



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

| | | |
|----------------------------------|-----------------|-------------------|
| ATVI - NASDAQ | (as of 2/12/18) | \$68.32 |
| Price Target | | N/A |
| 52-Week Range | | \$44.47 - \$74.94 |
| Shares Outstanding (mil) (basic) | | 757 |
| Market Cap. (\$mil) | | \$51,718 |
| 3-Mo. Average Daily Volume | | 6,050,000 |
| Institutional Ownership ~ | | 92% |
| Total Debt/Total Capital (12/17) | | 32% |
| ROE (TTM ended 12/17) | | 19% |
| Book Value/Share (12/17) | | \$12.50 |
| Price/Book Value | | 5.5x |
| Annual Dividend & Yield | \$0.34 | 0.5% |
| EBITDA Margin (TTM ended 12/17) | | 36% |

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

| | 2016 | 2017 | Prior 2018E | Curr. 2018E |
|------|--------|--------|----------------|----------------|
| 1Q | \$0.23 | \$0.31 | | \$0.32 |
| 2Q | \$0.54 | \$0.43 | | \$0.46 |
| 3Q | \$0.52 | \$0.60 | | \$0.65 |
| 4Q | \$0.92 | \$0.94 | | \$1.12 |
| Year | \$2.20 | \$2.28 | \$2.53 | \$2.55 |
| P/E | 31.1x | 30.0x | | 26.8x |

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

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

| | 2016 | Curr. 2017 | Prior 2018E | Curr. 2018E |
|------|---------|---------------|----------------|----------------|
| 1Q | \$908 | \$1,196 | | \$1,290 |
| 2Q | \$1,609 | \$1,418 | | \$1,450 |
| 3Q | \$1,630 | \$1,902 | | \$1,935 |
| 4Q | \$2,452 | \$2,640 | | \$2,800 |
| Year | \$6,599 | \$7,156 | \$7,400 | \$7,475 |

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 — Neutral-2

4Q Results: A Good End to 2017

Investment Highlights

- 4Q results impressed us.** Net bookings (a non-GAAP revenue measure that excludes changes in deferred revenue and certain nonrecurring items) were \$2.640 billion, up 8% from a year ago. The street consensus estimate was \$2.550 billion. Console Games was up 11%, about as we expected; the main driver was the performance from an overall better *Call of Duty* game compared to last year's iteration. The other segments—PC, Mobile, and Other—all exceeded our expectation. The Other segment is relatively small at this time but includes businesses related to e-sports/competitive gaming; net bookings for this segment rose nearly 40%.
- Profits also exceeded expectations.** Operating margin declined compared to a relatively lofty figure a year ago, but profits rose nonetheless, as non-GAAP diluted EPS moved to \$0.94 from \$0.92 a year ago. This was above original company guidance of \$0.82 and recent street consensus of \$0.93. The company produced EPS “beats” relative to guidance in all four quarters of 2017.
- The balance sheet was solid, in our view.** Total cash and equivalents as of 12/31/17 were \$4.713 billion. This exceeded total debt of \$4.390 billion, which was 32% of total capitalization. Interest coverage and leverage ratios were adequate, indicating additional borrowing power, if desired. Shareholders' equity was \$9.462 billion.
- Management issued 2018 financial guidance.** Net bookings for the current year were set at \$7.450 billion, up 4% from last year. Non-GAAP EPS guidance was set at \$2.50, up 10% from 2017. We have fine-tuned our net bookings and EPS projections, which are just slightly above company guidance.
- We maintain our Neutral rating.** We like recent results and growth-oriented outlooks for the company and industry. However, we prefer a lower valuation for purchases. Our Suitability rating remains 2.

Note Important Disclosures on Pages 6-7.

Note Analyst Certification on Page 6.

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.

