

Microsoft Acquires Activision Blizzard for \$68.7bn

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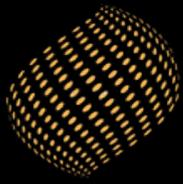
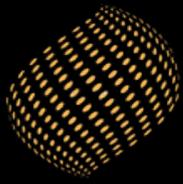


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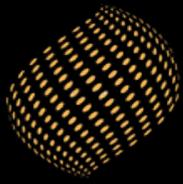
DEAL INTRODUCTION

DETAILS ABOUT THE DEAL

- The proposed deal was announced on 18th January 2022 to be an all-cash purchase of \$68.7 billion in stock (\$95 per share). The deal is expected to be complete in the 2023 fiscal year, subject to regulatory approval.
- This was internally agreed in April, with 98% of Activision's shares in favour of the proposal.
- Goldman Sachs is said to be advising Microsoft, while Allen & Company are advising Activision Blizzard.
- This will be Microsoft's biggest purchase, twice the size of its acquisition of LinkedIn in 2016.



Source: TechCrunch

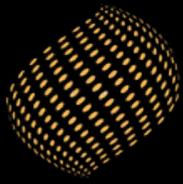


REASONS FOR M&A

- Enables Microsoft to utilize the surplus of cash on the balance sheet; Microsoft has historically been a **cash healthy company**, ending each of the last seven years with over \$100B in cash and short-term investments. Fiscal year 2022 saw no change in this trend, as they ended the period with \$105B in cash and short-term investments with a mere \$26B in net debt.
- Despite Microsoft distributing its **liquid assets** in share repurchases and dividend payments, accounting for \$49B, and **deleveraging** its balance sheet, accounting for \$9B, the company generated \$65B in free cash flow in the same period, meaning their cash pile has only increased. It is in Microsoft's interest to put this large reserve of cash to use and ramping up its M&A activity will allow the company to create value from these reserves.
- The opportunities presented through this practice are endless, allowing the company to forecast higher expected growth, with its shares, then commanding a higher multiple (e.g. PE, PS). This will of course please shareholders, who will see gains in their investment.



Source: Polygon



INDUSTRY OVERVIEW: ELECTRONIC GAMING & MULTIMEDIA

TRENDS FOR 2022

Subscription Gaming:

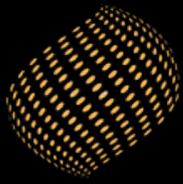
Subscription gaming is expected to become more competitive. Since 2017, Microsoft has been an outlier in the industry with its Xbox Game Pass subscription. 2022 will see a change to this; Nintendo has begun to beef up its Switch Online subscription with extra add-ons and other perks, and subscription gaming is already proving a useful delivery mechanism for new services like cloud gaming. However, subscription gaming may have some complex and unforeseen consequences on how games are funded, made and sold.

Cloud Gaming's Make-or-Break Year :

Cloud gaming has been steadily trying to prove itself for years, and in 2021 it stumbled as Google Stadia shut down its in-house game development efforts and many of the promises of streaming games over the internet remained unfulfilled. Looking forward, the industry will have to find ways to make cloud gaming more enticing, or simply walk away from it until the technology improves.

Crypto Movement :

In 2022, expect to see many more startups arriving on the blockchain gaming scene. VCs are funnelling money into the space, including millions from the Web3 evangelists at Andreessen Horowitz, and the financial incentives baked into NFTs and play-to-earn are already proving popular among younger generations and those in developing markets.



HISTORICAL TRENDS

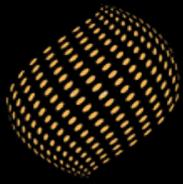
Post pandemic, there has been an M&A gaming boom, with Tencent, Sony, and Microsoft, being the fastest in the industry to move in this direction.

With companies across the technology sector actively merging their product offerings, much acquisition activity is an example of the 'Technotainment' movement. Firms in recent years, such as Microsoft, are launching cloud-based subscription services, alongside their traditional console offerings.

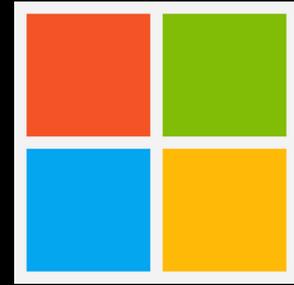
January 2022 saw \$85.4 billion worth of acquisitions announced, this quickly surpassed the record breaking \$85 billion totalled in all of 2021.

