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**Entertainment: Software** 

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# June 2013 Video Game Monthly / E3 Preview

- This newsletter lists the key events (including key game releases and financial news) in May, previews our
  expectations for June, and provides our views of the current state of the video game industry.
- This newsletter also includes our E3 2013 Preview. E3 (The Electronic Entertainment Expo) takes place next week in Los Angeles. Events start Monday, June 10, and continue through Thursday, June 13. The E3 Expo will be held at the Los Angeles Convention Center, and as many as 50,000 attendees are expected. We expect E3 to again be a spectacle, full of news and useful information for video game fans and investors.
- We expect the focus of E3 to be the two new next-generation consoles, Microsoft's Xbox One and Sony's PlayStation 4, both of which will be released later this year. The official unveilings for both consoles left many questions unanswered (including pricing and specific release dates, with controversy about whether the Xbox One will limit transfers of used games), and we expect additional clarity next week. The most high-profile games will again be headlined by sequels (including for Activision Blizzard's Call of Duty, Electronic Arts' Battlefield, and Ubisoft's Assassin's Creed franchises), although we expect to learn more about many new IPs (including Activision Blizzard's Destiny and Ubisoft's Watch Dogs). In addition, we expect many new games to be unveiled, including for the two next-gen consoles and for Nintendo's Wii U, which has struggled since its November 2012 debut due in large part to mediocre content.
- We also expect the hardware manufacturers to announce price cuts. We expect the prices for the PS3 and Xbox 360 to drop by at least \$50 as we approach the holidays, with the Wii dropping to \$99. In addition, Nintendo may look to spur Wii U sales through either a hardware price drop of \$50 or a bundle that includes some of its more popular software. Sony will likely cut price for its PS Vita handheld, which has struggled since release due in part to its high starting price point of \$249.
- We expect E3 to have a positive impact on the share prices of many of the major publishers. We believe additional details on the PS4 and Xbox One will help to drive share prices higher as investor perception about the long-term outlook of the video game industry improves. Attractive starting price points for hardware and software will be a key factor in the success of the next gen consoles, and we continue to believe that ISP or MSO subsidized boxes remain a possibility. In addition, Microsoft, Sony, and the publishers will likely seek to provide strong release slates for the next-gen consoles early in their life cycles in order to avoid one of the major pitfalls that has hindered Wii U's success thus far.
- In May, Activision, GameStop, Take-Two, and Ubisoft reported better-than-expected quarterly EPS, while EA reported results that were in line with its negative preannouncement. In addition, Sony reported Q4 results.
- The Wedbush Video Game Index—our market cap-weighted index of video game companies—was roughly flat for the month of May, below the broader market averages due to declines for three of the larger companies. The Russell 2000 and S&P 500 increased 4% and 2%, respectively, due to the continuation of quantitative easing and easing concerns around the European debt crisis and the China slowdown. Electronic Arts and Ubisoft were up 31% and 19%, respectively, after providing bullish FY:14 guidance. Nintendo had the worst month, down 6%, the result of sluggish Wii U sales and the belief that the next-gen consoles from Microsoft and Sony may trample the Wii U. GameStop was down 5% over concerns that Microsoft will alter the used gaming landscape. Activision Blizzard was down 4% due in part to uncertainty over its relationship with Vivendi. On a constant f/x basis, the Index increased 1%. It increased 4% excluding Nintendo (on a constant f/x basis).
- April U.S. console/handheld software sales were \$254 million, down 17% from last year's \$307 million, and well below our estimate of \$300 million (down 2%). April sales were the second-lowest since May 2004, with only August 2012 lower. Sales have now been down 16 of the last 17 months. A relatively strong new release slate, a slew of high-profile releases last month (including Take-Two's BioShock Infinite), and an easy comparison (down 39%) did not mitigate catalog weakness and continuing declines in a transition year. In addition, Easter fell in March this year and in April in 2012, likely having a minor, but negative impact on sales. PC SW sales were down 15%, despite two recent high-profile releases.
- Solid new releases could not offset sluggish catalog sales in April. New release Warner Bros.' Injustice: Gods Among Us (360, PS3, Wii U) led sales by a wide margin, with fellow new release Deep Silver's Dead Island: Riptide (360, PS3, PC) having a decent debut. The multiple high-profile March releases performed well below our expectations, with older catalog content performing poorly for the most part, as gamers appear to be waiting for next-generation consoles to launch. Only a deep price cut for current generation consoles is likely to spur sales over the balance of the year.

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# **RISKS**

Investment risks to companies and attainment of our share price target in this sector include changes to game release timing, greater than expected deterioration of the average selling price (ASP) for game software, the effects of competition, changing macroeconomic factors, and slower than expected consumer demand for video game hardware and software.

 We expect May sales to be led by new releases Capcom's Resident Evil: Revelations (360, PS3, Wii U) and Nintendo's Donkey Kong Country Returns 3D (3DS), April release Injustice: Gods Among Us, and Activision Blizzard's Call of Duty: Black Ops II.

#### Key May headlines:

- 5/6 The Walt Disney Company and EA announced a multi-year exclusive licensing agreement to develop and publish
  globally games based on Star Wars characters and storylines. Financial terms of the agreement were not disclosed.
- o 5/7 EA reported Q4:13 results in-line with its negative preannouncement and provided bullish FY:14 EPS guidance.
- 5/8 Activision reported better-than-expected Q1:13 results, but did not fully pass-through the quarterly beats to full year guidance due to several factors expected to impact 2H, particularly in Q4.
- 5/9 Sony reported Q4:12 results.
- 5/13 Take-Two reported better-than-expected Q4:13 results and provided bullish FY:14 guidance.
- 5/15 Ubisoft reported Q4:13 revenue towards the high-end of the guidance range with better-than-expected EPS, and provided much better-than-expected FY:14 guidance.
- o 5/16 NPD announced much lower-than-expected April U.S. console/handheld software and hardware sales.
- 5/21 Microsoft unveiled Xbox One, launching worldwide later this year. Key features include a new controller, an upgraded Kinect sensor, built-in Smart Glass, and TV integration, among others. In a Q&A session that followed the presentation, it disclosed that the new console will play used games, although specifics around used gaming remain unclear. Other unknowns remain, including the specific release date, pricing, and whether it can act as a standalone device for TV viewing.
- 5/23 GameStop reported Q1:13 revenue towards the high-end of implied guidance, and better-than-expected EPS. It
  increased FY:13 guidance at the low-end to reflect Q1 results and Xbox One.

