Nintendo Co., Ltd.

(7974 JP / NTDOF/Y)

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Executive Summary

- Nintendo has some best-in-class intellectual properties, which have been historically *under-monetized* due to the conservative nature of the company and over-focus on hardware consoles
- There is a bias among many investors who grew up idolizing the gaming systems and characters, which often results in excess optimism about what NTDOY can do and how great of a company it can be (“***the next Disney***!”)
- However, investors may finally be able to say “this time is different” *although* it will largely be due to industry trends and the IP, not the strength of management pursuing maximization of cash flows. Don’t expect miracles from NTDOY unless ValueAct is able to push a more aggressive business strategy.
- Valuation seems to always be a bit fickle, as investors get excited about the strength of a hardware console hit (which also improves software sales, a virtuous cycle), but have to worry about “the next console” given the mis-fires (see: Wii U) and subsequent revenue declines, cash flow turning negative
- If the Nintendo Switch strategy continues to pay dividends, with the add-on of the Online service, and future licensing deals to drive interest (movie, theme parks), NTDOY shares could “re-rate” based on financials moving from very cyclical to one that is more recurring revenue. Similar to how SNE has re-rated over the last year, NTDOF could do similarly.

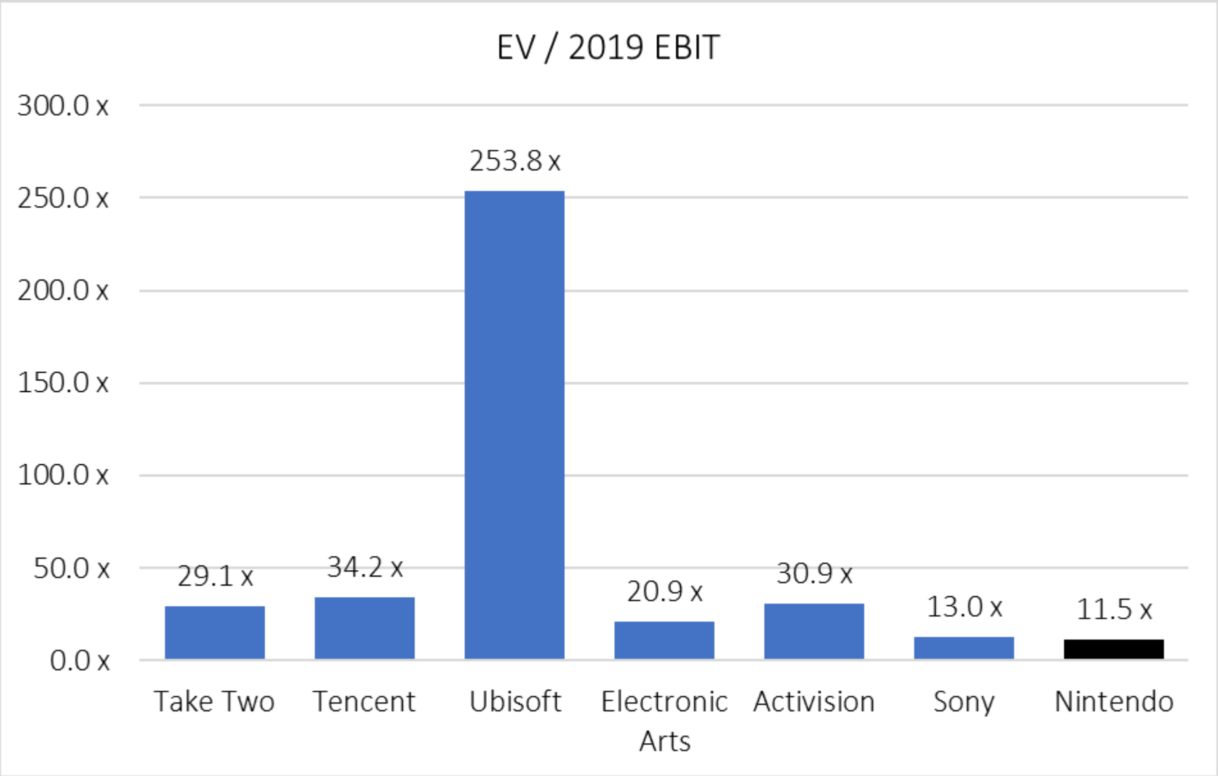
Snapshot: 7974.T-JP / NTDOF-Y

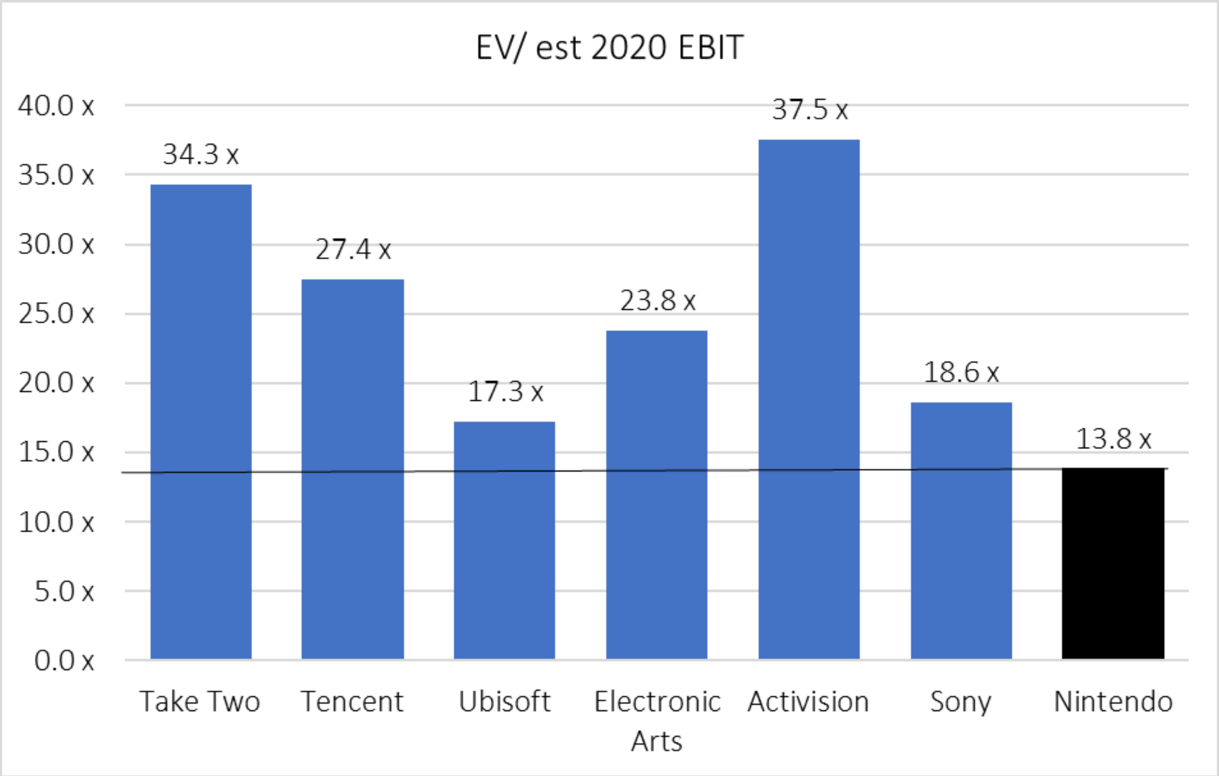
Nintendo Co., Ltd					
		7974.T-JP		NTDOF	
Share Price	¥	45,070	$	408.00	
Shares Outstanding		119.21		119.21	
Market Cap	¥	5,372,795	$	48,638	
Cash	¥	621,402	$	5,625	
Investments	¥	564,092	$	5,106	
Debt	¥	-	$	-	
Net Cash	¥	1,185,494	$	10,732	
Enterprise Value	¥	4,187,301	$	37,906	
EV (w/ net cash) per share	¥	35,125	$	317.98	
YEN : $USD		110.47		107.27	
2019 EPS	¥	2,171.00	$	19.65	*16.2 x*
2020 EPS (est. by Nintendo)	¥	1,678.93	$	15.20	*20.9 x*