As revenues continued to increase alongside the possible growth opportunities, by July 2022, video game M&A surpassed \$100B in gross transactional value. In terms of volume, this is the best year on record, outweighing previous years enormously.

While there has been an increased number of gaming M&A deals announced in 2022, so far, compared to 2021, there has been considerably less value per transaction. Despite Microsoft's announcement being record breaking in size, this does not necessarily reflect the market, more generally.



ACQUIRER OVERVIEW



TICKER: MSFT

MICROSOFT INC.

- Microsoft is an American multinational technology corporation which was founded in 1975.
- Microsoft specialises in computer software (Windows), consumer electronics, personal computers, gaming (Xbox) and other technological services.
- Products include computer software, consumer electronics, personal computers, and related services.

BUSINESS MODEL

Microsoft generated revenue through three core business areas:

- Productivity and business processes - The segment consists of products and services developed for productivity and information, and represents about one-third of Microsoft's revenue. Its flagship is the Microsoft Office soft-wear suite. Additionally, there are LinkedIn, the professional social network, and Dynamics, the cloud-based solutions for business apps, such as ERP or CRM.
- Intelligent Cloud - The other third of Microsoft's revenue is made up of its public, private, and hybrid cloud services, such as Microsoft SQL Server, Windows Server, and Azure. Furthermore, there are enterprise services, like Microsoft Consulting, to help customers plan and implement Microsoft products.
- Personal computing - The final third comprises the products and services created to improve users' experience. The main example is, of course, Windows, with the licenses in devices. Other solutions include Xbox games and consoles, advertising in Bing (the search engine), and sales of devices and PCs.



ESG PRACTICES

Environmental: As of June 30th 2021, Microsoft had allocated \$571M via their Climate Innovation Fund. This is in keeping with Microsoft's aim to be carbon negative, water positive and produce zero waste by 2030.

Social: Microsoft are committed to supporting inclusive economic opportunity:

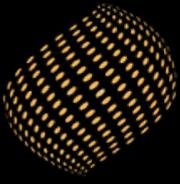
- 42 million people accessed free digital skills training for in-demand jobs in just the first year of Microsoft's global skills initiative.
- Protecting fundamental rights – More than \$410 million in cash, technology, and resources committed to support COVID-19 response efforts as of June 2021.

Governance: Microsoft's Board of Directors works with management to establish and promote business goals, organizational objectives, and a strategy that is mindful of how our business affects and is affected by the broader environment. Key corporate government objectives:

