



### COMPANY UPDATE / ESTIMATE CHANGE

#### Key Metrics

EA - NASDAQ (as of 8/2/17)	\$116.83
Two Year Price Target	N/A
52-Week Range	\$73.74 - \$120.25
Shares Outstanding (mil)	309
Market Cap. (\$mil)	\$36,100
3-Mo. Average Daily Volume	3,500,000
Institutional Ownership	99%
Total Debt/Total Capital (6/17)	18%
ROE (TTM ended 6/17)	32%
Book Value/Share (6/17)	\$14.52
Price/Book Value	8.0x
Annual Dividend & Yield	Nil Nil
EBITDA Margin (TTM ended 6/17, estim.)	35%

#### EPS FY 3/31 (non-GAAP figures)

	2016	2017	Prior 2018E	Curr. 2018E
1Q	\$0.15	\$0.07		\$0.31 A
2Q	\$0.65	\$0.53		\$0.50
3Q	\$1.83	\$2.48		\$2.40
4Q	\$0.50	\$0.85		\$0.99
<b>Year</b>	<b>\$3.14</b>	<b>\$3.91</b>	<b>\$4.15</b>	<b>\$4.20</b>
P/E	37.2x	29.9x		27.8x

Note: Quarterly EPS figures may not add to annual figure due to rounding

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

	2016	2017	Prior 2018E	Curr. 2018E
1Q	\$693	\$682		\$775 A
2Q	\$1,146	\$1,098		\$1,170
3Q	\$1,803	\$2,070		\$2,055
4Q	\$924	\$1,092		\$1,150
<b>Year</b>	<b>\$4,566</b>	<b>\$4,942</b>	<b>\$5,175</b>	<b>\$5,150</b>

**Company Description:** *Electronic Arts Inc., headquartered in Redwood City, California, is a leading interactive entertainment software company. Founded in 1982, EA develops, publishes, and distributes interactive software worldwide for videogame systems, mobile devices, personal computers, and the Internet. Popular franchises include Madden NFL, FIFA Soccer, Dragon Age, Need for Speed, Battlefield, Mass Effect, Star Wars Battlefront, Titanfall, The Sims, Bejeweled, Plants vs. Zombies, and others.*

## Electronic Arts Inc.

EA — NASDAQ — Neutral-2

### Good Start to FY18; Neutral Rating Based on Stock Valuation

#### Investment Highlights

- **EA produced strong fiscal 1Q results.** Non-GAAP sales for the quarter ended 6/30/17 were \$775 million, up 14% from a year ago and ahead of company guidance and street consensus. Key contributions came from *Mass Effect: Andromeda*, *FIFA Ultimate Team*, *The Sims 4*, and *FIFA Online*. Live services, such as with the *FIFA*, *Battlefield*, and *Sims* franchises and various mobile games, were strong and led to digital sales of \$681 million, or 88% of the quarter's total.
- **Earnings exceeded expectations.** Gross margin on a non-GAAP basis rose 445 basis points as the product mix included greater digital sales. In addition, operating leverage was a positive factor and helped lead to a jump in operating income and operating margin. Non-GAAP EPS of \$0.31 increased considerably from \$0.07 a year ago. This exceeded company guidance of \$0.25 and the street consensus estimate of \$0.27.
- **The balance sheet is in good shape, in our view.** Total cash at quarter end was \$4.470 billion, while debt of \$991 million represented just 18% of total capital.
- **We have fine-tuned our financial model.** Changes to our FY18 outlook are relatively minor, but reflect a slight decline in our sales estimate and a slight increase to our earnings per share figure. We continue to believe factors such as the product pipeline, game quality, industry environment, digital sales, financial strength, and management are positives.
- **We maintain our Neutral rating on EA due to valuation.** We like company and industry fundamentals quite a bit, yet substantial price appreciation of late has kept the shares out of our preferred buying range. The multiple on our FY18 EPS estimate is approximately 28x, above recent and historical median levels. We could consider a rating upgrade at a lower valuation. Our Suitability rating remains 2.

