

## Flagship Quarterly Telescope December 2019

Welcome to our latest *QUARTERLY TELESCOPE*. We hope these quarterlies provide you with greater insight into our thoughts on global assets, as well as how our global funds are being managed. In this quarter's Telescope, Pieter takes us through the investment case for Japanese gaming company **Square Enix**, a holding in Flagship's global funds.



### The Quick Take

- The global gaming industry comprises 2.5 billion gamers and will generate \$150bn in revenue in 2019
- Engaging content and efficient distribution have seen gaming take share from other forms of entertainment
- Industry consolidation, new revenue models, and more favourable distribution is improving the investment credibility of the industry
- Companies like *Square Enix* with desirable content and a record of success are best positioned to succeed
- Our in-depth global experience allows us to quickly identify and execute on ideas such as *Square Enix*
- The Flagship global strategy funds have held *Square Enix* since April 1, 2019

### Gaming: Lucky roots

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*Japanese gaming company Nintendo was founded in 1889 to manufacture 'hanafuda', a Japanese playing card used by the Yakuza (Japanese mobsters) in their gambling parlours. Even the name of the company, 任天堂 or 'Nin-Ten-Do' is construed as 'leave luck to Heaven', which was itself a gambling reference to placing your luck in the hands of the gods.*

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Lady Luck has certainly smiled on the gaming industry in the intervening 130 years: in 2019 the industry is expected to be larger than the total global cinema box office as well as the global music industry. From its roots as a fringe form of amusement, video games and related content have become the driving form of entertainment for a generation.

The growth in video gaming has media moguls like Netflix chief executive Reed Hastings rightly concerned. In the company's most recent shareholder letter, Netflix said that the popular game *Fortnite* was more of a threat to its business than Time Warner's HBO (the owner of the *Game of Thrones* franchise, among others).

### An attractive, growing industry

*In April 2018 the premiere of the Avengers: Infinity War generated \$257 million, the best opening box office of any movie to date. Meanwhile, in the parallel universe of video games, Grand Theft Auto V came out in September 2013 and in 24 hours generated \$818 million in sales. In just 3 days, the game registered revenue of \$1 billion. It is now the best-selling entertainment product in history, generating over \$6 billion since launch.*

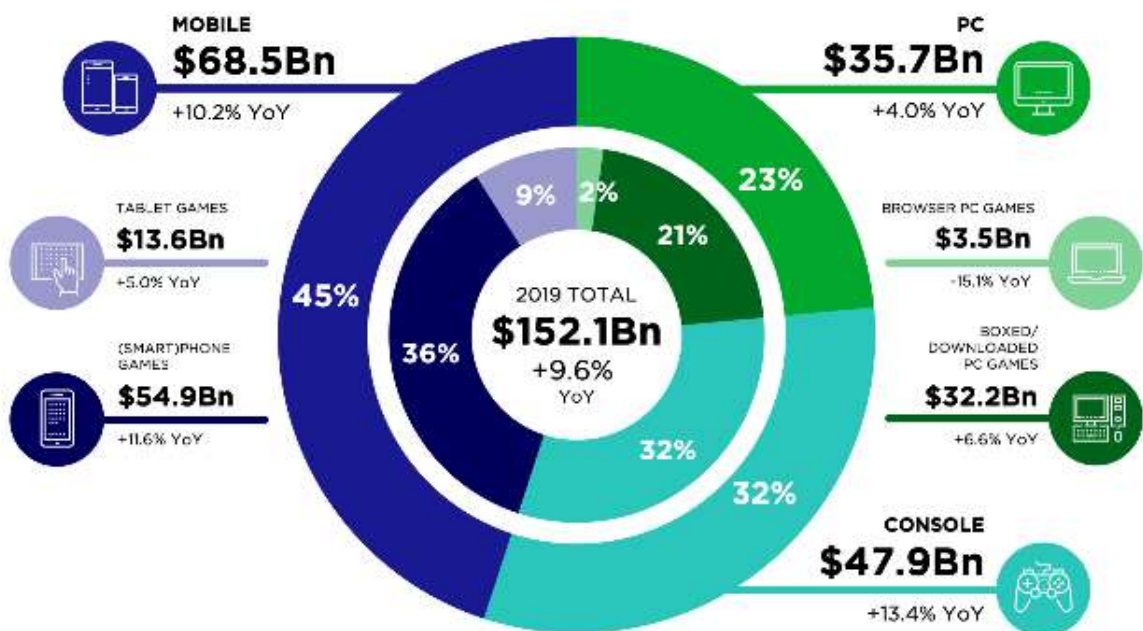
There are now more than 2.5 billion gamers across the world, accounting for nearly a third of the total global population. Combined, they will spend \$152 billion on games in 2019, representing an increase of +9.6% on 2018 according to consultancy NewZoo.

