November 16, 2021

To: The Board of Directors, Ubisoft Entertainment

Dear Board of Directors,

Flagship Asset Management ("Flagship") has, on behalf of its clients, acquired an interest in Ubisoft Entertainment ("Ubisoft" or "the Company") over the course of the last 12 months.

As of November 2021, shares in Ubisoft have dramatically underperformed those of its major peers since 2017, and every period in between. In the past year alone, Ubisoft shares have fallen by nearly 40%[1], erasing over EUR 4 billion from the Company's market capitalisation.

Poor performance of this magnitude is hardly expected from a company that claims to be one of the world's leading game developers and publishers. Even shares in Activision Blizzard ("Activision"), beset with similar game delays and workplace harassment issues as those at play at Ubisoft, and who on November 3 suffered a punishing 15% drop in its share price in one day, have easily trounced Ubisoft over the past year, as well as longer periods.

We know that Ubisoft's underperformance is not purely due to the recent negative media around its 'toxic' workplace culture. The poor operating and share price performance over many years, on both absolute and relative bases, informs us that the issues facing Ubisoft are in fact more deeply rooted in the poor operational and strategic performance of current management.

We believe the Board needs to address the critical issues that we lay out in this letter, which include the fact that consequences to current leadership must be forthcoming for there to be any believable accountability at the Company going forward.

Sincerely,

Pieter Hundersmarck

Global Portfolio Manager

[1] 44% as of November 16, 2021

**Strategic and operating performance has been weak for over five years**

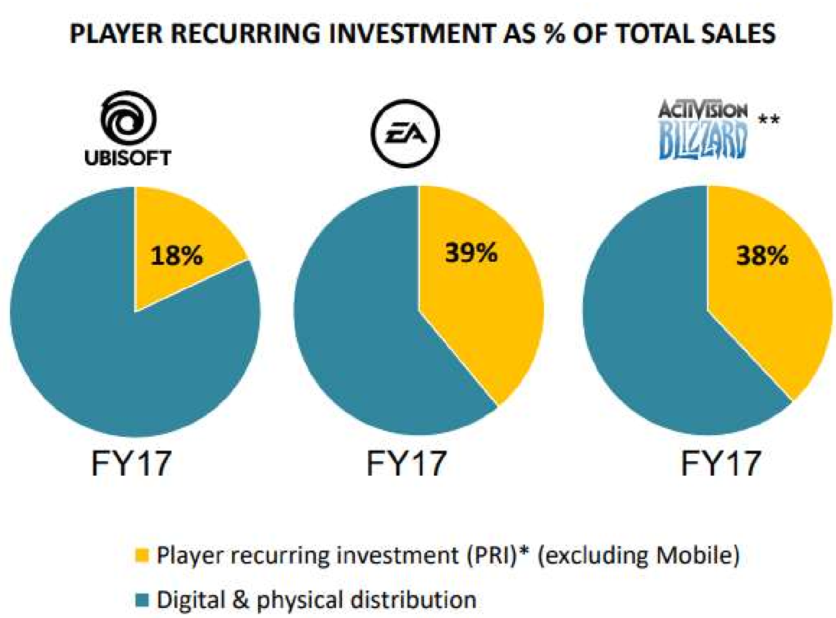
In our view, whether it comes to investing in specific game categories, like Free to Play (F2P), where Ubisoft is desperately late to the party, or Sports franchise games, where Ubisoft has precious few high-quality games, or managing workplace culture, where management seem incapable of assuming top level accountability, Ubisoft have shown themselves to be consistently **reactive** to the world around them.

As one of the oldest and most prestigious game publishers, Ubisoft should be leading the industry. Instead, it appears that Ubisoft is:

1. unable to translate gamers in its franchises towards more sustainable monetization methods (evidenced by the weak performance on in-game purchases and subscription revenue)
2. unable to marry the dual goals of creating great games and also generating strong financial performance (as evidenced by the lowest levels of profitability in the industry that we cover)
3. unable to lead its culture towards a more diverse, inclusive one while providing a place where employees feel safe (as evidence by the recent sexist and harassment allegations, and the alleged high churn of senior employees at the Company)

For example, the chart below on monetization PRI (Player Recurring Investment) from a Ubisoft presentation in 2017, informs us that management have long been aware of the fact that they fall short on generating recurring revenue from their games. The business case is easy to understand: games that focus on subscription and in-game purchases wind up generating much more revenue over the long term, meaning that a yearly game released as a service makes a lot more money over the long term than simple single-player launches.

