



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

EA - NASDAQ (as of 10/31/17)	\$119.60
Two Year Price Target	N/A
52-Week Range	\$73.74 - \$122.79
Shares Outstanding (mil)	309
Market Cap. (\$mil)	\$36,956
3-Mo. Average Daily Volume	2,370,000
Institutional Ownership	97%
Total Debt/Total Capital (9/17)	18%
ROE (TTM ended 9/17)	30%
Book Value/Share (9/17)	\$14.20
Price/Book Value	8.4x
Annual Dividend & Yield	Nil Nil
EBITDA Margin (TTM ended 9/17, estim.)	31%

EPS FY 3/31 (non-GAAP figures)

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	\$0.07		\$0.31	A	
2Q	\$0.53		\$0.62	A	
3Q	\$2.48	\$2.40	\$2.17		
4Q	\$0.85	\$0.99	\$1.12		
Year	\$3.91	\$4.20	\$4.22		\$4.85
P/E	30.6x		28.3x		24.7x

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

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

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	\$682		\$775	A	
2Q	\$1,098		\$1,179	A	
3Q	\$2,070	\$2,055	\$2,010		
4Q	\$1,092	\$1,150	\$1,201		
Year	\$4,942	\$5,150	\$5,165		\$5,600

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 2Q Results; Neutral Rating Based on Stock Valuation

Investment Highlights

- EA produced higher fiscal 2Q results.** Non-GAAP net bookings (term used for traditional revenue plus the change in deferred revenue for online-enabled games) for the quarter ended 9/30/17 were \$1.179 billion, up 7% from a year ago. This was slightly above guidance but in line with the street consensus expectation. Key contributions came from new iterations of the company's well-established sports franchises, particularly *Madden NFL* and *FIFA*. Live services, with those and other franchises, and mobile gaming continue to fuel revenues at EA. Digitally derived revenues represented nearly two-thirds of EA's trailing twelve-month total revenue.
- Earnings exceeded expectations.** Gross margin on a non-GAAP basis rose as the product mix included greater digital sales. Operating income rose nearly 15% while operating margin improved 130 basis points. Non-GAAP EPS of \$0.62 compared favorably to \$0.53 a year ago, recent company guidance of \$0.50, and the street consensus estimate of \$0.54.
- We have fine-tuned our financial model.** Changes to our FY18 outlook are relatively minor, but reflect slight increases to our annual non-GAAP sales (bookings) and EPS estimates. Also, we are initiating FY19 estimates, including a 15% projected increase in EPS.
- We maintain our Neutral rating due to valuation.** We like company and industry fundamentals, and believe factors such as game quality, product pipeline, industry environment, digital sales, financial strength, and management are positives. However, these attributes may be largely reflected in the current share price. The multiple on our estimate of forward twelve-month earnings is 26.5x, 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**2Q FY18 - Non-GAAP Financial Highlights**

(figures in millions except per share data and percentages)

	Second Quarter Ended		% chg.
	<u>9/30/17</u>	<u>9/30/16</u>	
Net Revenue	\$1,179	\$1,098	7.4%
Cost of Good Sold	<u>388</u>	<u>388</u>	0.0%
Gross Profit	791	710	11.4%
Total Operating Expenses	548	498	10.0%
Operating Income	243	212	14.6%
Interest and Other Income, net	<u>3</u>	<u>(3)</u>	
Income Before Taxes	246	209	17.7%
Taxes	<u>52</u>	<u>44</u>	17.7%
Net Income	<u>\$194</u>	<u>\$165</u>	17.7%
Diluted Earnings Per Share	<u>\$0.62</u>	<u>\$0.53</u>	18.5%
Avg. Diluted Shares Outst.	312	314	(0.6%)
% of Net Revenue:			<u>bp chg.</u>
Gross Profit	67.09%	64.66%	243
Marketing & Sales	12.64%	13.57%	(93)
General & Administrative	7.63%	8.20%	(56)
Research & Development	20.36%	21.86%	(150)
Operating Income	20.61%	19.31%	130
Net Income	16.48%	15.04%	145

Source: Electronic Arts Inc.