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

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

	<b>First Quarter Ended</b>		<b>% chg.</b>
	<b><u>6/30/17</u></b>	<b><u>6/30/16</u></b>	
Net Revenue	\$775	\$682	13.6%
Cost of Good Sold	<u>153</u>	<u>165</u>	(7.3%)
Gross Profit	622	517	20.3%
Marketing & Sales	114	121	(5.8%)
General & Administrative	93	95	(2.1%)
Research & Development	<u>297</u>	<u>267</u>	11.2%
Total Operating Expenses	504	483	4.3%
Operating Income	118	34	247.1%
Interest and Other Income (Exp.), net	<u>6</u>	<u>(6)</u>	N/A
Income Before Taxes	124	28	342.9%
Taxes	<u>26</u>	<u>6</u>	334.0%
Net Income	<u>\$98</u>	<u>\$22</u>	345.3%
<b>Diluted Earnings Per Share</b>	<b><u>\$0.31</u></b>	<b><u>\$0.07</u></b>	348.1%
Avg. Diluted Shares Outst.	313	315	(0.6%)
<b>% of Net Revenue:</b>			<b><u>bp chg.</u></b>
Gross Profit	80.26%	75.81%	445
Marketing & Sales	14.71%	17.74%	(303)
General & Administrative	12.00%	13.93%	(193)
Research & Development	38.32%	39.15%	(83)
Operating Income	15.23%	4.99%	1,024

Source: Electronic Arts Inc.

Note: March fiscal year

**Further comments on fiscal 1Q.** We were impressed by EA's June quarter, particularly growth in live online services and the resulting margin benefit that comes from greater digital sales. Digital sales can include full game or add-on content downloads as well as in-game purchases (known as microtransactions) for greater gaming experiences. This has been an identifiable industry trend for the past few years. For the trailing twelve-month period, EA's digital sales represented 63% of total company sales. We expect this percentage to increase in the coming quarters, consistent with industry trends. There were no major new videogame releases in the quarter, which kept marketing expenses down.

Slight interest income rather than interest expense, and a modest decline in the weighted average share count led to non-GAAP EPS of \$0.31 versus a low \$0.07 in the year ago period. During the quarter, the company spent \$150 million to repurchase 1.4 million shares, for an average price of about \$107 per share. As a point of reference, we note for all of FY17 (March year end), the company spent \$508 million to repurchase 6.5 million shares, for an average price of \$78 per share. There is currently \$1.080 billion remaining on a share repurchase authorization that was implemented earlier this year.

Although 1Q results were strong relative to year ago figures and general expectations, we note the quarter is typically the smallest of the year due to industry seasonality and EA's product release schedule. Also, we do not expect similarly high percentage increases in operating income and EPS in the remaining quarters of FY18 as EA produced in 1Q.

**Financial condition.** The balance sheet remained strong, in our view. Cash and short-term investments at June 30, 2017, amounted to \$4.470 billion; one year ago, this figure was \$3.425 billion. Inventory and accounts receivable were at satisfactory levels, in our view. Total debt was \$991 million, about 18% of total capitalization; one year ago, this figure was 23%. Shareholders' equity at quarter end was \$4.486 billion.

**Outlook.** We remain bullish on the industry in general and EA in particular. The debut of new gaming consoles in 2013 spurred demand for hardware and software. New versions (basically faster, quicker and less expensive) of the consoles are now on the market, and further refined versions are in the works, including those with 4K video and virtual reality features. Price cuts on existing consoles are likely to continue, in our view, and could further increase overall console ownership levels on a global basis. As for EA, we believe it has a strong portfolio of high quality franchises, including some relatively new ones such as *Mass Effect* and *Titanfall*, along with “evergreen” franchises such as *Battlefield*, *Sims*, *Madden NFL* and *FIFA*. Importantly, we feel all of the company’s franchises have a meaningful digital sales component that we expect to increase over time.

