



COMPANY UPDATE / ESTIMATE CHANGE / RATING CHANGE

Key Metrics

EA - NASDAQ	(as of 5/11/17)	\$108.58
Two Year Price Target		N/A
52-Week Range		\$71.01 - \$110.61
Shares Outstanding (mm)		308
Market Cap. (\$mm)		\$33,443
3-Mo. Average Daily Volume		2,822,818
Institutional Ownership		98%
Total Debt/Total Capital (3/17)		20%
ROE (TTM ended 3/17)		33%
Book Value/Share (3/17)		\$13.18
Price/Book Value		8.2x
Annual Dividend & Yield	Nil	Nil
EBITDA Margin (TTM ended 3/17, estim.)		34%

EPS FY 3/31 (non-GAAP figures)

	2016	2017	Prior 2018E	Curr. 2018E
1Q	\$0.15	\$0.07		
2Q	\$0.65	\$0.53		
3Q	\$1.83	\$2.48		
4Q	\$0.50	\$0.85		
Year	\$3.14	\$3.91	\$4.20	\$4.15
P/E	34.6x	27.8x		26.2x

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		
2Q	\$1,146	\$1,098		
3Q	\$1,803	\$2,070		
4Q	\$924	\$1,092		
Year	\$4,566	\$4,942	\$5,250	\$5,175

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.*

Entertainment & Leisure

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May 12, 2017

Electronic Arts Inc.

EA — NASDAQ — Neutral-2

Good 4Q Results, But Share Price Rise Takes Stock Out of Our Preferred Buying Range

Investment Highlights

- **EA produced strong fiscal 4Q results.** Non-GAAP sales of \$1.092 billion were up 18% from a year ago, ahead of company guidance but essentially in line with our and street expectations. A key game release (*Mass Effect: Andromeda*), solid sales of older releases (such as *Battlefield 1*), and growth in high margin digital sales (including the *FIFA* franchise) were contributing factors.
- **As in recent quarters, earnings exceeded expectations.** Gross margin rose as the product mix included greater digital sales. In addition, operating costs were well contained and the weighted average share count was down due to past repurchases. Non-GAAP EPS of \$0.85 increased considerably from \$0.50 a year ago. This exceeded company guidance, the street consensus estimate, and our projection.
- **We have fine-tuned our financial model.** We view FY17 results and the outlook for the current year favorably. Changes to our FY18 outlook reflect slight declines in non-GAAP sales and EPS, but our new figures remain above company guidance. Our outlook reflects a game release that we assumed would occur in FY18 but has been pushed into FY19. Longer-term, we believe key factors such as the product pipeline, game quality, industry environment, digital sales, financial strength, and management are positives.
- **We are lowering our rating on EA to Neutral from Long-term Buy.** We like company and industry fundamentals, yet recent substantial price appreciation has moved EA shares out of our preferred buying range. The multiple on our estimate of forward earnings is just over 26x, meaningfully 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.**

Further comments on 4Q results. We were impressed by the March quarter's continued strength of digital sales, which are typically higher margin than disk-based 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. EA's digital sales for the recent 4Q rose 24% from the year ago period to \$885 million, or 81% of the company's \$1.092 billion. Key drivers of digital sales included *FIFA Ultimate Team*, *The Sims*, and games for mobile devices, among others.

Growth in digital sales and general cost containment led to higher profit margins in 4Q. In addition, the weighted average share count was 3% lower due to share repurchases over the past year. In 4Q, the company spent \$125 million to repurchase 1.5 million shares, for an average price of \$83 per share. For all of FY17, \$508 million was spent to repurchase 6.5 million shares, for an average price of \$78 per share. For 4Q, non-GAAP EPS of \$0.85 compared favorably to \$0.50 a year ago. This was above our estimate of \$0.74 and street consensus of \$0.75.

The videogame business can be seasonal and unsystematic due to game release patterns. Some quarters can have multiple releases, while others can have essentially none. For that reason, we suggest investors pay close attention to annual results. For the recently concluded FY17 year (March period end), EA's non-GAAP sales were \$4.942 billion and non-GAAP EPS were \$3.91. This represents gains of 8% and 25%, respectively, from the prior year.

