

Gaming Giants Unite: Microsoft's Move to Conquer the Metaverse Through Gaming

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October 7, 2023

“Gaming is the most dynamic and exciting category in entertainment across all platforms today and will play a key role in the development of Metaverse platforms. We’re investing deeply in world-class content, community, and the cloud to usher in a new era of gaming that puts players and creators first and makes gaming safe, inclusive, and accessible to all.”

– Satya Nadella, Microsoft CEO

Deal Overview

- Acquiror: Microsoft Corporation (NASDAQ: MSFT)
- Target: Activision Blizzard, Inc. (NASDAQ: ATVI)
- Industry: Media and Entertainment
- Transaction amount: \$68.7 B
- Announcement date: January 18th, 2022
- Advisors to Microsoft: Goldman Sachs Group, Inc.
- Advisors to Activision Blizzard: Allen & Company LLC

Deal Summary

On January 18, 2022, Microsoft announced the acquisition of gaming developer Activision Blizzard in an all-share deal. The deal, if approved by national competition authorities, is set out to be the biggest acquisition in the history of the technology industry. According to the terms of the agreement, Microsoft will make a cash payment of \$95 per share to Activision Blizzard shareholders.

The acquisition allows Microsoft to significantly expand its presence in the gaming industry by adding several highly successful franchises to its portfolio. Activision Blizzard is a leading video game publisher with a strong game portfolio, including Call of Duty, World of Warcraft, and Candy Crush, as well as a growing e-sports business.

By acquiring Activision Blizzard, Microsoft will gain access to a large, existing player base, as well as a talented development team with expertise in creating successful and popular games. This will help Microsoft to drive growth in its gaming division, which has been playing a significant part in the trajectory of the company in recent years.

Microsoft seeks to harness the potential of its gaming portfolio as a strategic means to bolster its presence within the Metaverse. Recognising gaming as a pivotal gateway, the company aims to leverage this platform as a strategic advantage in its Metaverse endeavors.

Company overview – Microsoft

Microsoft Corporation was founded in 1976 by Bill Gates and Paul G. Allen. Their primary business is connected to computer software, consumer electron-

ics, and personal computers. Additionally, Microsoft produces the gaming console Xbox.

Satya Nadella succeeded Steve Ballmer as company CEO in 2014. Since then, Microsoft has gone through a period of strong growth followed by a restructuring that took place in 2018. Following the restructuring, the Windows engineering team split up, and two new business units, namely Experiences & Devices and Cloud + AI, were added to the organisation.

Microsoft has been expanding its gaming business in recent years, including the launch of its subscription service Xbox Game Pass, and the acquisition of the global creator and publisher of interactive entertainment ZeniMax Media for \$7.5 B.

Cloud computing and artificial intelligence have also become key areas of focus, with their cloud platform “Azure” and their AI services being among their fastest-growing businesses. Considering Microsoft’s magnitude, they are actively engaging in M&A activity, evidenced by the acquisition of LinkedIn in 2016 and GitHub in 2018, among others.

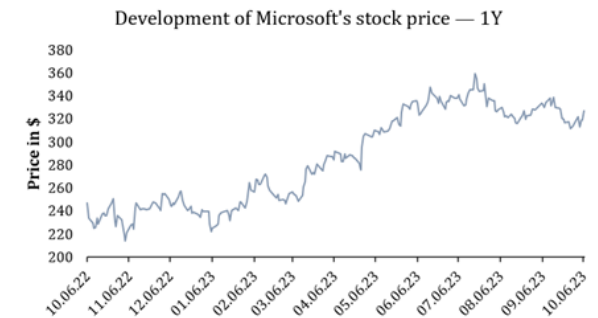


Figure 1: Source FactSet - own illustration

Profits have increased steadily since 2018, going from \$16.5 B in 2018 to \$72.75 B in 2022, which can be reflected in Microsoft’s stock performance. It sits at \$327.26 per share at the time of writing, up over

36% YTD. It is currently the world's second-largest technology company with a market cap of \$2.43 T.

Company overview – Activision Blizzard

Activision Blizzard is a leading American video game holding company with a rich history in the gaming industry. The company was founded in 2008, following the merger of Activision and Vivendi Games with Robert Kotick being the CEO. Robert Kotick, who holds a degree from the University of Michigan, had a significant impact on both the technology and gaming industries. Throughout his career, he worked with Steve Jobs, ventured into investments in various software companies, and served as a board member in various tech companies. However, it was in the gaming realm where Robert Kotick truly left an indelible mark. His experience and influence were instrumental in shaping Activision Blizzard, leading to the initiation of its ground-breaking merger.