#### Key June events:

- o 6/10-6/13 E3 Electronic Entertainment Expo video game conference in Los Angeles, CA.
- o 6/11 Wedbush / Intel E3 Mixer hosted by Michael Pachter (contact your sales person for information).
- o 6/17 May NPD U.S. video games sales data release.
- 6/17-21 (est.) Majesco Entertainment to report Q2:13 results.

# **E3 2013 PREVIEW**

We expect the focus of E3 to be the two new next-generation consoles, Microsoft's Xbox One (announced on May 21) and Sony's PlayStation 4 (announced on February 20), both of which will be released later this year. The official unveilings for both consoles left many questions unanswered (including pricing and specific release dates, with controversy about whether the Xbox One will limit transfers of used games), and we expect additional clarity next week. The most high-profile games will again be headlined by sequels (including for Activision Blizzard's *Call of Duty*, Electronic Arts' *Battlefield*, and Ubisoft's *Assassin's Creed* franchises), although we expect to learn more about many new IPs (including Activision Blizzard's *Destiny* and Ubisoft's *Watch Dogs*). In addition, we expect many new games to be unveiled, including for the two next-gen consoles, which at this point in time have relatively light release slates, and Nintendo's Wii U, which has struggled since its November 2011 debut due in large part to mediocre content.

We also expect the hardware manufacturers to announce price cuts. We expect the prices for the PS3 and Xbox 360 to drop by at least \$50 as we approach the holidays, with the Wii dropping to \$99. In addition, Nintendo may look to spur Wii U sales through either a hardware price drop of \$50 or a bundle that includes some of its more popular software. Sony will likely cut price for its PS Vita handheld, which has struggled since release due in part to its high starting price point of \$249.

We expect E3 to have a positive impact on the share prices of many of the major video game publishers. We believe additional details on the PS4 and Xbox One will help to drive share prices higher as investor perception about the long-term outlook of the video game industry improves. Attractive starting price points for hardware *and* software will be a key factor in the success of the next gen consoles, and we continue to believe that ISP or MSO subsidized boxes remain a possibility. In addition, Microsoft, Sony, and the publishers will likely seek to provide strong release slates for the next gen consoles early in their life cycles in order to avoid one of the major pitfalls that has hindered Wii U's success thus far.

For the Xbox One, if there are in fact no meaningful subsidies, we believe a starting price of \$399 makes sense given that the Xbox 360 Pro debuted at that price point in November 2005. Our estimate of the bill of materials for the Xbox One (based upon speculation regarding many of the specs) is around \$325, suggesting that Microsoft could make a modest profit at the \$399 price point. For the PS4, we remain confident that the new console will have a lower initial MSRP than the PS3, which had a lofty starting price of \$599 that we believe negatively impacted its long-term popularity. We expect the PS4 to debut at \$349, as our estimate of the bill of materials is \$275.



In our view, the Xbox One is the more likely of the two new consoles to be subsidized due to its functionality. We believe the ability to watch live TV from a cable, telco, or satellite set-top box through Xbox One could entice an MSO to drive subscriptions through a subsidized box in exchange for a multi-year contract. The "always connected" requirement for the Xbox One likely means that a broadband connection will be required, suggesting to us that ISPs may have an incentive to offer a subsidy as well. In addition, Microsoft could conceivably subsidize the Xbox One through prepaid Xbox Live Gold subscriptions (as it has done on a limited basis in the past) or premium Skype functionality as well. Similarly, Sony could subsidize the PS4 through prepaid PlayStation Network subscriptions, but unlike Microsoft, it does not have a history of doing so. We believe that many of the multimedia functions demonstrated at the Xbox One reveal event could be emulated by Sony in the next year or so through a firmware update.

In addition, Microsoft, Sony, and the publishers will likely seek to provide strong release slates for the next-gen consoles early in their respective life cycles in order to avoid one of the major pitfalls that has hindered Wii U's success thus far. We learned relatively little from the unveilings about the games that will be available for the next-gen consoles. At the Xbox One unveiling, Microsoft announced that *Forza Motorsport 5* will be available at launch. It also announced a new and broad relationship with EA Sports that includes the development of four games for Xbox One: next-gen versions of *FIFA*, *Madden*, *NBA*, and *UFC*. Activision's *Call of Duty: Ghosts* was also on display, as was Remedy's *Quantum Break*. Microsoft disclosed that its game studios have more games in development for Xbox than at any other time in history. Over fifteen titles are expected in year one, eight of which are new franchises. We believe Microsoft may announce a new *Halo* for the Xbox One next week. The PS4 unveiling showed more games than Xbox One's. New games from Sony will include *Driveclub* (team-based racing), *inFamous Second Son*, and *Killzone Shadow Fall*. Other new games are expected to include Capcom's *deep down* and a new *Final Fantasy* from Square Enix. Blizzard Entertainment announced a strategic partnership with Sony, and will release *Diablo III* (previously a PC exclusive) on PS4 and PS3. Previously announced games discussed during the presentation included Activision's *Destiny*, Sony's *Beyond: Two Souls*, and Ubisoft's *Watch Dogs*.

We believe the Wii U release slate on display will be a key determinant of the console's long-term staying power. With the more powerful PS4 and Xbox One launching later this year, Nintendo risks losing additional share to its console competitors if the quality and volume of content available for Wii U does not pick up markedly in the near-term. In addition, if the Wii U's popularity does not improve by the end of the year, many third-party publishers may pass on producing games for the console. We note that EA recently announced that it had no Wii U games in development, and it remains a possibility that the publisher will abandon the platform entirely. Should other third parties follow EA's lead, the Wii U could be relegated to a first party only platform. We expect the Wii U release slate on display at E3 to be very first-party-centric (as outlined below), with limited third-party support coming from Activision Blizzard, Warner Bros., and Ubisoft, among others.

