

October 23, 2020

## Dear Clients and Colleagues:

One leisure industry that has benefited from COVID is the gaming industry, and for many good reasons. Games have some of the lowest cost per hour of all entertainment mediums, with an estimated average of \$0.46/hour versus pay TV (\$1.32/hour), eating out (\$7.31/hour) and live sports (\$32.53/hour). In 2018, gaming passed TV services as the biggest entertainment segment in the world. Valued at \$150 billion, the gaming industry is expected to grow annually at 9% to 2025, and will continue to increase its footprint in the entertainment world.

The gaming industry can generally be broken down between three players: developers, publishers and distributors. Developers are in charge of the game's content. Among other things, they usually handle the technical, gameplay, story, audio and functional testing of the product. Publishers are responsible for making the game accessible to the public. This includes marketing the game, translation and localization, creation of user manual and art design. They usually finance the development and consequently own the intellectual property (IP) of the games. Distributors have a less defined role. For physical releases, distributors are in charge of packaging the games and managing relationships with physical retailers. For digital content, the distributors are the platforms where individuals can download and play the games. Larger publishers are often distributors for their own products.

Global Alpha likes investing in companies with clear secular tailwinds, and the video game industry is not lacking on that front. The first, and probably most significant trend in the near-term, is the move toward the digital release of games, accelerated by COVID. In the United States (US) in 2009, 80% of game sales were physical copies versus 17% in 2018. Analysts expect digital sales to reach 100% before 2030. During the initial lockdown in Europe, it is estimated that 98% of game sales were digital, with an expectation that Q4 2020 will see it go back to the mid-80s. This move to digital distribution means increased gross margins for publishers, less compatibility issues with different hardware, and less second-hand games sales. These impacts all benefit the bottom line of a company directly.

Another tailwind for gaming is the evolution of monetization models. Whereas a decade ago you paid for a game upfront and maybe downloadable content (DLC) a year later, today's monetization models are more varied. Freemium, free to play, games as a service (GaaS), micro transactions, and loot boxes are all tools or models that publishers use nowadays to get the most money out of their games. While some of these raise concerns, such as loot boxes being akin to gambling for gamers, or the presence of micro transactions in the game not being made clear before purchase, others can benefit both consumers and companies. Freemium, for example, is a model where the base game is free to play,

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but players can pay for cosmetics and enhancements. This makes the game accessible to a wider range of players, while still allowing the company to profit without depending on advertising. Fortnite is the best example of how successful this model can be. GaaS is also gaining in popularity as it is essentially a subscription-based model that provides an incentive for companies to continue working on an already released game, thus prolonging the game's life and increasing the strength of the company's back catalogue. World of Warcraft is a good example of this, as the video game is 15 years old and still being played every month by over 5 million people worldwide.

Finally, the industry is set to benefit from cloud gaming as a new medium to consume games. Cloud gaming is a system where consumers do not have to buy physical copies or even download the game, which are instead streamed from data centres, much like Netflix for video gaming. Although still in the initial phase of adoption (Google Stadia is one of the first movers and was released in November 2019), there is a lot of promise to a medium that does not require any fancy hardware, but instead just a good internet connection and a screen. Currently limited to games that are not as data or latency dependant, the implementation of 5G over the next decade means that eventually all types of games can be device agnostic. It is expected to make games more accessible and increase the potential for more quality content, while lowering distribution costs.

So how is Global Alpha positioning itself to benefit from these trends? We currently own Konami Holdings (9766 JP), a Japanese entertainment conglomerate. A strong defensive growth company, Konami is a developer and publisher with globally known franchises, such as Metal Gear, Castlevania, Yu-Gi-Oh, and Silent Hill. It is among the 20 largest game companies in the world by revenue. Roughly half of its revenue is derived from digital entertainment, with the other half being a mix of physical fitness gyms, casino software, and arcade machines. While the revenue stream is diversified, the real growth driver is its digital entertainment business.

Within its digital entertainment segment, two-thirds of Konami's revenue comes from mobile games and the vast majority comes from Japan, where it has an estimated 6% market share (versus less than 1% worldwide). The other one-third of revenue is mostly focused on consoles, although some of its titles are in the process of being added to the Google Stadia platform. Konami is also one of the most prominent esports organizers in Japan, hosting tournaments for its eBASEBALL Pro League game alongside the Nippon Professional Baseball Organization and the KC Grand Tournament for its Yu-Gi-Oh mobile card game.

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### SWOT Analysis

- Strengths
  - Strong brand and IP portfolio
  - Solid balance sheet
  
- Weaknesses
  - Overexposure to sport games in gaming segment
  - Sub-par profitability for its sport business
  
- Opportunities
  - Gaming segment growth in Europe, China and U.S.
  - Esports
  
- Threats
  - Lack of new titles
  - Changing consumer behaviour

Konami's management team has been very stable over time. The chairman is the founder of the company and his son is the president. Together, they own 23% of the company. The company's governance compares favourably to its Japanese peers, with the chairman and CEO being separate roles (a rare thing for Japanese companies), a woman on the board and 33% of its directors being considered independent. Konami's 2020 fiscal year was a transition year, marked by investments in its business segments and corporate reorganization. We now expect Konami to experience strong growth over the next few years.

Have a great weekend.

The Global Alpha team

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