Despite its large size, the industry is far from mature. NewZoo expects it to grow to \$196 billion by 2022, equating to +9.0% growth per year. Mobile gaming has been the rocket fuel behind this growth, increasing the accessible audience by nearly 1 billion users in the past 10 years, while console games have steadily held their number two position.



## 2019 GLOBAL GAMES MARKET

PER DEVICE & SEGMENT WITH YEAR-ON-YEAR GROWTH RATES



Source: NewZoo

This revenue growth is backed by prodigious investment in content, platforms and distribution. Over the last 18 months, the global gaming industry has seen \$9.6 billion in investments and if things continue at the current pace, the amount of investment generated in 2018-19 will exceed the eight previous years combined.

### Who's buying the content? Not who you think....

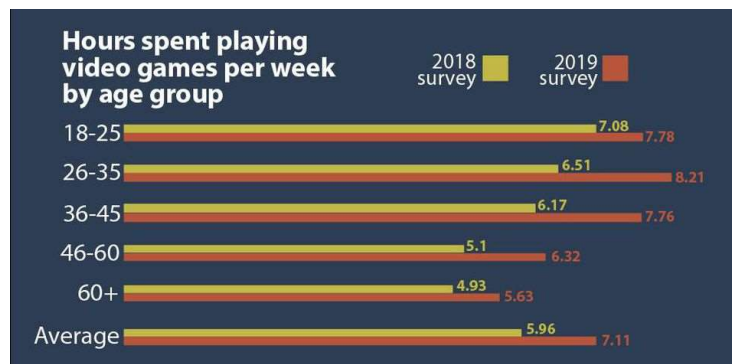
*Games are played by almost every demographic stratum of society. The average age of a mobile gamer is 36 years old (compared with 27 in 2014), the gender split is 51% female, 49% male, and one-third of all gamers are between the ages of 36-50. This is a far cry from the traditional stereotype of a "gamer."*

But do millennials have the buying power? In fact, millennials (age 18-36) spend an average of \$112 a month on gaming content, more than any other age group according to research company SuperData, and they don't just spend that money on buying games or downloadable content. SuperData notes that 71% of millennial gamers watch video game content on sites like Twitch and YouTube, and spend about \$29 a month in donations to video content creators.

There is also a lesson for traditional TV content here: *Millennial gamers spend more time watching other people play video games than they spend watching traditional sports on television*, while younger gamers (age 18-25) spend almost an hour more each week watching online gaming than watching traditional sports.

### Escapism drives adoption

People who play video games spend an average of nearly six hours each week playing, with much of this time spent on mobile phones. Games are capturing our time because as a society we seek distraction and escapism, and convenience demands that we want both of these 'now'.



Source: Limelight Networks, State of Online Gaming 2019

Escapism is the tendency to seek distraction and relief from reality by pursuing entertainment or engaging in fantasy. For many, gaming of the casual or puzzle genre allows for the passage of time during commutes and other 'in-between' moments. No demands, no expectations, no opponents. For others, gaming of the competitive genre allows us to battle against challengers to forget who we are and be someone totally different. Some would say we become who we 'really are': Are you timid? Are you bold? Do you take risks? What kind of risks do you take? Versus who you are in real life ('irl' for those gamers reading this report...).

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*The difference that gaming provides versus traditional movies and spectator sports is that gaming provides the opportunity to not only escape but participate in that escape. It is in this participation that gaming has the one-up on other forms of entertainment, and why it has become the leading form of entertainment globally. People love a story, but they also love shaping that story.*

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### What are the barriers to entry in gaming?

In theory there are very few barriers; in practice, the big studios have an edge. There are those that would have you believe that any small studio can make a game, and cite *Candy Crush*, *Angry Birds* and other games as examples. *The Witcher 3*, the 2015 game of the year on Xbox, cost less than \$15 million to develop and another \$15 million or so to market.

These are the very rare successes, and slanted heavily to mobile. Many so called 'triple A' games take 2 to 4 years to develop with teams of 70 to 300 developers, leading to a total cost of about \$15 to \$150 million. That means a game needs to sell 2.5 – 3.5m units just to pay for development, much less make a profit.

Game success is akin to the movie business: the occasional indie film can generate a successful title, but none will reach the magnitude of success achieved by *Titanic*, *Avatar*, *Lord of the Rings* and *Avengers: Endgame*, not to mention the repeatability of success that is vital for longevity and talent retention.

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*Game development has some surprising real-world impact. Game company Ubisoft, the French studio behind Assassin's Creed, is offering up its 'over 5,000 hours' of research of Notre-Dame during the French Revolution to assist in the cathedral's reconstruction after the fire in April this year.*

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Distribution is also critical to success. Putting your game on Xbox or an app store is a relatively easy endeavour compared to getting it to stand out amongst thousands of similar games. Large publishers have an edge here, as they can outspend and out distribute through a combination of marketing spend and Steam/Twitch publishing.