Activision Blizzard is primarily focused on creating and publishing interactive entertainment software and related products for gaming consoles, mobile devices, and personal computers. Activision Blizzard's revenues have remained stable in recent years, with Activision contributing the largest portion of these revenues. In 2016, there was a significant revenue boost attributed to the acquisition of King. The revenue derived from monthly active users also saw growth, nearly doubling from 2016 to 2021. Among its impressive game line-up, Overwatch, a team-based multiplayer shooter, stood out by generating over 1 billion in its debut year in 2016. Activision Blizzard achieved total revenues of around 6.6 billion in that year. The iconic "Call of Duty"

series, known for its immersive first-person shooter gameplay spanning various military settings, includes the highly successful "Call of Duty: Mobile," with over 500 million downloads and an anticipated revenue of \$2 B by 2023. Collectively, these factors illustrate Activision Blizzard's enduring success in the dynamic world of interactive entertainment, marked by consistent revenues, strategic acquisitions, and a portfolio of beloved games enjoyed by a global audience.

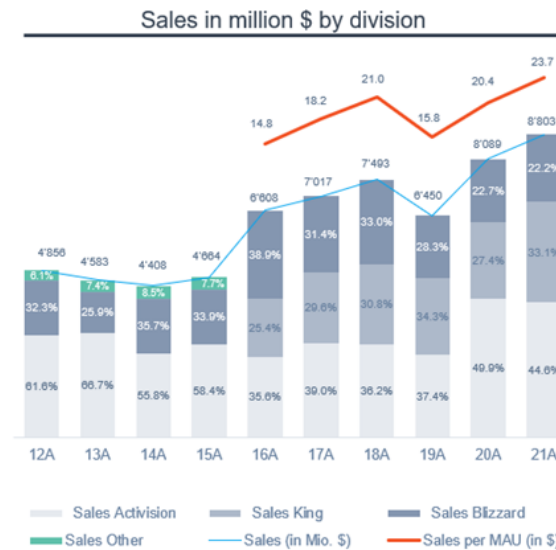


Figure 2: Source: Annual reports - own illustration

In an era marked by the remarkable expansion of the gaming sector, the parallel growth of the e-sports industry comes as a natural progression. The surge in gaming engagement and its pervasive influence have paved the way for the meteoric rise of competitive gaming events, leagues, and tournaments. Amidst this landscape, gaming giant Activision Blizzard has seized the opportunity to immerse itself in the flourishing e-sports realm. Drawing from its profound expertise in the gaming domain, the company has made significant

investments in the creation of its proprietary e-sports Overwatch League. This groundbreaking league serves as a global stage, rallying professional teams hailing from various corners of the world. Moreover, Activision Blizzard actively supports e-sports initiatives and collaborates with external organisations to promote competitive gaming.

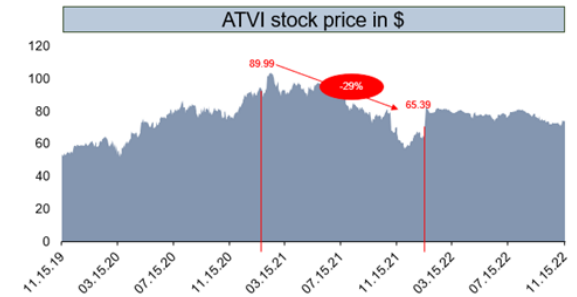


Figure 3: Source: FactSet - own illustration

The stock of Activision Blizzard has shown remarkable growth over the past decade and even increased ten-fold since the financial crisis. It reached an all-time high in February 2021, breaking \$100 per share, driven primarily by the digitalisation spurred by the COVID-19 pandemic and the video game hype. For approximately one year after that, the stock experienced a decline until the potential acquisition by Microsoft was announced, causing the stock to surge to the \$80 level. Since then, the stock has shown positive development and is on its way to a new all-time high. The company remains a significant player in the video game industry, with established franchises and expertise that position it for continued growth and is especially looking forward to the outcome of the acquisition by Microsoft.

Industry overview – Video game development

Lockdown restrictions that were imposed in a fighting measure towards the COVID-19 pandemic triggered new enthusiasm for gaming, and certain experts expect yearly revenue growth of 8%. Gaming is now a \$200+ billion industry and the fastest-growing form of entertainment. There are currently 3 billion daily active users of video games, but this number could possibly increase to \$4.5 billion by 2030. Due to the huge growth potential, the technology sector has started to take a keen interest in the gaming sector and specifically investigated bringing video game developers in-house. Video game development involves the creation, design, and production of video games. Some of the largest companies in the industry include EA Sports, Activision Blizzard, Epic Games, and Nintendo. Game developers may specialise in distinct areas, such as graphics, sound design, or game mechanics. Moreover, they may also specialise in game types (for example, Electronic Arts (EA) focuses on sports-oriented video games, whereas Rockstar Games focuses on action-adventure titles) and platforms (Rovio Entertainment is concentrated in mobile gaming, Nintendo on console, and Roblox on PC).

Community building has recently become an important trend in the gaming sector, as many games have incorporated social features and online multiplayer possibilities. The industry has also seen a significant shift in recent years with the rise of mobile gaming, especially in Asia and Latin America. This has led to a focus on inter-platform gaming, i.e., the ability to play games across a variety of platforms. Inter-platform gaming gives the opportunity for people to play to-

gether despite being on different platforms, as well as being able to play with the same game progression no matter which platform is used.

