Candy Crush - great entertainment but subscribing to its share issue may be a dangerous game to play...

By Wouter De Maeseneire (Professor of Corporate Finance at Vlerick Business School), March 17, 2014

In this piece, I will explain why I am rather critical about King (Entertainment)’s upcoming IPO – it is not fully clear why it claims to need additional capital at this stage. I will similarly argue why I believe that the company – and its current shareholders - may be attempting to take advantage of a window of opportunity to go public at an inflated offer price, which could potentially result in disappointing long term returns for new investors who buy into this dicey offering.

A risky investment

Many observers agree that King comes to the market at stunning valuation levels, and I would back that up. Most will furthermore admit that it is a rather high risk investment. The entertainment industry in general and the gaming sector in specific is scattered with one hit wonders – they experienced huge success with a single song/movie/game but were not capable of repeating the success. People who invest in such companies bet their money on the genius of a few creative people – who can easily be snatched away by competitors. For instance, Don Mattrick, current Zynga chief executive is the former Microsoft head of gaming and was previously at Electronic Arts. Those whizz kids must sustainably develop new blockbusters in order for the company to generate a lasting stream of cash flows for investors. And sure, the mobile device market is still rapidly growing which is expanding the potential customer base but as barriers to entry in this area are limited and competition is getting more fierce it will prove challenging to develop (or just keep) and monetize the user base. Moreover, companies like King are reliant on 3rd party platforms for distribution, just like Zynga was very dependent on Facebook as its distribution channel.

The high level of risk is also clear from the huge list of risk factors reported in the prospectus – it spans about 25 pages. King currently obtains 78% of its revenues from
one single game, Candy Crush Saga. It is equally reflected in the volatility factor that the company uses to value its employee stock options in a Black and Scholes model, ie 55%!

In the IPO prospectus, management is open about its uncertain outlooks and admits it is “difficult to forecast future revenue growth, if any, and to plan operating expenses appropriately”, making it problematic to predict future operating results.

*Why is King actually seeking a listing?*

Commonly cited reasons to go public include raising capital, publicity/marketing and name recognition motives, and getting liquid shares that may be useful for employee compensation or M&A payment. Going public typically enables the existing shareholders to keep control as ownership will be dispersed among many small retail investors – in contrast to selling shares to a big corporation or a private equity firm. It equally presents an exit avenue for early investors who may sell their stake at IPO and cash in.

King reports as principal purposes: to create a public market for its shares, facilitate access to public equity, increase visibility in the marketplace, as well as to obtain additional resources for working capital and other general corporate purposes like acquisitions. Most of this makes sense but I am a bit doubtful for at least two reasons.

First, they should perhaps more explicitly state that the public issue is offering an exit opportunity (now or when the lock-up periods expire) for existing shareholders – but then again this is hardly ever emphasized. The majority of King shares is held by two venture capitalists, Apax Partners and Index Ventures, for whom this IPO will provide an astonishing ROI. The number of shares offered at IPO is relatively small though – about $500 mio will be raised compared to an estimated market cap ranging between $6.6 and 7.5 bio, and only about 1/3 of the shares is offered by current shareholders. So all of this does not seem to be excessive but I would investigate more closely the exact lock-up agreement details – keep in mind that IPOs may present a lemon’s problem. Insiders (the existing shareholders) are by definition better informed about future outlooks than outsiders, ie new public shareholders. Why would the latter want to buy if insiders (desperately) want to get out? The percentage of shares retained by early
investors is an important signal of IPO quality, evidently. The sheer fact that current shareholders want to exit is not a concern – venture capital firms continuously need to exit their portfolio companies in order to compensate their investors and to obtain financial means to invest in new attractive opportunities. Yet, hopefully this exit will occur at fair valuation levels, and not exploit naïve uninformed retail investors who are willing to pay high prices for hyped social media or app developer IPOs. Remember the Facebook May 2012 IPO, where existing shareholders including founder and CEO Mark Zuckerberg heavily offloaded their holdings while many felt that its $38 offer price – corresponding to a $104 bio market cap – was insane. Soon after IPO, its stock price tumbled, leaving a bad taste in the mouth of investors. Later the stock price recovered miraculously fuelled by positive growth and earnings evolutions.