### A changing landscape

The way consumers engage with and through games is constantly changing. Not only does this result in higher overall engagement, but it also leads to entirely new segments of game enthusiasts.

- **Distribution**, traditionally via physical disks and cartridges, is rapidly moving to online downloads.
- **Monetization** is changing. No longer do consumers get charged upfront for the game, but are instead charged for in-app purchases (like most mobile games) or via subscriptions (Xbox Gold, Stadio).
- **Infrastructure** is changing. The rollout of 5G networks will mean a colossal boost to gaming speeds, increasing gaming occasions and playing frequency.
- Finally, **consolidation** in the industry is happening at an ever-increasing pace.

### But...who to back in this changing landscape?

With rapid growth and changes to distribution, monetization and infrastructure, our bet is on the one constant: *back the content*. With the right content, game sales and profits allow the firm to defend and procure developer talent, procure

more content, monetise the content in a variety of ways and also navigate the changing distribution landscape. We found one firm, in particular, that has been able to achieve this.

### **Square Enix: The creator of the original Role-Playing Game**

*Square Enix* is a Japanese video game developer, publisher, and distribution company known for its *Final Fantasy*, *Dragon Quest*, and *Kingdom Hearts* role-playing video game franchises, as well as *Tomb Raider* and *Hitman* action genre games. Its headquarters, which Flagship's global portfolio managers have visited, are in Shinjuku, Tokyo.

*Square Enix* has a distinguished history as a gaming company. Its main franchise, *Final Fantasy*, is one of the best-selling video game franchises of all time with over \$10 billion grossed since launch in 1987. The seventh instalment of the game (*Final Fantasy VII*) is one of the most successful games of all time and helped launch the Sony PlayStation.

Outside of *Final Fantasy*, the company's *Dragon Quest* franchise has sold over 70 million copies and the *Kingdom Hearts* franchise has sold over 30 million. It is rare to see so many hits in a single company.

### **Why did we invest?**

*Square Enix* is a company we know well. We have met the management and understand their business model. It has always looked fully priced but, in April we noticed a few critical things:

- 1) Our weekly screening revealed the company was starting to look cheap versus peers and its own history
- 2) Earnings expectations for upcoming fiscal years had been consistently falling
- 3) The company's profitability was lower than peers despite industry changes that would increase margins

After a closer look, we found that nearly all of the titles launched in the last two financial years (March FY2018 and March FY2019) have materially underperformed, failing to add to sales generated by the existing catalogue of titles. This means that all revenue is coming from the existing (pre-2018) titles, while EBIT (earnings before interest and tax) is depressed due to the development costs (which are all expensed) of the mediocre titles.

Going forward, *Square Enix* has an impressive launch line-up which should revive sales growth in its core titles, including *Final Fantasy*, *Tomb Raider* and *Dragon Quest*, with promising *Final Fantasy VII Remake* and *Avengers* titles confirmed for March and May 2020. Also, improving mobile game sales and the expansion of its massively multiplayer online games with the release of *Final Fantasy XIV Shadowbringers* will likely support sales this year.

The investment into content will furthermore support *Square Enix's* longer-term strategy of diversifying revenue into new franchises and platforms, such as augmented and virtual reality, to increase sales. Along with the higher revenue, we expect cost optimisation on the distribution side, as well as new monetisation opportunities to drive higher earnings growth over the next 5 years. Regional expansion into emerging markets remains an opportunity as well.

Running the numbers, we found that if the company can achieve the midpoint of its revenue and profit target, it stands to earn EBIT of 45 billion yen in FY 2021. This put the share on 12.7x March 2021 earnings at our time of purchase.

Having met with *Square Enix* before, it was easy to use our screening to identify and act on the opportunity it presented. The investment opportunity was typical for us: short term noise had unduly impacted an iconic business, and upon careful research, we were able to execute on the opportunity to buy a great business at a bargain price.



## Summary

The Flagship global investment team focusses on allocating investors' capital to the highest return assets in our mandated universe. We also follow the time-tested philosophy of investing for the long-term, steadfastly avoiding the siren call of the dangers of short-term thinking.

Please contact the team at Flagship if you have queries regarding your investment in Flagship, your portfolio's holdings, or if you would like to speak to one of the portfolio managers. Our door is open. We thank you for your continued support.

Regards,

*Pieter, Kyle and Winston*



*Established in 2001, Flagship is an independent asset manager, owned entirely by staff and directors. We are a specialist global equity manager and we run three distinct global strategies: Equity, Flexible and Fund of Funds. We follow a robust, common sense approach to investment management founded on fundamental principles. We believe that long-term, focused, valuation-based management is the best way to manage our investors capital.*