Below we have highlighted the key scheduled E3 events (all times are PDT):

# Monday, June 10

8:45am – Microsoft's Xbox E3 2013 Media Briefing (presentation to begin at 9:00am)

1:00pm - The Download: EA's 2013 Press Conference

1:30pm – Ubisoft E3 2013 Media Briefing (presentation to begin at 3:00pm)

6:00pm - Sony PlayStation E3 2013 Press Conference (pre-press conference party to begin at 4:00pm)

#### Tuesday, June 11

7:30am – Ubisoft's Analysts & Investors Meeting with Top Management

8:30am – Nintendo's Business Partner Presentation @ E3 (presentation to begin at 10:30am)

12:00pm - Exhibit Floor Opens

5:00pm - Wedbush / Intel 2013 Networking Event hosted by Michael Pachter

# Wednesday, June 12

7:15am – EA's Analyst Breakfast (executive discussion to begin at 7:45am)

9:00am – Nintendo E3 Analyst Briefing (presentation to begin at 9:30am)

# Thursday, June 13

5:00pm - Exhibit floor closes

All of the major publishers are hosting press conferences, group meetings, or analyst events at E3. We expect the news from video game publishers to be informative, with each presenting additional information about key games in development. Below are the key games expected to be shown by our covered publishers.

# Activision Blizzard

Call of Duty: Ghosts, Bungie's Destiny, Diablo III (for PS3 and PS4), and Skylanders SWAP Force. The focus of Activision's E3 presentation will once again be Call of Duty, with the latest iteration, Call of Duty: Ghosts, to be released in November. In addition, we expect the company to announce that the Elite service will be free for a second consecutive year, as the switch to free from premium appears to have lengthened the sales tail of 2012's Call of Duty: Black Ops II. Bungie's Destiny, likely a 2014 release, will also garner a significant amount of attention from gamers and investors alike. We note that Blizzard's games are typically shown at BlizzCon,



scheduled for November 8 – 9 in Anaheim, not E3. We continue to expect a second Blizzard release in 2013, most likely either the first Diablo III expansion or the second StarCraft II expansion.

#### Electronic Arts

Battlefield 4, Dragon Age 3: Inquisition, NBA Live 14, Need for Speed Rivals, The Sims 3: Island Paradise, UFC, and the 2013 iterations of its sports franchises. We do not expect EA to announce a Star Wars game so soon after disclosing that it had reached an agreement with Disney, although it may provide an update on the future content planned for the Star Wars: The Old Republic MMO. We expect an update on the game from Respawn Entertainment, although a 2013 release seems unlikely.

#### Majesco

As disclosed in its E3 press release, it will be showing its own titles, *Phineas and Ferb: Quest for Cool Stuff* and *Zumba Fitness World Party*, as well as *Barbie Dreamhouse Party*, *Monster High 13 Wishes Shadow Secrets*, and *Young Justice: Legacy* from Little Orbit. Majesco will distribute the three Little Orbit titles.

#### Nintendo

Nintendo will need a slew of high-profile Wii U releases to reinvigorate the struggling console. The most high-profile of these releases are expected to be from Nintendo, and not third-party publishers, many of which have been stung by disappointing game sales for the new console thus far. In addition to games, Nintendo may also announce a Wii U hardware price cut of at least \$50 to further jumpstart sales. Even if a price cut is not announced at E3, if either the Xbox One or PS4 debuts later this year at \$349, the current price for Wii U Deluxe, we believe Nintendo will be compelled to drop price as the newer consoles are expected to be more powerful with better online and social integration. We expect Nintendo to drop the price of the original Wii console by \$30 to \$99.

We expect to learn more about the 3D Mario action game, Mario Kart, a Party game, Super Smash Bros., Yoshi, and Zelda for Wii U. Other Wii U games on display will likely include: Bayonetta 2, Game & Wario, The Legend of Zelda: The Wind Waker, Monoliths X, New Super Luigi U, Pikmin 3, Shin Megami Tensei X Fire Emblem, the Sonic games, The Wonderful 101, and Wii Fit U. For the 3DS, we expect The Legend of Zelda: A Link to the Past, Mario and Luigi Dream Team, Mario Golf World Tour, Party Like It's the Year of Luigi, Pokémon X, Pokémon Y, Super Smash Bros., and Yoshi's Island.

#### Take-Two Interactive

Agent, Grand Theft Auto V, NBA 2K14, Sid Meier's Civilization V: Brave New World, The Bureau: XCOM Declassified, and WWE 2K14. It is not clear whether Agent (a Rockstar title announced in 2006 as a PS3 exclusive) has finally been cancelled, and it is unlikely we will learn much at E3, as Take-Two has no presence on the show floor, and is hosting only private meetings.

# **Ubisoft Entertainment**

As disclosed in its E3 press release, Ubisoft will be showing Assassin's Creed IV: Black Flag, Rayman Legends, South Park: The Stick of Truth, Tom Clancy's Splinter Cell: Blacklist, and Watch Dogs. We also expect to see Just Dance 5. An update on Tom Clancy's Rainbow 6: Patriots is also a possibility.

# **INVESTMENT UPDATE**

We have continued to be surprised by the persistent declines in year-over-year hardware and software sales, particularly given the fact that the video game industry has seen software sales declines for four consecutive years prior to this one. We can only surmise that unlike other transition years, this one is plagued by stubbornly high console prices, a limited software release lineup, and fatigue over a seemingly never-ending parade of sequels in this, the eighth year of the current generation. Of particular concern is the fact that current generation consoles from Microsoft and Sony are still priced at \$299 and \$249, respectively. It appears to us that the biggest driver of continuing software sales decline is a reticence on the part of more value conscious consumers to buy consoles at these prices when it is clear to most that Microsoft and Sony must cut price in front of the launches of their next-generation consoles, with release dates and pricing to be formally announced on June 10. We believe that unless and until Microsoft and Sony cut prices dramatically (to at least \$199), we will not see a rebound in foot traffic at retail, and game sales (especially catalog sales) will continue to languish. Fortunately, we think that price cuts will come no later than E3 for the two current generation consoles, with a cut for the Wii and a bundle for the Wii U likely before holiday. That should mitigate some of the declines in monthly software sales we have seen so far this year.

The bright spot on the horizon is Take-Two's *Grand Theft Auto V*, expected in September. We think the game will sell extremely well, and believe that it will cause many consumers to return to retailers that they haven't visited all year. With that said, it is not clear that the game will generate its historically strong catalog sales, given that next-generation consoles are slated to launch by November. Should Sony and Microsoft choose to keep current generation console prices high for the remainder of the year, sales of current generation hardware and software may continue to stagnate.