As of 6/8/2020

Nintendo®

Valuation of Nintendo to Peers





TTWO - EBIT mid point of management guidance from May 2020, cash includes restricted cash
Ubisoft - uses a 1.13 Euro to USD, non-IFRS EBIT for 2020, mid-point of 400-600m euro non-IFRS, compared to previous guidance of 600m Euro
NTDOF using 300bn yen EBIT for 3/31/2021 annual year, a 110 FX ratio
ATVI uses 20% EBIT margin on mngmt 2020 est. of $6.8bn revenue
SNE estimated a 30% reduction from YE 3/31/2020 EBIT using their assumptions, exc;udes cash & mkt securities due to financial services businesses
TCEHY uses non-IFRS Q1 2020 run rate for FY 2019 est., a 0.13 HK Dollar FX Ratio, a 15% growth rate for FY 2020

As of 6/8/2020

Nintendo vs. Peers

- There are <u>no</u> direct public comps
- The most direct console & software companies would be Sony (SNE) and Microsoft (Xbox, MSFT) but both have a multitude of other business lines, making a direct valuation comparison unrealistic
- Other comps are largely software (they make games only) based, and a large component of NTDOY revenues come from console sales
- Furthermore, the software of NTDOY is a different strategy than other video game producing companies

Stock prices as of 6/8/2020

	Ticker	5 Yr Return %	S/O	Stock Price	M Cap	Cash Etc	Debt	Net Debt	Enterprise Value	2020 EBIT	2019 EBIT	EV / 2019 EBIT	V/ est 2020 EBIT
Take Two	TTWO	35.6%	115.1	$ 130.56	$ 15,027	$ 2,637	$ -	$ (2,637)	$ 12,390	$ 361	$ 425	29.1 x	34.3 x
Tencent	TCEHY	22.7%	9667.8	$ 55.24	$ 534,049		$ (743)	$ (743)	$ 533,306	$ 19,435	$ 16,900	31.6 x	27.4 x
Ubisoft	UBSFF	33.5%	112.05	$ 76.00	$ 8,516		$ 114	$ 114	$ 8,630	$ 500	$ 34	253.8 x	17.3 x
Electronic Arts	EA	13.5%	295	$ 118.56	$ 34,975	$ 5,735	$ 996	$ (4,739)	$ 30,236	$ 1,270	$ 1,445	20.9 x	23.8 x
Activision	ATVI	23.0%	774	$ 70.06	$ 54,226	$ 5,906	$ 2,675	$ (3,231)	$ 50,995	$ 1,360	$ 1,649	30.9 x	37.5 x
Sony	SNE	18.1%	1262.26	$ 68.20	$ 86,086		$ 14,027	$ 14,027	$ 100,113	$ 5,380	$ 7,686	13.0 x	18.6 x
Nintendo	NTDOF	19.5%	119.21	$ 408.00	$ 48,638	$ 10,879	$ -	$ (10,879)	$ 37,759	$ 2,727	$ 3,273	11.5 x	13.8 x
Average		23.7%										55.8 x	24.7 x