Next, the company will also raise about $300-350 mio of new cash. Why? Very recently, electric car company Tesla publicly raised $2 bio (through convertible bonds – to some extent a type of postponed equity issue) as its operations are burning cash and it wants to invest a vast amount in a battery factory. I get that. But for King it is a different story – a totally different one. End of 2013, it had $408 mio of cash and cash equivalents on a balance sheet total of $806 mio. It had zero financial debt. They only spent $2 mio, $6 mio and $23 mio on investments in 2011, 2012, 2013, respectively. But with a 2013 operating cash flow of $679 mio there is no need to raise additional financing. King estimates that its ongoing capital requirements will scale proportionately with overall business growth yet will remain a tiny fraction of its cash generation. So do they really need to raise fresh capital? Moreover, the only financing activities undertaken in the 2010-2013 period was a relatively small ($6 million) share buyback in 2011 but besides an interim dividend of $287 million in October 2013 – that is almost a 50% pay out of its full year net profits. This is not very common – to say the least - for a growth firm and signals it does not need money for corporate investment opportunities. So why first giving back (excess) cash to shareholders just to raise it again a few months later? This may signal opportunistic behaviour rather than reflect sound financing policies.

Sure – one may always claim that the money is raised to build a war chest that can be used if future takeover opportunities arise. But that is a major risk factor too, as the cash can turn out to be an unproductive asset not put to work for many years, and
typically managers like to build and hold on to big piles of cash rather than returning it to shareholders. Moreover, and perhaps even potentially more value destroying, it allows managers to have full discretion over any planned investment opportunity like an acquisition and removes subjecting companies to market discipline. If companies do not have enough cash for a proposed M&A deal, they will need to seek and obtain approval of investors (banks or shareholders) who will scrutinize the project. Zynga, that raised about $1bio at IPO, for instance did not turn out to be a great acquirer, at least so far: it bought OMG for $180 mio – half of which was written down 6 months later. Early 2014, it announced it will buy NaturalMotion for $529 mio (in cash and stock) which it can comfortably afford and even after the deal closes it will be left with $1.2 bio in cash on its balance sheet.

By the way, one could actually debate the necessity to have a massive pile of cash for M&A: good companies that have a sound investment project should normally be able to raise capital whenever needed at appropriate terms from the capital markets. Think of Inbev that acquired Anheuser Busch in 2008 in a $50 bio cash deal, and that succeeded raising the money despite a really harsh economic environment as well as volatile financial markets. The same applies to Verizon, who spent $130 bio on the 2013 acquisition of its mobile US joint venture with Vodafone, and who also did not raise the necessary monetary resources upfront. Usually, companies raise money – eg through bank loans or bond issues at the time they actually need these financial resources and not upfront – though obviously they may want to be sure of being capable to do so for instance through having available credit lines or other types of committed loan facilities. Sure – it is a balancing act: sometimes stock markets may be so depressed and occasionally there may be banking crises that hinder raising financing but in the end this is rather exceptional and even then, it typically does not prevent great companies of securing the financing for their desired value creating projects.

In some respect, again it is similar to what we have observed at Facebook, that likewise claimed it needed to raise additional financing as an IPO motive: I do not get that – they had zero financial debt before the deal, and 3.9 bio in cash. They raised about 6 bio more cash – so end of 2012 they had close to 10 bio cash on a balance sheet total of $15 bio. These resources have not been put to use during 1.5 years! End of 2013, they again
sold new shares (secondary offering) for about $1.5 bio, raising its pile of cash to $11.5 bio. Why raise more money if you are currently sitting on a big pile that you do not see opportunities for? Sure they claim they are building a war chest for M&A opportunities but why not raise the money at the moment these deals effectively take place? Moreover, as these are typically paid for with shares, there is basically no need to raise cash up front – see again the $19bio offer of Facebook for WhatsApp, which is only $4 bio cash and the remainder in shares.

At the same time, it is obvious and logical that this happens. An IPO in which only existing shareholders exit and where no new shares are offered would typically not be well received by the markets, as it would signal that the company actually does not need financial resources but simply that the existing shareholders (insiders) just want to exit...

Notably, if King needs financial resources it can only look for equity while debt will not be available as banks and bondholders consider its business model to be far too precarious. King and its peers have hardly any tangible assets that may serve as security, and although some do generate positive operating cash flows their business performance is pretty volatile. Zynga has no financial debt either, and even established competitors with long track records and who mainly derive income from desktops or game consoles like Electronic Arts (The Sims, Battlefield, FIFA) and Activision Blizzard (Call of Duty, Warcraft) have no financial liabilities either, and have about 30% of their balance sheet total in cash reserves.

