

Investment Insight

eSports: LET THE GAMES BEGIN

Sports present a paradox for the investor. It is an extremely popular global industry with enormous revenues and massive growth potential. Football, the biggest sport, had \$4.8 billion in player transfer payments in 2016 and China has just gotten started. It would be extremely attractive to be able to invest in football or other individual sports. But it is often difficult, if not impossible, because of the limited group that is able to benefit. In football, the bulk of the value goes to the few global players who play for the highest bidders. Leagues are cooperatives held by owners. The vast amounts clubs receive for TV rights, go straight out to their top players. Most struggle to be consistently profitable. The value of players' rights change with their fortunes and third-party ownership is typically banned.

But this is not the case with eSports, the latest sports phenomenon. For the uninitiated, including ourselves and most investors, eSports are competitive video game tournaments. They have spawned the rise of the professional video game player. They have grown out of a subculture and into the mainstream media. Newzoo, an expert in video games data, predicts that the global eSports audience will increase to a staggering 385 million people in 2017 and estimates that revenues from eSports will grow from \$130 million in 2012 to \$696 million this year.

On a boiling hot July weekend in London we conducted primary research and attended Activision Blizzard's Call of Duty World League in London as we endeavoured to better understand the remarkable rise of eSports.

Activision Blizzard, one of the world's leading video game publishers, owns the rights to eSports games from its titles, including hits like Call of Duty and World of Warcraft, and has the potential to extract significant value from them.

We invested in Activision Blizzard at the start of 2017. Its shares have risen by more than 60% so far this year, making it one of the very best performing companies in the US stock market. Other video game publishers have done well too. Whilst there are many factors

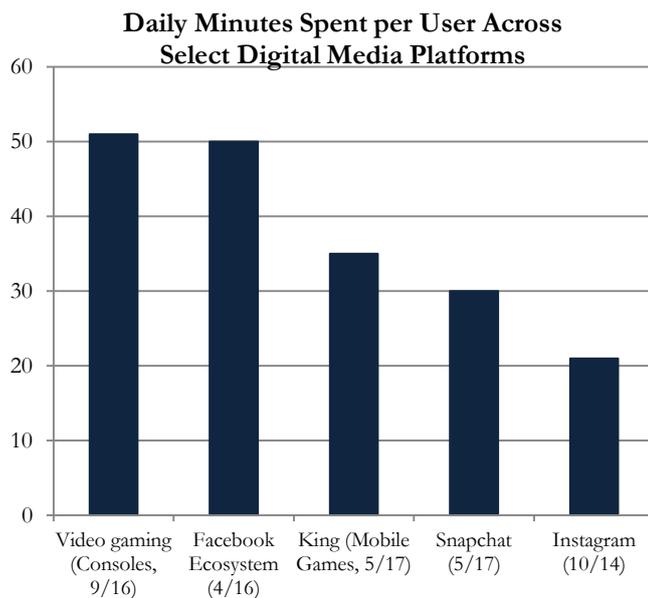


Giles Tulloch, Call of Duty World League, London, 2017

which help explain their rising share prices, we think that the rapid growth of eSports is one of the key drivers and will continue to propel the sector higher.

The internet has been absolutely fundamental to the growth of multiplayer video games. It has taken video game play away from simple one and two player games on consoles, and helped foster collaborative mass multiplayer online games (MMOs) played on PCs. Video games have also evolved in style and changed social norms. It is not uncommon for gamers to play with people from around the world and to develop friendships through these games. Young people now gather and socialize within these online worlds thanks to the internet. Unsurprisingly, these popular mass multiplayer online games have become some of the most popular eSports games.

Interestingly, a working paper published in June this year by the National Bureau of Economic Research in the United States attempted to examine the leisure activity of young men. Researchers discovered that the time young men spend working has declined by over 200 hours per year over the last 15 years. Somewhat predictably, this drop in working hours was mirrored by an increase in leisure hours, but amazingly, three quarters of this new leisure time was spent on video games. Young men have almost doubled the length of time that they play video games over the last decade. The millennial generation is often chastised for being lazy and entitled, perhaps helping to explain the decline in working hours, but one thing is certain, they have been born into the video games era and they love playing them. The average length of time an active user spends playing video games is close to an hour. What did we do before video games and Facebook?!



