Global Technology

VIDEO GAMES COULD PROVE TO BE DISRUPTOR IN DIGITAL AGE

KEY POINTS

- Video gaming has an impressive global footprint, and industry leaders are benefiting from an improved business model that yields more transactions with customers over the life of a franchise.

- The transition to digital games is occurring at a rapid pace. It coincides with several other industry-wide tailwinds, including favourable demographics, technological advances, and industry consolidation.

- Leading gaming companies also stand to benefit from increased social engagement, such as competitive gaming.

- We seek companies capable of successfully navigating this digitally driven business model. We value companies trading at reasonable valuations that can grow their market share.

THE RULES HAVE CHANGED

The video gaming industry is maturing. While it has been around for nearly half a century, we believe this fast-growing market segment is entering a new and potentially disruptive stage. Over the past decade, the consumer video game market underwent a significant transformation. Smartphones made everyone a potential gamer, and the emergence of more powerful consoles with increased storage capabilities paired with faster Internet connectivity further supported the move from packaged to digital games. The net result has been a durable and consumer-friendly business model with impressive global consumption growth.

Perhaps the most exciting aspect of gaming from an investment standpoint is the ways in which it resembles the software industry. Mobile gaming companies can also eschew consoles and opt to efficiently load games and updates for customers using digital platforms. Anyone with a smartphone is just one app away from becoming a gamer. Furthermore, thanks to increased Internet connectivity and console storage, games and additional content can easily be downloaded to gaming systems. These trends have expanded the addressable market for the industry.
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A shift in gamers’ demographics represents another significant tailwind. Many gamers are young adults with disposable incomes. These gamers also demonstrate a strong willingness to spend incrementally on gaming, suggesting they equate spending on video games with entertainment. Indeed, the cost per hour of gaming remains low relative to other forms of entertainment. Not only are they willing to spend more money on gaming, but gamers overall are now devoting more leisure time to gaming. Nielsen recently reported that, on average, gamers spend approximately 6.5 hours per week playing video games. The Entertainment Software Association (ESA) found that the most frequent gamers who play multiplayer games average six hours playing online and five hours gaming with others in person per week. The transition to digital games further bolsters the amount of time spent gaming. Nielsen also noted that both console and PC gamers who prefer digital over packaged games spend more time playing.

PARADIGM SHIFT IN TECHNOLOGY

Technological advances have prompted a paradigm shift, with gaming consoles increasingly viewed as mainstream home entertainment systems. According to the ESA, nearly 50% of U.S. households own a gaming system, and leading consoles such as the Xbox One and PlayStation 4 also function as smart TVs, providing access to Netflix, Amazon’s Prime Video, and other streaming services. Smartphones continue to play a major role in expanding the addressable market outside the home, and consumers are increasingly willing to pay for mobile games. The video game industry has expanded every year since 2000, and smartphones are a key accelerator (Figure 1).

**Figure 1: Transformation of Gaming**

As of December 31, 2016

![Global Video Game Spend (US$ billions)](image)

Source: EA Investor Presentation
Add-on digital content purchased after initial game sales enables consumers to increase their engagement with their favourite titles and publishers as well as expands the monetisation of intellectual property.

As gamers have matured, so too have their expectations. Today, consumers demand sophisticated graphics and complex storylines with multiplayer and immersive gameplay. Consumers now play fewer titles but for longer periods of time. These demands, coupled with the cost of supporting games across platforms, have increased development costs over the past decade. Additionally, the move to digital also allows these companies to assess engagement and make additional changes in content. The changes, which benefit top publishers who have created scale and an effective distribution model, contributed to the industry’s considerable consolidation over the last 10 years—a move which helped eliminate some of the unpredictability that previously characterised the space.

Technological changes and consumption patterns are helping digital games generate recurring revenues. Add-on digital content purchased after initial game sales enables consumers to increase their engagement with their favourite titles and publishers as well as expands the monetisation of intellectual property. Doing so generates new and ongoing revenue streams at higher profitability. In-game content on console and PC games yields gross margins of more than 90%. Leading video game publishers are continuously getting better at delivering this extra content, and the more content they create, the more time gamers have been willing to pay to play.