Figure 1: Ubisoft meaningfully lagged peers on PRI in 2017 ( ** Player Recurring Investment which includes in game items, DLCs/season pass, subscription & advertising. ** Excluding WoW subscriptions)*



Ubisoft's latest annual report (2021) shows that the Company has indeed made progress on PRI. As of March 2021, the total percentage of revenue from in-game sources and subscriptions reached EUR 780m, or 35% of total revenue (up from 18% in 2017).

However, as of 2021, peers EA and Activision now generate 71% and 58% of sales from in-game sources and subscriptions respectively. Put differently, Ubisoft today has successfully caught up *to where its peers were nearly five years ago.*

The transition to Free to play (F2P) did not sneak up overnight. Why has there been so little progress at Ubisoft on this critical front over such a long time period? The few attempts that we have seen to address this have been poor: for example, we know that (1) Ubisoft has impaired c€250m of assets since FY'17, (2) *XDefiant* has been negatively received by the community and (3) the closed beta of *Frontline* has been rolled back indefinitely as of November 2021.

The challenges of F2P are not unique to Ubisoft. The challenges facing EA and Activision management in transitioning their portfolios were as considerable as the ones that faced Ubisoft in 2017. Why has Ubisoft been unable to meet this challenge successfully?

If the answer is that EA and Activision had 'a head start' in terms of transitioning, this only begs the question as to why did they have the head start, and not Ubisoft? If the answer is that I have cherry picked two successful peers, this can easily be refuted (in fact, Take-Two Interactive generated 62% of revenue from in-game and subscriptions in 2021, higher than Activision. Many publishers are in this cohort).

Consider the different approach that Take-Two has taken with its leading Franchise: Red Dead with the Assassins Creed Franchise. While Ubisoft adopted a deluge of content (monetized mostly with upfront purchases), Take-Two took considerable time polishing a game that could generate money for far longer using subscription and in-game purchases. Why has this model not been adopted at Ubisoft?

Figure 2: The cadence of releases of Red Dead has led to a valuable, enduring franchise.

| Title | Released |
|---|---|
| **Assassin's Creed** | 2007 |
| *Assassin's Creed: Altaïr's Chronicles* | 2008 |
| *Assassin's Creed: Bloodlines* | 2009 |
| **Assassin's Creed II** | |
| *Assassin's Creed II: Discovery* | |
| **Assassin's Creed: Brotherhood** | 2010 |
| **Assassin's Creed: Revelations** | 2011 |
| **Assassin's Creed III** | 2012 |
| *Assassin's Creed III: Liberation*[a] | |
| **Assassin's Creed IV: Black Flag** | 2013 |
| *Assassin's Creed: Pirates* | |
| *Assassin's Creed: Freedom Cry*[b] | 2014 |
| **Assassin's Creed Rogue** | |
| **Assassin's Creed Unity** | |
| *Assassin's Creed Chronicles: China*[c] | 2015 |
| **Assassin's Creed Syndicate** | |
| *Assassin's Creed Chronicles: India* | 2016 |
| *Assassin's Creed Identity* | |
| *Assassin's Creed Chronicles: Russia* | |
| *Assassin's Creed Unity: Arno's Chronicles* | 2017 |
| **Assassin's Creed Origins** | |
| **Assassin's Creed Odyssey** | 2018 |
| *Assassin's Creed Rebellion* | |
| **Assassin's Creed Valhalla** | 2020 |

While the transition to F2P has been poor, game delays have compounded the issue. FTP game "Tom Clancy's The Division Heartland", scheduled for release in this financial year (2022) is now expected to premiere over 2022-23, along with "Prince of Persia: The Sands of Time" and "Rocksmith+", two games that had *already* been delayed this year. "Riders Republic" and multi-player shooter "Tom Clancy's Rainbow Six Extraction" have been delayed to October and January respectively. Skull and Bones seems to have 'sailed into 2022'.