Source: Global Web Index, Facebook earnings call, Activision Blizzard earnings call, Snapchat earnings call, Kleiner Perkins Caulfield Byers

The origins of the popularity of mass multiplayer online games can be traced back to South Korea. The South Korean government encouraged the growth of the internet and computer gaming. The country still has some of the fastest broadband speeds in the world. An entire generation of South Koreans began gathering in internet cafés (known as PC Bangs) and playing computer games all through the night. It became a social hangout and from there tournaments sprung up.

While broadband internet allows people to play against others from around the world, it has also facilitated a trend whereby gamers stream themselves playing online, to millions of spectators. This has spurred the growth of eSports as viewers can watch live streams of

tournaments online, free from the expense and scheduling restrictions of broadcast TV. Twitch.tv has become one of the most popular websites to watch others play and was recently acquired by Amazon for close to \$1 billion. It has around 100 million monthly unique users and estimates suggest that Twitch.tv is responsible for the fourth highest amount of internet traffic across the USA as people stream its content.

The number of people who watch eSports is enormous. According to NewZoo, of the approximately 385 million people who watch eSports, half are watching at least once a month. Unsurprisingly, the audience is skewed towards the younger male generation, with three quarters of the audience under 35, and two thirds male. Yet this audience is still growing rapidly, with NewZoo predicting by 2020 that it will reach almost 600 million. This large audience is taking eSports into the mainstream and beyond its core fan base.

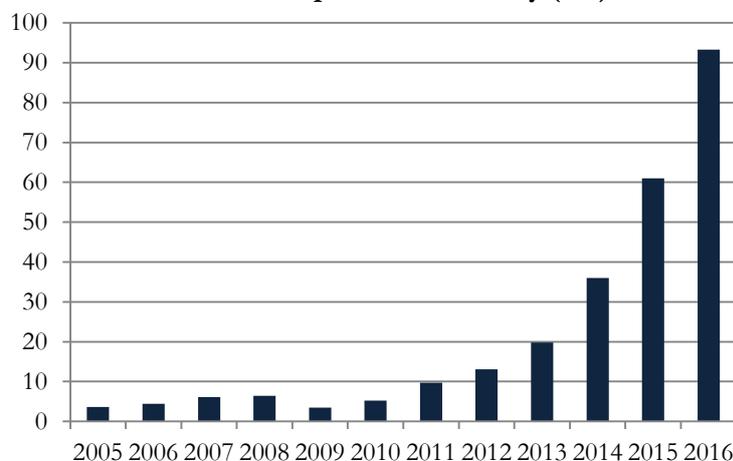
With millions of people watching these video game tournaments, prize money has grown substantially over the last three years. One of the largest tournaments is Dota2: The International, which offered a prize pool of over \$20 million last year.

With such large prize money at stake, being a professional video game player has now become a lucrative career. For example, the average salary of a League of Legends player in North America is over \$100,000. Top eSports players, especially those in South Korea, are being feted like pop stars or soccer players are in the West. South

Korean sides have won the last four League of Legends World Championships in a row, with the 2016 winners taking home more than \$2.5 million in prize money, so it is unsurprising that South Korea's best players have become celebrities.

However, as more money flows into eSports, there are growing calls for a more professional and structured approach. There are attempts to grow players' unions and create overarching industry standards. There are also concerns that as many of the players are teenagers and young adults, they are being taken advantage of. In order to become one of the very best players in the world, it requires intense practice and long hours. It can encourage addiction, with gamers and especially teenagers totally consumed by playing these games. Indeed, the South Korean government decided to introduce a shutdown law (or more colloquially known as the Cinderella law) which forbids children under the age of 16 playing video games from 12am to 6am. Tencent, one of the leading publishers in China,

Worldwide eSports Prize Money (\$m)



Source: NewZoo 2017 Global eSports report

recently introduced rules restricting teenagers to a maximum of just two hours play time a day on one of its most popular mobile games, Honour of Kings.

We believe that these issues are serious but that as the industry matures and becomes more structured it should be able to address them and generate substantial and sustainable economic value.

Many of the most popular eSports games are team games, leading to the creation of dedicated eSports teams around the world. Interestingly, this has also attracted the interest of other sports teams and franchise owners. Soccer teams in Europe (for example Schalke 04, Borussia Dortmund, Paris St Germain and AS Roma) as well as some NBA franchise owners (like the Miami Heat, the Philadelphia 76ers, the Golden State Warriors and the Washington Wizards) have associations with eSports sides. These organisations see clear synergies with eSports teams and even offer their expertise, for example in training and diet programs.