The impact of NPD results on video game publishers is more muted in 2013 than in any year in our memory (we have covered the sector since 2001). Investors appear to expect persistent software sales declines, and recent solid earnings results and share price performance by several game publishers suggests that investors have increasing confidence that the next generation of consoles will usher in newfound enthusiasm from gamers and corresponding growth in software sales. In particular, each of the publishers that has



reported earnings in the last two weeks has cautioned investors to expect weak sales in the June quarter, setting up a calm reception for continuing abysmal NPD figures. We think that investor confidence is well-placed, and expect the next-generation consoles from Microsoft and Sony to impress and delight consumers, particularly if both permit unrestricted transfer of used titles. With that said, we continue to believe that Nintendo misfired with the Wii U, and believe that the next-generation of consoles will see a market share shift from Nintendo platforms to Microsoft and Sony platforms.

In the aggregate, we think that the installed base of next-generation of home consoles at a similar point in the cycle will be smaller than the current generation, likely by 10-20%. However, the composition will be much different, with Sony and Microsoft each selling 85-100 million home consoles (compared to approximately 75 million each in the current cycle) and Nintendo selling 50 million or fewer (compared to approximately 100 million in the current cycle). The 50 million decline in our forecast for Nintendo's home console installed base reflects defections of more non-traditional gamers to social and mobile games. The 20-50 million increase in our forecast for Sony's and Microsoft's combined installed base reflects our view of healthy growth for the addressable market plus some market share gains from Nintendo's historical base of more traditional gamers. The market share gains we have forecast should be beneficial for game publishers focused on the Sony and Microsoft platforms, and includes all four of our OUTPERFORM-rated publishers (Activision, Electronic Arts, Take-Two and Ubisoft). Should third parties follow EA's lead and abandon the Wii U, it is likely that many Wii U households will purchase a next-generation console from Microsoft or Sony in addition to their Nintendo consoles, driving the installed base for "hard core" consoles to 220 million or higher. It is important to note that Microsoft recently put out a forecast predicting 385 million consoles sold next-generation, with a large increase in penetration in developing markets (Latin America and Southern Europe). While this number sounds high, we think it remains a possibility.

We continue to expect handheld hardware sales to decline over the next few years, as many non-traditional gamers consider smartphone and tablet games a perfect substitute for casual games played on dedicated handheld hardware. While we believe this news is bad for third-party game publishers focused on the Nintendo 3DS, there are few publishers remaining who are focused in any meaningful way on the 3DS. At least one publisher formerly focused on the Nintendo handhelds is bankrupt (THQ), and another (Ubisoft) appears to have successfully shifted its focus from handheld games to a broader hard core offering. With the exception of Ubisoft, our OUTPERFORM-rated publishers have little exposure to Nintendo's handheld platforms.

We are hopeful that Microsoft reverses the damage done at its "Xbox Reveal" event two weeks ago, and clarifies its intentions about the transfer of used games for the Xbox One. We also expect many high profile announcements at this year's E3 Expo from June 10-13, and those interested in investing in the games sector should plan on attending E3.



# **EQUITY PERFORMANCE**

The Wedbush Video Game Index—our market cap-weighted index of video game companies—was roughly flat for the month of May, below the broader market averages due to declines for three of the larger companies. The Russell 2000 and S&P 500 increased 4% and 2%, respectively, due to the continuation of quantitative easing and easing concerns around the European debt crisis and the China slowdown. Electronic Arts and Ubisoft were up 31% and 19%, respectively, after providing stronger-than-expected FY:14 guidance. Nintendo had the worst month, down 6%, the result of sluggish Wii U sales and the belief that the next gen consoles from Microsoft and Sony may trample the Wii U. GameStop was down 5% over concerns that Microsoft will alter the used gaming landscape with Xbox One, significantly reducing GameStop's lofty used revenues and margins. Microsoft has already confirmed that Xbox One will allow used gaming, and we continue to expect that the used gaming landscape will remain largely unchanged for the next gen consoles as Microsoft will likely not risk angering its most important retail gaming partner, GameStop, or alienating core gamers, who can opt for the PS4 instead of the Xbox One. Activision Blizzard was down 4% due in part to uncertainty over its relationship with Vivendi. On a constant f/x basis, the Index increased 1%. The Index increased 4% excluding Nintendo (on a constant f/x basis).

Electronic Arts 31% 19% Ubisoft Majesco 11% Take-Two Russell 2000 4% S&P 500 2% Wedbush V.G.I. (F/X Constant) Wedbush V.G.I. (0% (4%) Activision Blizzard GameStop (5%) Nintendo (6%)(10%)0% 10% 20% 30% 40%

**Exhibit 1: Monthly Video Game Stock Performance** 

Source: Thomson Baseline and Wedbush Securities estimates.

Note: As of May 31, 2013. Excludes THQ and Zynga. "Wedbush V.G.I." is the Wedbush Video Game Index. "F/X Constant" means no year-over-year change to foreign exchange rates used for Nintendo (yen) or Ubisoft (euro).



#### **INDUSTRY NEWS**

- 5/6 The Walt Disney Company and EA announced a multi-year exclusive licensing agreement to develop and publish globally games based on *Star Wars* characters and storylines. EA will develop and publish *Star Wars* games for core audiences across all platforms, while Disney will retain certain rights for developing games for mobile, social, tablet, and online game categories. EA's DICE and Visceral will produce new games, with BioWare continuing to develop *Star Wars* content, including the *Star Wars: The Old Republic* MMO. The games will feature new stories and gameplay. Financial terms of the agreement were not disclosed.
- 5/7 EA reported Q4:13 results that were in-line with its negative preannouncement, with new release SimCity performing better-than-expected, but fellow new releases Crysis 3 and Dead Space 3 underperforming expectations. It provided bullish FY:14 EPS guidance that exceeded then-consensus.
- 5/8 Activision reported better-than-expected Q1:13 results with strong top-line growth (including for digital) and cost control. It did not fully pass-through the quarterly beats to full year guidance due to several factors expected to impact 2H, particularly in Q4.
- 5/9 Sony reported Q4:12 results.
- 5/13 Take-Two reported better-than-expected Q4:13 results from new release *BioShock Infinite*, digital, and catalog, combined with gross margin improvement from the expiration of its previous contract with Major League Baseball. It provided bullish FY:14 guidance.
- 5/15 Ubisoft reported Q4:13 revenue towards the high-end of the guidance range, with better-than-expected EPS driven by a goodwill amortization add-back. Assassin's Creed III, Far Cry 3, and Just Dance 4 were among its top performers in FY:13. It provided much better-than-expected FY:14 guidance.
- 5/16 NPD announced much lower-than-expected April U.S. console/handheld software sales from catalog weakness, including for a slew of high-profile March releases. Hardware sales were also well below expectations due to current gen console fatigue and the disappointing impact of the Wii U.
- 5/21 Microsoft unveiled its Xbox One next-generation console, which will launch worldwide later this year, with key features including a new controller with forty design innovations, an upgraded Kinect sensor, built-in Smart Glass, and TV integration. In addition, it announced a new Xbox Live experience. In a Q&A session that followed the presentation, Microsoft disclosed that the new console will play used games, although many specifics around used gaming remain unclear. Other unknowns remain, including the console's specific release date, pricing, and whether it can act as a standalone device for TV viewing. We expect Microsoft and Sony to provide additional details about the next gen consoles at E3.
- 5/23 GameStop reported Q1:13 revenue towards the high-end of implied guidance, and better-than-expected EPS from a 1% gross margin increase from mix shift to digital and mobile. It increased FY:13 guidance at the low-end to reflect Q1 and Xbox One.