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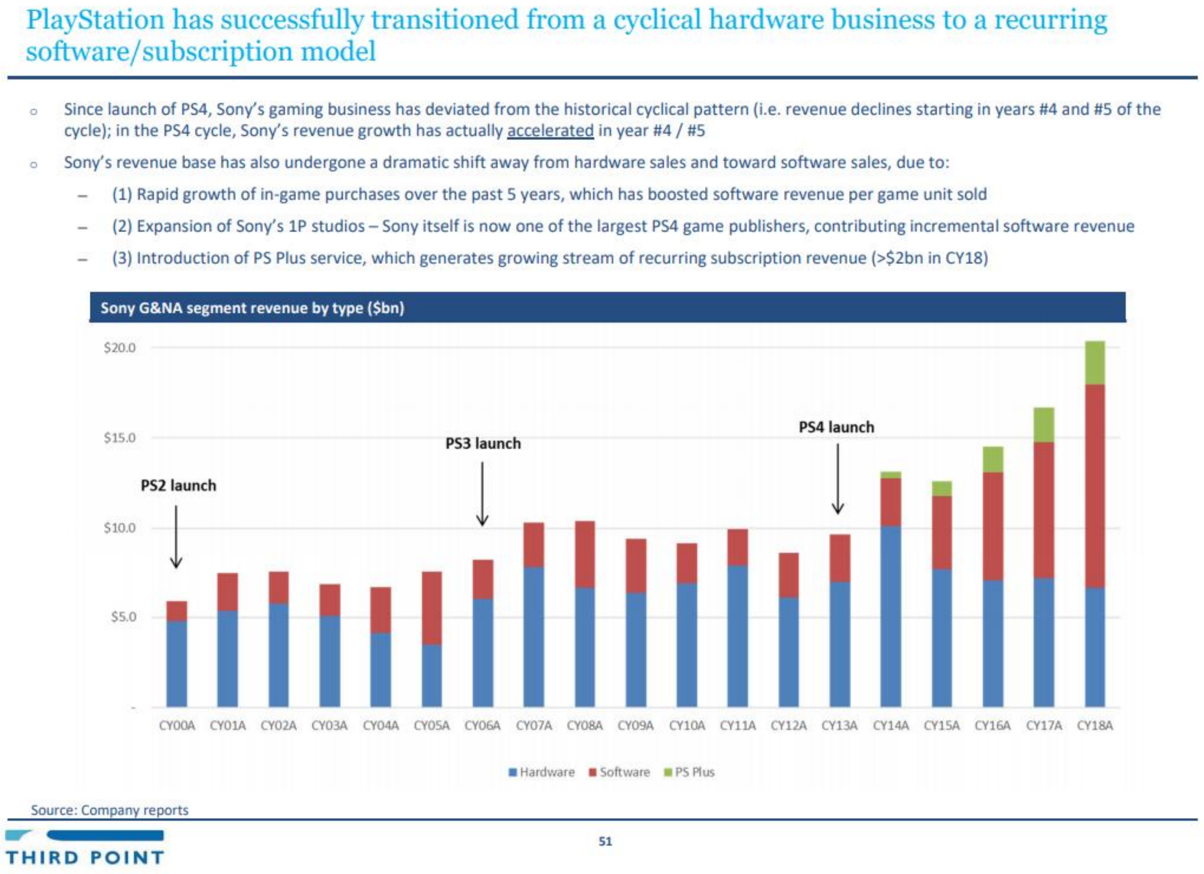
Why Does Nintendo Trade at a Discount?

- I believe Nintendo is undervalued given a few reasons:
  - It is a Japanese company, and Japanese companies are traditionally more focused on long term business sustainability over profit maximization (see: less focused on shareholder returns)
  - Essentially all Japanese video game companies typically trade at discounts to China and U.S. similar comps –Konami, Square Enix, Nexon, Bandai Namco.
  - Most of Nintendo’s legacy business is highly cyclical, relying heavily on hit consoles, otherwise revenues and cash flows fall off a cliff. It’s always about remaining on edge about whether the next console will be a hit (Game Boy, Wii, Switch) or a huge bust (Wii U)
  - Concern over cloud gaming and the next upgrade cycle for Play Station and Microsoft consoles in 2020/2021
  - Excessive conservatism at times (tying into #1 above) which leads to too much cash on the balance sheet (due to the Japanese way of sustainability & historical boom or bust cycle on console sales every ~5 years) and zero debt
  - Inadequate shareholder communication efforts – earnings calls, business overview, strategy communication, etc. – leaves investors largely to “figure out the story for themselves” with not much help from Nintendo and management
  - Investors recognition that Nintendo goes through cycles of “being cheap” to “being expensive”, largely related to the unknown success or failure of the next console cycle that happens every 5 years. A solid product (Wii) excited investors, followed by a poor performer (Wii U) and the stock craters, then to be surprised by the success of the Nintendo Switch, which causes the shares to boom again.
  - Lack of strategy with respect to smartphone and cloud gaming

Follow the Sony Playbook?