As with earlier quarters in 2017, we were positively surprised by ATVI's 4Q results as revenues and profits exceeded our expectations. Due to past acquisitions and various levels of growth among business segments, the company now has an enviable mix of console, PC, and mobile gaming revenues, in our view. Total company audience reach was at a substantial 385 million monthly active users (MAUs) in 4Q, up slightly from the previous quarter. The Console gaming segment had 55 million MAUs in the quarter and grew net bookings 11% due largely to a more popular and more traditional *Call of Duty: WWII* game compared to somewhat of a deviation with *Call of Duty: Infinity Warfare* one year ago.

The PC segment, largely product from the Blizzard Entertainment division, ended the quarter with 40 million MAUs, continuing a six-quarter streak of meeting or surpassing this figure. The leading driver at this time remains *Overwatch*, a May 2016 release, with *Hearthstone* also a significant contributor. Net bookings were down about 7% due mainly to the natural maturation trend of *Overwatch* since its debut.

At mobile game developer King Digital (a February 2016 acquisition), net bookings were up about 7% even with lower MAUs. This was possible due to fresh content releases with compelling in-game features and a record 37 minutes of gaming time spent per user. The biggest franchise, *Candy Crush*, was up in MAUs.

The Other category grew net bookings nearly 40%. This segment includes the company's studio and distribution businesses, along with the faster growing competitive gaming initiatives—the Major League Gaming platform and the recently launched *Overwatch League*.

We were impressed by ATVI's operating performance for the quarter, with revenues and earnings surpassing year ago and guidance levels. MAUs are at significant levels and we expect higher figures in 2018. We continue to like the strength of the digital business; revenues through digital/online channels represented a record 78% of 4Q revenues.

Financial condition. We consider ATVI's balance sheet to be in good shape, with a sizable cash position and a manageable debt level. Strong cash flows have allowed for significant debt reduction in recent years. Net debt (debt minus cash) at 2017 year end produced a positive cash figure of \$323 million. This compares to net debt figures of \$1.642 billion at 2016 year end and \$2.251 billion at 2015 year end. Shareholders' equity at 2017 year end was \$9.462 billion.

The company also announced a dividend increase, taking its annual payment up 13% to \$0.34 per share. The dividend is payable on May 9 to shareholders of record March 30. The company initiated dividends in 2014 and has raised the rate each year. Further, the Board authorized \$1 billion in potential debt reduction and continued to support an existing \$1 billion share repurchase program.

E-sports update. The *Call of Duty World League* began in December with strong viewership metrics. The inaugural season of the company's *Overwatch League* began in January 2018. Initial franchises were sold to 12 teams, with owners/buyers including some high-profile figures with sports/entertainment/business backgrounds. In addition, league sponsorship deals have been signed with some major companies, including HP, Intel, Toyota, and T-Mobile. The *Overwatch League* involves world-class players/teams competing against each other, with viewing options either live (ex: Blizzard Arena in Los Angeles) or worldwide streaming (ex: online/Internet-enabled devices).

As a refresher, e-sports 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. Associated revenue streams from competitive gaming leagues could be multi-fold, in our view, including live streaming media rights, franchise fees, sponsorship deals, and advertising.

At this time, we believe 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 stated it expects the *Overwatch League* to be profitable in 2018 but is building the e-sports business for the long-term. We view e-sports as a significant long-term positive factor and will be closely monitoring the company's and industry's initiatives.

Outlook. Major contributors in 2018 are expected to include continued sales of *Destiny 2* (a September 2017 release) and a major expansion pack for the franchise (4Q 2018), a new *Call of Duty* game (planned November 2018 release), a major new expansion pack for the *World of Warcraft* PC franchise (3Q 2018), and continued growth of the company's competitive gaming initiatives, including its Major League Gaming platform and the recently launched *Overwatch League*.

We also anticipate a major step forward for the company's mobile gaming business; this includes greater revenue generation from King Digital's existing offerings (including *Candy Crush*), new franchises, and the introduction of a proven console/PC franchise from the company on mobile platforms. We expect in-game ad revenue generation to take a step forward following relatively small steps in past years.