#### **FINANCIAL NEWS**

• In May, Activision, GameStop, Take-Two, and Ubisoft reported better-than-expected quarterly EPS, while EA reported results that were in-line with its negative preannouncement. In addition, Sony reported Q4 results. A summary follows (all estimates and rating/price target changes as of the date of the event):

# Electronic Arts (5/7)

- Revenue was \$1.04 billion, compared with our estimate of \$1.025 billion, consensus of \$1.03 billion, and guidance of \$1.025 1.125 billion. SimCity performed better-than-expected, while Crysis 3 and Dead Space 3 underperformed expectations.
- EPS was \$0.55 (excluding a \$0.50 per share net benefit), compared with our estimate of \$0.56, consensus of \$0.58, and guidance of \$0.57 0.72. EPS was below expectations due in large part to \$16 million of severance costs.
- Management provided initial FY:14 guidance for revenue of \$4.0 billion and EPS of \$1.20, compared to FY:13 results of revenue of \$3.793 billion and EPS of \$0.84. Top-line guidance reflects packaged goods softness, the console transition, and fewer major titles.
- Initial Q1:14 guidance is for revenue of \$450 million and EPS of \$(0.62). Q1:14 guidance reflects lower expected sales of *FUSE* compared to the ongoing strength of *Mass Effect 3* in Q1:13.
- We decreased our FY:14 estimates for revenue to \$4.06 billion from \$4.25 billion and EPS to \$1.25 from \$1.58 to reflect guidance.
- We maintained our OUTPERFORM rating, but raised our 12-month price target to \$26 from \$25. Our revised price target values
  EA at a forward P/E of 18x our \$1.25 EPS estimate, plus roughly \$4 in net cash per share. The P/E multiple we have assigned is a
  discount to EA's historical multiple, but is in line with the current market multiple, reflecting superior growth prospects offset by
  recent execution missteps. Electronic Arts shares are on the Wedbush Securities Investment Committee's Best Ideas List.
- Risks to attainment of our share price target include changes to game release timing, greater than expected deterioration of the average selling price (ASP) for game software, the effects of competition, changing macroeconomic factors, and lower-than-expected consumer demand for video game hardware.

# **Activision Blizzard (5/8)**

- Revenue was \$804 million, vs. our estimate of \$737 million, consensus of \$704 million, and guidance of \$690 million. Key drivers of revenue included digital, *Skylanders Giants*, *Call of Duty: Black Ops II*, *StarCraft II: Heart of the Swarm*, and *World of Warcraft*. The Q1 subs number for *World of Warcraft* of 8.3 million was down by ≈ 1.3 million g-o-g, driven primarily by losses in the East.
- EPS was \$0.17 (excluding a \$0.23/share net benefit), compared with our estimate of \$0.12, the consensus estimate of \$0.11, and guidance of \$0.10. The beat was driven by better-than-expected top-line growth (including higher margin digital) and cost control.
- The company increased FY:13 guidance for revenue to \$4.250 billion from \$4.175 billion and for EPS to \$0.82 from \$0.80. Despite beating Q1 EPS guidance by \$0.07, full year guidance was raised by only \$0.02 due to several factors expected to impact 2H.



- The company provided initial Q2:13 guidance for revenue of \$590 million and EPS of \$0.05. Q2 results are expected to be down from last year due to a tough *Diablo III* comparison and increased revenue concentration to the holiday period this year.
- We decreased our 2013 estimates for revenue to \$4.36 billion from \$4.74 billion, and for EPS to \$0.90 from \$1.05 to reflect revised guidance, the 2H challenges listed by management, and the expected release of *Destiny* in 2014, not 2013.
- We decreased our 2014 estimates for revenue to \$4.66 billion from \$4.74 billion, and for EPS to \$1.00 from \$1.05.
- We maintained our OUTPERFORM rating, but raised our 12-month price target to \$22 from \$21. We value Activision shares at a market multiple of 18x our 2014 \$1.00/share EPS estimate, plus approximately \$4 per share in cash. The company communicates clearly, executes well, and its management appears to truly understand how to make money. We recommend that investors accumulate shares of Activision Blizzard while they remain below our 12-month price target.
- Risks to attainment of our share price target include changes to game release timing, greater than expected deterioration of the
  average selling price (ASP) for game software, the effects of competition, changes in macroeconomic factors, and lower-thanexpected consumer demand for video game hardware.

# Sony (5/9)

- Announced Q4:12 (ending March 2013) unit sales: For hardware, PS3 / PS2 of 3.4 million (compared to 2.5 million last year) and PS Vita / PSP of 1.3 million (compared to 0.9 million last year). For software, PS3 / PS2 of 30.7 million (compared to 28.0 million last year) and PS Vita / PSP of 5.4 million (compared to 6.0 million last year).
- Provided FY:13 (ending March 2014) guidance: PS3 / PS2 of 10.0 million (compared to 16.5 million last year), PS Vita / PSP of 5.0 million (compared to 7.0 million last year), and software sales of 319 million (compared to 266 million last year).