- From Third Point's deck on SNE, it highlights the transition from a cyclical hardware business to a recurring software/subscription model. Since this deck was released – June 2019, **SNE shares +45%**
- Sony has also improved their cloud gaming platform, which has gone from about 1m members to 2.2m by April 2020
- By YE 2018, Sony gaming derived approx. 40% of revenues from hardware sales, the remaining from software and PS Plus (>$2bn business)
- The SNE playbook provides ample insight into "what could happen" if NTDOY cash flow profile gets highlighted, primarily with less cyclicality due to a lower % of sales being console, and more based on mobile / digital / software



PlayStation has successfully transitioned from a cyclical hardware business to a recurring software/subscription model

- Since launch of PS4, Sony's gaming business has deviated from the historical cyclical pattern (i.e. revenue declines starting in years #4 and #5 of the cycle); in the PS4 cycle, Sony's revenue growth has actually accelerated in year #4 / #5
- Sony's revenue base has also undergone a dramatic shift away from hardware sales and toward software sales, due to:
  - (1) Rapid growth of in-game purchases over the past 5 years, which has boosted software revenue per game unit sold
  - (2) Expansion of Sony's 1P studios – Sony itself is now one of the largest PS4 game publishers, contributing incremental software revenue
  - (3) Introduction of PS Plus service, which generates growing stream of recurring subscription revenue (>$2bn in CY18)

Source: Company reports

THIRD POINT

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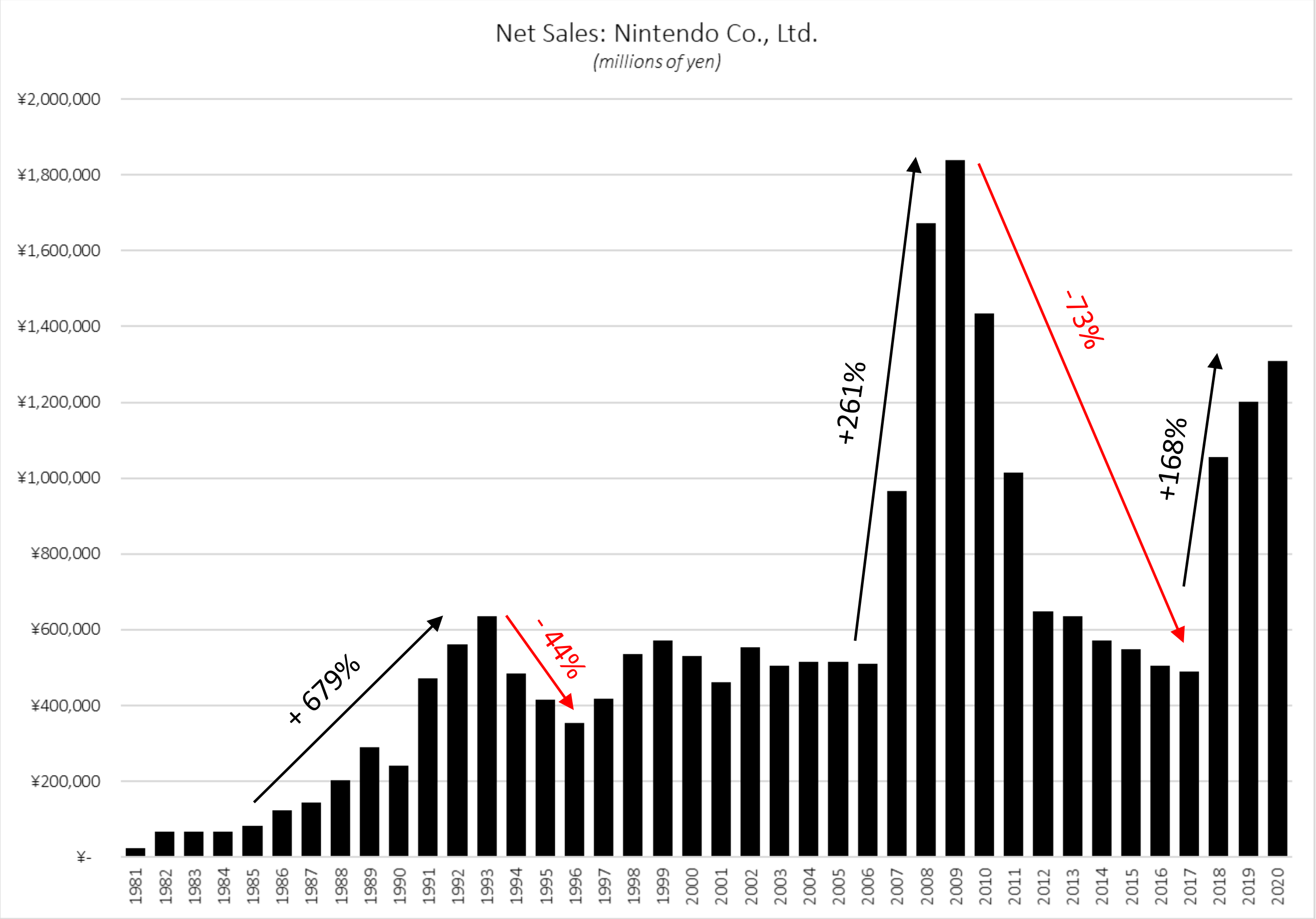
A Turbulent History

