FINC-GB 3145 Investment Banking and Private Equity in Media and Entertainment

Proposed $20.3B Leveraged Buyout of Activision Blizzard

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1. Given the desire of the Activision's majority shareholder, Vivendi, to sell its 62% stake and the relatively attractive multiple (7.6x EV/EBITDA) at which the stock trades, we believe that we can convince the board of **Activision Blizzard** to approve a sale of all the outstanding equity to our Private Equity consortium.

   Vivendi, the European media conglomerate, has been eager to shed assets after a splurge of acquisitions by their previous CEO. After purchasing the stake for $9.8bn in 2008, one of the major setbacks for a sale has been the ability to get the right price for the company. Through our $20.3bn LBO, Vivendi will be able to sell this asset at a gain (c.$2.6bn). More importantly, however, this will:
   1) improve Vivendi's debt servicing ability (Vivendi's debt rating has been at risk);
   2) realign the focus on its core media business, and;
   3) unlock shareholder value via buybacks & dividends.

   We believe both parties have an incentive to accept our deal. As stated above, Vivendi is in position where it is looking to right-size and re-align their core business. The new CFO is focused on maximizing shareholder value, which he will be able to do after monetizing Activision (buyback & dividend implementation). Like Vivendi, Activision is also aggressive when it comes to enhancing shareholder value (the company has a consistent track record for corporate buybacks). In a low-to-no-growth environment, management will be compelled to act when given a 25% premium to the current share price.

   While managements and boards can often be on opposing sides when determining whether or not to accept a Private Equity bid, in this case, we think both parties at Activision would have an incentive to accept. Management is accustomed to dealing with large outside investors given their experience with Vivendi. The board's job is to act in the best interest of shareholders and both parties have proven very shareholder friendly. Given this commitment to shareholder returns, we believe that they would certainly favor the purchase of shares at a 25% premium. Furthermore, we think that they would be receptive to ownership by a financial sponsor who could optimize cash flows and profitability as opposed to ownership by Vivendi, which is fairly distracted with its core business.

Bobby Kotick has been the CEO of Activision since 1991 and of Activision Blizzard since the merger in 2008. In our arrangement, Kotick will remain at the helm post-transaction. Kotick is likely to want to participate in the transaction. The transaction is not only consistent with his track record of increasing shareholder returns, but it will also significantly boost Kotick's personal wealth (he owns c.6mm ATVI shares).

The biggest risk from a private equity perspective is the lack of precedent deals in the gaming industry. The cyclicality and dependence on creative content does not meet typical PE norms. However, Activision has an established and consistent stream of cash flows that is being underutilized (see model). They also have key franchises that have recurring revenue streams that act much like annuities.

2. We believe the purchase of Activision Blizzard presents an attractive investment opportunity to buy an asset at a cheap price ($18/share). The company is the industry leader (#1 software games publisher in the US) and is near the top of its peers in terms of growth rate yet trades below its peers on EV/EBITDA (most important metric; comp table attached). We also believe that there is the potential for significant costs savings upon the acquisition that will immediately boost cash flow and the bottom line.

   Our proposal utilizes Activision's current cash pile ($4.3bn) while tapping a private-equity consortium for $8bn in new equity. We intend to utilize primarily lower interest bank loans (model assumes c.$4.5bn) while accessing the high yield market for a remaining $3.5bn. We believe it is critical to be prudent on leverage given the cyclicality of the video game industry, which explains the slight overweight on equity on this deal. Leverage is 5.1X EBITDA13E, in-line with LBOs in recent years. Levering up the company (it currently has no debt) and gradually deleveraging the company with the stable cash flows allows the PE consortium to achieve a healthy IRR upon its exit.

   We assume that our consortium could cut R&D and SG&A by 10% and 15%, respectively, in year one. This is mainly due to headcount and operational inefficiencies as well as misallocated resources to non-core franchises. After making some aggressive changes in the first year, we believe we can consistently lower both line-items by 3% into perpetuity by instilling disciplined cost management. This operating leverage allows us to pay down the acquired debt load at a fast pace by boosting free cash flow.

   We would also realign development focus internally to online / massive multiplayer online (MMO) games. With PC games expected to continue to decline at a modest pace, our focus instead would be to invest in online/MMO games, the fastest growing global gaming segment. With strong content like "Call of Duty", ATVI has margin leverage by focusing on online/subscription based purchases versus traditional console-based offerings (products with higher COGS). This does not mean that we will neglect console updates that can be extremely lucrative. Our objective is simply aimed at exploiting the higher growth/higher profitability nature of online/MMO gaming.