We think that the future of eSports could potentially follow that of football, most notably the English Premier League in the 1990s. The introduction of the Sky Sports TV deal set off a chain reaction as greater money flowed into the league. The clubs became more professional and attracted higher calibre players. The standard of matches improved and with innovations such as punditry analysis and scheduling kick off times to suit TV audiences, Sky and the Premier League were able to grow the English Premier League into the global phenomenon it is today.

For eSports to track a similar path, we think that it needs to be more professionally structured, starting with an organised calendar of events and leagues. Crucially, eSports already have a global audience with players and fans from across Asia, Europe and North America. Video game publishers have seized upon the opportunity to structure the industry, as ultimately it is their intellectual property in the games upon which the tournaments are constructed.

Two of the most popular eSports games are League of Legends (published by Riot Games owned by Tencent), and Counter Strike: GO (published by Valve). Riot Games are in the process of overhauling the structure of the League of Legends Championship in North America where they plan to introduce minimum salary caps and a players association. As highlighted earlier, they realize the importance of player protection and creating a healthy and sustainable team structure. Riot Games recently inked a \$300 million rights deal with BAMTech (a streaming platform owned by Major League Baseball and Disney) to stream the League of Legends series over the next seven years. It is in their best interests to create an exciting product, and this starts with retaining and incentivizing players.

Media mogul Ted Turner's Turner Broadcasting has also made a foray into eSports by creating a dedicated eSports channel called ELeague, which started out broadcasting Counter Strike: GO tournaments. It is notable that many other media channels, including Facebook and Twitch.tv, are also trying to gain eSports content and even ESPN has a dedicated eSports section on their website.

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When we attended the Call of Duty World League earlier this month, we were struck by how professionally it was run. Activision Blizzard (the Call of Duty publisher) has recently acquired a specialist eSports promotions company and had a collection of pundits and casters (commentators) on hand to talk spectators through the action. Whilst Call of Duty is one of the most popular console games in the world, it has not yet transferred this popularity over to eSports. Compared to the League of Legends events in America that sell out Madison Square Gardens in New York and the Staples Centre in Los Angeles, the audience for Call of Duty in London was far smaller.



Source: Riot Games League of Legends, Madison Square Garden 2016

In order to capitalize on the eSports opportunity and complement its existing franchises, Activision Blizzard designed a brand new game called Overwatch, configured especially for eSports. Released in May 2016 to rave reviews, Overwatch already has over 30 million players and continues to grow. It marks Activision Blizzard's first major push to create a structured eSports league. It has sold the first franchise rights to owners for \$20 million each, including to the owner of the New England Patriots NFL side Bob Kraft, and has signed a broadcast deal with Twitch.tv. It will be particularly interesting to see how it can grow the game from scratch into a leading eSports title. As eSports are still growing rapidly, we do not think that it is a winner takes all market just yet and there are further attractive opportunities both for publishers and media channels.

Importantly, the growth of eSports has already permeated other industries. Pinnacle Sports, one of the leading online bookmakers, spotted the opportunity for betting on eSports. It disclosed that in December 2014, that eSports was its seventh biggest market in terms of volume, ahead of golf and rugby. Last year, Pinnacle said that its betting volumes on eSports had doubled from the year prior. We take this as another signal that eSports is growing strongly in terms of engagement and popularity.

In addition, with the high and growing audience figures, we expect advertisers to be keen to address this market. The young male audience should be an attractive demographic for

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advertisers, especially given the “cord cutting” trend that is seeing young people turn their backs on linear television. We will closely observe how traditional large advertisers, in particular autos and financial services, will approach the opportunity.

During Mary Meeker’s seminal annual Internet Trends presentation earlier this year, she quoted Mark Zuckerberg, Reid Hoffman and Elon Musk. They are all fans of gaming experiences and talked about how fundamental they have been to their entrepreneurial vision. Many aspects of some of the largest contemporary businesses have their roots in video games.

We think that eSports will grow with both greater prize money and increased viewers over the next decade. There is an attractive opportunity for some businesses to seize the economic value in the sector. Video game publishers like Activision Blizzard are in a strong position to capture the opportunity and generate significant shareholder value over the long-term.

Giles Tulloch

July 2017

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