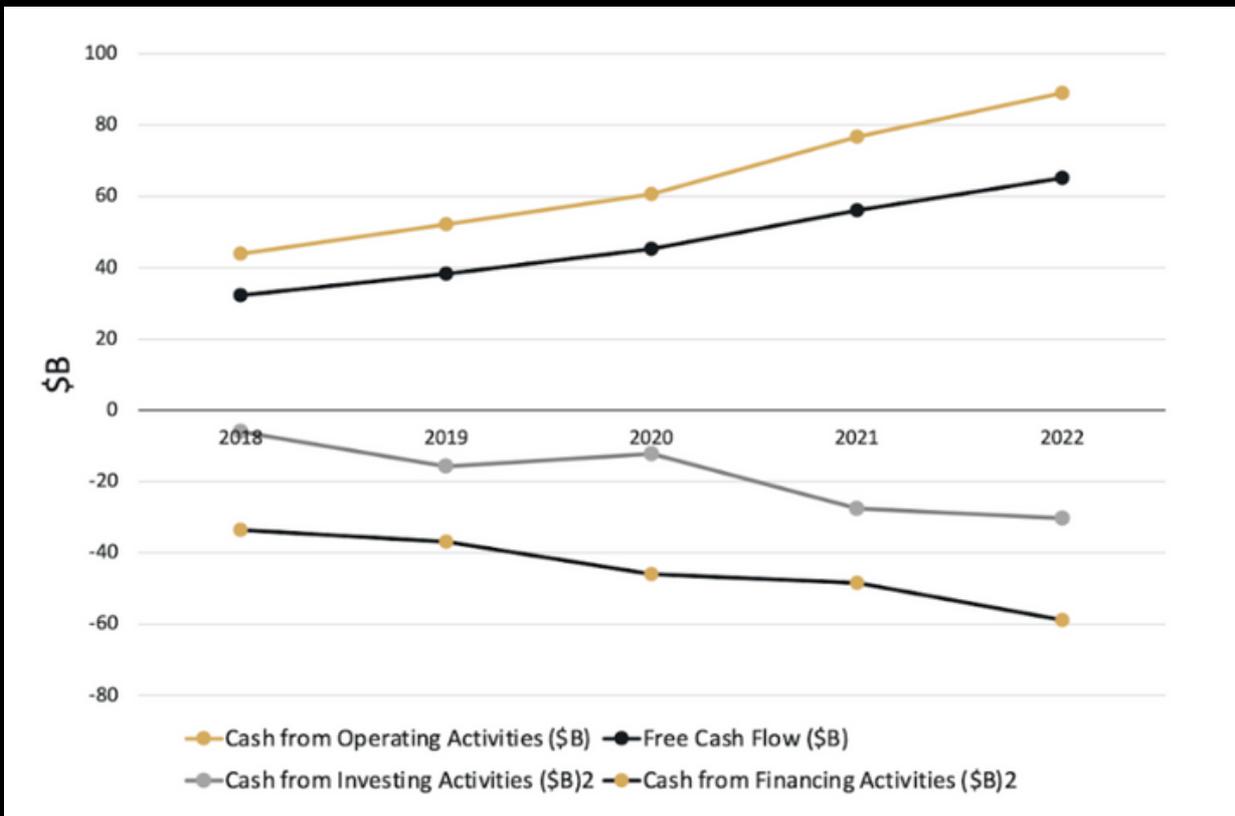
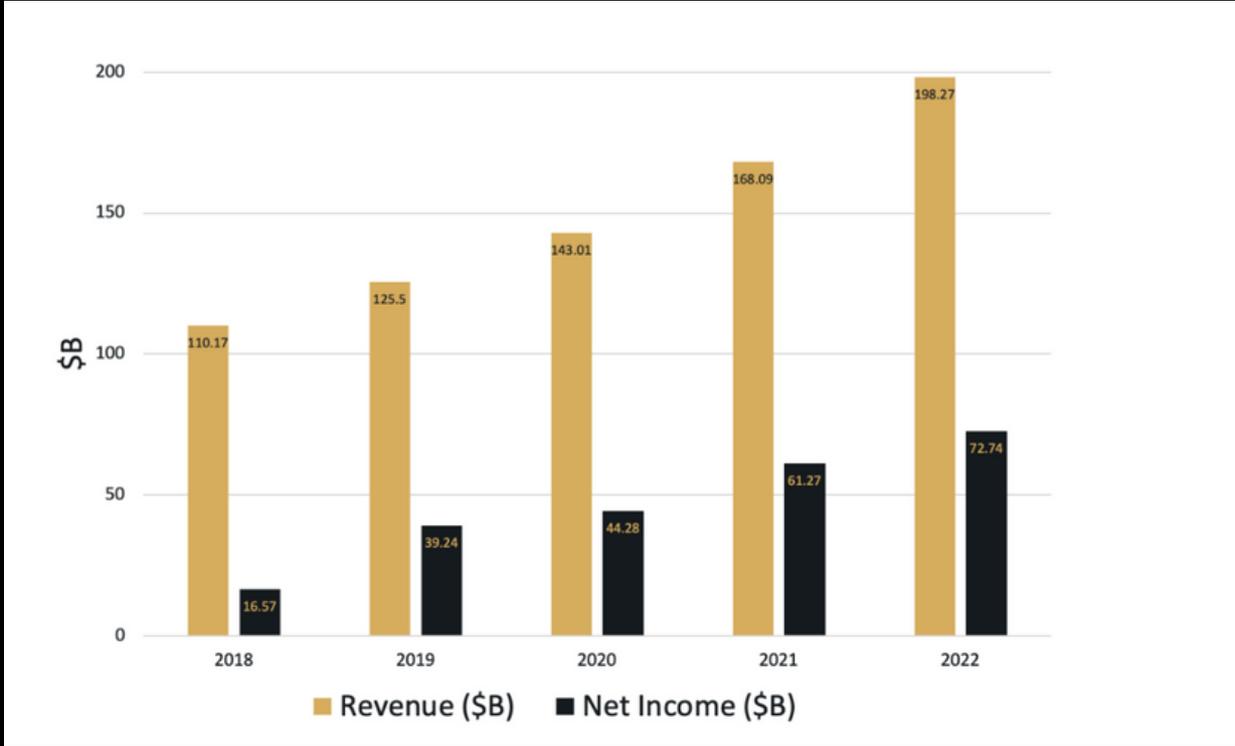
- Encourage the efficient use of resources.
- Strengthen and safeguard our culture of business integrity and responsible business practices.
- Provides a structure for management and the Board to set objectives and monitor performance.