Note: March fiscal year

Further comments on fiscal 2Q. We were impressed by EA's September quarter, particularly the strength of the sports franchises, continued growth in live online services, and the benefit on margins that comes from greater digital sales. Digital sales 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 quarter, digital sales represented about half of total company sales, but this figure was 63% of trailing twelve-month sales. We expect these percentages to increase in the coming quarters, consistent with industry trends.

EA's sports games lend themselves well to industry trends of online, multi-player, and competitive gaming, in our view. There were 25% more players engaged in *Madden Ultimate Team* (highly customized teams ideally suited for online, competitive gameplay) in 2Q compared to one year ago. The company's *FIFA* soccer franchise was also a key contributor in 2Q, which may be understandable given its popularity in more than 50 countries. The *FIFA Mobile* player base grew to more than 113 million. Other key contributing franchises in 2Q included *Battlefield* and *The Sims*.

Financial condition. The balance sheet is in good shape, in our view. Total cash at quarter end was \$4.355 billion, while debt of \$991 million represented just 18% of total capital. Inventory and accounts receivable were at satisfactory levels, in our view. Stockholders' equity at quarter end was \$4.388 billion. During the quarter, the company repurchased 1.3 million shares for \$153 million, leaving \$928 million on the current authorization.

Outlook. We are bullish on the industry in general and EA in particular. The debut of new gaming consoles in 2013 spurred demand for hardware and software. Updated versions (basically faster, quicker and less expensive) of those consoles are now on the market, with features related to 4K video and virtual reality technology. Price cuts on these existing consoles are likely to continue over the next year or so, in our view, which could boost console ownership to new levels. As for EA, we believe it has one of the strongest portfolios of game franchises in the industry. Importantly, we feel essentially all of EA's franchises have growth potential, particularly as it relates to digital sales, mobile gaming, and competitive gaming.

For 2H FY18, we expect an overall healthy industry environment and some powerful new releases. *Need for Speed: Payback* racing game is set for release on November 10. Much anticipation exists for *Star Wars Battlefront II* on November 17, roughly one month before the new *Star Wars* feature film is released. Also, *The Sims 4* is coming to consoles in November as well. These, and other titles from EA's portfolio, position the company well for the coming holiday sales period, in our view.

The recent industry trend of e-sports continues to hold significant long-term potential, in our view. 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—primarily its globally popular sports franchises but also the action/shooter games. 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 2Q results and updated company guidance. We expect the shift to digital sales to continue, which could allow for further margin improvement. Company guidance includes non-GAAP net bookings of \$5.150 billion and EPS of \$4.20, both up slightly from previous guidance. We have increased our FY18 estimates slightly. In a fine-tuning measure, the quarterly impact of an updated product release schedule and operating expense projections lead to slight decreases to our fiscal 3Q figures and increases to our 4Q figures.

We have also formed our initial FY19 financial outlook. This includes a projected 8% increase (from our updated FY18 estimates) in net bookings to \$5.600 billion and an approximate 15% gain in non-GAAP EPS to \$4.85.

Valuation. EA shares are currently trading at 28.3x our FY18 non-GAAP EPS estimate and 24.7x our FY19 estimate. This translates into an approximate 26.5x multiple on our estimate of forward twelve-month EPS. EA's median forward P/E multiple over the past ten years is 22.5x and over the past five years is 21.5x. 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 52% compared to a 22% 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 that includes new growth opportunities, 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)