Financial condition. The balance sheet remained solid, in our view. Cash and short-term investments at March 31, 2017, amounted to \$4.532 billion. Inventory and accounts receivable were at satisfactory levels, in our view. Total debt was \$990 million, about 20% of total capitalization. Shareholders' equity at quarter end was \$4.060 billion.

As mentioned above, the company continued with share repurchase activity during the quarter and throughout all of FY17. Subsequent to 4Q end, an additional \$31 million of repurchases represented completion of a \$1 billion buyback program that began in May 2015. Along with the release of 4Q results, the company announced a new \$1.2 billion program that expires in May 2019.

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, 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, along with "evergreen" franchises such as *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 generally 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 previously expected new action-adventure game from the highly respected internal studio, BioWare, is now slated for FY19. For FY18, we expect the shift to digital sales to continue, which could allow for further margin improvement. On the negative side, foreign currency headwinds are expected to continue in FY18 and we expect the industry to remain competitive as always. 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 \$75 million to \$5.175 billion and lowering our EPS estimate by \$0.05 to \$4.15.

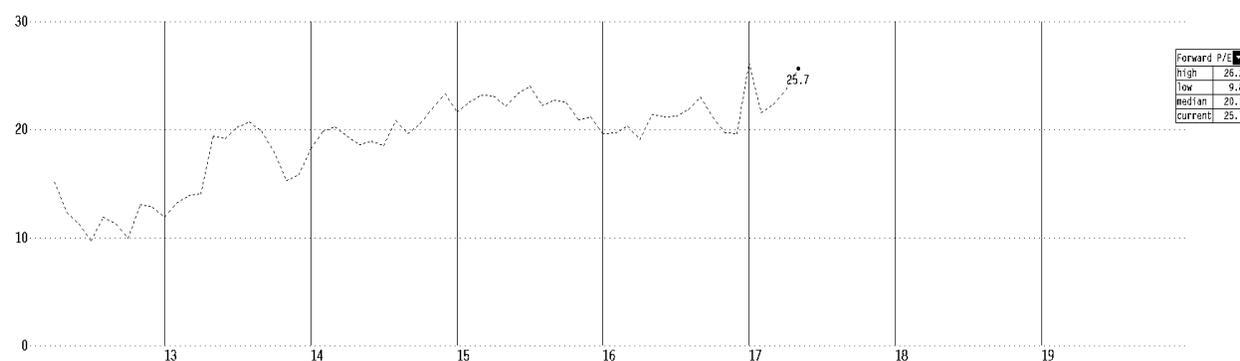
Valuation. EA shares are currently trading at 26.2x our non-GAAP EPS estimate for FY18, a period that also represents forward twelve-month earnings. For recent perspective, when we discussed the company's FY17 2Q and 3Q results (at which times our rating on EA was Long-term Buy), the forward multiples were approximately 21x in both instances.

For a longer term perspective, the current 26.2x multiple on projected twelve-month forward earnings compares to EA's median forward P/E multiple over the past ten years of 21.4x and 20.1x over the past five years (see Exhibit 1 below).

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.

Exhibit 1

EA - Historical Forward P/E Multiples



Source: Baseline

Note: March fiscal year

Opinion. We are lowering our rating on EA to Neutral from Long-term Buy, as the share price has surpassed our previous two-year target of \$103. With meaningful price appreciation over the past twelve months—EA up 68% compared to a 15% rise for the S&P 500—we consider the shares out of our preferred buying range. Current valuations are above recent and historical median levels, perhaps reflective of strong recent results and a generally 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)

