting vs. military combat) compared to previous iterations from the franchise. Unfortunately, *Infinite Warfare* underperformed the company's expectations and garnered only average reviews.

At King Digital (a February 2016 acquisition of the mobile gaming giant responsible for the popular *Candy Crush* game, among others), monthly average users of 355 million declined from a year ago. For the year, it averaged 405 million monthly average users, also down compared to the prior year.

We liked the continued growth in revenues derived from higher margin digital channels—up an estimated 65% year-over-year. ATVI is among the industry leaders in this favorable (higher profit margin) trend, and the King acquisition boosted its efforts. Indeed, non-GAAP gross margin for 4Q was up compared to a year ago.

4Q earnings exceeded expectations by a considerable margin. This reflected the revenue beat as well as a lower tax rate compared to the year ago period. Looking ahead, we believe this will represent a difficult comparison when 4Q 2017 arrives.

**Financial condition.** The company's free cash flow generation of over \$2 billion in 2016 boosted an already solid balance sheet. Total cash and equivalents at December 31, 2016 were \$3.245 billion and long-term debt was \$4.887 billion, for a net debt position of \$1.642 billion. Net debt divided by trailing adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) was at a conservative 0.7x. Shareholders' equity at 4Q end was \$9.119 billion.

Along with 4Q results, the company made several other announcements that we view as shareholder friendly. First, it announced a \$1 billion share repurchase program that will be in effect over a two-year period. Second, the company plans to reduce its debt by \$500 million during the year. In fact, the company announced it has already paid down \$139 million in the short calendar year-to-date period. Third, the Board declared a 15% increase to the annual dividend, with a rate of \$0.30 per share payable May 10, 2017. The rate has been raised each year since dividends were initiated in 2010.

**Outlook.** We continue to believe the videogame industry is at a favorable point in its business cycle. We consider ATVI's fundamentals to generally 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 (competitive gaming and accompanying viewership), television, movies, and consumer products.

For 2017, key contributors are likely to be *Overwatch*, a potentially better received *Call of Duty* game, a sequel to popular franchise *Destiny*, and greater ad revenue generation from King Digital's mobile platform. However, management noted that 2017 is looking like a relatively light product release year. Financial guidance for 2017 was considerably below our previous figures. ATVI's non-GAAP revenues for 2017 are now expected to approximate \$6.300 billion and non-GAAP EPS are projected at \$1.85. Our new estimates are a bit above guidance. This includes non-GAAP revenues of \$6.330 billion (down 4% from 2016) and non-GAAP EPS of \$1.92 (down 13% from 2016). We have not factored in much share repurchase activity given the current all-time high stock price.

**Stock valuation.** ATVI shares are currently trading at approximately 25x our 2017 non-GAAP EPS estimate of \$1.92 and 20x our preliminary 2018 estimate of \$2.40. The median forward multiple for ATVI over the past ten years is approximately 17x. Meanwhile, the stock's forward P/E multiple is 1.3x that of the S&P 500's forward multiple, exceeding the median relative multiple of 1.1x over the past ten years.

**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 pushed ATVI shares out of our buying range and into a range we consider suitable for taking some profits.

Over the past twelve months, ATVI shares are up 57% compared to a 25% gain for the S&P 500, a 34% rise in the NASDAQ Composite, and a 25% increase for the S&P Consumer Discretionary sector.

For the relatively short 2017 calendar YTD period, ATVI shares are up 31% compared to a 3% gain for the S&P 500, a 7% rise in the NASDAQ Composite, and a 5% increase for the S&P Consumer Discretionary sector.

Potential upside to our previous two-year price target of \$49 per share equates to less than a 2% annual increase. This falls short of our required return for investments in ATVI. Furthermore, even with the recently announced dividend increase, the current yield of 0.6% is not high enough to significantly enhance total return potential, in our view.

In sum, we believe 2017 is shaping up to be a down year for ATVI's revenues and earnings, while the stock price is at an all-time high and valuation is near the upper end of a historical range. Given that 2018 prospects seem considerably more attractive, we believe better investment opportunities could surface later this year. We suggest taking profits in existing positions and moving proceeds 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 supply and demand for 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; and general economic and consumer spending conditions.

