

Wealth Management Games Investors Should Play

WEALTH MANAGEMENT RESEARCH

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Video games have come a long way from the days of Space Invaders, Pac-Man and Super Mario. The range of game content has broadened, the games have become more sophisticated, they've become available on more platforms, user engagement is strong and the user base keeps growing, and gaming business models have become more attractive. We believe the sector offers an attractive medium-term growth outlook for investors.

Video games have come a long way

The COVID-19 pandemic created a step-up in demand for video gaming content, with player numbers rising +5% to 2.7b or 35% of the global population, which is more than double the 1.2b players in 2013. This strong demand environment led to stocks and funds in the sector performing very strongly, with the **Global X Video Games & eSports ETF** gaining +85% last year and the **VanEck Vectors Video Gaming and eSports ETF** up +79%.

The data shows continued strength in player demand and engagement as the sector transitions from a hit driven business model, where players make a one-off CD-ROM purchase, to a subscription/pay-as-you-play model. This new environment provides gaming companies the opportunity to increase monetisation within games by offering additional downloadable content, character personalisation, and digital advertising.

Whilst revenue growth may slow over 2021, we believe the leading gaming companies are well positioned to achieve above-average earnings growth over the medium term. From US\$159b in revenue in 2020 (which was triple the revenue generated by the global entertainment streaming sector in 2020), the global video games sector looks on track to reach US\$200b revenue by 2023. We see a significant runway for growth in mobile and multi-player games where players socialise within a game's ecosystem. New customers, new segments and gains in market share of eyeballs from TV and movie content should also contribute to growth.

Some of the leading global technology companies have exposure to video gaming-related markets, including **Alphabet, Microsoft and Tencent**. Specialist video gaming companies include **Activision Blizzard, NetEase** and **Take-two Interactive**.

Themes of the week

Central bankers were busy last week trying to talk down interest rates which have been rising. Prices of some bonds with longer durations have fallen below par, which is reasonably rare in an often expensive retail debt market. Whether the sell-off in bonds has more to go depends on how the market's expectations for inflation develop from here and how central banks react.

Looking ahead

With corporate event diaries around the world looking sparsely populated this week, **attention will likely remain on oil prices, the passage of the US fiscal stimulus bill through the legislative apparatus, bond yields, and the prospects for economic reopening**. Adidas will release results and hold an investor day on Tuesday night/Wednesday morning NZT. The US House of Representatives is set to hold votes on Tuesday and Wednesday to approve the gigantic US\$1.9t stimulus bill passed by the Senate over the weekend. The price of crude briefly rose above US\$70/barrel over the weekend following last week's OPEC+ meeting and an intercepted attack on a Saudi oil storage terminal; the US Energy Information Administration will release its short-term outlook for oil prices early on Wednesday morning. A speech by the Reserve Bank of Australia's Governor Lowe will be closely watched by bond investors late on Wednesday morning, as will Chinese and US inflation data for February (due on Wednesday and Thursday, respectively) and the European Central Bank's monthly press conference early on Friday. Markets could remain sensitive to news on the reopening of economies as UK schools and Israeli restaurants and cafes resume full service this week while the vaccine rollout continues around the world.

Global Equities

Gaming — Promoting Productivity

The changing face of gaming

Perceptions that playing video games is anti-social, unhealthy and addictive are probably due for an update:

- The rise in popularity of online multiplayer games — which allows gamers to connect and play with friends from around the globe — and of esports, in which gamers compete against each other in live events viewed by thousands, means gaming can be a social activity
- Gaming teaches strategy and planning, stimulates brain activity (indeed the US Food and Drug Administration has approved the marketing of an electronic game to improve attention function in kids with ADHD), and reportedly improves the fine motor skills, eye-hand coordination, depth perception and computer competency of laparoscopic surgeons

Video games are competing against other forms of digital entertainment, but recent data suggests the average person still spends significantly more time watching shows (whether on traditional TV or on streaming platforms) than gaming in a week.