Management's initial guidance for 2018 included net bookings of \$7.450 billion and non-GAAP EPS of \$2.50. Our new estimates for these metrics are \$7.475 billion and \$2.55, respectively. At this point, we have not factored e-sports into our 2018 outlook to a meaningful degree. As the league develops and gains traction, and as economics (revenues and expenses) become clearer, we could update our estimates.

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, consumer products, movies, and television.

Stock valuation. ATVI shares are currently trading at approximately 27x our 2018 non-GAAP EPS estimate. According to Thomson Reuters, the forward multiple range for ATVI over the past five years is 13x-29x, with a median of 18x. However, multiples in recent years have typically been in the upper end of that range; we believe this is directly related to the company's strong operating results and expanding growth opportunities including e-sports. For example, over the past twelve months, the forward multiple range is 25x-29x with a median figure of 28x.

Opinion. We believe 2018 is likely to be another record year for ATVI based on favorable industry dynamics and a strong company-specific outlook. We like the product pipelines across each segment as well as the new businesses being launched or explored. We believe there are some uncertainties, such as those associated with the e-sports initiative (economics and magnitude of the business, the competitive environment, and long-term viability), but we take solace by the company's proven strong financial management with profits and shareholder value as high priorities.

We believe ATVI is a best-in-class operator with an exciting growth-oriented future. The company's fundamental outlook is strong and its cash flow generation potential is healthy, in our view. Substantial price appreciation in 2017 (up 75% for the calendar year) and a further rise in the 2018 year-to-date period has kept ATVI shares at an above-average valuation and out of our preferred buying range. However, given the strength of its core business along with potential new waves of growth from e-sports, consumer products, movies, and television initiatives, we believe investors should hold existing positions. Based on the current stock valuation and fundamental factors including earnings growth potential, we maintain our Neutral rating. We could upgrade our rating at a lower valuation, assuming no change in company fundamentals.

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

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018E |
|-------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Console | \$2,895 | \$2,686 | \$2,700 | \$2,269 | \$2,599 | \$2,700 |
| PC | 1,124 | 1,720 | 1,565 | 2,259 | 1,975 | 2,175 |
| Mobile & Ancillary | 0 | 0 | 0 | 1,706 | 2,095 | 2,150 |
| Other | 323 | 407 | 356 | 365 | 487 | 450 |
| Net Revenue | 4,342 | 4,813 | 4,621 | 6,599 | 7,156 | 7,475 |
| Cost of Sales | 1,479 | 1,684 | 1,477 | 1,919 | 2,104 | 2,100 |
| Gross Profit | 2,863 | 3,129 | 3,144 | 4,680 | 5,052 | 5,375 |
| Product Development | 551 | 549 | 621 | 911 | 1,006 | 1,075 |
| Sales & Marketing Exp. | 599 | 704 | 725 | 928 | 1,039 | 1,110 |
| General & Admin. Exp. | 358 | 349 | 332 | 507 | 609 | 640 |
| Total Oper. Exp. | 1,508 | 1,602 | 1,678 | 2,346 | 2,654 | 2,825 |
| Operating Income | 1,355 | 1,527 | 1,466 | 2,334 | 2,398 | 2,550 |
| Int. Inc. (Exp.) & Other | (53) | (202) | (200) | (214) | (146) | (105) |
| Income Before Taxes | 1,302 | 1,325 | 1,266 | 2,120 | 2,252 | 2,445 |
| Provision for Taxes | 303 | 268 | 277 | 450 | 503 | 489 |
| Net Income | \$999 | \$1,057 | \$989 | \$1,670 | \$1,749 | \$1,956 |
| Diluted EPS | \$0.94 | \$1.42 | \$1.32 | \$2.20 | \$2.28 | \$2.55 |
| Wtd. Diluted Shares Outst. | 1,035 | 726 | 739 | 754 | 766 | 768 |
| % Year Over Year Chg. | | | | | | |
| Net Revenue | (12.93%) | 10.85% | (3.99%) | 42.80% | 8.44% | 4.46% |
| Gross Profit | (14.54%) | 9.29% | 0.48% | 48.85% | 7.95% | 6.39% |
| Operating Income | (20.53%) | 12.69% | (3.99%) | 59.21% | 2.74% | 6.34% |
| Net Income | (26.38%) | 5.81% | (6.43%) | 68.86% | 4.73% | 11.84% |
| As a % of Net Revenue: | | | | | | |
| Gross Profit | 65.94% | 65.01% | 68.04% | 70.92% | 70.60% | 71.91% |
| Product Development | 12.69% | 11.41% | 13.44% | 13.81% | 14.06% | 14.38% |
| Sales & Marketing Exp. | 13.80% | 14.63% | 15.69% | 14.06% | 14.52% | 14.85% |
| General & Admin. Exp. | 8.25% | 7.25% | 7.18% | 7.68% | 8.51% | 8.56% |
| Operating Income | 31.21% | 31.73% | 31.72% | 35.37% | 33.51% | 34.11% |
| Net Income | 23.01% | 21.96% | 21.40% | 25.31% | 24.44% | 26.17% |
| Tax Rate | 23.27% | 20.23% | 21.88% | 21.23% | 22.34% | 20.00% |