- Nintendo, since entering the video game market, has had a very boom-or-bust financial history
- This is predominantly due to the business lines they are in and the focus – specifically, they sell video game consoles, and the nuances of this product results in big swings in revenue due to unit sales
    - Product cycles every 5-6 years
    - R&D and expectations of what consumers would want years in advance, while attempting to create something differentiated, can lead to very big hits (Game Boy, Wii, Switch) or misfires (Wii U)
- As the industry has expanded with smartphone gaming (as the smartphone is a "mini console" itself), legacy home/handheld console sales have stagnated for the most part
- NTDOY – with > 52% of revenues from hardware sales, needs to rely less on the cyclical component, push for a more improved strategy on:
    - Mobile gaming
    - Licensing deals
    - Online / cloud gaming



Nintendo's Intellectual Property

THE LEGEND OF ZELDA®

Splatoon

History & Japanese Culture

Japanese Culture

- Japan has 33,000 businesses at least a century old (Teikoku Data Bank)
- Oldest hotel in the world has been open since 705 in Yamanashi
- Japan has had to adjust due to changes in:
  - Rapidly ageing population
  - Influx of visitors from overseas
  - More robots than ever
- In 2008, Bank of Korea found that 5,586 companies were older than 200 years old in 41 countries globally – and **56% of those were in Japan alone**
- These legacy businesses are known as “shinise” – “old shop”
- The culture puts an emphasis on sustainability, rather than quick profit maximization, which is why many have had staying power
- In Japan, the thought process is more about “how can we move the company on to our descendants, our children, our grandchildren”

Japanese Culture

- Children grow up with the thought of running the family business, its not even a question much of “what else is there to do”
- It’s a culture of respecting tradition and ancestors, combined with the fact it is an island country with limited interaction with other countries
- Several companies adopted the widely accepted practice of male workers into family bloodline to ensure unbroken succession for business – look at Suzuki Motor, Panasonic
- Closing a company or selling it is considered something of a failure and shame in Japan, and this feeling goes back centuries. So the cultural issues are to encourage families to keep firms going
- The society is not as flexible as U.S., so Japan does not generate big new firms so easily, but rather to preserve businesses and minimize risk