Game delays are understandable – especially in COVID related times - up to a point. However, the news of game delays at Ubisoft far exceeds those of other game publishers. Due to Ubisoft's higher dependence on game sales (as opposed to subscription and in-games sales) these game delays have an outsized impact on the income statement, as well as on revenue growth rates (while most costs remain fixed). This means lower revenue growth and lower profits. It also leaves Ubisoft far more vulnerable to failed franchises than other game publishers. The chart below illustrates this.

Table 1: Ubisoft has generated a mere EUR 325m of cumulative net profit over the past 5 financial years from nearly EUR 9bn in revenue and 7.3bn of Gross Profit, far lower than peers.

| Company | Cumulative Sales over the last 5 years (EURm) | Cumulative Gross Profit over the last 5 years (EURm) | Cumulative Net Profit over the last 5 years (EURm) |
|---|---|---|---|
| Ubisoft | 8,856 | 7,299 | 325 |
| Electronic Arts | 26,111 | 19,416 | 6,905 |
| Activision Blizzard | 35,700 | 23,939 | 6,787 |
| Take Two | 12,703 | 5,921 | 1,568 |

To us it appears as if there is a deep strategic issue here: it appears to us that Ubisoft management wants 'the best of both worlds'. On the one hand they want the nice large cash flow provided by immediate game sales, but they also want to slowly incorporate FTP at their own pace. This 'tiptoeing' pace has made little financial sense and has only served to confuse gamers and investors.

We believe the key reason for this tip toe approach is the fragility of the Ubisoft business model, with weak portfolio profitability and a precarious balance sheet that cannot withstand adverse revenue impacts. We touch on this in the next section.

**Ubisoft is grossly inefficient versus peers**

In the latest press release (1H22) management state the following:

> *Ubisoft's unparalleled production capacity, delivering deep and diverse gaming experiences to players, reflects the strength of its dependable assets:*
>
> *• A production powerhouse, strong of 17,000 talents, structured around the seasoned multi-studio collaboration organization from Ubisoft global network of studios that combine high AAA production standards with world class creative and engineering talents.*
>
> *• The deepest and most diverse portfolio of proprietary brands of the industry.*

Upon closer inspection, it seems abundantly clear that Ubisoft fails to grasp that these 'strengths' are, in fact, its greatest weaknesses.

**Firstly**, Ubisoft employs a disproportionately high number of employees in comparison to its peers, and has little to show for the extra headcount. As the table below shows, Ubisoft generates $125k of revenue per employee, less than ¼ of peers EA and Take-Two and a mere 15% of Activision revenue per employee.

Table 2. EA has half the number of employees as Ubisoft and generates over twice as much revenue

| Company | 2021 Headcount | 2021 Revenue | 2021 Revenue per employee |
|---|---|---|---|
| Ubisoft | 20,324 | €2,224m | €109,417 ($125,160) |
| Electronic Arts | 11,000 | $5,629m | $511,727 |
| Activision Blizzard | 9,500 | $8,086m | $851,158 |
| Take Two | 6,495 | $3,373m | $519,287 |

It is worth noting that game publishers have a mix of business models, and different insourcing and outsourcing policies which impact their employee count. For example, Ubisoft generally insources more than peers. However, at the end of the day these decisions should manifest in a desirable financial outcome for the Company: i.e., it should lead to higher revenue growth, or higher operating margins, or both. In Ubisoft's case, the Company spends nearly 50% of revenue on labour costs - far higher than peers - and suffers from the lowest profitability in its peer group.

This not only seems absurdly inefficient in our view, but it also exposes the Company to material risk: Ubisoft has the highest exposure to labour inflation.