KEY FINANCIALS





KEY FINANCIALS





TARGET OVERVIEW



TICKER: ATVI

ACTIVISION BLIZZARD

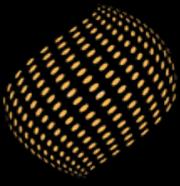
- Activision Blizzard is an American multinational company, that is a 'developer, publisher and distributor of interactive entertainment'.
- Founded in 2008, through the merger of Activision Inc. and Vivendi Games and is now headquartered in Santa Monica, California with 9,800 employees.

BUSINESS MODEL

'Activision Publishing, Inc.' - Premium and free to play products
Generating revenue from full-game and in-game sales, alongside licensing software to third-party companies that provide Activision products. Call of Duty is Activision's flagship franchise.

'Blizzard Entertainment, Inc.' - Premium and free to play products
Like Activision, Blizzard generates revenue through full-game and in-game sales, alongside licensing software to third-party companies that provide Blizzard's products. Blizzard also facilitates a gaming platform, named Battle.net, distributing its content, providing social connectivity, and user-generated content. Key product franchises include Warcraft, Overwatch, and Diablo.

'King Digital Entertainment' - Free to play products
Generates revenue from in-game sales and in-game advertising on mobile platforms. Flagship product franchise is Candy Crush.



ESG PRACTICES

Environmental:

- 60% reduction of plastic waste, compared to 2019 levels, exceeding the target of 50% reduction by 2024. This is through the company's ongoing 'digital product transition'.
- Established operating plan to reduce carbon intensity, water usage and waste.
- Developing a roadmap to meet the 2050 target of net zero carbon emissions.

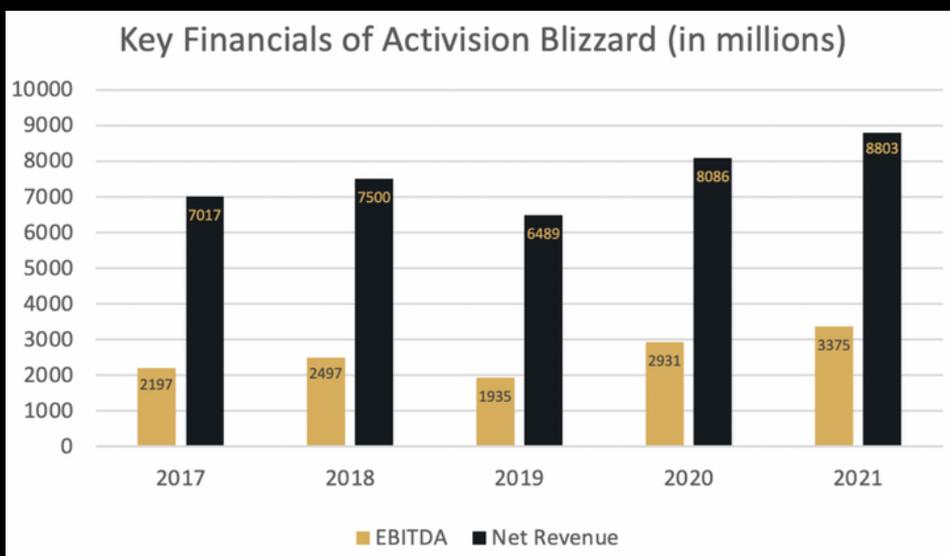
Social:

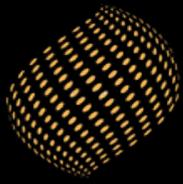
- 2021 saw the company invest 1.25 billion in social impact funds, 'for their support of more diverse and inclusive communities'.

Governance

- Governance strategy aimed to oversee employee experience, corporate social responsibility, targeted ESG programmes, alongside the structural side of the business.
- CEO, Bobby Kotick, requested his salary to be the lowest legal amount possible, \$62,000, until appropriate progress has been made towards the gender-related goals. Any alteration will be decided by the Workplace Responsibility Committee.

