

# THE DEVIL'S ADVOCATE REPORT

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## Studies in Absurdity

### REFLECTIONS ON ELECTRONIC ARTS, INC.

#### AN UPDATE OF THE *SELL* RECOMMENDATION DATED OCTOBER 2001

<b>Price (5/2):</b>	\$59 ½	<b>Ticker:</b>	ERTS
<b>52-wk. range:</b>	\$40.99 - \$66.92	<b>Dividend:</b>	none
<b>Shares out:</b>	144.2 million		
<b>Market Cap.:</b>	\$8.31 billion		

From the virtually inexhaustible trove of Winston Churchill quotations, readers might enjoy the following definition of a fanatic. According to Mr. Churchill, a fanatic may be defined as one who “will not change his mind and will not change the subject.” This definition might reasonably be applied to the subject of Electronic Arts. It will be recalled by regular readers that a sell recommendation was issued one-half year ago. Unfortunately for this publication, the shares have thus far failed to cooperate with the spirit of the report. However, the reasons for this are intriguing.

The basic investment thesis for *buying* as opposed to selling short Electronic Arts was the increased popular enthusiasm for buying video games that would be generated by the introduction of X-Box by Microsoft as well as the continued success of Sony Playstation 2. The latter appliance is the dominant game platform. It was this phenomenon that created the first genuinely successful quarter at Electronic Arts in some years. This, of course, was the quarter ended December 2001. Earnings for the year ended March 2002 are now anticipated to be perhaps \$0.83 per share. Analysts seem to gravitate towards a fiscal 2003 expectation of \$1.50 per share. The logic is that the strong sales of video game platforms will continue and probably accelerate, and thus promulgate the expected 80.7% profit growth.

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This is a most intriguing forecast in light of the fact that as of April 30, 2002, analysts do have possession of certain well-documented facts that might lead one to challenge the consensus view.

The most obvious fact is the recent very disappointing sales of X-Box. This platform sold 1.5 million units from its November 2001 introduction to year-end 2001. It had been expected that 4.6-6.0 million units would be sold from product launch to June 30, 2002. Microsoft has now informed its followers that such a forecast is entirely optimistic. The new range of forecasted unit sales from product launch to June 30, 2002 is 3.5-4.5 million.

The new range of weekly forecasted sales may be easily derived. In the last six weeks of 2001, X-Box sold 250,000 units per week. Subtracting this known sales amount from the new optimistic and pessimistic forecasts and then dividing by 26, which is the number of weeks in the Jan.-June 30 period, produces the range 76,923-115,384. Surely, this might influence the consensus view on Electronic Arts. Unfortunately, this was not the case.

Electronic Arts recorded \$44 million in X-Box associated revenue in six weeks during the December quarter 2001. If one were to assume substantial revenue growth, one should probably rely upon some meaningful contribution from X-Box. Sales of 1.5 million units in the crucial December quarter should be insufficient to create any growth in X-Box related video gaming. Interestingly, 50% growth would require X-Box sales of 2.25 million units in the Christmas quarter, assuming that people maintain a constant rate of video game software spending per average X-Box unit.

On April 18, 2002, Microsoft announced a 33% price reduction on X-Box units sold in the U.S. The firm also announced 37% price reductions on units sold in Europe. This is hardly an indication of robust sales.

Electronic Arts increased revenue by \$168 million, or 30% in the December 2001 quarter versus the December 2000 quarter. X-Box related video games accounted for \$44 million of this growth. We shall return to the question of X-Box.

However, it is first necessary to explore the other pillar of the growth thesis, which are the robust or seemingly robust sales of Sony Playstation 2. Revenues associated with this platform increased from \$144 million to \$227 million in the December 2001 quarter versus the comparable period one year ago. The sales increase is \$83 million. Thus, this sum, when added to X-Box, is rather significant. It must be quite evident that if this

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pillar as well as the X-Box pillar were to falter in some manner, the growth forecast would be difficult to achieve. Incidentally, it is believed that Playstation 2 has sold more than 23 million units since its introduction in March 2000. Thus, it is for the moment far more important than X-Box.

According to Sony and as represented in Nikkei Electronics Magazine on January 29, 2002, Sony had been producing 1.8 million units per month. The production rate has now been somewhat reduced to 1.3 million per month. This is still tepid and the slowdown may be explained by ordinary post Christmas sales reductions. In any event, the important point is that Sony sold 5.4 million consoles in the December 2001 quarter. A growth rate of 50% would require sales of 8.1 million units in the December 2002 quarter. The current production rate should result in unit sales of 3.9 million in the January – March quarter 2002. The anticipated growth rate results in 8.1 million units in the December 2002 quarter. Since, no one can predict the future, let us assume that this will happen. Sony states that it sold 18 million Playstation 2 consoles in 2001. If 1.3 million units are sold and produced each month between March 31, 2002 and September 30, 2002, this would be another 7.8 million units. Thus, Playstation 2 would sell 3.9 million units plus 8.1 million units plus 7.8 million units for a total of 19.8 million units in 2002. This is hardly consistent with 50% growth.

A forecast of 50% growth would quite obviously be consistent with 27 million Playstation 2 units sold over the course of 2002. If the so-called slow months of January to September were at the rate of 1.3 million units per month, then 15.3 million Playstation 2 consoles would need to be sold in the Christmas 2002 quarter, which would be nearly triple the number sold in the Christmas 2001 quarter. No responsible analyst maintains such a forecast.

