Capital Account

Special Situations and Value-Based Investing Opportunities

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The King and I

King Digital, was among a slew of gaming /social media IPO's over the past few years, and having disappointed on their first earnings report has left investors wary. We think the concerns though are unjust and see tremendous upside potential in the equity today.

King Digital Plc

Situation: Unique business model, unfairly discounted on guilt by association

Key Data:

Ticker: KING

Market Cap: $5,100mln

EV/EBIT: 4.5x

PER: 8.2x (1yr fwd)

Return Potential: >50%

Introduction

Among the many social media and failed gaming IPO's of the past 2 years, King Digital stands out for the right, rather than wrong reason. It is a business with Twitter's reach, Google's economics and Berkshire's governance, and can be had 2009 prices… a heady mix no? King Digital is the preeminent casual gaming company operating in a new but fast growing field of free-to-play downloadable games. Unlike the traditional $50+/unit shrink wrapped games played on the console or PC, casual gaming usually involves a free to download game, where monetization occurs during game play. Although an already crowded field, King have cemented an early dominance via their hit title Candy Crush which propelled the company from revenues of just $64mln in 2011 to $1.8bn in 2013 and on track to generate revenues of around $2.5bn in 2014. On the back of this success the company completed an IPO in April of 2014 at $19/share capitalizing the business at around $6bn.

Sceptics of the model scored an early win though with the company missing expectations and lowering their outlook for the full year on their June quarter earnings call. Indeed this was a disappointment in their first report after the IPO, and confirmed what many had already determined to be a one-hit wonder, going the same way as Zynga and Rovio. We contend though that King Digital is different. Yes the company have created an enormous hurdle with the success of Candy Crush, however the company operate an extremely effective game development engine that has seen their non-Candy Crush titles grow rapidly as the latter's star inevitably fades. In fact by the third quarter of 2014, non-Candy Crush titles pulled in

around $264mln in quarterly revenues or 46% of the total. This non-Candy Cush revenues stream was up 167% on the third quarter of 2013, and featured titles such Bubble Witch, Pet Rescue, Farm Hero's and the most recently released Diamond Digger Saga. Candy Crush revenues though have likely peaked and will continue to track lower, leaving the overall growth of the company in near term declining to stagnant. In the third quarter just reported overall revenues were down 22%. If this were structural decline that would certainly be concerning, however we see it as a transition and expect the company to be recording positive year on year growth again in the second half of 2015. Conveniently though for us at just 8x forward earnings, the market is pricing for structural decline.

KING price action since IPO:

King is not a one-hit wonder. They are not just a bunch of guys in a garage that got lucky. This is a highly professional operation that has been profitable from the second year after their inception (2003), and received no external funding since the last round of financing in 2005. It is managed by the founder and significant shareholder Riccardo Zacconi, and work a fail-fast, fail-cheaply development model. In an industry inextricably linked to hits titles, this is extremely important. A key aspect to the King story is their development platform called royalgames.com. This is a website that hosts many of King's free to play development games, and allow the company to closely monitor the attraction or otherwise of new titles and game mechanics in order to determine which to take to the studios for commercialization. If the motion picture industry could host a cinema with millions of seats showing short films to gauge audience reaction before spending the dollars on final development, it would be the equivalent of the way King Digital operate. In ensures a very high hit rate on new titles, and with a $1bn in run-rate of revenues from their newer titles, suggests they are getting it right.

The other element we like to the story is the governance structure. Unlike the majority of technology IPO's of recent years, King's arrangement is far more democratic. There are no

dual share structures that have wrested effective control of the company from minorities, and King's early actions in the 9 months since their IPO suggest a mature approach to shareholder interests. In the immediate aftermath of their second quarter earnings miss, the company announced a capital return of 46c/share to shareholder which was paid in October '14, and then with their 3rd quarter earnings release announced a further $150mln share buyback to begin in the first quarter of 2015. Together the two actions are a $300mln capital return program or around 8% of the company, less than a year after the IPO. The how and why of this is simple when you look at the economics of the business. There is very little capital tied up in the company, and each dollar of sales drops through around 40c of free cash flow after taxes. On our preferred measures of business quality, King ranks amongst the very best business that we know of today.

King's early lead, and an already enormous reach with some 348mln monthly unique users has a created a self-propelled marketing machine. With very few dollars spent, King have the ability to reach at least their existing user base, which incidentally grew 29% in the September quarter, when they release new titles. This creates a unique competitive advantage over other players it market, where there is an extremely long tail of casual games, but none with the reach of King. By way of example their most recently released Candy Crush Soda Saga (a sister title to Candy Crush) became the most downloaded casual game on iTunes in the immediate days after release, without a single cent being spent on marketing. The company have since begun to spend real dollars on this title, but have created an enormous head start for themselves already.

