The Way Things Work

- **Developers**
  - Create/design the game

- **Publishers**
  - Fund the developers
  - Market the game

- **Distributors**
  - Channel the game to the consumer

**Platform Royalties**

- PS2/Nintendo: Royalties for hardware and manufacturing
- Xbox: Royalties for hardware; manufacturing optional

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### Cyclical Camaraderie

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td><strong>Playstation</strong></td>
<td>0.6</td>
<td>2.0</td>
<td>4.6</td>
<td>7.2</td>
<td>6.0</td>
<td>3.2</td>
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<tr>
<td><strong>Nintendo 64</strong></td>
<td>-</td>
<td>2.0</td>
<td>4.4</td>
<td>4.1</td>
<td>3.6</td>
<td>2.6</td>
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<tr>
<td><strong>Handheld</strong></td>
<td>1.9</td>
<td>1.7</td>
<td>2.1</td>
<td>3.1</td>
<td>7.3</td>
<td>6.9</td>
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<tr>
<td><strong>GameCube</strong></td>
<td>1.1</td>
<td>6.2</td>
<td>8.6</td>
<td>9.7</td>
<td>7.5</td>
<td>5.5</td>
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<tr>
<td><strong>Xbox</strong></td>
<td>-</td>
<td>1.2</td>
<td>2.3</td>
<td>2.5</td>
<td>2.0</td>
<td>1.5</td>
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<td><strong>Handheld</strong></td>
<td>6.9</td>
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<td>8.0</td>
<td>9.0</td>
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Source: NPD/UBS
Logistical Prowess

Industry Specific
- High supply vs. low demand
  - 60–80% more SKUs compared to last year
- Smaller packaging leads to more shelf space
- Publishing has higher margins than distribution
- PC games have higher margins than console games
- Firms set aside reserves of around 20% for returns/underselling

Company Specific
- 75% of sales are sequels or expansions
- 60-65% publishing / 35-40% distribution

Sneaking Around The Neighborhood

<table>
<thead>
<tr>
<th>Company</th>
<th>Ticker</th>
<th>Market Capitalization</th>
<th>P/E</th>
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<tbody>
<tr>
<td>Electronic Arts</td>
<td>ERTS</td>
<td>13.96B</td>
<td>42.34</td>
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<tr>
<td>Take Two</td>
<td>TTWO</td>
<td>1.55B</td>
<td>16.16</td>
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<tr>
<td>Activision</td>
<td>ATVI</td>
<td>1.07B</td>
<td>26.60</td>
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<tr>
<td>THQ</td>
<td>THQI</td>
<td>616.33M</td>
<td>89.22</td>
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<tr>
<td>Eidos</td>
<td>EIDSY</td>
<td>349.38M</td>
<td>N/A</td>
</tr>
<tr>
<td>Atari</td>
<td>ATAR</td>
<td>303.36M</td>
<td>8.12</td>
</tr>
<tr>
<td>Midway</td>
<td>MWY</td>
<td>145.84M</td>
<td>N/A</td>
</tr>
</tbody>
</table>
In A League Of Their Own

The Untouchables
- Sony
  - Playstation, Playstation 2
  - Developer & Publisher
- Microsoft
  - Xbox & PC
  - Developer & Publisher
- Nintendo
  - GameCube, GameBoy, GameBoy Advance
  - Developer & Publisher

The Lost One
- Vivendi Games
- Potentially top tier gaming company
- Potent franchises: Half-Life, Counter-Strike, Warcraft/Starcraft

A Company of Controversy
Sales By Geography & Platform

United States: 64.31%
Canada: 5.80%
UK: 6.19%
Europe: 10.15%
Asia: 4.16%

PS2: 6.84%
PS1: 2.83%
Xbox: 4.16%
PC: 18.15%
GameBoy: 6.19%
GameCube: 5.80%
Other: 2.00%

Grand Theft Market Share

- #1 Selling Game of 2001: Grand Theft Auto III
  - 8.5 million copies
- #1 Selling Game of 2002: Grand Theft Auto: Vice City
  - 9 million copies
- Grand Theft Bundle Pack for PS2/Xbox coming up
- Grand Theft Auto in Japan
- Grand Theft Auto 4 in October 04
Anatomy Of A Company