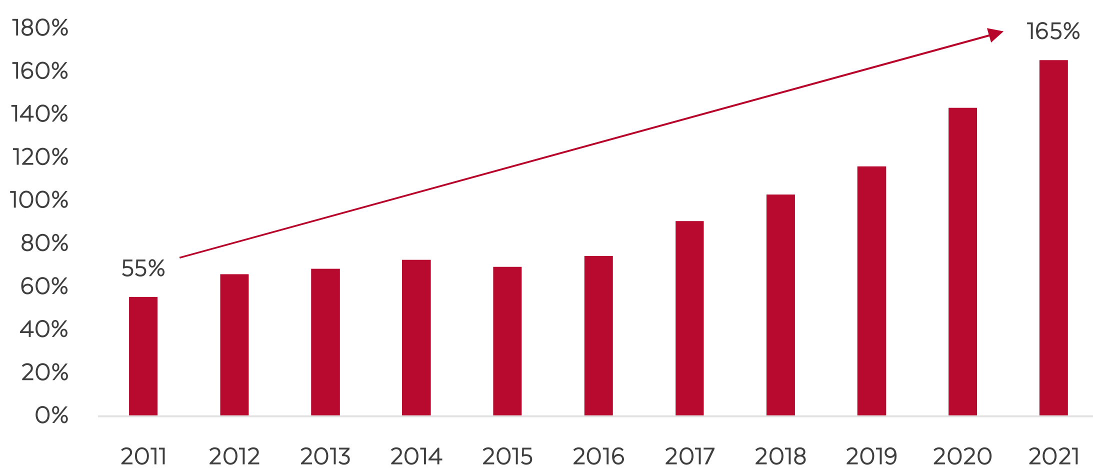
The current market value of Ubisoft staff is shown below.

Table 3: Ubisoft market capitalisation per employee is a fraction of peers

| Company | Current Market Cap (USDm) | Mkt Value per employee |
|---|---|---|
| Ubisoft | 6,740 | $331,609 |
| Electronic Arts | 41,132 | $3,739,238 |
| Activision Blizzard | 54,281 | $5,713,763 |
| Take Two | 21,657 | $3,334,374 |

**Secondly**, Ubisoft's 'deep and diverse' brand portfolio is perhaps "too deep and too diverse" to make financial sense. Besides (1) the enormous proliferation of Assassins Creed releases and extensions over the years, (2) the wide variety of IP displayed on the Ubisoft website, we note with concern the capitalized R&D budget. The chart below shows capitalized R&D as a percentage of revenue over the past 10 financial years, showing the increase from 55% to 165% over this period. What has happened here? And who is going to rein this in?