Japanese Culture

- From the book “**The Internationalization of the Japanese Economy**”
  - The Japanese M&A philosophy is that the key to a successful merger or acquisition is the understanding of the targeted firm's corporate culture and tradition
  - “Of course, Japanese managers are well aware that such a philosophy is not applicable in the United States or other industrialized nations”
  - “While Japanese acquisitions abroad are going to increase in the future, it is unlikely that acquisitions of Japanese businesses by foreign corporations will also grow”
  - “The reluctance of Japanese corporate managers and investors to sell to non-Japanese investors even part of their organizations….”
- The biggest challenge is that historically in the 1970s and 1980s, M&A was a dirty word; managers were thought to look after their group and minimize outside influences on business decisions
- Foreign Investment inflows in Japan are substantially lower than other large countries due to this mentality
- The Japanese prefer doing business only with “known parties”, and it is preferable to establish networks and alliances with companies and national professional organizations (which is why Nintendo has preferred licensing deals with Comcast rather than an acquisition?)

Japanese Culture

- An article in the “Japan Times” in May 2020 said Japan is limiting foreign investment in half of the firms listed on their exchanges
- They want to protect industries that are core to national security from the influence of foreign state interference
- Some examples include foreign investors must report in advance when they plan to buy more than 1% stake in designated firms, versus a previous threshold of 10%
- Some of the core groups affected: Toyota Motor, Sony Corp., and SoftBank Group
- Other companies like Fanuc Corp. and Nintendo Co. (NTDOY) are considered “non-core”
- In summary – Japan has different beliefs and traditions than in the U.S., and thus the future economics may not be as maximized as it would be attempted in the U.S.
- Enter ValueAct Capital - a hedge fund that takes large positions and attempts to be an active investor in the company they invest in, took a > $1bn stake in NTDOY, I truly wonder if this is more of a passive investment than active, given the Japanese tradition of being reluctant to outside influence, as well as the desire for sustainability rather than profit maximization (May 2020) or if they will implement the Olympus playbook (discussed later)
- 14 activist campaigns have been waged this year, the same as 2019, according to Activist Insight

https://www.japantimes.co.jp/news/2020/05/11/business/economy-business/japan-limit-foreign-investment-listed-firms/#.XtVkijpKiUk

Japanese Culture *Imprint* on Nintendo

- Given the large overlap historically in transactions and deals with Comcast, I would imagine (yes, speculation) that Nintendo has marked itself "not for sale" and would rather license out the IP instead (discussed in other area in this presentation)
- After the failure of the movie "Super Mario Bros" in 1993, it will be about 30 years since Nintendo has given the film industry the opportunity to utilize the IP, this time by making a deal with Comcast's "Illumination" (Minions, Despicable Me)
- Very hesitant originally to adopt games and software / services for mobile devices, saying that it is possible the reason Nintendo would still be around in the future was because they *didn't* do mobile games (they soon caved in)
- Board of Directors is dominated by men, with 9 males and 0 females
- All BOD members have been with the company for many years, except 3 which are "independent" of NTDOY
  - 1980,1985, 1992, 1989, 1977, 1994 = average tenure with the company is 34 years
  - Average age of the BOD who has been with NTDOY is 58, so essentially they have spent their entire careers with Nintendo (example: starting at 24, now average age of 58)

Overview of Nintendo Co., Ltd

- Founded in 1889 in Kyoto, Japan
- Founder – Fusajiro Yamauchi – sought to capitalize on the rising popularity of playing cards
- Playing cards were looked down upon prior, during the Edo Period, due to their connection to gambling
- In the late 1880's, as Meiji Emperor sough to Westernize Japan, European trends became popular and old restrictions on gambling were loosened
- Once again, similar to capitalizing on the strength of playing cards, Nintendo sought to capitalize on the rising popularity of arcade games in the early 1980s
- The Famicom was intro'd in 1983 in Japan, eventually pushing to the "NES" as Nintendo looked to expand globally, introducing the NES to America in 1985/6. It was a monumental change in video game history as the industry was thought as near-dead following "the crash of 1983"
- Nintendo has partial ownership of "The Pokémon Company", which may be a surprise to many as Pokémon and Nintendo are often closely associated.
  - NTDOY shares rose > 50% following the popularity of Pokémon Go (~ $14bn gain)
  - Then, at earnings release, tanked 12% after realizing Nintendo only owns ~32% of The Pokémon Co.

https://www.bbc.com/news/business-36791275#:~:text=Shares%20in%20the%20Japanese%20company,34bn%3B%20%C2%A325.7bn).

