

COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

ATVI - NASDAQ	(as of 5/8/17)	\$53.99
Price Target		N/A
52-Week Range		\$35.12 - \$54.75
Shares Outstanding (mm) (basic)		749
Market Cap. (\$mm)		\$40,439
3-Mo. Average Daily Volume		7,680,334
Institutional Ownership ~		89%
Total Debt/Total Capital (3/17)		32%
ROE (TTM ended 3/17)		19%
Book Value/Share (3/17)		\$12.60
Price/Book Value		4.3x
Annual Dividend & Yield	\$0.30	0.6%
EBITDA Margin (TTM ended 3/17)		37%

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		\$0.28		
3Q	\$0.52		\$0.44		
4Q	\$0.92		\$0.88		
Year	\$2.20	\$1.92	\$1.91		\$2.35
P/E	24.5x		28.3x		23.0x

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		\$1,200		
3Q	\$1,630		\$1,527		
4Q	\$2,452		\$2,427		
Year	\$6,599	\$6,330	\$6,350		\$6,925

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 1Q Results; Fundamentals Remain Strong, But Valuation Seems Rich to Us
Investment Highlights

- 1Q results were better than expected.** Non-GAAP revenues of \$1.196 billion were up 32% from a year ago, reflecting growth from Blizzard Entertainment (large-scale PC games) and King Digital (a mobile videogame publisher acquired in February 2016). The quarter included a revenue decline from Activision Publishing, which is seeing lower demand for the most recent *Call of Duty* game versus the franchise's previous release.
- Profits were considerably higher.** Operating margin rose over 150 basis points, helping lead to non-GAAP diluted EPS of \$0.31 versus \$0.23 a year ago, up 35%. Company guidance was \$0.18 and recent street consensus was \$0.21. In a display of favorable operating momentum, the considerable "beat" in 1Q 2017 EPS followed a similar outcome in the preceding quarter (4Q 2016).
- The balance sheet improved a bit.** The company paid down \$500 million of debt, ending the quarter with total debt of \$4.393 billion. Total cash was \$3.248 billion. There were no share buybacks in the quarter, despite a recently announced \$1 billion repurchase authorization.
- Management updated its financial guidance.** Non-GAAP revenue guidance for 2017 was set at \$6.330 billion, up \$30 million from the previous figure. Non-GAAP EPS guidance was set at \$1.88, up from \$1.85 previously. We have fine-tuned our projections, which are slightly above company guidance. Consistent with history, we feel guidance may be conservative.
- We rate ATVI Underperform based solely on valuation.** Considerable share price gains of late results in an above-average stock valuation compared to company historical averages and current market levels. We believe some profit taking is prudent. Our Suitability rating remains 2.

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

Additional comments on 1Q 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.

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

	Quarter Ended		% chg
	<u>3/31/17</u>	<u>3/31/16</u>	
Activision	\$215	\$360	(40.3%)
Blizzard	441	294	50.0%
King Digital Ent.	474	207	129.0%
Distribution	66	47	40.4%
Net Revenues	<u>1,196</u>	<u>908</u>	31.7%
Cost of Sales	<u>336</u>	<u>257</u>	30.7%
Gross Profit	860	651	32.1%
Product Development	213	165	29.1%
Sales and Marketing Exp.	165	132	25.0%
General & Admin. Exp.	131	102	28.4%
Total Operating Expenses	<u>509</u>	<u>399</u>	27.6%
Operating Income	351	252	39.3%
Investment Inc. (Exp.), net	<u>(40)</u>	<u>(52)</u>	(23.1%)
Income Before Taxes	311	200	55.5%
Provision for Taxes	<u>75</u>	<u>27</u>	177.8%
Net Income	<u>\$236</u>	<u>\$173</u>	36.4%
Diluted Earnings Per Share	<u>\$0.31</u>	<u>\$0.23</u>	34.7%
Avg. Diluted Shares Outst.	761	749	1.6%
Adjusted EBITDA	\$781	\$646	20.9%
% of Net Revenues:			<u>bp chg.</u>
Gross Profit	71.91%	71.70%	21
Product Development	17.81%	18.17%	(36)
Selling & Marketing Exp.	13.80%	14.54%	(74)
General & Admin. Exp.	10.95%	11.23%	(28)
Total Operating Expenses	42.56%	43.94%	(138)
Operating Income	29.35%	27.75%	159
Net Income	19.73%	19.05%	68
Adjusted EBITDA	65.30%	71.15%	(584)
Tax Rate	24.12%	13.50%	1,062

Source: Activision Blizzard, Inc.