We believe that this represents a significant growth opportunity for the industry. Additionally, most mobile games are free to play and then monetised through similar high-margin digital content that is continuously added to the game. As mobile devices increase the addressable market, mobile gaming will continue to play an important role in spurring growth for the industry. Finally, the transition to full-game downloads offers an additional upside for video game publishers. Digitally downloaded console games generate approximately 80% gross margins, while their packaged counterparts generate about 60% gross margins. We believe increased storage capacity on consoles, faster Internet speeds, and growing consumer comfort with buying digital goods will help increase full-game digital downloads and enable companies to capitalise on this margin gap.

GLOBAL INNOVATION

Some of the most promising gaming markets are in Asia, which has seen the arrival of two esports championships that rival professional sports viewership. These include the League of Legends and Dota 2 championships. In 2016, the former brought in 43 million people throughout the finals, with a peak viewership of 14.7 million for the final matchup. For comparison, the most recent NBA Finals generated an average of 20.4 million viewers across the series. Competitions like League of Legends are helping to drive engagement levels—and revenues—higher.

The social aspects should also contribute to higher revenues as digital applications of the industry not only promote competition, but sharing. While this form of entertainment is relatively new, publishers could expect to benefit from essentially free advertising among new audiences. The success of Twitch, a leading video platform for gamers, suggests that this trend will continue. In early 2015, Amazon.com’s Twitch Interactive reported that it averaged 100 million viewers per month. Now, Twitch boasts approximately 9.7 million daily users.

Finally, gaming is benefiting from the continuing penetration of smartphones, as well as the more recent rise of virtual reality and augmented reality, the integration of digital information and actual imagery.

Chinese Internet services company Tencent Holdings is among companies that are facilitating gaming engagement through mobile devices and its popular WeChat messaging service. The success of Nintendo’s Pokémon GO last summer offers another proof point of market prospects. Nintendo, known for closely guarding its intellectual property, leveraged augmented reality to bring one of its most valuable franchises to mobile
devices. In doing so, the company created a gameplay experience that connected and energised its fans. We believe that other forms of entertainment do not benefit from a similar rate of innovation, making gaming a potential disruptor in entertainment.

WHAT WE LOOK FOR: MARKET SHARE AND APPEALING VALUATIONS

When conducting our bottom-up analysis of companies in the gaming industry, we consider a company's ability to grow by expanding its addressable market. We first examine a company's track record and portfolio of intellectual property as well as its ability to monetise beyond initial game sales. These elements form the foundation of increasing market share, in our view.

We also consider the degree to which a company’s revenues come from digital downloads. Companies with more room for growth and the ability to achieve it present intriguing investment opportunities that warrant additional attention. Because the move to digital is still a relatively new phenomenon, we value companies that are finding ways to innovate.

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Electronic Arts, a video game content provider, is a good example of both. The company possesses a strong portfolio of sports franchises, including FIFA and Madden Football, and non-sports franchises, such as Star Wars Battlefront. The company also offers a consumer-friendly subscription business that helps introduce gamers to other names within the Electronic Arts universe. We believe franchises like this, coupled with a company’s strategy for increasing in-game monetisation, can result in higher revenues from digital. At the same time, we’re mindful that Electronic Arts’ recent fourth-quarter earnings report highlighted that its mobile growth has slowed, and we will continue to closely follow developments in this area. Furthermore, the company relies on several large franchises, and it will need to continue to innovate to avoid franchise fatigue from customers.

We also place a premium on companies trading at reasonable valuations. While we believe that several leading companies are poised to achieve impressive growth in the next several years, share prices have already factored in this growth to varying degrees. Our fundamental research plays a key role in identifying companies best positioned to generate shareholder value. We routinely update our estimates, so we are prepared to take advantage of volatility in the market to purchase or sell companies based on market dynamics.

CONCLUSION

Success in investing in gaming isn’t dictated by one variable. Recent changes within the industry have produced a strong business model that is further supported by several key tailwinds, making it appealing by additional upside potential. Still, any of these variables in isolation isn’t enough to create meaningful shareholder value. Investors must be strategic. For this reason, we seek to invest in innovative gaming companies capable of effectively navigating the digitally driven business model. We also look for companies that can grow their addressable markets and seek out shares trading at reasonable valuations.

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