Who Owns Pokémon?

- Plenty of confusion around the association of Nintendo and Pokémon
- Pokémon characters have crossed over into Nintendo titles from time to time, and Nintendo is copyrighted at the bottom of the Pokémon website
- But who actually owns *The Pokémon Company*?
- **Nintendo** is one of the owners (share is unknown but estimated to be 33% +/-) along with **Creatures** and **Game Freak**
- The Pokémon Company does not own the Pokémon brand, they manage it, license it, publish games, help operate stores and produce toys and cards, etc.
- Nintendo is the full owner of the Pokémon trademarks – the name, logo, and every character name from Pikachu on
- Game Freak is a 3rd party developer and partnered with Nintendo on the IP
- Nintendo owns about of Creatures, which is largely made up of ex-Nintendo employees
- All in, it is possible that NTDOY, through ownership in Creatures / Game Freak, and cash infusions, own more than 50% of The Pokémon Company
- Pokémon doesn't share much of their financial information, but they made $124m in profits in 2018, +50% from 2017, due to Pokémon GO

https://toucharcade.com/2016/07/28/who-owns-pokemon-anyway-its-complicated/
https://nintendowire.com/news/2019/06/03/the-pokemon-companys-fiscal-year-net-profit-soars-50-to-124-million-us/

The Nintendo Way

- Nintendo's long history (going back to 1889) is rooted in doing things their own way, which at times has severely hindered the financial and stock performance, which frustrates fans/gamers who can be fanatical about the characters/IP, and investors who see the fanaticism behind the brands yet lack of determination to monetize them
- Nintendo's value was largely rooted in its ability to bring unique experiences to video game fans by building its own hardware to do things that other devices can't
- The console business can be tough, as R&D takes a few years, and they are all trying to skate to where the puck is to drive sales, but at times Nintendo has spent the R&D poorly and misfired on what are typically 5-6 console cycles, which in turn creates a massive lull in financial performance (see: Virtual Boy, Wii U)
- It is common for Japanese businesses to limit seeking outside influence, instead focusing internally to solve issues. This means Nintendo has been historically very slow at times to adapt to trends that may seem obvious to others in the industry (example: smartphone gaming)
- Initially Nintendo saw smartphone gaming as a huge risk, one that could be existential, and resisted conforming
- From 2008 to 2013, shares fell about 80% as investors called Nintendo "out of touch" with misfires such as the Wii U, a slowdown in Wii sales, lack of extending some franchises – Super Mario, Pokémon, Donkey Kong, Zelda – to a younger generation who are more smartphone oriented

The Nintendo Way

Out With the Old….

"I understand the reality that there are some in the market who are more supportive of doing things differently than the way we are doing it," Mr. Iwata said. "If you want to make short-term profits from the stock price, then I am a very bad president. But I don't think I'm so bad for maximizing the long-term value of Nintendo."

- Nintendo President Satoru Iwata (2013)

(NTDOY stock was down 80% over previous 5 years)

In With The New….???

- More partnerships – film with Illumination (2022 release), Super Nintendo World at Universal theme parks, mobile with DeNA, Niantic
- More focused on mobile gaming – Super Mario Kart, Super Mario Run, etc.
- Cloud – Nintendo Switch Online (late 2018)
- Working in partnership with investor firm Value Act – TBD on results
- Focusing on operational efficiencies such as continued R&D for the Switch to extend the life, versus the traditional 6-year console cycle, or consolidating the 4 Tokyo offices into one
- Change in corporate governance – established a Nomination Advisory Committee to serve as advisory body to BOD

End of the Trial

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- Thank you