#### Take-Two (5/13)

- Revenue was \$303 million, compared with our estimate of \$290 million, consensus of \$280 million, and guidance of \$235 285 million. Key drivers of the revenue beat included strong sales of BioShock Infinite, digital, and catalog sales.
- EPS was \$0.38 (excluding a \$0.14/share net charge), vs. our estimate of \$0.27, consensus of \$0.23, and guidance of \$0.10 0.25. Drivers of the beat included top-line growth and gross margin improvement from the expiration of its previous baseball contract.
- The company provided initial FY:14 guidance for revenue of \$1.75 1.85 billion and EPS of \$2.05 2.30, compared to FY:13 results of revenue of \$1.22 billion and EPS of \$0.36.
- Initial Q1:14 guidance is for revenue of \$100 125 million and EPS of \$(0.70) (0.55).
- The company announced that it currently expects to be profitable in FY:15 and for the foreseeable future.
- We maintained our FY:14 estimates for revenue of \$2.10 billion and EPS of \$3.00, although our estimates are more heavily weighted to Q2 through Q4 due to lower-than-expected Q1 guidance.
- We maintained our OUTPERFORM rating and 12-month price target of \$19. Our price target reflects a forward multiple of ≈ 16x estimated sustainable EPS of \$1.20 (fully taxed). This multiple is in line with industry peers, and reflects an improving outlook for video game publishers ahead of the launches of the next-gen consoles.
- Risks to attainment of our share price target include performance of its games, levels of competition, changing macroeconomic factors, changes in consumer demand for video game hardware, and the ability of the company to attract merger partners.

# **Ubisoft (5/15)**

- Q4 revenue was €175 million, compared with our estimate of €181 million, consensus of €174 million, and guidance of €159 179 million. Strong performers in FY:13 were *Assassin's Creed 3, Far Cry 3*, and *Just Dance 4*. For FY:13, it had core gaming revenue of €928 million (up 60% y-o-y), casual revenue of €328 million (down 32%), and online / digital revenue of €148 million (up 86%).
- 2H:13 pro forma EPS was €1.11, compared with our estimate of €1.06, and the consensus estimate of €1.07. Ubisoft did not provide EPS guidance. The EPS beat was driven primarily by a goodwill amortization add-back.
- The company provided initial FY:14 guidance for revenue of €1.42 1.45 billion and non-IFRS operating income of €110 125 million, compared to FY:13 results of €1.26 billion and €100 million, respectively. Drivers of growth are expected to include a bigger AAA lineup, new IPs for the next gen consoles, digital, and online growth.
- Initial Q1:14 guidance is for revenue of €70 million, down 47% y-o-y due to the release of Tom Clancy's Ghost Recon Future Soldier last year.
- We increased our FY:14 estimates for revenue to €1.46 billion from €1.30 billion and for EPS to €0.88 from €0.69 to reflect stronger-than-expected guidance.
- We upgraded our rating for Ubisoft shares to OUTPERFORM from NEUTRAL, and increased our 12-month price target to €14 from €9 to reflect bullish guidance for FY:14, a better-executed release slate, and the upcoming launches of the next generation of consoles. Our revised price target reflects a market multiple of 16x our FY:14 EPS estimate of €0.88.
- Risks to attainment of our share price target include changes to game release timing, greater-than-expected deterioration of the average selling price (ASP) for game software, the effects of competition, foreign exchange changes, macroeconomic factors and lower-than-expected consumer demand for video game hardware.

#### GameStop (5/23)

- Revenue was \$1.87 billion, compared with our estimate of \$1.81 billion, the consensus estimate of \$1.84 billion, and implied guidance of \$1.83 1.88 billion.
- Same-store sales were down 6.7%, compared with our estimate of down 9.0%, and guidance of down 8.0 5.5%.

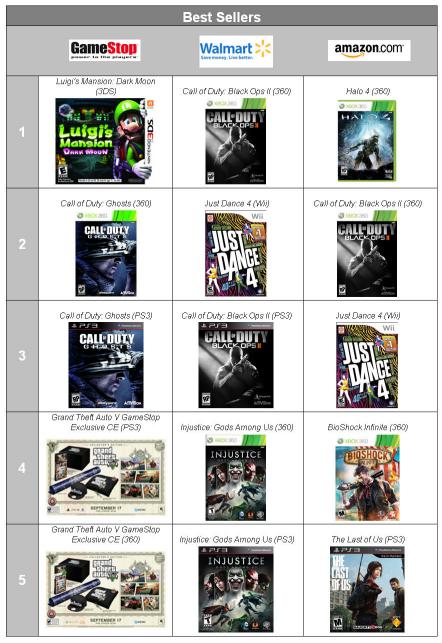


- EPS was \$0.46, compared with our estimate of \$0.39, consensus of \$0.40, and guidance of \$0.38 0.43. The EPS beat was driven primarily by a 100 basis point improvement in gross margin from a mix shift towards digital and mobile sales.
- The company narrowed FY:13 guidance for comps to down 5.0% to up 1.5% from down 6.0% to up 1.5%, and for EPS to \$2.90 3.15 from \$2.75 3.15. Revised guidance reflects Q1 results and the launch of two next gen consoles.
- Initial Q2:13 guidance is for comps of down 16.0 12.5%, and for EPS of \$0.01 0.07.
- We increased our FY:13 estimates for revenue to \$8.85 billion from \$8.79 billion and for comps to up 1.5% from up 1.0% to reflect better-than-expected top-line growth in Q1, but maintained our EPS estimate of \$3.28 to reflect lower-than-expected Q2 guidance.
- We maintained our FY:14 estimates for revenue of \$9.16 billion and EPS of \$3.89, but lowered our comps estimate to up 5.3% from up 6.0% to reflect slightly better-than-expected top-line growth in the preceding year.
- We maintained our OUTPERFORM rating and our 12-month price target of \$49. Our price target is based on 11x our FY:14 EPS estimate of \$3.89 plus \$6/share of cash at year-end, and reflects strong revenue and EPS growth from market share gains, digital growth, and the share repurchase program.
- Risks to attainment of our share price target include changes to game release timing, the effects of competition, supply of video game products, macroeconomic factors, and slower than expected consumer demand for video game hardware and software.



# **VIDEO GAME BEST SELLER LISTS**

**Exhibit 2: Video Game Best Seller Lists** 



Source: GameStop.com, Walmart.com, and Amazon.com.

Note: As of May 28, 2013. Excludes discounted PC game downloads, and console and multiple video game bundles.

# U.S. RETAIL SALES OF VIDEO GAME SOFTWARE AND HARDWARE (NPD)

- April U.S. console/handheld software sales were \$254 million, down 17% from last year's \$307 million, and well below our estimate
  of \$300 million (down 2%). SW units were down 26%, with ASPs up 11%. PC SW sales were down 15%, despite two recent highprofile releases.
- Hardware sales were \$110 million, down 42% compared with last year's \$188 million, and below our estimate of \$175 million due to current-gen console fatigue and the disappointing impact of the Wii U. Combined hardware and software (including PC) sales for April were down 26% y-o-y, indicating slowing demand for current generation products.
- Solid new releases could not offset sluggish catalog sales. New release Warner Bros.' *Injustice: Gods Among Us* (360, PS3, Wii U) led sales by a wide margin, with fellow new release Deep Silver's *Dead Island: Riptide* (360, PS3, PC) having a decent debut. The multiple high-profile March releases performed well below our expectations, with older catalog content performing poorly for the



most part, as gamers appear to be waiting for next-generation consoles to launch. Only a deep price cut for current generation consoles is likely to spur sales over the balance of the year.