Deal Structure

We ran 3 different cases for our DCF, which all reached a steady state after 10 years and which you can see below.

Results in \$B	EV
Conservative case	46.0
Base case	55.3
Optimistic case	66.7

Figure 4: Source: Own illustration

The base case for which you also see a sensitivity analysis represents a TV/EV ratio of 56%.

EBIT margin	sales growth 2025					
	4.99%	5.76%	6.49%	7.24%	7.99%	
33.65%	47.62	48.66	49.73	50.83	51.94	
35.65%	56.27	51.39	52.53	53.69	54.89	
37.65%	52.92	54.11	55.32	56.56	57.83	
39.65%	55.57	56.83	58.12	59.43	60.77	
41.65%	58.23	59.55	60.91	62.30	63.71	

Figure 5: Source: Own illustration

As shown below, we further looked at other valuation methods shown in the football field below.

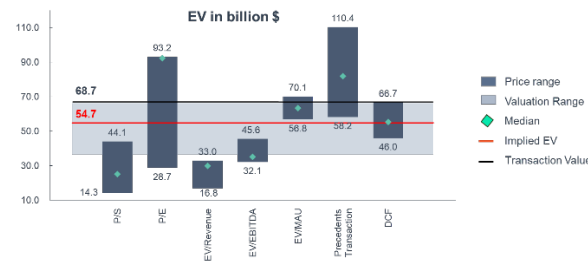


Figure 6: Source: Own illustration

The conclusion from our analysis is that the true enterprise value of Activision Blizzard laid between c.

\$38 B and c. \$68 B at the time of announcement. The precedent transactions method shows values on the upper end because they include a premium. The implied target EV was \$54.7 B representing a discount of 21.4% which shows that the transaction was in a financially feasible range taking into account a control premium required to gain the approval of current shareholders.

Synergies are expected to be quite high since combining game development and hardware capabilities will push technological advancement and, therefore, user experience in gaming and thus make Microsoft the dominant force on the block.

The cross-platform optionality leveraging Microsoft's Cloud capabilities is making gaming ubiquitous and driving customer engagement and revenues. The larger selection of games enables Microsoft Gaming to also shift its business model to subscription-based revenues. The transaction will improve Microsoft's position in mobile gaming, which is a higher margin segment while at the same time being very popular in Asia and South America, which brings new intensified exposure to these exposures for the firm. Lastly, the very long-term view of the transaction is that the combination of development and hardware capabilities enables unlocking Virtual Reality and the Metaverse for Gaming and ultimately trying to build a strong market position there to then in a next step attempt to conquer the corporate Metaverse market.

We see this as the core strategic long-term rationale of the transaction that is in line with Microsoft's identity of defining the enterprise software.

Potential Risks & Upsides

If successful, Microsoft's acquisition of Activision Blizzard would make it the third-largest global gaming company, benefitting both firms. Regulatory concerns have led to mixed responses from authorities. While the European Commission approved the deal, Microsoft is fighting the FTC in court and won in district court. The FTC appealed, and the process is still ongoing. Also, in the UK, negotiations continue with the UK's Competition and Markets Authority (CMA). Their main worry is potential competition issues in the cloud gaming market. To address concerns raised by the CMA and to navigate potential regulatory challenges, Microsoft strategically introduced the transfer of cloud streaming rights for all current and new Activision Blizzard PC and console games released over the next 15 years to Ubisoft Entertainment SA, a leading global game publisher. This proposition not only serves to appease regulatory concerns but also brings the potential for increased market competition and innovation in cloud gaming. By enabling multiple players to offer Activision Blizzard games on their platforms, this transfer can foster a dynamic ecosystem with varied business models, pricing strategies, and elevated player experiences.

The most significant outcome is the alteration of game release strategies. By consolidating resources, the possibility of synergistic game launches emerges. Games that were once restricted to consoles might now see simultaneous launches on computers. For example, Microsoft aims to expand its reach to fans of the competitor console Nintendo by releasing popular Activision Blizzard titles on the Nintendo Switch, including games like Call of Duty. This strategic move has the potential to create fresh avenues for sales across a di-

verse range of platforms. However, these decisions to expand games could also lead in the opposite direction. Despite the statement of the European Commission, it is possible that Microsoft might choose not to offer certain games on certain platforms or cease providing updates. This scenario could potentially lead to a monopoly, especially regarding Microsoft's Xbox console, and Microsoft might face backlash as a result. Blizzard games have passionate player communities. If Microsoft's involvement disrupts the dynamic or game experience of these communities by changing or neglecting games too much, it could lead to player dissatisfaction or even alienation. "Star Wars Battlefront II" developed by DICE and published by EA, serves as a clear example of player community concerns affecting game revenues. Backlash over microtransactions resembling EA-like practices led to negative sentiments, lower pre-launch reservations, and decreased sales and revenue projections. This demonstrates how player concerns about authenticity can directly impact financial outcomes in the gaming industry.