By the way, the media often reports that King will raise $500 mio in its planned IPO but that is obviously not an accurate description. King (the company) will raise about 2/3 of that, while the remainder will flow to its current shareholders. For the Facebook IPO we often read that it had raised $16 bio through its public offering, but here the company itself only raised $6.8 billion, the rest was for its selling shareholders.

Maybe we could add two more motivations about why King is seeking a public listing. First, personal motives could be at play. Riccardo Zacconi, King's co-founder and CEO, previously worked at Spray, an internet start-up which was gearing up for an IPO in
March 2000. It did not materialize as Nasdaq crashed and the company was sold for $764 million – less than aimed for – in a trade sale to Lycos. Second, plenty of parties might be pushing for an IPO, including top management and personnel who may stand to make a fortune upon successful floatation, and investment banks who are handsomely compensated with a percentage of the amount raised, if the offering takes place.

In any case, if the company successfully reaches the market, it will undoubtedly be confronted with the well-known drawbacks, such as more regulation and compliance combined with burdensome disclosure requirements. Add to this spending an awful lot of time on building and maintaining relations with investors, who may have a hard time understanding the dynamics of King’s business, and who might urge the company to focus on short term profits rather than building a sustainable long term strategy. Already in the 1980s, reputed academic Michael Jensen clearly outlined the many cons related to being a publicly held corporation (and even predicted the eclipse of it). Not surprisingly, for some firms the costs of being listed may outweigh the benefits driving them to become private again, like Dell Computers and many more.

Is it really overpriced?

Although many claim that King’s IPO valuation is astronomically high, there are some arguments which could suggest that is reasonably priced. King’s peers such as Activision Blizzard or Electronic Arts respectively have a market cap of $14.85 bio and $9.2 bio, and are valued at roughly 2-3 times sales. In that respect, one could state that King with its astonishing track record is just valued at 3.5-4 times sales and that this is justifiable. But the peers mentioned above are more mature and established firms. Activision for instance for the last 3 years generated a growing sales number exceeding $4.4 bio, and managed to generate strong margins leading to operating profits of $1.3 bio and $1.4 bio in 2011 and 2012, which justifies its rather high P/S ratio. These companies have more moderate risk profiles, with a 0.54 beta estimate for Electronic Arts as reported by Yahoo Finance, contributing to rather high valuation levels.
Compared to the valuation ratios at which Zynga went public in December 2011 one might even have the guts to declare that the King IPO is an absolute bargain. Zynga went public at a $7 bio valuation, corresponding to about 12 times its 2010 sales and more than 6 times 2011 sales. It went public at 78 times 2010 earnings, yet sales growth basically stalled after its IPO and the company has been loss making ever since (more than $400 mio in 2011).

King's operating performance is unambiguously mind blowing: sales increased from $64 mio in 2011 to $164 mio in 2012, and exploded to $1.88 bio in 2013. Net after tax earnings display an even more amazing evolution, from $1.3 mio loss in 2011, to $7.8 mio in 2012 and $568 in 2013 – and that with a workforce of 665. In that respect, one could say that the suggested IPO price is just 11-13 times current earnings, peanuts for a rapidly growing business.

King has a 324 mio user base – measured by monthly users, corresponding to a valuation of about $20-25 per user. This seems fairly low compared to the 40$ per user paid by Facebook in its $19 bio WhatsApp deal, as well as the $32 per user Japanese Rakuten spent on messenger service Viber in its $900 mio transaction – despite the target just having $1.5 mio in revenues and losses of $29.5 mio in 2013. It moreover compares favourably to the $90-150 per user at which social media firms like Twitter, LinkedIn and Facebook are trading. But what exactly is the underlying economic and valuation rationale behind these high numbers that we observe currently in social media?