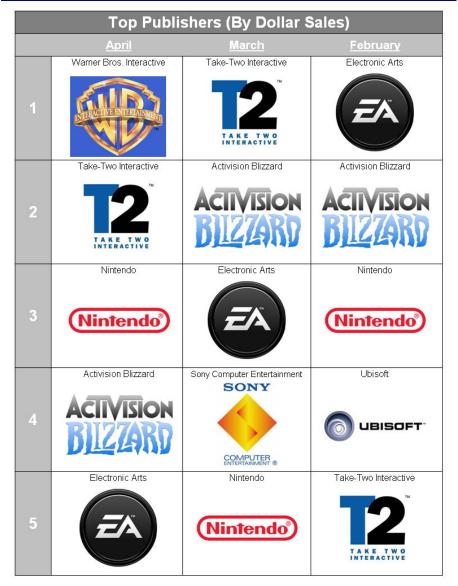
• We expect packaged goods weakness to persist for much of 2013. We expect positive growth to return in September (the launch month of Take-Two's *Grand Theft Auto V*), and we do not expect sustained growth until 2014.

Exhibit 3:	Video	Game	Software:	Sales	Growth
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	YoY <u>% change</u>	Est. YoY <u>% change</u>	MoM <u>% change</u>	Est. MoM <u>% change</u>
Activision Blizzard	-39%	-6%	-59%	-37%
Electronic Arts	-50%	-5%	-58%	-21%
Majesco	-67%	-37%	-55%	-14%
Nintendo	-30%	-3%	-50%	-31%
Take Two Interactive	21%	89%	-70%	-53%
Ubisoft Entertainment	-45%	-13%	-61%	-38%
Covered Publishers	-33%	6%	-61%	-38%
Overall Industry	-17%	<b>-2%</b>	-54%	-46%

Source: The NPD Group/Retail Track and Wedbush Securities estimates.

**Exhibit 4: Top Publishers** 



Source: The NPD Group/Retail Track. Note: Includes PC sales. Note: EA includes MTV Games.

- New release Warner Bros.' *Injustice: Gods Among Us* (360, PS3, Wii U) led sales by a wide margin, with fellow new release Deep Silver's *Dead Island: Riptide* (360, PS3, PC) having a decent debut. The multiple high-profile March releases performed well below our expectations, with older catalog content performing poorly for the most part. Other top performers included Activision Blizzard's *Call of Duty: Black Ops II*, Nintendo's *Luigi's Mansion: Dark Moon*, Take-Two's *BioShock Infinite* and *NBA 2K13*, and Trion Worlds' *Defiance*. PC software sales were led by two recent releases: Activision Blizzard's *StarCraft II: Heart of the Swarm* and Electronic Arts' *SimCity*; however, both performed well below our expectations, and as PC games, were excluded from NPD's console/handheld sales data.
- There were 5 SKUs that sold over 100,000 units in April, below our estimate of 10, compared to 5 last year.
- Combined current-generation home console (PS3, 360, Wii, Wii U) hardware unit sales were down 38% year-over-year, while handheld hardware unit sales were down 38% as well, resulting in overall hardware unit sales being down 39% for the month. There were 37,000 Wii U units sold vs. our 55,000 estimate in its sixth month, 42,000 Wiis sold (down 53% y-o-y) vs. our 75,000 estimate, and 130,000 Xbox 360s sold (down 45% y-o-y) vs. our 205,000 estimate. PS3 hardware sales were down 42% y-o-y and well below our 165,000 estimate, 3DS hardware sales were well below our 185,000 estimate and PS Vita hardware sales were well below our 30,000 estimate as well. DS sales were below our 60,000 estimate.



Exhibit 5: Top Platforms

Top Platforms (By Unit Sales)				
	<u>April</u>	<u>March</u>	<u>February</u>	
	Xbox 360	Xbox 360	Xbox 360	
1	lation D	don't be a second		
	Nintendo 3DS	Nintendo 3DS	PlayStation 3	
2	MATTAGO 3DS	MITTHOGE DS		
	PlayStation 3	PlayStation 3	Nintendo 3DS	
3			MNTDAGGEDS.	
	Nintendo DS	Nintendo Wii	Nintendo DS	
4		2.52 2.53 3.53 3.53		
	Nintendo Wii	Nintendo DS	Nintendo Wii	
5			1	

Source: The NPD Group/Retail Track.



# **NPD PREVIEW**

We expect NPD U.S. retail video game console software sales data for the month of May (four-week period ending June 1, 2013) to be released on Monday, June 17 after the market close. We note that the data release has been delayed by a few days due to E3 the previous week. We will publish our NPD preview note next week. We expect May sales to be led by new releases Capcom's Resident Evil: Revelations (360, PS3, Wii U) and Nintendo's Donkey Kong Country Returns 3D (3DS), April release Injustice: Gods Among Us, and Activision Blizzard's Call of Duty: Black Ops II. Below, we have highlighted key releases for May and upcoming months.

Exhibit 6: Last Month's Key Video Game Releases

Game Title	Publisher	Platform	Date
Metro: Last Light - Deep Silver	Other	PS3	5/14/13
Metro: Last Light - Deep Silver	Other	360	5/14/13
Metro: Last Light - Deep Silver	Other	PC	5/14/13
Fast and Furious Showdown	Activision	PC	5/21/13
Fast and Furious Showdown	Activision	360	5/21/13
Fast and Furious Showdown	Activision	PS3	5/21/13
Fast and Furious Showdown	Activision	Wii U	5/21/13
Fast and Furious Showdown	Activision	3DS	5/21/13
Lego Batman 2: DC Super Heroes - Warner Bros.	Other	Wii U	5/21/13
Resident Evil: Revelations - Capcom	Other	360	5/21/13
Resident Evil: Revelations - Capcom	Other	PS3	5/21/13
Resident Evil: Revelations - Capcom	Other	Wii U	5/21/13
Sniper Elite V2 - 505 Games	Other	Wii U	5/21/13
Donkey Kong Country Returns 3D	Nintendo	3DS	5/24/13
Fuse	Electronic Arts	360	5/28/13
Fuse	Electronic Arts	PS3	5/28/13
GRID 2 - Warner Bros.	Other	360	5/28/13
GRID 2 - Warner Bros.	Other	PS3	5/28/13
GRID 2 - Warner Bros.	Other	PC	5/28/13

Source: Company reports and Wedbush Securities estimates.