In July 2020 the Entertainment Software Association (ESA) released some interesting facts about the US video game industry:

- 65% of American adults play video games daily
- The average US gamer is 34 years old, owns a house and has children
- 70% of parents say gaming has a positive influence on their child's life, and 67% play video games with their child at least once a week
- 56% of the most frequent gamers play multiplayer games

Evolution of platforms

The gaming landscape has evolved significantly over the last two decades. Well before the turn of the millennium, arcade gaming, which was popular in the 1970s, had lost its following. Players moved to PCs then console platforms whose popularity peaked in the mid-2000s, then back to PCs again. Since the turn of the millennium two innovations have contributed to the growth of the gaming industry and the shape of today's market landscape:

1. **Online gaming — allowing gaming between friends without having to be in the same room:** In 2001, Microsoft (MSFT.O) launched the Xbox Live online gaming platform for a monthly subscription fee, giving players access to multiplayer matchmaking and voice chat services that revolutionised the gaming experience. Some of the most successful games have relied on online multiplayer functionality, such as World of Warcraft, Call of Duty, FIFA, League of Legends and Grand Theft Auto.
2. **Smartphones and the rise of the mobile gaming sector:** The computational power of smartphones and their touch screens and accelerometers enabled mobile games that were accessible yet complex and entertaining. Games available on smartphones are typically cheap, and quick and easy to download and play. Mobile gaming has been a tailwind for the gaming sector over the last 15 years to make up US\$85b or just over 50% of gaming revenues in 2020. One-third of mobile game users are above the age of 45. A key benefit of gaming attracting increasing numbers of older players is their ability and willingness to spend money.

Increasing user engagement with games has led to a willingness to spend more.

The next growth drivers could include improving virtual reality gaming technologies such as Facebook's Oculus Rift or augmented reality games such as Nintendo's Pokemon Go!, and the increasing viewership of esports.

The revenue timeline for games has changed with the rise of downloadable content and micro-purchases

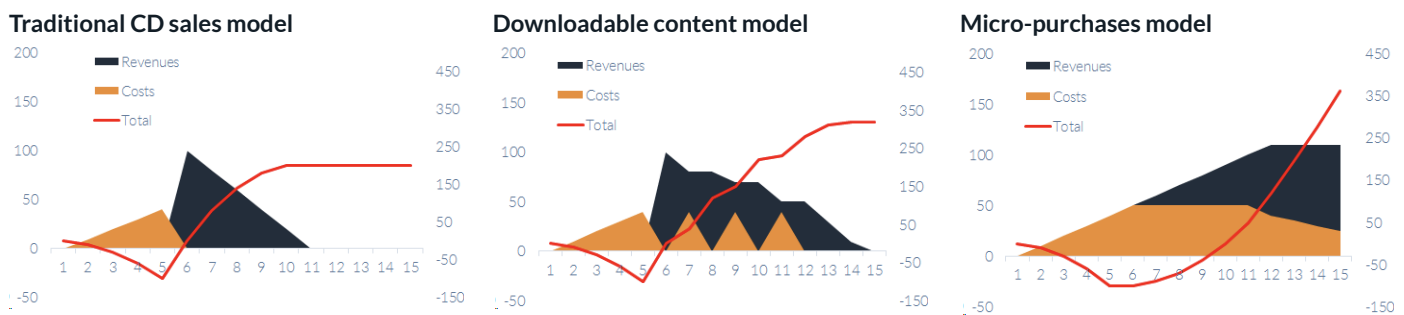
Game development can be a lengthy and costly process. In the past, a game would be released on a compact disc (CD-ROM), distributed to retail stores, and sold for a relatively high one-off price. (Figure 1 — Traditional CD sales model).

This business model was revolutionised by improving online connectivity, allowing games to be distributed online and the addition of downloadable content. Developers could create new content for existing games and sell it to consumers to download. This changed the revenue timeline for gaming companies, and allowed companies to extend the revenue generating potential of video games (Figure 1 — Downloadable content model).