Three Primary Divisions
- Rockstar Games (Mostly propriety)
  - Grand Theft Auto
  - Max Payne
  - Midnight Club
  - Manhunt
  - State of Emergency
- Gathering (More outside developers)
  - Mafia
  - Hidden & Dangerous
  - Chrome
- Gotham Games (Mainstream/budget)
  - Conflict Desert Storm
  - Celebrity Deathmatch

Welcome To The Family
- TDK Mediactive (2003/$22.3M)
- Frog City (2003/$3.6M)
  - Tropico developer
- Destineer Games (2003/$6.7M)
  - Access to Mac market
- Angel Studios (2002/$40.1M)
- Midnight Club
- Barking Dog Studios (2002/$7.6M)
- Techcorp Limited (2001/$0.6M)
  - HK firm that designs accessories
- PopTop Software (2000/$5.8M)
  - Railroad Tycoon developer
- Gathering of Developers (1999/$10.4)
  - Max Payne (2002/$28M)
  - Duke Nukem (2000/$7.7M)
- Next: Vivendi Games?
Full Service Packaging

- Acquiring TDK Mediactive for $22.7M
  - FY02 Sales: $42.4M
  - FY02 EPS: ($0.36)
- Access to mass market gaming
- Access to *decent* franchises
  - Shrek
  - The Muppets
  - Pirates of the Caribbean
  - Star Trek
- No internal studios

On The Horizon

**Q4/03**
- Max Payne 2 (PC)
- GTA Double Pack (PS2)
- Grand Theft Auto III (Japan)
- Hidden & Dangerous 2 (PC)
- Conflict Desert Storm 2 (PS2)
- Railroad Tycoon 3 (PC)
- Starsky & Hutch (All)
- MTV Celebrity Deathmatch
- Chrome (PC)

**Q1/04**
- Max Payne 2 (PS2/Xbox)
- Manhunt (PS2)
- GTA Double Pack (Xbox)
- Mafia (PS2, Xbox)

**QX/04**
- Duke Nukem Forever (PC)
- Grand Theft Auto “4” (PS2)
Always A Risky Business

- Failure of a “hit” game will result in disaster
- Console software demand is slowing
- Few titles lead to most revenues
- Overwhelming dependence on the Playstation 2
  - Only because that’s where the market is
- Delays in “hit” game productions
  - Duke Nukem Forever in production for… forever
- Legal controversy
  - Being sued for “shooting rampage by teens” in UK

Valuating The Fun Times
Financial Highlights

- Q303 Revenue ($156M) up 27% YoY
  - Publishing: $93M / 9% YoY
  - Distribution: $62M / 69% YoY
- Net Margin increase from 7.0% to 9.8% (LTM)
- DSO decreased to 38 from 48 (LTM)
- Virtually no debt
- $225M in cash

Free Cash Flow To Equity (FCFE)

<table>
<thead>
<tr>
<th>Risk Premium</th>
<th>4.77%</th>
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<tbody>
<tr>
<td>Beta (via Bloomberg: 2 yrs vs. S&amp;P)</td>
<td>1.33</td>
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<tr>
<td>30 Year Bond</td>
<td>5.07%</td>
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<tr>
<td>Cost of Equity</td>
<td>11.41%</td>
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<tr>
<td>Assumed HyperGrowth Rate</td>
<td>15.00%</td>
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<tr>
<td>Assumed Stable Growth Rate</td>
<td>4.50%</td>
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Worth The Hype?

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<thead>
<tr>
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<tbody>
<tr>
<td>Intrinsic Value (w/o R&amp;D)</td>
<td>$38.41</td>
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<tr>
<td>Intrinsic Value (w/ R&amp;D)</td>
<td>$42.05</td>
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<tr>
<td>Current Share Price</td>
<td>$36.07</td>
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<tr>
<td>Upside Potential</td>
<td>14.22%</td>
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Techniques For Survival

- One solid title a year
  - Sequels/expansions are usually guaranteed moneymakers
- Developers under multiple platforms
- Distribution deals overseas
- Quality control
- Plenty of luck
<table>
<thead>
<tr>
<th>The Recommendation</th>
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<tbody>
<tr>
<td><strong>Long-Term</strong></td>
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<td><strong>Short-Term</strong></td>
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<tr>
<td><strong>Buy Price</strong></td>
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<td><strong>Target Price</strong></td>
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Ask Anything You Want