Chart 1: Capitalized R&D as a % of sales continues to grow

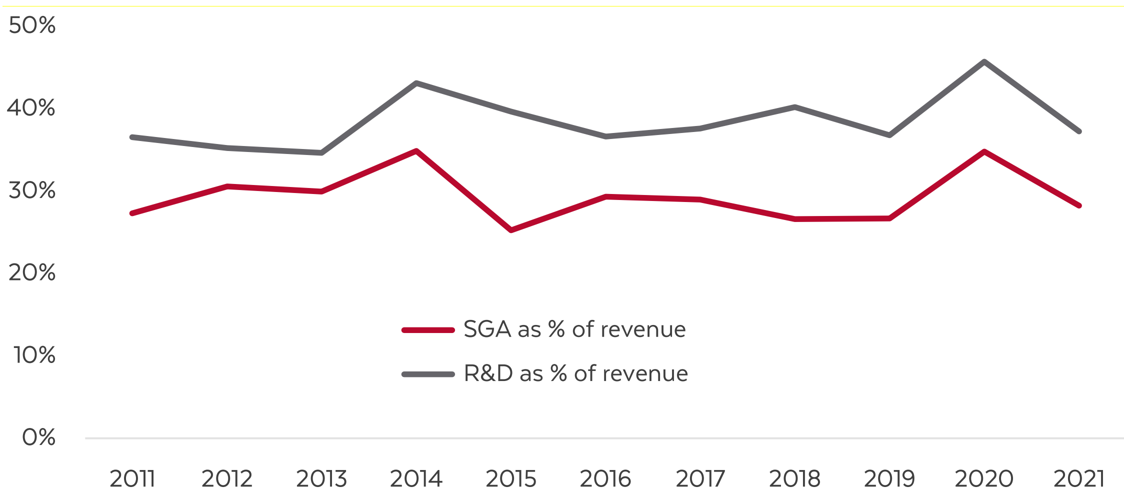



Anecdotally, we have read about the ongoing effort to release Skull and Bones, which is perhaps a good example of what is happening on the R&D front. Kotaku published its exposé on the game, and their entire article need not be repeated here save the following quotes: *"No one wants to admit they f**ked up,"* said one developer. *"It's too big to fail, just like the banks in the U.S."* and *"If Skull & Bones were at a competitor it would have been killed 10 times already,"* said another former developer.

We understand Ubisoft's rebuttal (released in the article), but the fact remains that Ubisoft's own developers stand almost too ready to speak candidly about issues in the development space, and will not be silenced. This raises pertinent questions: where do management draw the line with franchise development? Some of the write-offs (and development costs for Skull and Bones) are moving into the hundreds of millions of Euros. It seems that financial sense would dictate writing off and moving on?

Finally, the chart below shows SGA and R&D as a percentage of sales for the past 10 financial years. We note that there has been almost no change in this percentage, meaning every Euro of revenue comes with an additional Euro of SGA and R&D. Why is this poor profitability allowed to continue? What is the plan to remedy it?

Chart 2: The cost base has not scaled with revenue growth for 10 years




**Sexual harassment claims have been poorly handled, leaving Ubisoft's image in tatters**

Under the mantle of the current management team, Ubisoft has become the public face of workplace toxicity in the game industry. We find it entirely incomprehensible that no serious sanction has befallen any senior management team member, or the CEO himself, due to the ongoing HR crisis unfolding at Ubisoft. We believe the lack of consequences at senior level raises significant concerns about the business judgment of the current CEO, which extends to serious doubts about the Board's role in actively managing sensitive issues at Ubisoft.

Instead of action by the management team to hold those responsible to account, it appears from media reports that their inaction has led to a slew of senior departures at Ubisoft.

We believe it would be unwise to assume that these departures are simply due to the normal rate of churn at video game companies. It would also be unwise to assume that such a dismissive response would be accepted as a rebuttal by the broader investment community. We all know that these departures are a sign of lack of faith in the leadership of Ubisoft, and, in particular, the family structure that has been at the helm since its founding.

It is worth describing the media reports of Ubisoft's predicament in some detail. In October 2021, Kotaku published this article (https://kotaku.com/despite-filing-harassment-reports-employees-say-ubisof-

1847907748 ) detailing in lurid detail how Ubisoft management failed to address employee complaints. We quote the article here:

> *"Shortly after Valerie arrived at Ubisoft Montreal in 2018, home to the hit Far Cry and Assassin's Creed franchises, she says she was sexually harassed and the victim of racist remarks. She reported the incidents, but says nothing was done. The harassment happened again last year, only this time she hoped the company, then in the midst of a very public reckoning with accusations of sexual misconduct and the failure of its workplace culture, might respond differently. But after filing complaints through multiple reporting tools and completing half a dozen interviews with supervisors and HR managers, Valerie never received a resolution to her case. Earlier this year, she decided to resign."*

The article mentions other instances.

> *"In July, following the news of a California lawsuit accusing Activision Blizzard of widespread sexual harassment and discrimination among employees, current and former Ubisoft workers formed the group ABetterUbisoft in solidarity, calling for industry-wide change to how companies deal with reports of misconduct. The group shared with Kotaku testimonials from eight current employees and one former one, across different offices, who say that despite the promised changes, Ubisoft has continued to ignore their complaints and repeated calls for greater accountability."*

We recognize that, to address a lack of faith in its human resource management, Ubisoft management have set up reporting tools. Amongst them are the "Respect at Ubisoft" email address to which complaints could be sent, and a third-party reporting platform called Whispli. However, these don't seem to be enough:

> *"They tried going through the "Respect at Ubisoft" email, and later Whispli, getting different responses from different people each time, but always along the lines that their complaint would be investigated and escalated up the chain of command. Like Valerie, however, they said they never received any updates about the outcome of their report, likening the entire process to the dystopian bureaucracy game, Papers, Please."*

We would highlight that the problem is not only the escalating number of reports of such incidents: it is 1) the lack of senior people being held to account in the face of these incidents, and 2) the poor press handling of these incidents.