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 - \$26.71
- HP Inc. - HPQ - 20.41
- Intel Corp. - INTC - \$44.83 - Long-term Buy
- Toyota Motor Corp. - TM - \$138.76
- T-Mobile US Inc. - TMUS - \$58.12

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

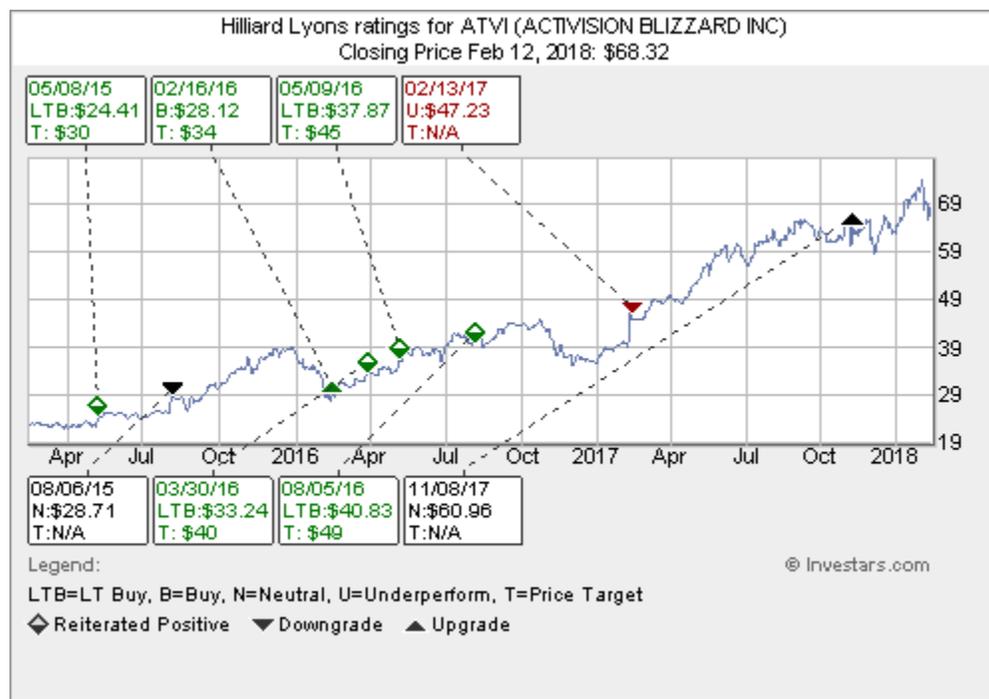
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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

| Rating | Hilliard Lyons Recommended Issues | | Investment Banking Provided in Past 12 Mo. | |
|---------------------|--|--------------------------------|---|-------------------|
| | # of Stocks Covered | % of Stocks Covered | Banking | No Banking |
| Buy | 31 | 28% | 10% | 90% |
| Hold/Neutral | 74 | 66% | 9% | 91% |
| Sell | 7 | 6% | 0% | 100% |

As of 7 February 2018



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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