For FY18, we expect a healthy industry environment, strong new titles, and further growth of existing titles. Key releases include a new *Star Wars Battlefront* game in November 2017, new versions of popular sports franchises such as *Madden NFL* and *FIFA*, the addition of *NBA Live* (from a previous assumption of a late FY17 release), a new *Need for Speed* racing game, growth of recent releases *Battlefield 1* and *Titanfall 2*, and growth in the mobile game business including new *Star Wars* content. A new action-adventure game called *Anthem* from the highly respected internal studio BioWare is slated for FY19.

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 EA has numerous videogame franchises well-suited for competitive dynamics and global viewership (including its globally popular sports franchises). 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. We will be closely monitoring this development.

We have made minor adjustments to our FY18 financial model based on 1Q results and the latest company guidance. We expect the shift to digital sales to continue, which could allow for further margin improvement. Foreign currency headwinds are expected to continue in FY18 and we expect the industry to remain highly competitive as usual. Company guidance includes non-GAAP sales of \$5.100 billion and EPS of \$4.10. In a fine-tuning measure, we are lowering our sales estimate by \$25 million to \$5.150 billion but increasing our EPS estimate by \$0.05 to \$4.20 after updating our margin assumptions.

**Valuation.** EA shares are currently trading at about 28x our non-GAAP EPS estimate for FY18. For recent perspective, at the time of our recent downgrade to a Neutral rating (research report dated 5/12/17), the stock was trading at 26x our FY18 EPS estimate. EA’s median forward P/E multiple over the past ten years is 22.5x and over the past five years is 21.3x. On a relative valuation note, EA shares are currently trading at 1.4x the forward multiple on the S&P 500. This compares to a median multiple of 1.3x over the past ten years and 1.2x over the past five years.

**Opinion.** With meaningful price appreciation over the past twelve months—EA up 48% compared to an 11% rise for the S&P 500—valuations have risen and the share price is out of our preferred buying range. Current valuations are above recent and historical median levels, perhaps reflective of strong recent results and a favorable outlook, in our view. Still, we find current valuations a bit rich and therefore prefer the sidelines at this time.

**Suitability.** Our Suitability rating on EA is 2 on a 1-to-4 scale (1=most conservative, 4=most aggressive). This is based on factors such as earnings history, market capitalization, financial condition, product portfolio, and market leadership positions.

**Risks.** We believe factors that could affect the outlook for the company and the stock price include: financial management during various stages of the industry's hardware cycle; success and availability of new consoles in the marketplace; investment spending to sustain market leadership positions; product development costs related to coming platforms; creative and financial abilities to bring popular games to market; healthy relationships with the major console manufacturers; and maintenance of key entertainment property licenses.

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

	<b><u>FY18E</u></b>	<b><u>FY17</u></b>	<b><u>FY16</u></b>	<b><u>FY15</u></b>	<b><u>FY14</u></b>
Net Revenue	\$5,150	\$4,942	\$4,566	\$4,219	\$4,021
Cost of Good Sold	<u>1,280</u>	<u>1,252</u>	<u>1,305</u>	<u>1,153</u>	<u>1,285</u>
Gross Profit	3,870	3,690	3,261	3,066	2,736
Marketing & Sales	645	642	598	626	654
General & Administrative	390	386	357	352	330
Research & Development	<u>1,150</u>	<u>1,096</u>	<u>1,006</u>	<u>1,012</u>	<u>1,035</u>
Total Operating Expenses	2,185	2,124	1,961	1,990	2,019
Operating Income	1,685	1,566	1,300	1,076	717
Interest and Other Inc. (Exp.), net	<u>(10)</u>	<u>(12)</u>	<u>6</u>	<u>(1)</u>	<u>(5)</u>
Income Before Taxes	1,675	1,554	1,306	1,075	712
Taxes	<u>352</u>	<u>326</u>	<u>288</u>	<u>269</u>	<u>178</u>
Net Income	<u>\$1,323</u>	<u>\$1,228</u>	<u>\$1,018</u>	<u>\$806</u>	<u>\$534</u>
<b>Diluted Earnings Per Share</b>	<b><u>\$4.20</u></b>	<b><u>\$3.91</u></b>	<b><u>\$3.14</u></b>	<b><u>\$2.51</u></b>	<b><u>\$1.69</u></b>
Avg. Diluted Shares Outst.	315	314	324	321	316
<b>% change:</b>					
Net Revenue	4.21%	8.23%	8.22%	4.92%	6.01%
Gross Profit	4.88%	13.16%	6.36%	12.06%	9.44%
Marketing & Sales	0.47%	7.36%	(4.47%)	(4.28%)	(13.72%)
General & Administrative	1.04%	8.12%	1.42%	6.67%	4.43%
Research & Development	4.93%	8.95%	(0.59%)	(2.22%)	(2.27%)
Operating Income	7.60%	20.46%	20.82%	50.07%	95.37%
Net Income	7.79%	20.60%	26.26%	50.98%	102.27%
<b>% of Net Revenue:</b>					
Gross Profit	75.15%	74.67%	71.42%	72.67%	68.04%
Marketing & Sales	12.52%	12.99%	13.10%	14.84%	16.26%
General & Administrative	7.57%	7.81%	7.82%	8.34%	8.21%
Research & Development	22.33%	22.18%	22.03%	23.99%	25.74%
Operating Income	32.72%	31.69%	28.47%	25.50%	17.83%
Net Income	25.69%	24.84%	22.30%	19.11%	13.28%
Tax Rate	21.00%	21.00%	22.05%	25.00%	25.00%