	<u>FY19E</u>	<u>FY18E</u>	<u>FY17</u>	<u>FY16</u>	<u>FY15</u>
Net Revenue	\$5,600	\$5,165	\$4,942	\$4,566	\$4,219
Cost of Good Sold	1,350	1,290	1,252	1,305	1,153
Gross Profit	4,250	3,875	3,690	3,261	3,066
Marketing & Sales	700	650	642	598	626
General & Administrative	420	400	386	357	352
Research & Development	1,235	1,145	1,096	1,006	1,012
Total Operating Expenses	2,355	2,195	2,124	1,961	1,990
Operating Income	1,895	1,680	1,566	1,300	1,076
Interest and Other Inc. (Exp.), net	(5)	(10)	(12)	6	(1)
Income Before Taxes	1,890	1,670	1,554	1,306	1,075
Taxes	397	351	326	288	269
Net Income	\$1,493	\$1,319	\$1,228	\$1,018	\$806
Diluted Earnings Per Share	\$4.85	\$4.22	\$3.91	\$3.14	\$2.51
Avg. Diluted Shares Outst.	308	313	314	324	321
% change:					
Net Revenue	8.42%	4.51%	8.23%	8.22%	4.92%
Gross Profit	9.68%	5.01%	13.16%	6.36%	12.06%
Marketing & Sales	7.69%	1.25%	7.36%	(4.47%)	(4.28%)
General & Administrative	5.00%	3.63%	8.12%	1.42%	6.67%
Research & Development	7.86%	4.47%	8.95%	(0.59%)	(2.22%)
Operating Income	12.80%	7.28%	20.46%	20.82%	50.07%
Net Income	13.17%	7.46%	20.60%	26.26%	50.98%
% of Net Revenue:					
Gross Profit	75.89%	75.02%	74.67%	71.42%	72.67%
Marketing & Sales	12.50%	12.58%	12.99%	13.10%	14.84%
General & Administrative	7.50%	7.74%	7.81%	7.82%	8.34%
Research & Development	22.05%	22.17%	22.18%	22.03%	23.99%
Operating Income	33.84%	32.53%	31.69%	28.47%	25.50%
Net Income	26.66%	25.54%	24.84%	22.30%	19.11%
Tax Rate	21.00%	21.00%	21.00%	22.05%	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. (owner of Star Wars franchise) - DIS - \$97.81 - 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

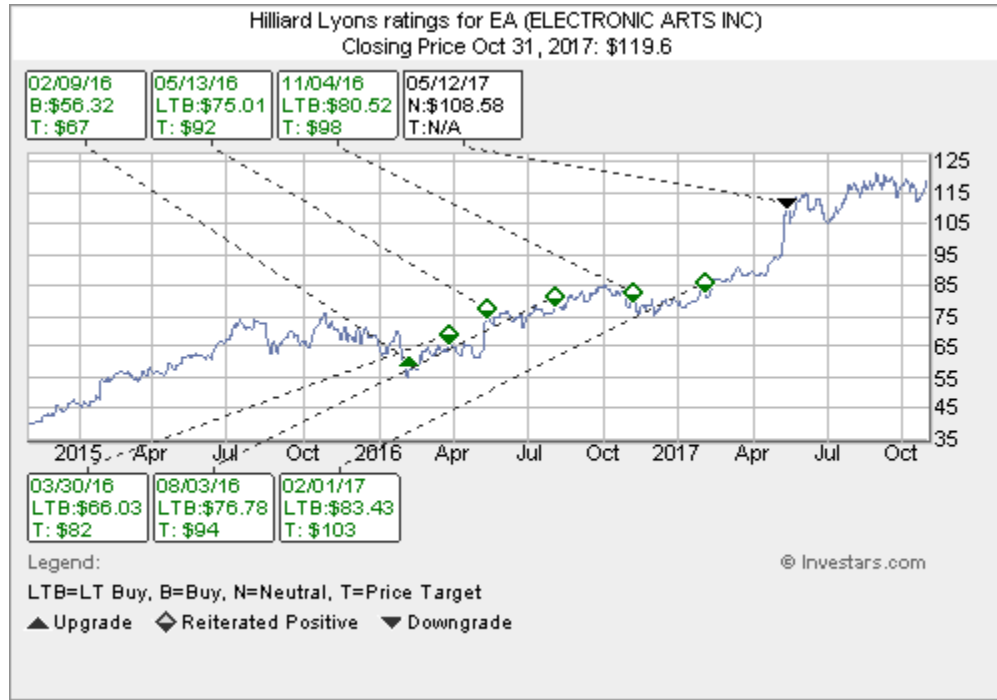
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 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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