The next evolution, which accompanied the growth of mobile games, was the micro-transaction business model, where players could download games for free and then make small purchases at any time to improve the gaming experience or the game-playing ability of

its characters (Figure 1 – Micro-purchases model). This allowed for recurring revenue streams that improved the lifetime earnings potential of video games compared to the old model. Having a portfolio of games that utilises this model provides companies a more stable revenue stream.

Figure 1. Lifetime earnings under different gaming revenue models



Source: Forsyth Barr analysis

Companies with exposure to the gaming sector

COVID-19 and global lockdowns gave the gaming industry a significant boost in 2020, and while some demand may have been pulled forward, we believe the trends support long-term growth in the sector.

Traditionally, video game developers like **Take Two Interactive** and **NetEase** created games, and were paid by publishers who brought the games to market. The lines between developers and publishers have blurred, with publishers like **Activision Blizzard** becoming increasingly involved in game development while also showing interest in acquiring developers for access to their games.

Some large cap tech companies like **Alphabet**, **Microsoft** and **Tencent** are also exposed to the gaming sector, although gaming typically represents only a small portion of their businesses.

In our opinion these companies offer a good value base and a solid exposure to the gaming sector.

- **Activision Blizzard** is an American video game company founded in July 2008 through the merger of Activision and Vivendi Games. Activision Blizzard currently includes five business units: Activision Publishing, Blizzard Entertainment, King, Major League Gaming, and Activision Blizzard Studios. It has a track record of developing some of the most popular game franchises globally, with hits including Call of Duty and World of Warcraft.
- **NetEase** is a leading online games company founded and based in China, albeit listed in the US, and ranks second globally in terms of online games revenue. NTES was established in 1997 and is one of the leading internet technology companies globally, with other areas of business including e-commerce, audio streaming, and email. NetEase's gaming business is mobile and PC based, with major titles including Westwar Journey and Onmyoji.
- **Take-Two** is a US company and one of the world's largest developers, publishers and marketers of interactive entertainment across all platforms. The company owns two major game development and publishing labels: Rockstar Games (makers of the Grand Theft Auto and Red Dead Redemption Franchises) and 2K (makers of the 2K Basketball, 2K Golf and Borderland franchises). It also publishes and distributes games developed by third parties, as well as operating a significant mobile game developer, Social Point.
- **Alphabet**, which owns Google, is exposed to the gaming sector through its mobile app store, where it collects revenues from purchases made through Google Play, and Stadia, its subscription based video game streaming service.
- **Microsoft** is one of the world's largest software companies, generating \$100B+ in annual revenue. The company is a market leader across numerous IT categories, with core solutions including a broad array of cloud computing services, enterprise infrastructure software, business productivity applications, as well as personal computing/gaming devices including Xbox.
- **Tencent Holdings** is a Chinese multinational conglomerate company founded in 1998, whose subsidiaries specialise in various internet-related services and products, entertainment, artificial intelligence and technology both in China and globally. The company is one of, if not the, largest gaming companies on the planet thanks to its strong portfolio of PC and mobile online games.

Themes of the Week

Fixed Interest

Talk it up...or down

Central banks around the globe have been busy trying to talk down their respective yield curves as longer-term interest rates continue to climb higher. The Reserve Bank of Australia (RBA) has done more than just talk, bringing forward bond purchases alongside a clear reminder to the market that it has plenty of firepower left in its quantitative easing gun.

The US Federal Reserve, however, was a touch light on fighting talk and the reaction from the market was one of disappointment. US 10yr yields were +17bp higher over the week.

In New Zealand the Reserve Bank of New Zealand (RBNZ) has been particularly busy providing the market with reminders that it is not going to deviate away from its current monetary policy for a considerable period of time. The RBNZ has increased its bond buying this week in another signal it can do more than just talk. The RBNZ has been at pains to point out that the government's request to "consider" sustainable house prices in their monetary policy decisions is largely a non-event given the RBNZ already considers such issues as part of its financial stability responsibility.