Note: December fiscal year

At the Activision Publishing segment, the *Call of Duty* franchise is seeing the effects of sub-par performance for its most recent release. The franchise tends to have a new release in November of each year. In 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. *Infinite Warfare* has underperformed the company's expectations and garnered only average reviews. This has led to some down quarters for the Activision Publishing segment, including the recent 1Q. We note the next *Call of Duty* game, set for November 2017, will return to a traditional military warfare environment, this being based on World War II.

We were impressed with ATVI's 1Q 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 30 million registered players. As an aside, we note *Overwatch* has won over 50 "game of the year" awards from various entities. In addition, Blizzard's *Hearthstone* and *World of Warcraft* franchises had solid quarters.

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 342 million declined from a year ago, but per user engagement figures improved. King has had 2 or more of the top 10 mobile games in the U.S. for 14 consecutive quarters. *Candy Crush* has been the steadiest contributor. The revenue gain in the recent 1Q reflects the timing of the acquisition (only partial quarter of contribution in 1Q 2016).

We liked the increases in total revenues and earnings, led by growth in the higher margin digital channels—up an estimated 32% year-over-year and representing just under 90% of the quarter's revenues. ATVI is among the industry leaders in this favorable (higher profit margin) trend, and the King acquisition boosted its efforts.

1Q earnings exceeded expectations by a considerable margin. This reflected the revenue beat as well as higher margins compared to the year ago period. We note the quarter's strong year-over-year EPS gain despite a higher tax rate and a slightly higher share count.

Financial condition. We consider ATVI's balance sheet to be in good shape, with strong cash flows leading to year-over-year improvement. Total cash and equivalents at March 31, 2017 were \$3.248 billion and long-term debt was \$4.393 billion. Including all debt, the company's net debt was \$1.170 billion, whereas one year ago net debt was a significantly higher \$3.010 billion. Net debt divided by trailing adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) was at a conservative 0.5x, down from 1.9x one year ago. Shareholders' equity at 1Q end was \$9.436 billion.

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 slightly from previous figures, although based mostly on strong 1Q results. ATVI's non-GAAP revenues for 2017 are now expected to approximate \$6.330 billion and non-GAAP EPS are projected at \$1.88. Our new estimates are little changed from our previous view; this reflects strong 1Q results yet conservative assumptions regarding the remaining quarters. Our new annual estimates include non-GAAP revenues of \$6.350 billion and non-GAAP EPS of \$1.91. We have not assumed any share repurchases given the current all-time high stock price.

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 (competitive gaming and accompanying viewership), television, movies, and consumer products.

Management led off its 1Q earnings conference call by discussing what it considers significant long-term opportunities regarding e-sports, including the creation of gaming "leagues" in various cities around the world. This business model could include team sponsors/owners, broadcast revenues, advertising, licensing, and ticket sales for this burgeoning spectator "sport." We have not factored these opportunities into our financial estimates.

Stock valuation. ATVI shares are currently trading at approximately 28x our estimate of forward twelve-month non-GAAP EPS. According to Baseline, the median forward multiple for ATVI over the past ten years is approximately 17x. Meanwhile, the stock's forward P/E multiple is 1.4x 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 55% compared to a 17% gain for the S&P 500, a 29% rise in the NASDAQ Composite, and a 15% increase for the S&P Consumer Discretionary sector.

In sum, we believe 2017 is shaping up to be a solid year for ATVI's revenues and earnings, yet down from a particularly strong year in 2016. Meanwhile, the stock price recently set an all-time high and valuation is at the highest level in about nine years. Prospects for 2018 seem attractive considering the product pipeline and some new businesses being explored, but this could be factored into the current stock price, in our view. 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 2**Non-GAAP Consolidated Statements of Income** (figures in millions except per share data and percentages)