**Exhibit 7: Key Upcoming Video Game Releases** 

Game Title	Publisher	Platform	Date
Remember Me - Capcom	Other	360	6/4/13
Remember Me - Capcom	Other	PS3	6/4/13
Remember Me - Capcom	Other	PC	6/4/13
Animal Crossing: New Leaf	Nintendo	3DS	6/9/13
Jak and Daxter Collection	Sony	PS Vita	6/11/13
The Last of Us - Sony	Other	PS3	6/14/13
Game & Wario	Nintendo	Wii U	6/23/13
LEGO Legends of Chima: Laval's Journey - Warner Bros.	Other	PS Vita	6/25/13
LEGO Legends of Chima: Laval's Journey - Warner Bros.	Other	3DS	6/25/13
Company of Heroes 2 - Sega	Other	PC	6/25/13
DeadPool	Activision	360	6/25/13
DeadPool	Activision	PS3	6/25/13
Project X Zone - Namco Bandai	Other	3DS	6/25/13
Ride to Hell: Retribution - Deep Silver	Other	360	6/25/13
Ride to Hell: Retribution - Deep Silver	Other	PS3	6/25/13
The Sims 3: Island Paradise	Electronic Arts	PC	6/25/13
NCAA Football 14	Electronic Arts	PS3	7/9/13
NCAA Football 14	Electronic Arts	360	7/9/13
Sid Meier's Civilization V: Brave New World	Take 2	PC	7/9/13
Dynasty Warriors 8 - Tecmo Koei	Other	PS3	7/16/13
Dynasty Warriors 8 - Tecmo Koei	Other	360	7/16/13
The Smurfs 2	Ubisoft	360	7/23/13
The Smurfs 2	Ubisoft	PS3	7/23/13
The Smurfs 2	Ubisoft	Wii	7/23/13
The Smurfs 2	Ubisoft	Wii U	7/23/13
The Smurfs 2	Ubisoft	DS	7/23/13

Source: Company reports and Wedbush Securities estimates.



# **Exhibit 8: Profiles For The Top Upcoming Releases**

# **Top Upcoming Releases**

# June

Title: The Last of Us
Publisher(s): Sony Computer Entertainment

Studio(s): Naughty Dog Console(s): PS3 Release Date: 6/14/2013



# July

Title: NCAA Football 14

Publisher(s): EA Sports Studio(s): EA Tiburon Console(s): 360, PS3 Release Date: 7/9/2013



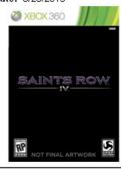
# August

Title: Disney Infinity
Publisher(s): Disney Interactive Studios
Studio(s): Avalanche Software
Console(s): Wii, 360, Wii U, PS3, 3DS, PC

Release Date: 8/18/2013



Title: Saints Row IV
Publisher(s): Deep Silver
Studio(s): Volition
Console(s): 360, PS3, PC
Release Date: 8/20/2013



#### August

Title: Tom Clancy's Splinter Cell: Blacklist

Publisher(s): Ubisoft

Studio(s): Ubisoft Toronto, Ubisoft Shanghai

Console(s): 360, PS3, Wii U, PC

Release Date: 8/20/2013



Title: Madden NFL 25
Publisher(s): EA Sports
Studio(s): EA Tiburon

Console(s): 360, PS3, Xbox One, PS4 Release Date: 8/27/2013 (360, PS3)



Source: Company reports, Wedbush Securities estimates, and www.wikipedia.org.



# Covered Companies Mentioned in this Report (priced as of close May 31, 2013)

COMPANY	TICKER	RATING	PRICE	PRICE TARGET
ACTIVISION BLIZZARD	ATVI	OUTPERFORM	\$14.43	\$22
ELECTRONIC ARTS	EA	OUTPERFORM	\$22.99	\$26
GAMESTOP	GME	OUTPERFORM	\$33.16	\$49
MAJESCO ENTERTAINMENT	COOL	NEUTRAL	\$0.66	\$1
NINTENDO	7974.JP	NEUTRAL	¥10,070	¥10,000
TAKE TWO INTERACTIVE	TTWO	OUTPERFORM	\$16.64	\$19
UBISOFT ENTERTAINMENT	UBI.FP	OUTPERFORM	€10.12	€14
ZYNGA	ZNGA	OUTPERFORM	\$3.40	\$4.25

# **Analyst Certification**

I, Michael Pachter, Nick McKay, certify that the views expressed in this report accurately reflect my personal opinion and that I have not and will not, directly or indirectly, receive compensation or other payments in connection with my specific recommendations or views contained in this report.

Disclosure information regarding historical ratings and price targets is available at <a href="http://www.wedbush.com/ResearchDisclosure/Disclo

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Outperform: Expect the total return of the stock to outperform relative to the median total return of the analyst's (or the analyst's team) coverage universe over the next 6-12 months.

Neutral: Expect the total return of the stock to perform in-line with the median total return of the analyst's (or the analyst's team) coverage universe over the next 6-12 months.

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The Investment Ratings are based on the expected performance of a stock (based on anticipated total return to price target) relative to the other stocks in the analyst's coverage universe (or the analyst's team coverage).\*

Rating Distribution (as of March 31, 2013)	Investment Banking Relationships (as of March 31, 2013)
Outperform:51%	Outperform:18%
Neutral: 44%	Neutral: 2%
Underperform: 5%	Underperform: 0%

The Distribution of Ratings is required by FINRA rules; however, WS' stock ratings of Outperform, Neutral, and Underperform most closely conform to Buy, Hold, and Sell, respectively. Please note, however, the definitions are not the same as WS' stock ratings are on a relative basis.

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# Wedbush Equity Research Disclosures as of June 2, 2013

Company	Disclosure
Activision Blizzard	1
Electronic Arts	1
GameStop	1
Majesco Entertainment Co.	1
Nintendo	1
Take-Two Interactive Software	1
Ubisoft Entertainment	
Zynga	1 1

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