Source: Electronic Arts Inc. and Hilliard Lyons estimates

Note: March fiscal year

*Additional information is available upon request.*

Prices of other stocks mentioned: The Walt Disney Co. - DIS - \$108.67 - Long-term Buy

### 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.

### 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

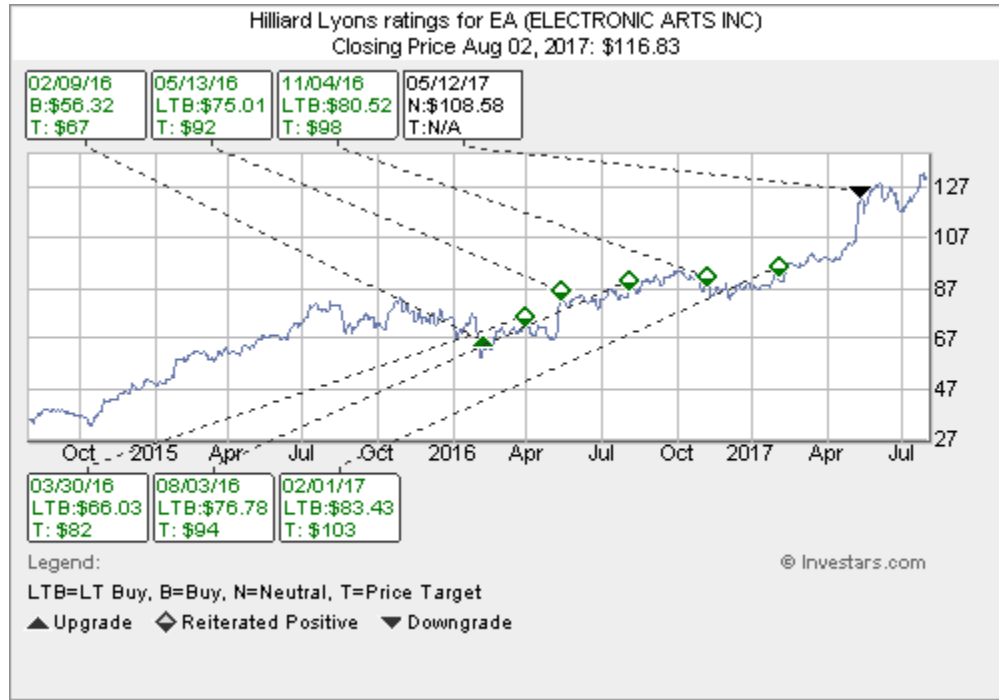
**2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

**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

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

### Other Disclosures

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