By our reckoning, and assuming very modest growth, King's shares should trade at around 12x earnings. This reflects the stratospheric returns on capital, but recognizes the early stage of the industry's development. Benchmarked against our forecast for 2016 EPS of $2.20, and discounted back suggests a fair value today of around $24, 50% above recent prices. If we take Twitter as a comparator, the later should generate revenues of around $2.3bn in 2015, not dissimilar to King, has audience reach of around 280 monthly active users (30% below King) and generated an ebitda margin of 18% in their most recent quarter (versus >40% at King). For this the market accords Twitter a market cap of $23bn versus King at $5.1bn. In fact King will return more money to shareholder this year, than Twitter will net after taxes… where's the justice? Answer: somewhere in the future, so position yourself before it arrives.

Other observations…. A Noted Management Change

This month Unisys (UIS), the struggling IT services organisation formed through the merger of Sperry and Wang (remember those names!) named a new CEO. One figures the board finally lost confidence in the previous CEO Ed Coleman, who himself was brought in to revive the organisation back in 2008. So what of the new man Peter Altabef? In prior roles he lead Texas based Perot Systems, which he sold to Dell, and more recently Micros Systems, which he sold to Oracle. Perot and Micros were not turnaround stories as such, thus he had some

wind at his back with those two organisations, he seems however to have a template that has brought some success. Unisys is interesting also based the extent of its underperformance and lowly valuation. At just 0.35x ev/sales and 3.5x trailing ebitda Unysis places at the very bottom of the pile in terms of absolute valuation. Yes there are hurdles to overcome, falling sales and depressed earnings, however this may be worth looking more closely at given the arrival of a new Promotor and his recent track record.

Free Money!

Well never in equities is there such a thing as free money, but with DirecTV in the very final stages of being acquired by AT&T, this looks as close risk free returns as you could hope for. Back in May AT&T announced the intention to acquire DirecTV in a cash and stock deal with an effective closing price to DTV shareholders of $95. The deal was subject to three things:

1) shareholder approval – done
2) renewal of DTV's NFL contract – done
3) regulatory approval – pending but unlikely to be problematic

There is a collar involved in the deal which means that so long as AT&T shares fall within a range of $34.9 and $38.58 at the time of closing, DirecTV shareholders would receive:

a) $28.50/share in cash +

b) $66.50 worth of AT&T stock = which sums to $95 of value.

Should AT&T shares trade below the lower limit DTV shareholders will receive 1.905 AT&T shares for each DTV share, and should it trade above higher limit will receive 1.724 shares of AT&T for each DTV share. There are two worst case (reasonable) scenarios here:

1) The deal falls over: here you end up owning the premier satellite broadcast franchise on 14x earnings. Personally I'd be happy with this as I actually think the business is worth a lot more
2) AT&T shares close say 10% below the lower limit at say $31.41.

The close date is still uncertain but using a March 31st 2015 estimate, the following table shows the payoffs in annualised % returns:

DTV Shares		1	Stock	Cash	Total Received	# AT&T Share	Annualised Return	
		34.90	66.5	28.5	95.0	1.91		
		35.50	66.5	28.5	95.0	1.87		
		36.00	66.5	28.5	95.0	1.85		
		36.60	66.5	28.5	95.0	1.82		
AT&T Price		37.00	66.5	28.5	95.0	1.80	**36.4%**	**Most Likely**
		37.50	66.5	28.5	95.0	1.77		
		37.50	66.5	28.5	95.0	1.77		
		38.00	66.5	28.5	95.0	1.75		
		38.58	66.5	28.5	95.0	1.72		
		Price	AT&T Shares	Cash	Total		**Annualized Return**	
	-10%	31.41	59.836	29	88.3		**6.8%**	**Worst Case**
Below:		34.90	1.905					
Above		38.58	1.724					
	+10%	42.438	73.163	29	101.7		**66.1%**	**Best Case**

You can see that in the most likely scenario of the stock closing within the collar an annualised return of 36.4% is achievable. In the downside case of $31.41, you still generate a positive annualised return of 6.8%. Of course if the close date is pushed out to June 30th these (annualised) returns fall to 18.5% and 3.4% respectively. It's also worth noting, that AT&T just last week raised their dividend and their equity today yields 5.7%, so other than a market meltdown, our sense is that AT&T has limited downside from current levels. If one were currently considering the acquisition of AT&T shares, this might be a clever way to go about it as you're doing so with an effective year 1 dividend yield of 15%. Possibly this is too good to pass up.

What We're Reading:

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