If the sell-off is temporary then opportunities exist

As a consequence of the move higher in longer-term interest rates, bonds with longer duration have seen their prices fall (yields rise). As we go to print there are 14 bonds quoted on the NZDX (excluding perpetual securities) that are currently trading at a discount (below par). This is reasonably rare in an often expensive retail debt market.

The question is, has the sell-off in interest rates got more to go? Is it temporary? Or a sign of a sustained trend higher? The speed of the rise suggests that it may slow or retreat at some point, but in such uncertain times forecasts are largely useless. Depending on bond portfolio duration, some of the discounted opportunities may appeal to some investors.

Figure 2. NZDX Bonds trading below par

Issuer	Code	Rating	Maturity	Coupon	Bid	Offer	Last	Price	Last Traded
Argosy Property	ARG030	n/r	27/10/2027	2.20%	2.95%	2.90%	3.06%	95.10	5/03/2021
Chorus	CNU030	BBB	2/12/2027	1.98%	2.42%	2.30%	2.30%	98.05	5/03/2021
Chorus	CNU040	BBB	2/12/2030	2.51%	2.90%	2.52%	2.85%	97.14	3/03/2021
Infratil	IFT300	n/r	15/03/2026	3.35%	3.45%	3.30%	3.46%	99.46	5/03/2021
Infratil	IFT280	n/r	15/12/2026	3.35%	3.50%	3.46%	3.46%	99.37	5/03/2021
Infratil	IFTHC	n/r	15/12/2029	2.75%	0.990	1.000	0.995	99.50	2/03/2021
Investore Property	IPL020	n/r	31/08/2027	2.40%	2.90%	2.85%	2.95%	96.83	5/03/2021
Local Govt Funding	LGF110	AAA	20/04/2029	1.50%	No Bid	2.08%	2.10%	96.16	5/03/2021
Mercury Energy	MCY030	BBB+	14/09/2027	1.56%	2.50%	2.25%	2.15%	96.40	4/03/2021
Oceania Healthcare	OCA010	n/r	19/10/2027	2.30%	3.00%	2.80%	2.80%	97.30	5/03/2021
Refining NZ	NZR010	n/r	1/03/2024	5.10%	5.70%	No Offer	5.70%	98.49	5/03/2021
Ryman Healthcare	RYM010	n/r	18/12/2026	2.55%	2.75%	2.70%	2.72%	99.03	5/03/2021
Summerset	SUM030	n/r	21/09/2027	2.30%	2.80%	2.40%	2.80%	97.52	5/03/2021
Wgtn Int'l Airport	WIA070	n/r	14/08/2026	2.50%	2.75%	2.65%	2.65%	99.40	5/03/2021

Source: Forsyth Barr analysis, Refinitiv

Research Worth Reading

New Zealand

Electricity Sector – S&P Clean Energy Index Consultation Threepeat

The upshot of S&P's third go at changing its Global Clean Energy (GCE) Index rules is a probable further reduction of the GCE Index weights of Contact Energy (CEN) and Meridian Energy (MEL). We estimate that under the proposed changes the ETFs that track the index will be required to sell between 72m–78m shares in CEN (~9% of free float) and between 100m–109m shares in MEL (~8% of free float). The exact amount will depend on the size and liquidity of new GCE Index constituents. (Published by Forsyth Barr)

Power Points – Drying Out – March 2021

Wholesale electricity market conditions are tight, with gas availability issues and well below average hydro storage lakes pushing the February 2021 average wholesale electricity price at Otahuhu to NZ\$238/MWh, the third highest on record. As a result the earnings outlook for FY21 is more uncertain than usual, although Genesis Energy (GNE) is in the best position, with all of the other three large generator/retailers facing downside earnings risk if hydro conditions stay dry. The key take-out from the recent 1H21 results season is that we are moving from a "returning cash to shareholders" phase to a "building" phase requiring more capital. Contact Energy (CEN) and Meridian Energy (MEL) both announced new builds (as expected), had lower dividends and indicated the possibility of commencing a dividend reinvestment plan at the FY21 result. (Published by Forsyth Barr)