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

	2011	2012	2013	2014	2015	1Q	2Q	3Q	4Q	2016	2017E
Activision Publishing	\$2,828	\$3,072	\$2,895	\$2,686	\$2,700	\$360	\$332	\$377	\$1,151	\$2,220	\$2,360
Blizzard Entertainment	1,243	1,609	1,124	1,720	1,565	294	738	727	669	2,428	1,910
King Digital Ent.	0	0	0	0	0	207	484	459	436	1,586	1,700
Other	418	306	323	407	356	47	55	67	196	365	360
Net Revenue	4,489	4,987	4,342	4,813	4,621	908	1,609	1,630	2,452	6,599	6,330
Cost of Sales	1,590	1,637	1,479	1,684	1,477	257	399	425	838	1,919	1,831
Gross Profit	2,899	3,350	2,863	3,129	3,144	651	1,210	1,205	1,614	4,680	4,499
Product Development	606	602	551	549	621	165	236	238	272	911	935
Sales & Marketing Exp.	539	571	599	704	725	132	240	257	299	928	955
General & Admin. Exp.	396	472	358	349	332	102	146	135	124	507	525
Total Oper. Exp.	1,541	1,645	1,508	1,602	1,678	399	622	630	695	2,346	2,415
Operating Income	1,358	1,705	1,355	1,527	1,466	252	588	575	919	2,334	2,084
Int. Inc. (Exp.) & Other	3	5	(53)	(202)	(200)	(52)	(65)	(52)	(43)	(214)	(150)
Income Before Taxes	1,361	1,710	1,302	1,325	1,266	200	523	523	876	2,120	1,934
Provision for Taxes	274	353	303	268	277	27	119	126	180	450	464
Net Income	\$1,087	\$1,357	\$999	\$1,057	\$989	\$173	\$404	\$397	\$696	\$1,670	\$1,470
<b>Diluted EPS</b>	<b>\$0.93</b>	<b>\$1.18</b>	<b>\$0.94</b>	<b>\$1.42</b>	<b>\$1.32</b>	<b>\$0.23</b>	<b>\$0.54</b>	<b>\$0.52</b>	<b>\$0.92</b>	<b>\$2.20</b>	<b>\$1.92</b>
Wtd. Diluted Shares Outst.	1,156	1,118	1,035	726	739	746	750	758	757	753	765
<b>% Year Over Year Chg.</b>											
Net Revenue	(6.54%)	11.09%	(12.93%)	10.85%	(3.99%)	29.16%	111.99%	56.73%	15.77%	42.80%	(4.08%)
Gross Profit	2.55%	15.56%	(14.54%)	9.29%	0.48%	28.15%	112.28%	75.91%	16.87%	48.85%	(3.87%)
Operating Income	(1.02%)	25.55%	(20.53%)	12.69%	(3.99%)	23.53%	239.88%	129.08%	9.67%	59.21%	(10.71%)
Net Income	9.71%	24.82%	(26.38%)	5.81%	(6.43%)	49.14%	334.41%	151.57%	11.90%	68.86%	(11.99%)
<b>As a % of Net Revenue:</b>											
Gross Profit	64.58%	67.17%	65.94%	65.01%	68.04%	71.70%	75.20%	73.93%	65.82%	70.92%	71.07%
Product Development	13.50%	12.07%	12.69%	11.41%	13.44%	18.17%	14.67%	14.60%	11.09%	13.81%	14.77%
Sales & Marketing Exp.	12.01%	11.45%	13.80%	14.63%	15.69%	14.54%	14.92%	15.77%	12.19%	14.06%	15.09%
General & Admin. Exp.	8.82%	9.46%	8.25%	7.25%	7.18%	11.23%	9.07%	8.28%	5.06%	7.68%	8.29%
Operating Income	30.25%	34.19%	31.21%	31.73%	31.72%	27.75%	36.54%	35.28%	37.48%	35.37%	32.92%
Net Income	24.22%	27.21%	23.01%	21.96%	21.40%	19.05%	25.11%	24.39%	28.38%	25.31%	23.22%
<b>Tax Rate</b>	20.12%	20.64%	23.27%	20.23%	21.88%	13.50%	22.75%	24.00%	20.55%	21.23%	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 - \$18.29

### **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

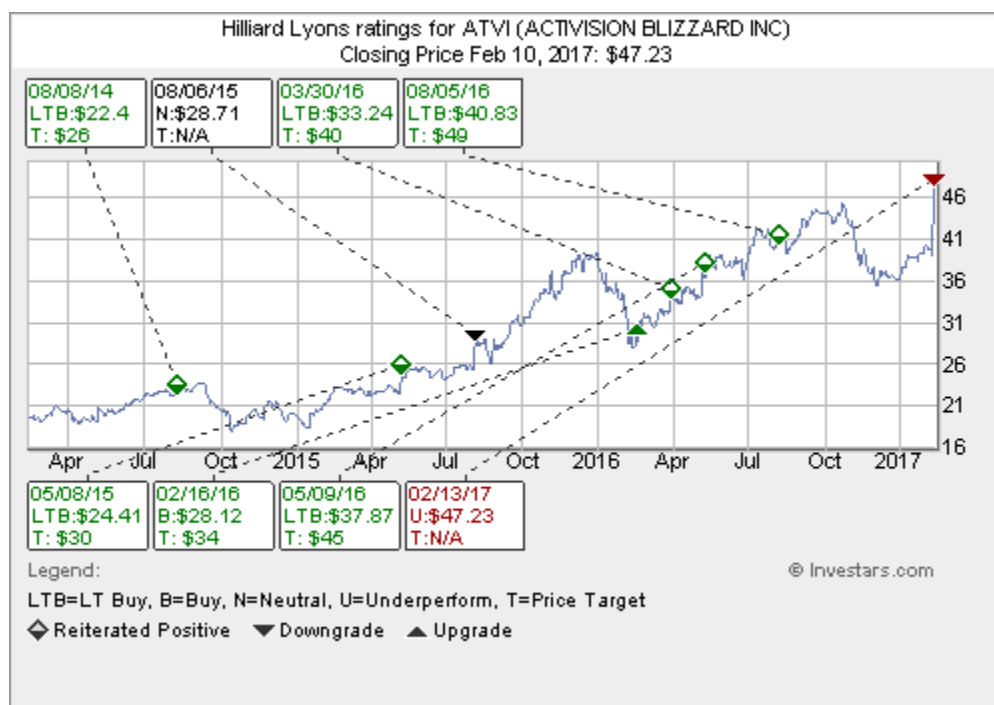
**2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

**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

<b>Rating</b>	<b>Hilliard Lyons Recommended Issues</b>		<b>Investment Banking Provided in Past 12 Mo.</b>	
	<b># of Stocks Covered</b>	<b>% of Stocks Covered</b>	<b>Banking</b>	<b>No Banking</b>
<b>Buy</b>	36	30%	17%	83%
<b>Hold/Neutral</b>	76	62%	7%	93%
<b>Sell</b>	10	8%	0%	100%

*As of 6 February 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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