KEY FINANCIALS





DEAL ANALYSIS

STRENGTHS

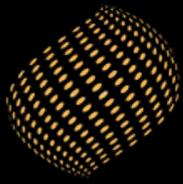
- The acquisition solves a key problem on Microsoft's balance sheet. Record sales during the pandemic resulted in a swollen **cash reserves** on the software giant's balance sheet.
- Toward the end of 2021, the company had the third-highest cash reserves of all companies in the S&P 500. The \$68.7 billion all-cash deal uses up some of the \$137.7 billion available to company executives in November last year.

WEAKNESSES

- Microsoft will have to contend with Activision's internal problems. A toxic work culture at the company led to lawsuits, large-scale layoffs, and a significant decline in its share price.
- However, Activision Blizzard's management has taken corrective steps and announced investments to promote diversity and inclusion in the gaming industry.

OPPORTUNITIES

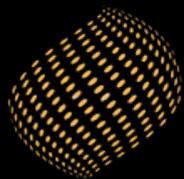
- In Activision Blizzard, Microsoft has acquired a content powerhouse responsible for some of the biggest blockbusters in the industry. Activision's development team continued to churn out best-sellers. Two titles from the company's Call of Duty franchise were the top two sellers of 2021. During its latest earnings call, Activision's management announced that revenues from the World of Warcraft and Diablo franchises also jumped, propelling 22% revenue growth in the company's Blizzard division. The Activision acquisition provides a short cut to Microsoft to ramp up its content credentials.
- It also helps the company access valuable intellectual property. A Bloomberg report states that "some content" from Activision Blizzard will be "exclusive" to the Xbox console.
- Great content from Activision could also bolster subscription numbers for Game Pass—Microsoft's gaming subscription service that allows players to play games across platforms—and its cloud gaming service. Both are expected to drive future growth for Microsoft's gaming division as revenue models and platforms shift in the industry.



DEAL ANALYSIS

THREATS / REGULATORY CONCERNS

- There's the regulatory blowback from a merger of two giants. Both companies are leaders in their respective industry—Microsoft in tech and Activision in gaming. A combined entity will easily have the heft and resources to crush competition. Regulatory authorities have increasingly taken a dim view of such combinations due to concerns over anti-competitive behaviour.
- The Federal Trade Commission, in the US, is investigating the deal, particularly in terms of how it may affect workers at Activision.
- The UK's Competition and Markets Authority have announced an investigation, pointing to the "substantial lessening of competition" expected, as a result of the acquisition. A decision will be made in March 2023. This was after an original 'phase 1' investigation that requested such concerns to be addressed by Microsoft.
- New Zealand and Brazilian regulators are also said to be investigating, with Saudi Arabia being the only country to announce no objection.



VALUATION ANALYSIS

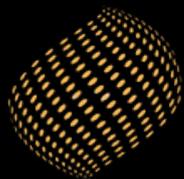
PUBLIC COMPARABLES MODEL

Video Game Developer	Low	High
Selected EBITDA Multiple:	18.5x	19.8x
Implied Enterprise Value	70,038	74,956
Net Debt	(3,608)	(3,608)
Implied Equity Value	66,430	71,348
Equity Value per share	\$ 84.92	\$ 91.20
Premium / (Discount) %	11.88%	4.16%

As calculated by the Public Comparables Model (CCA), the Activision Blizzard stock was undervalued at the time of Microsoft's offer of acquisition. It was found to be between \$84.92 and \$91.20, suggesting that Microsoft paid a premium of between 4.16% and 11.88%. This is compared to the price per share paid, which was \$95.

In terms of the valuation multiples found, the EV/EBITDA ratio was found to be between 18.5x (mean) and 19.8x (median). The multiples generated the implied enterprise values for the model, which were used when finding the equity value and subsequently, the implied equity value per share, which was used to calculate the premium paid.

In terms of the competitors chosen, video game developers were favoured, due to the similar revenue drivers and business model to Activision Blizzard.