	FY18E	FY17	FY16	FY15	FY14
Net Revenue	\$5,175	\$4,942	\$4,566	\$4,219	\$4,021
Cost of Good Sold	<u>1,300</u>	<u>1,252</u>	<u>1,305</u>	<u>1,153</u>	<u>1,285</u>
Gross Profit	3,875	3,690	3,261	3,066	2,736
Marketing & Sales	675	642	598	626	654
General & Administrative	405	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	2,230	2,124	1,961	1,990	2,019
Operating Income	1,645	1,566	1,300	1,076	717
Interest and Other Inc. (Exp.), net	<u>(12)</u>	<u>(12)</u>	<u>6</u>	<u>(1)</u>	<u>(5)</u>
Income Before Taxes	1,633	1,554	1,306	1,075	712
Taxes	<u>343</u>	<u>326</u>	<u>288</u>	<u>269</u>	<u>178</u>
Net Income	<u>\$1,290</u>	<u>\$1,228</u>	<u>\$1,018</u>	<u>\$806</u>	<u>\$534</u>
Diluted Earnings Per Share	<u>\$4.15</u>	<u>\$3.91</u>	<u>\$3.14</u>	<u>\$2.51</u>	<u>\$1.69</u>
Avg. Diluted Shares Outst.	311	314	324	321	316
% change:					
Net Revenue	4.71%	8.23%	8.22%	4.92%	6.01%
Gross Profit	5.01%	13.16%	6.36%	12.06%	9.44%
Marketing & Sales	5.14%	7.36%	(4.47%)	(4.28%)	(13.72%)
General & Administrative	4.92%	8.12%	1.42%	6.67%	4.43%
Research & Development	4.93%	8.95%	(0.59%)	(2.22%)	(2.27%)
Operating Income	5.04%	20.46%	20.82%	50.07%	95.37%
Net Income	5.08%	20.60%	26.26%	50.98%	102.27%
% of Net Revenue:					
Gross Profit	74.88%	74.67%	71.42%	72.67%	68.04%
Marketing & Sales	13.04%	12.99%	13.10%	14.84%	16.26%
General & Administrative	7.83%	7.81%	7.82%	8.34%	8.21%
Research & Development	22.22%	22.18%	22.03%	23.99%	25.74%
Operating Income	31.79%	31.69%	28.47%	25.50%	17.83%
Net Income	24.93%	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 - \$109.58 - 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

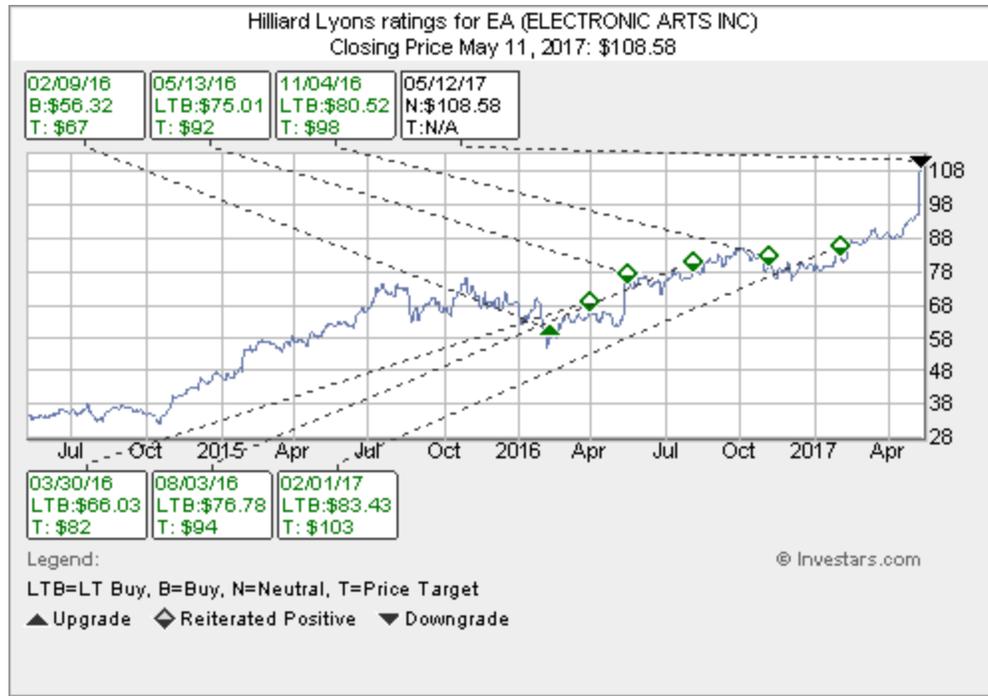
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Rating				
Buy	32	26%	13%	88%
Hold/Neutral	79	64%	8%	92%
Sell	12	10%	0%	100%

As of 8 May 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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