Benchmarking with Supercell - valued at $3 bio by Softbank in an early 2014 deal - which has 132 employees, 2013 sales of $892 (2012: $101 mio) and EBITDA of $464 mio (2012: $51 mio) – suggests that the valuation multiples at which King is seeking a listing are not utterly high. But let’s keep in mind that this represents a huge drawback of multiple valuations or assessing comparable transactions – it assumes not only that the peer group is identical (or at least very similar) but as equally that these peers are accurately priced on the markets – while many believe that the average social media firm is tremendously overvalued. Furthermore, it hypothesizes that prices paid in comparable transactions reflect the fair intrinsic firm value, but maybe Facebook
and/or Rakuten were too bullish and just hugely overpaid. Facebook in particular might have been willing to pay a high price given that the biggest chunk of the deal will be paid for in shares, which enables to gladly pay more if you can pay with shares valued at astronomical levels. I am not sure whether it would pay the same amount in cash assuming it had the financial resources. It is just like the end of the 1990s, during the dotcom and high-tech bubble – we saw M&A deals with absurd values but of course one can easily overpay big time with highly inflated stock – the best well known example was newcomer America Online (AOL) paying $180 bio for established incumbent TimeWarner – this is obviously only possible due to irrational exuberance regarding the valuation of internet stocks.

Undeniably, the track records of some game developers are spectacular, past topline performance has been amazing and profit margins extraordinary. Zynga succeeded increasing its 2008 $19 mio sales 30-fold to 597 mio by 2010. Rovio, the developer of (in)famous Angry Birds, generated $77 mio operating profit on 2012 sales of $152 mio hence realizing a bewildering 50% margin – a figure rarely achieved by any firm. But for sure future growth – if any – will be far less impressive, and profits may rapidly evaporate, as illustrated by what happened to Zynga. Do not forget that past performance is basically irrelevant for valuing a company – it is about its capacity to sustainably generate future cash flows, and that is questionable, and for sure not simply an extrapolation of the past in this type of dynamic industry. Recently disclosed figures exhibit that the number of people playing Candy Crush started to decline...

Obviously – based upon the above observations one cannot safely conclude that for sure the company is enormously overvalued at the time of the IPO, but clearly it is not priced cheaply and its valuation levels imply a future growth level and margins which are very hard to generate – yet only time will tell whether the company indeed succeeds at displaying that level of performance. It furthermore pertains that reinvestments requirements or capital expenditures must be minimal, as spending millions or billions on acquisitions will obviously strongly reduce the free CF that can be paid out to shareholders. Clearly, there is no room for disappointing investors, as was correspondingly shown by Facebook’s falling stock price soon after IPO.
Surely, King and its peers have extremely valuable growth opportunities and similar real options – they may one day start selling toys & other merchandising, make movies,... Yet most likely their value is already to the full extent captured in their current stock prices, and also here only time will tell whether they actually can profitably deploy these opportunities. One should not forget that King is active in a competitive market where multiple players, incumbents as well as new challengers, are pursuing similar growth opportunities...

Another somewhat negative element affecting King’s value per share involves its equity based employee compensation. King in its reporting prefers to focus on adjusted EBITDA, a non-GAAP measure it believes to be more informative. For 2013, this number was $824 mio – the key difference residing in the fact that share-based compensation is adjusted for as well, otherwise EBITDA would be 12% less. And sure its measure may better proxy for cash generation than traditional EBITDA as these compensation packages do not entail cash outflows. But they may and will one day result in additional share issues and hence dilution causing a negative impact on the per share numbers. About 10 mio stock options have been issued, quite significant on a total number of shares outstanding of circa 120 mio.

IPO timing: taking advantage of a window of opportunity?

Admittedly, King’s IPO comes at a time that investor sentiment is rather positive in general, and this is particularly the case for companies in the broad domain of social media, like Twitter, or app developers, be it for messaging services such as WhatsApp or Snapchat, or game publishers, like Supercell. S&P 500 and many other indices are currently at record levels, and stock markets are fairly stable – except for the last couple of weeks where there was some turmoil in emerging markets including Ukraine. Alibaba, the Chinese counterpart of Amazon & eBay, is rumoured to raise $15 bio and secure a $100 bio initial valuation. Timing is hugely important in many aspects of business and management, so the same applies to timing public market entry. But this may equally mean that the company and its selling shareholders are grabbing this
window of opportunity of sky-high valuation levels for social media firms at the expense of new shareholders for whom limited upside potential remains.