Real Estate Reflections – The Long and the Short of it

The listed property vehicles (LPVs) and broader S&P/NZX 50 were both down in February, with fears of inflation and rising bond yields weighing on investor sentiment. While rising bond yields make LPV dividend yields relatively less attractive, banks continue to offer suppressed deposit rates and upcoming marginal tax rate changes increase the attractiveness of the portfolio investment entity (PIE) structure. Additionally, LPVs are finally delivering some DPS growth, with those that reported in the month on track to deliver +2–3%. That said, many LPVs continue to trade at tighter than average spreads of their earnings yield versus interest rates. Further lifts in bond yields remain a headwind for the sector, particularly if the short end of the yield curve begins to rise. (Published by Forsyth Barr)

Freightways (FRE) – Post More Reliant on Parcels (and Price?)

NZ Post's recently released six month result to December 2020. With profit flat through the first half, despite strong volume growth and high quality measured delivery performance, we believe current financial performance provides scope for further positive pricing initiatives in 2021. We continue to expect the parcel industry pricing dynamic to be a driver of a growing industry profit pool. This is supportive of FRE's 'Pricing for Effort' programme, which is closing in on its target of a ~NZ\$1.50 increase per business-to-consumer parcel. OUTPERFORM. (Published by Forsyth Barr)

Mainfreight (MFT) – Q4 Peer Read-through – Industry Delivering Growth

MFT's key global peers have reported a strong set of 4Q20 results that highlight 1) a return to revenue growth following 18 months of flat-to-negative top-line performance, and 2) margin expansion on the prior year. Improving freight industry fundamentals are a further positive for MFT, which has already been outperforming its peers through FY20 and 1H21. MFT is currently trading at a modest premium to its global peers on a one-year forward PE (~32x). This premium is justified given 1) it is more defensive, as shown by its financial out-performance through the pandemic, due to its favourable freight mix, 2) its organic growth track record and its ability to win market share, and 3) the favourable dividend tax regime in New Zealand for domestic and international investors. OUTPERFORM. (Published by Forsyth Barr)

Australia

Ancor (AMC.AX) – North America beverage data

Nielsen released data for the four weeks to 20 February, which showed continued strong trends in food and moderate growth in beverages in the latest four weeks, suggesting the demand environment for AMC's North America business has been supportive so far in the 3QFY21 period. ACCUMULATE. (Published by Ord Minnett)

Qube Holdings (QUB.AX) – Outlook improving for operations and acquisitions

QUB's track record as a company has historically been centred on exploiting strategic opportunities in the market. Ord Minnett believes this bodes well for investors over the coming years, as the business begins to free up capital to deploy. While investors wait, Ord Minnett expects tailwinds of the operating business to continue near term. BUY. (Published by Ord Minnett)

Treasury Wine Estates (TWE.AX) – America's Margin Task is Not Easy

TWE's Americas segment is about to restructure and reduce volumes significantly. The company's 25% Americas EBITs margin target may be achievable, but it would be done with a low operating cost base which may result in weaker revenue growth over the medium term. Citi values the Americas segment at A\$2.4b, or 9.2x EV/EBITDA based on FY23e earnings. FY23e is the year when the company achieves A\$200m in EBITs on Citi's forecasts. The upside risk is if TWE can create another "19 Crimes" brand (+A\$0.59 per share). The downside risk is additional sales and marketing is needed, leading to EBITs margins nearer to 18% (-A\$1.01 per share). SELL/ HIGH RISK. (Published by Citi)