	2013	2014	2015	2016	2017E	2018E
Activision Publishing	\$2,895	\$2,686	\$2,700	\$2,220	\$2,340	\$2,470
Blizzard Entertainment	1,124	1,720	1,565	2,428	1,940	2,275
King Digital Ent.	0	0	0	1,586	1,700	1,800
Other	323	407	356	365	370	380
Net Revenue	4,342	4,813	4,621	6,599	6,350	6,925
Cost of Sales	1,479	1,684	1,477	1,919	1,855	1,910
Gross Profit	2,863	3,129	3,144	4,680	4,495	5,015
Product Development	551	549	621	911	950	970
Sales & Marketing Exp.	599	704	725	928	935	975
General & Admin. Exp.	358	349	332	507	535	565
Total Oper Exp.	1,508	1,602	1,678	2,346	2,420	2,510
Operating Income	1,355	1,527	1,466	2,334	2,075	2,505
Int. Inc. (Exp.) & Other	(53)	(202)	(200)	(214)	(150)	(135)
Income Before Taxes	1,302	1,325	1,266	2,120	1,925	2,370
Provision for Taxes	303	268	277	450	462	569
Net Income	\$999	\$1,057	\$989	\$1,670	\$1,463	\$1,801
Diluted EPS	\$0.94	\$1.42	\$1.32	\$2.20	\$1.91	\$2.35
Wtd. Diluted Shares Outst.	1,035	726	739	753	765	768
% Year Over Year Chg.						
Net Revenue	(12.93%)	10.85%	(3.99%)	42.80%	(3.77%)	9.06%
Gross Profit	(14.54%)	9.29%	0.48%	48.85%	(3.95%)	11.57%
Operating Income	(20.53%)	12.69%	(3.99%)	59.21%	(11.10%)	20.72%
Net Income	(26.38%)	5.81%	(6.43%)	68.86%	(12.40%)	23.12%
As a % of Net Revenue:						
Gross Profit	65.94%	65.01%	68.04%	70.92%	70.79%	72.42%
Product Development	12.69%	11.41%	13.44%	13.81%	14.96%	14.01%
Sales & Marketing Exp.	13.80%	14.63%	15.69%	14.06%	14.72%	14.08%
General & Admin. Exp.	8.25%	7.25%	7.18%	7.68%	8.43%	8.16%
Operating Income	31.21%	31.73%	31.72%	35.37%	32.68%	36.17%
Net Income	23.01%	21.96%	21.40%	25.31%	23.04%	26.01%
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 - \$20.45

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

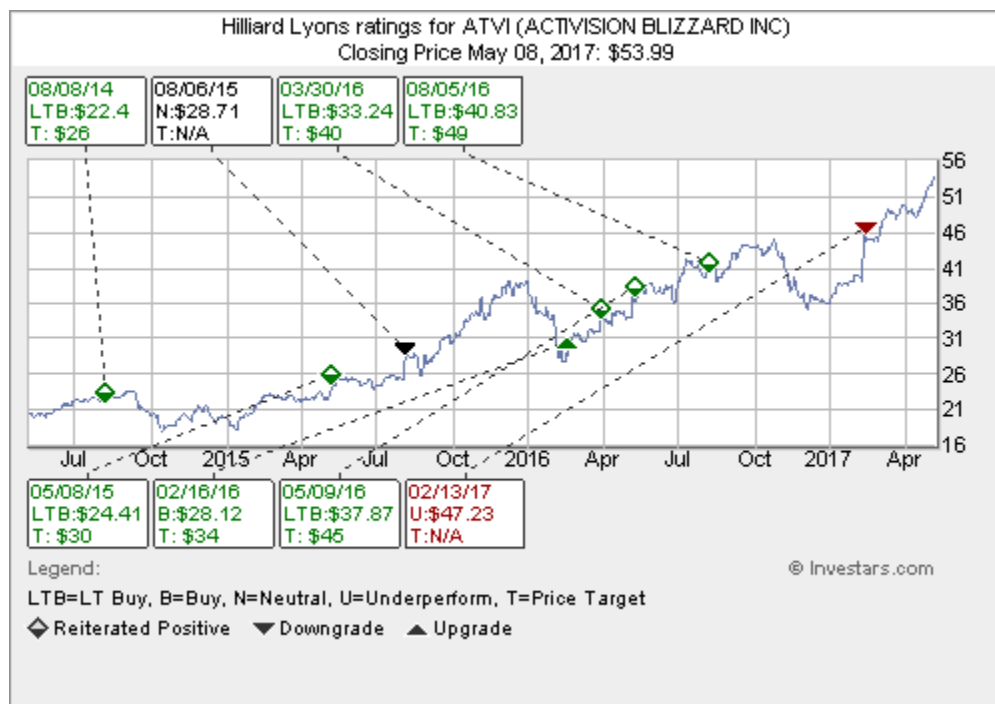
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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 Stocks Covered	% of Stocks Covered	Banking	No Banking
Rating				
Buy	36	30%	14%	86%
Hold/Neutral	71	58%	6%	94%
Sell	15	12%	7%	93%

As of 5 April 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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