And for sure there is a social media hype and valuation bubble going on. We saw a relatively limited number of IPOs in 2011 and early 2012 given relatively depressed market sentiment – yet, there was an exception: social media firms could easily go public. Examples include LinkedIn (May 2011), Groupon (Nov 2011) and Zynga (Dec 2011). Additionally, they could raise public equity at astonishing price levels. Facebook (May 2012) went public at about 28 times sales, while the average S&P 500 firm historically is trading at about 1-1.5 times sales. Some of its peers did an even better job: Twitter went public (Nov 2013) at $26 per share, i.e. at 34 times sales. A P/E (price-earnings) ratio cannot be computed here as it is not yet profitable. Despite this it rose by 73% on the first day of trading. Later, it even peaked to almost $75! Linkedin is currently valued at more than 700 times earnings (versus S&P500 average of 15-20x), while Facebook is trading at an enterprise value of 45 times EBITDA, compared to 5-7 times for reputed firms like Apple, Dell, Intel and Samsung. This all illustrates that either some investors are extremely optimistic - it for sure does not reflect the beliefs of the average market participant - or just display irrational behaviour – see for instance the greater fool principle observed during the dotcom bubble.

Neither should one forget that academic literature has found that usually firms try to go public at a stage where their operating performance is peaking – many firms do not succeed in actually realizing the high growth ambitions, often backed up by amazing historical performance, they brag about during the going public phase. Zynga illustrates this pretty well: in 2012, top line only rose by a meager 12% - way less than foreseen at IPO, and in the 5 year period 2008-2012, it was actually only profitable just the year before IPO. Unfortunately, studies similarly indicated that companies seeking a public listing more often rely on earnings management to present themselves in optimal shape to the investor audience.

What will likely happen to its stock price after IPO?
Most likely, King's IPO will be successful. The investment banks involved have ample experience with pre-marketing the offering, creating a positive vibe and building the book such that demand for the shares will exceed supply, guaranteeing a smooth conversion of King into a publicly traded business. In the process, they may furthermore exploit that not all market participants are equally well informed or behave rationally.

For the future stock price evolution we may expect the typical pattern for stock market newcomers, that is surging stock prices in the initial aftermarket trading but less positive long term prospects, commonly referred to as IPO anomalies. Frequently, IPOs offer abnormally positive initial returns as their stock price tends to go up quite a bit on the first day of trading. These abnormal returns are on average 10-15%. Some call this IPO underpricing, as one reason could be that the company and the underwriting investment bank price the IPO attractively such that the offering will be successful. Yet, it also means leaving money on the table for the company going public as well as for the exiting shareholders. For Groupon the first day pop was 31%, for Twitter even 73% and for LinkedIn it equalled a striking 109%. Simultaneously, another anomaly is that in the long term (1-3 years) IPO shares do not turn out to be great investments. On average, they do have positive returns but compared to the market or a peer group of comparable firms they show (abnormal) negative returns. Zynga for instance, initially priced at $10 per share and hitting a peak of $14.69, crashed to a little more than $2 in 2012. Today, both Zynga and Groupon are trading at roughly half of their offer price, imposing massive losses upon those who bought shares at IPO. Two reasons for this long-term underperformance phenomenon are commonly put forward. First, lock up periods expire at some point after the initial issue thereby raising supply of shares and putting downward pressure on the stock price. Secondly, given that IPOs typically take place during market heights or other windows of opportunity, it is not surprising that the long term performance is not quite positive. Interestingly, given this regularly observed negative long term abnormal performance, maybe we should refrain from referring to the first day positive returns as underpricing – their long term returns even suggest overpricing at IPO!

Where do I see the company's stock price within 5 years from now? Obviously, it is just impossible to predict that but I can safely say that there is limited room for significant
further increase in King’s share price, and that the stock will more likely stabilize or decrease rather than rise – the implicit valuation levels reflected in the suggested offer price leave no room whatsoever for disappointing investors and require the company to sustainably meet the markets’ very ambitious expectations about the company’s future performance in terms of competitive positioning, sales growth and profit generation. These days, start-ups that swiftly reach global audiences and multi-billion dollar valuations appear to sprout almost like weeds. Whether the ones who will ultimately succeed are worth their hefty price tags is about to be tested. Just like when after the dotcom bust the dust had settled, it may likely turn out that a few dominant players emerge, offering astonishing returns to investors while plenty may not survive or at least not succeed in meeting initial investor expectations and will prove lousy investments. Remember YouTube. Google bought it in 2006 for $1.65 bio and everybody felt it was a crazy price for a firm with 100 mio daily video viewings but no profits. But in 2013, YouTube generated $5.6 bio in revenues, up 50% year on year. Google now trades at record levels. By contrast, both LinkedIn and Twitter recently announced very disappointing user growth numbers resulting in sliding stock prices.

In summary, returns for King’s IPO investors may be positive but those buying the stock at IPO better be ready for potentially a bumpy ride...