Xero (XRO.AX) – Planday acquisition

XRO announced the acquisition of Planday, a workforce management platform based in Europe, for total consideration of up to €183.5m. Ord Minnett makes the following observations: 1) Strategically, the acquisition will increase the breadth of XRO's software offering to small to medium-sized businesses (SMBs) and allow for cross-selling opportunities. 2) Ord Minnett expects this acquisition to provide an additional platform for XRO's push into Europe. 3) The acquisition should be EPS-dilutive from FY22. Ord Minnett doesn't expect any meaningful positive earnings contribution from the acquisition in the medium term and has made minor changes to its earnings forecasts to reflect the acquisition. The FY22 revenue forecast has increased +3% to NZ\$1.02b, while the operating earnings (EBITDA) estimate has declined -3% to NZ\$228m. LIGHTEN. (Published by Ord Minnett)

International**Apple (AAPL.O) – UK Competition and Markets Authority (CMA) Examining Apple's App Store**

The UK's competition authority announced it has opened an investigation into AAPL following complaints that its App Store policies are anticompetitive. While complaints by developers are not new, the investigation by the UK watchdog comes less than two weeks after the UK Competition Appeal Tribunal dismissed Epic Games' lawsuit against AAPL citing the case did not have merit in the UK but suggested the dispute had merit in the US. According to the UK CMA, the regulator seeks to determine if AAPL acted unfairly, impacting user choice or causing higher prices for apps and/or additional content. While regulatory outcomes and potential remedies are unknown at this time, in a more draconian case where AAPL's average net fee on all apps is just 22.5%, UBS's FY22E EPS could be negatively impacted by almost -7% if AAPL was not able to offset the revenue impact from the fee reduction. (Published by UBS)

Stellantis (STLA.MI) – Looking at the accounting not the stars, consensus >15% too low

Following a period of restriction, Citi has resumed coverage of Stellantis ('to brighten with stars'), the group created from the recent merger of Fiat Chrysler Automobiles and Peugeot maker Groupe PSA. While shares are a consensus BUY among sell-side brokers, with obvious attractions from a self-help perspective (€5b of synergies are expected over the five-year integration period), Citi believes current market estimates are yet to reflect the details of the merger document fully and believes we are therefore likely to see significant upgrades over the coming six-months (Citi estimates consensus 2021E EBIT is >15% too low). BUY. (Published by Citi)

Volkswagen (VOWG_p.DE) – ID.3 teardown: The biggest EV opportunity – Buy

UBS Evidence Lab tore down the Volkswagen ID.3, the first of many launches on VW's all-new MEB electric vehicle (EV) platform. UBS's key findings: The ID.3 and future MEB-based models 1) have an efficient and scalable platform that sets a technology benchmark for legacy automakers, and 2) are EBIT-positive today and likely will achieve price and margin parity vs. internal combustion engine cars by 2025. Consequently, UBS is highly confident in VW's financial success in EVs (raising EPS by up to +10% with a widening gap vs. consensus over the years) and a subsequent multiple expansion. BUY. (Published by UBS)

Calendar

Figure 3. Calendar

Date	New Zealand	Australia	International
9-Mar	Manufacturing Sales Volume (4Q) ANZ Business Confidence (Feb)	ANZ Business Confidence NAB Business Survey (Feb) NAB Business Confidence	JP: GDP (4Q)
10-Mar	Electronic Card Retail Sales (Feb)	Westpac Consumer Sentiment (Mar) Building Approvals	US: EIA Short-Term Energy Outlook Adidas FY20 and investor day
11-Mar	Food Price Index (Feb)	RBA Governor Lowe Speaks Melbourne Institute Inflation Expectations	US: Core CPI (Feb) US: Crude Oil Inventories Adidas investor day Oracle 3Q21 Rolls-Royce FY20
12-Mar	Business NZ PMI (Feb)		US: Initial Jobless Claims US: JOLTs Job Openings (Jan) UK: GDP UK: Manufacturing Production (Jan) UK: Monthly GDP 3m/3m Change EU: ECB Interest Rate Decision (Mar) EU: ECB Press Conference (Mar)
13-Mar	CFTC NZD Speculative Net Positions	CFTC AUD Speculative Net Positions	US: PPI (Feb) US: Federal Budget AIA Group FY20

Source: Forsyth Barr analysis

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