VALUATION ANALYSIS

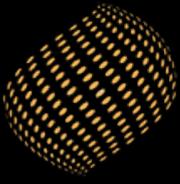
DISCOUNTED CASH FLOW MODEL

Enterprise Value	90,620,896,967
(+) Cash	10,423,000,000
(-) Debt	(3,608,000,000)
Equity Value	97,435,896,967
# of shares	782,310,000
Share Price	124.55

As calculated by the Discounted Cash Flow (DCF) Analysis, the Activision Blizzard stock was highly undervalued at the time of Microsoft's offer of acquisition (\$95). As a result, Microsoft has offered to pay 23.72% less than the implied share price (\$124.55), which is a huge drop from the positive 25.45% premium being paid considering the closing share price (\$75.73) as on 19th September 2022.

The **sensitivity analysis** of the model suggested that the Activision Blizzard's implied share price was in between \$95.88-\$165.85. In fact, the average price of analysts' estimates stands at \$117. This suggests that ATVI stock is significantly undervalued at the current levels, and investors can use this **dip** as a buying opportunity for long term gains.

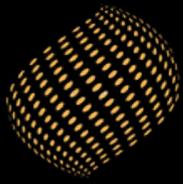
To build the model, various assumptions were taken into consideration to be able to obtain the Terminal Growth Rate (1.75% in the base case), and the Weighted Average Cost of Capital (WACC) (7.37% in the base case). Therefore, it must be noted that the share price obtained from the model was affected by these assumptions.



CONCLUSION

IMPACT ON THE CLOSE COMPETITORS

- As the largest gaming deal in history, the importance, and subsequent precedent that Microsoft's acquisition of Activision Blizzard will set on the industry is clear. Crucially, it will allow Microsoft to challenge its direct competitor, and market leader, Sony for a greater share of the lucrative gaming industry.
- Microsoft has promised to offer as many Activision Games on its Game Pass subscription service as possible. With it inheriting Activision Blizzard's 400 million monthly users, this move will see a major upside to its current 25 million-strong roster. The acquisition is predicted to increase Microsoft's video game revenue by around 50%.
- Microsoft is set to gain control over some of the world's most popular games. The most prominent of these is the *Call of Duty* franchise, which has sold over 400 million games since 2003. Should it be added exclusively to the Game Pass network in the future, it is likely that Sony will see its presence in the hardware gaming business waver as PlayStation users make the switch to Microsoft's equivalent: the Xbox.

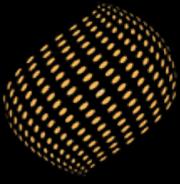


IMPACT ON THE INDUSTRY

The acquisition is facing scrutiny from regulatory bodies in the UK, US, and EU. The probes revolve largely around antitrust concerns, with it believed the acquisition would place Microsoft in a position to harm rivals by refusing access to Activision games, as mentioned above. However, should the deal be authorised by all relevant bodies, it will no doubt have rippling effects on the industry as a whole. The sweeping dominance that Microsoft will inherit in gaming consoles, multi-game subscriptions services, and cloud gaming services has the potential to see it break out as a market leader in the years ahead.

Microsoft's acquisition has also fuelled further development talks surrounding the metaverse. Following its purchase, Microsoft CEO Satya Nadella stated that gaming "will play a key role in the development of metaverse platforms." This could see Microsoft go head-to-head in the future with companies such as Mark Zuckerberg's Meta, recently rebranded from Facebook, which believes the virtual reality world could be worth as much as \$3 trillion within the next 10 years.

More widely, this deal represents the growing attractiveness and investment opportunities present in the expanding gaming industry. The sector boomed during the pandemic. And this momentum has carried over into this year despite the challenging economic environment. Q2 2022 saw a 135% increase in the total value of completed M&A deals compared to Q1 2022, topping a total value of \$18.6 billion. The magnitude of the Microsoft deal is an indication that M&A activity will continue to develop in the sector.



GLOSSARY

Cash-Healthy Company: A company is said to be cash healthy when it has sufficient cash reserves to fund its activities. It is vital that a company is cash-healthy, to avoid bankruptcy.

Cash Reserves: Money kept by a company to meet its short-term obligations.

Deleveraging: The rapid sale of assets to reduce debt levels.

Dip: Fall in the price of a security.

Liquid Assets: Assets that can be quickly sold and easily convertible to cash.

Operating Activities: Functions of a business relating to the company's core operations (e.g. manufacturing, distributing, marketing).

Sensitivity Analysis: The analysis of how a change in assumptions (inputs) can impact the output of a financial model.

Terminal Growth Rate: A growth rate that a company is expected to grow at forever based on the market and industry conditions.

WACC: Cost of capital used to represent a firm's after-tax costs from all resources.