With respect to international opportunities, we will look for strategic relationship in high-growth markets like China. ATVI is currently working with Chinese internet company Tencent to offer the celebrated "Call of Duty" title online. Our private equity consortium will seek out these JVs going forward in order to capitalize on the rapid video-gaming growth in these developing economies.

3. Activision Blizzard is one of the leading video game software publishing companies in the world, dominating console gaming, the largest category in the video games market. It also caters to other segments such as online, PC, handheld portable and mobile/tablet gaming. Their top title is "Call of Duty", the *Modern Warfare 3* version of which became the biggest entertainment launch in history, grossing $1 billion in sales within the first 16 days.

   Blizzard, their other business unit, focuses on online subscription based games such as "World of Warcraft" and "Diablo." The company's games include both internally developed titles and licensed properties. ATVI experienced an exceptional year in 2012. With record operating margins and EPS, they are the largest video game company in the US by most metrics, including revenues.

   According to PWC, the global video games market is growing at a compound annual rate of 7.2% and is expected to reach $83 billion in 2016. The industry is in a consolidation phase creating several barriers to entry for new players. Larger players such as Activision will be in a better position to exploit the projected industry growth.

   Though industry analysts predict promising future growth in the online & social gaming sector, the low margin-high volume trend makes this growth challenging to sustain as seen by the struggling performance of Zynga despite a highly publicized IPO less than two years ago. Unlike Zynga, ATVI's subscription-based online and mobile product offering will be more sophisticated and entertaining, attracting users to pay for the games. With 'Call of Duty' leading in the Massive Multiplayer Online Gaming (MMO) space, Activision will extract steady revenues from the projected 11.2% compound growth in video game advertising.

With respect to global competition, ATVI's partnership with Tencent will prove to be an effective move in a market where according to *IBISWorld*, in 2012, industry profitability was estimated at an impressive 40.3% of revenue and most of the publicly listed online game companies in China make over 50.0% profit.

Given its leadership position in the industry, strong portfolio of gaming titles, growing presence in the online/MMO sector, and strong management track record, we believe ATVI is at the forefront of the changing dynamics within the video game industry and will continue to remain profitable and maintain substantive cash flows.

4. LBO Model (Please see attached excel model)

5. Our proposed price for this transaction is $18.0 and an overall deal value of roughly $20.3bn, representing a 25% premium to the current stock price. The price is based on a multiple of 10.1x EV/EBITDA13E, an attractive premium for the seller as the stock currently trades at 7.6x EV/EBITDA. We think the price is still attractive for the PE consortium at 10.1x, as it is still below the 11.0x EV/EBITDA13E multiple that its closest comparable, Electronic Arts, trades at. ATVI has been a more profitable company historically and we think that will only continue once we implement our operational strategy of cutting SG&A and R&D expenses, while emphasizing the development of online products.

   As mentioned previously, the deal would be financed with a combination of the company's existing $4.0bn cash, $8.3bn in new equity from the consortium and $8.0bn in debt from a combination of low-rate bank loans and high yield paper. We think the leverage ratio of 5.1x Debt/EBITDA13E is manageable considering the stability of its cash flow stream.

   We think our proposed price is also attractive to the various parties on the sell-side. Vivendi, will be relieved to unload the asset at a profit. ATVI's CEO will be pleased to remove the overhang of the Vivendi ownership issue and see a tidy profit in his own equity. Additionally, the management team and the board have proven very shareholder friendly and would be attracted by the premium offered.

   Our exit multiple is 10.1x EV/EBITDA18E which would represent a total enterprise value of roughly c$22.9bn. For the consortium, this equates to a 22.6% IRR and 2.77x return on money. Our estimates are conservative considering ATVI's multiple discount relative to peer Electronic Arts and very low-growth revenue assumptions (we assumed 3.0% vs 7.2% annual industry growth rate).

We believe that the most likely exit scenario will be through an IPO. We think that the market will pay the 10.1x multiple for a combination of 1) removal of Vivendi ownership overhang 2) improved cash flow generation and 3) the increased profitability and cost discipline from our operational plan.

For the same reasons that an IPO will work, a more efficient, consistent, and profitable Activision Blizzard will also be potentially attractive to another Private Equity consortium or perhaps a big technology company like Microsoft, Google or Facebook. These parties could be looking to enhance or start a video game offering, and Activision could be the ideal means to do so. That said, given the size of the company and the lack of precedent for a strategic acquisition in the video game software industry, we think the IPO is the most realistic exit strategy for the PE consortium.