As an example, we would point to the promises that Activision Blizzard has already made in an effort to fix its working culture, including the end of forced arbitration and much more aggressive termination protocols against those found to be harassing or abusing their colleagues. This came in the wake of a lawsuit filed by California's Department of Fair Employment and Housing in July 2021 detailing a toxic working culture. Does such a case need to be moved forward at the various Ubisoft studios globally before serious change will be forthcoming?

While we know that one swallow does not make a summer, the number of reports, and the similarities expressed in these reports, is understandably alarming. Whatever the veracity of these claims, in our view management is utterly losing the media and public image battle.

In our view, Ubisoft management have failed to protect the public perception of Ubisoft by making it clear that top management are immune from the consequences of poor performance, and from their role in the alleged toxic workplace culture that is under such focus.

Indeed, the party that seems to be capturing positive public opinion – and rightfully so – is the aggrieved ABU (A Better Ubisoft) organization, with clear demands, timelines and communication on Ubisoft's lack of response. For the future management of Ubisoft's pubic image, we believe current management should take some tips from the authentic and sincere stance of the ABU organisation.

We note that consumers want to see Ubisoft taking a leading stance. NewZoo's recent Gamer Sentiment Study on Diversity and Inclusion highlights the importance of publishers taking a stance on societal issues. While we acknowledge that some small change has happened to the reward system of Ubisoft employees (Diversity and Inclusion targets are included in appraisals), we note that staff turnover remains at a very high level according to equity research we have seen on the Company.

### Summary

Culture - or soul - is the bonding glue that defines what a firm is determined to be, year after year. After all, employees come and go. But culture continues. That's why it ultimately dominates.

In our careers we have rarely seen a management team that has so completely lost control of the narrative around their strategic future, as well as the importance of handling critical employee concerns. In a business dependent on top talent to stay competitive, we find this hard to understand.

As we mentioned, this year, Ubisoft shares have fallen over 40%. CDProjeckt, a company with two pieces of valuable IP (Witcher and Cyberpunk), that released a completely broken version of CyperPunk 2077 so poor that Sony actually pulled the game from their store, has performed better. This is worth repeating - even a small AAA studio that released a broken game as part of their two-game offering - is doing better than Ubisoft.

Ubisoft has been given the benefit of the doubt for too long. These are the questions the Board needs to ask itself.

- Firstly, at what point should the CEO bear the consequences of the issues at Ubisoft? If the view is that this is not management's doing, then we ask the Board to describe a situation where such massive underperformance would, in fact, be management's doing? We would like a clear statement of exactly how many more years of low profitability, game delays and how many more sexual harassment allegations would call for more severe consequences.

- Also, if the view of the Board is that this is not management's doing, please inform us who, exactly, is to blame. How many of Ubisoft senior employees should be sanctioned? Once the employees responsible for Ubisoft's malaise are found, we trust the Board will act swiftly and decisively.

There is still time for redemption. Ubisoft is already benefitting from the fact that employees are talking openly about ending the toxic work culture. Ubisoft is punching far above their weight in terms of their IP, their game engines, and their desire to improve.

What is required is a fresh set of eyes to close the door on the past and move confidently into the future. Our suggestions to begin this fresh start are the following:

1. Yves Guillemont moved to the role of non-executive Chairman and a search put in place for his successor. This will communicate to employees that the Ubisoft Board takes the appropriate stance on underperformance.
2. A clear roadmap to be published on the Ubisoft website with regards to game portfolio development and the criteria when management cut games. This will show the market that Ubisoft has financial discipline.
3. The employee cost base needs to be critically looked at, with a view to rationalizing the number of employees and reducing costs. Targets on employee costs to be released. This will show that Ubisoft intends to make a greater success of the financial performance of the Company.

Sincerely,

Pieter Hundersmarck