If one wishes to track the progress of Playstation 2, one means of doing so would be to observe those firms that sell components to Sony. The Playstation 2 features a 128-bit CPU developed by Toshiba and an embedded Graphics Synthesizer developed by Sony. There is also an I/O processor developed by LSI Logic. Neither LSI Logic nor Toshiba record areas of robust sales. This is consistent with the slow growth scenario for Playstation 2, with obvious implications for the vigorous videogame market. Demand is powerfully influenced by console sales. This is the basic pillar of faith for the proponents of Electronic Arts.

There is another subtlety to this type of analysis. Let us presume for the purpose of discussion that the analysis as well as the fact pattern promulgated in this paper is wholly wrong. It would therefore follow that X-Box and Playstation 2 sales would grow at a prodigious rate. Would this support the growth in videogame pillar of faith?

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The question requires complex analysis. This is so because in the December 2001 quarter Electronic Arts sold \$122 million worth of videogames to owners of Playstation 1. This was 17.1% of revenues. It must by definition be the highest margin business of Electronic Arts. This is because Electronic Arts has ceased developing games for Playstation 1. There is no associated development cost. Indeed, since the focus of the marketing effort must be to sell the newer product, it must follow that there is little associated marketing expense.

The Playstation 1 videogame revenue decreased to \$122 million in the December 2001 quarter from \$183 million four quarters ago. If Playstation 2 is successful, one must presume that users of Playstation 1 will switch to the new system and the revenues of Playstation 1 will disappear. Thus, in order to grow, Electronic Arts must replace the presumed loss of the 17.1% of its quarterly revenue represented by Playstation 1.

Moreover, in the nine fiscal months ended December 31, 2001, Playstation 1 videogames produced \$162 million of revenue or 12.9% of consolidated revenue. Playstation 1 produced only \$46 million of revenue in the first six months of the fiscal year. Since Electronic Arts does not provide profit margins by revenue category, one cannot prove that Playstation 1 revenue had very little associated development and marketing cost. However, it is certainly reasonable to presume that a self interested party would expend very little effort and no development effort upon a product that is now obsolete. Thus, the highest margin business must disappear if the firm is successful. If the firm is not successful, the new products will not grow. This appears to be the most disagreeable paradox.

This is not the only paradox. Sony intends to introduce Playstation 3 in 2003. This is being written in the second quarter of 2002. Consequently, Electronic Arts as well as other game manufacturers will soon be forced to expend effort upon the Playstation 3 consol with no possibility of associated revenue until 2003. Increased expense with no marginal revenue is usually a recipe for decreasing profit margins. Naturally, the consensus view is that the profits of Electronic Arts will increase.

Let us now return to the subject of X-Box. It may be accepted as fact that the units are not selling at the desired pace. Microsoft must soon decide if it will develop a new generation of X-Box that will compete with Playstation 3. Sony claims that Playstation 3 will feature 256 MB of DRAM versus the current 32 MB of DRAM. It will be capable of filling a screen at the rate of 1.2 – 2.6 billion pixels per second. It will have a bandwidth of 48 GB per second. This creates two distinct possibilities. If Microsoft decides to compete with Playstation 3, the game developers will need to expend more resources upon the new X-Box development whereas now none is required. There can be no possibility of remuneration until a new X-Box would be released. Alternatively, if

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Microsoft does not intend to compete with Playstation 3, the developers will ultimately lose X-Box revenue as Playstation 3 displaces X-Box.

Another factor is the desire of game developers to write software for X-Box if there are insufficient sales to achieve an economy of scale. If software is not available, videogamers will not purchase the platform. Interestingly, videogames do not have a very long product life cycle. For example, the top publisher in December 2001 was Electronic Arts, with five of the top 20 titles. Nine of the top 20 titles from the December 2001 list had dropped off from the January 2002 list.

In any case, if the growth of X-Box is one of the pillars of faith upon which the proponents of Electronic Arts base their forecasts, then it is worthy of note that there are very few Electronic Arts titles for X-Box. As of late April 2002, these titles were as follows:

## **Exhibit 1 Electronic Arts Titles for XBOX, April 2002**

1	Battlefield 1942	Not currently available
2	Buffy the Vampire Slayer	Available June 2002
3	Cet Damage	
4	F1 2001	
5	James Bond in Agent Under Fire	
6	Knockout Kings	
7	Madden NFL 2002	
8	NASCAR Thunder 2002	
9	NBA Live 2002	
10	NHL 2002	
11	SSX Tricky	
12	Triple Play 2002	
13	The Simpsons Road Rage	

There are 121 published titles for X-Box. Microsoft has thus far published 18 titles. Thus, one must also believe that Electronic Arts can best all comers, including Microsoft, although the latter has more titles and far more money.

Belief in the future prosperity of Electronic Arts requires faith. It appears that this in no short supply given the current 39.66x P/E ratio placed upon that which must be regarded as a highly dubious 2003 fiscal year forecast. It is the type of faith that breeds fanaticism.

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In fairness, thus far the proponents of Electronic Arts have bested the Devil's Advocate short sale recommendation. The opinion of this publication is unchanged. However, this essay will close here on the premise that if one's mind cannot be changed, one can avoid Mr. Churchill's appellation of fanaticism by at least changing the subject.