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Video-game companies race past 'GO' as the world stumbles

by KHAW Ker Wei

If global commerce is played out as a Monopoly board, we would have seen the tokens of video-game companies (PC, console and mobile games) making rounds past the 'GO' tile while the companies from most other industries struggle to complete a single loop. Indeed, the physics of the global economy does not appear to apply to the video-game industry. According to McKinsey & Company's Global Media Report 2015, the industry boomed by a compound annual growth rate (CAGR) of 8.6% during the post-Great Financial Crisis period. Following the growth spurt, it now ranks second in consumer spending for entertainment, surpassing the expenditure on audio entertainment, as well as other consumer media like newspapers and books. The industry is expected to generate USD 100bn in revenue this year.

Under such favorable circumstances, the credit strength of video-game companies are among the strongest on offer in the market. The aggregate RMI-CRI 1-year Probability of Default (PD) for the industry, which is the median PD for 65 video-game companies in the RMI-CRI database, stood at 4.3 bps as of 5 August 2016 (see Figure 1, LHS). In contrast, the aggregate PD for the global economy, comprising all industries, was 11.9 bps. The low levels of debt, together with the capability to generate strong, consistent cash-flow, both contribute towards the credit strength of video-game companies with proven track records.

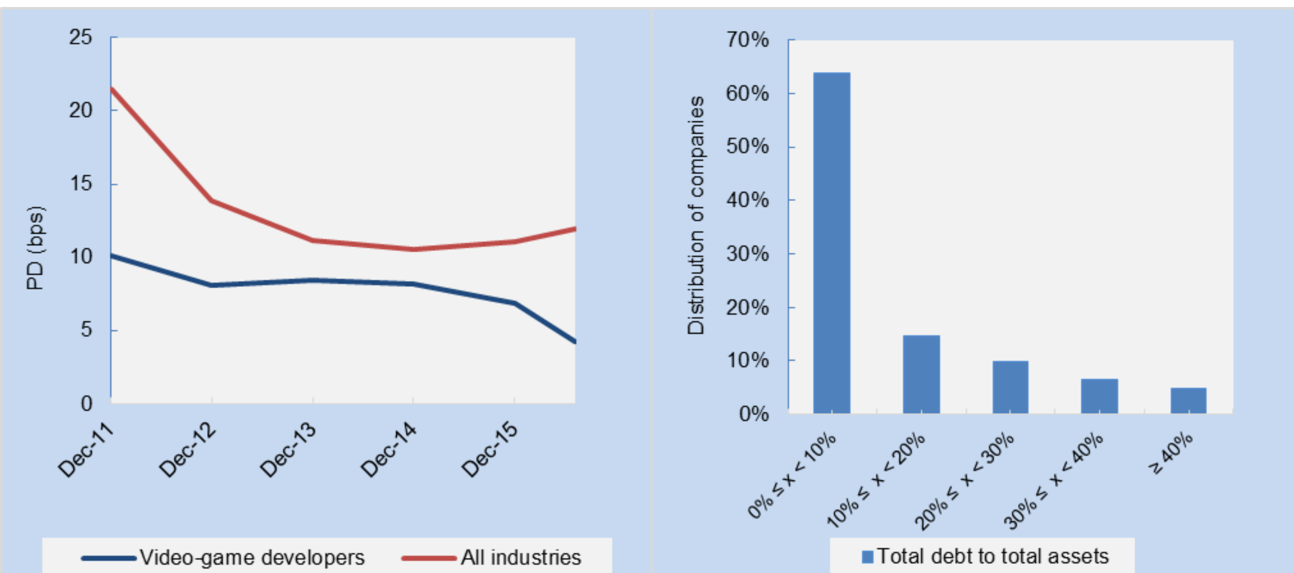

Figure 1: Aggregate RMI-CRI 1-year PD for video game developers and all industries (LHS) and the distribution of companies by the percentage of total debt to total assets (RHS). *Source: RMI-CRI, Bloomberg*

Video games development used to be a costly venture, when they were mostly played on personal computers and consoles. At current price levels, the development budget of 'triple-A' titles, which are typically the bestsellers, usually runs into the range of USD 50 – 100mn. Although a successful launch would allow the developers to rake in profits or at least break even, an unexpected cold reception from gamers would set these development studios back considerably. However, the emergence of social networks and later on, the introduction of the iPhone, totally upended the mechanics of the industry. Games on mobile devices can be developed for as little as USD 50,000 while more complicated, cross-platform ones can be completed within the USD 100 – 300k bracket. Quite suddenly, the barrier to entry vanished and games development became greatly economical.

The paradigm shift in technology consumption in the 2000's also ushered other changes in the video-game industry beyond product development. Game publishers have increasingly turned towards other avenues to monetize their products. Previously, video-game companies charged a hefty USD 60 on average for a game title to recover the development cost upfront, as much as possible. Now, many of these games are offered for free.

By doing so, video-game companies are able to expand their user base significantly. It is only then that the companies begin to recoup their development costs, and reap profits, as they sell virtual in-game items to players, a revenue model known as microtransactions.

On the back of these sweeping industry changes, established development studios have strengthened their credit positions. Japanese game developer Nexon, arguably one of the most successful companies in deploying the microtransactions strategy, has grown its net income by a CAGR of 20% since 2009, from JPY 17.7bn to JPY55.1bn in 2015. During the same period, the company's cash pile increased from JPY 26bn to JPY 198.6bn, while total debt dropped from JPY 18.3bn to just JPY 3.3bn. As a result, Nexon's cash ratio is higher than that of its peers at 7.95. Having said that, the video-game industry overall, still boasts superior liquidity characteristics compared to other traditional businesses. The industry reported an average cash ratio of 1.56x in 2015, far eclipsing the cash ratio of just 0.3x of the Bloomberg Intelligence North America Large Entertainment Content Valuation Peers group, which includes heavyweights like Time Warner and Walt Disney.

Further bolstering the credit profile of video-game developers is the lack of debt in their capital structure. The collapse in the cost of development in the early 2010s only serves to drive home this point. With such low capital outlays, companies have little incentives to borrow to finance their projects. In fact, games development can be such a passionate undertaking that it is possible to finance projects through crowd-sourcing efforts, leaving developers free to focus on their work without having to worry about debts.

The debt-lite structure lends resilience to these companies, though the proponents of corporate finance may argue that such businesses are operating far from optimum. Zynga, the social gaming company, has kept itself afloat despite making losses annually since 2011, due its failure in releasing new hit games and keeping up with industry trends. While the company benefited from the heady valuations during its initial public offering, which raised an additional USD 1bn to its balance sheets, the absence of an interest burden has certainly played a major role in keeping the business alive and retaining the jobs of its employees, for a chance to adapt its products to industry demands. Some video-game companies that have issued debts, such as industry leader Acitivision Blizzard – the creator of the wildly popular World of Warcraft, did it to fund acquisitions but even then, the amount of debt in their capital structure rarely exceeds 30%. For the record, more than three fifths of the video-game companies in the RMI-CRI database hold less than 10% of debt in their capital structure (see Figure 1, RHS).

As media technology continues to advance at a rapid pace, the future of the video-game industry looks promising. The Pokémon Go game, which recently took the world by storm, has successfully introduced the augmented reality technology to the mass market, a feat not achieved by other businesses (such as Starbucks, for example) despite being early adopters. The launch of the game itself is responsible for the revival of the market value of Nintendo, which owns about 30% of the stake in the game publisher The Pokémon Company, by doubling its market capitalization at one point of time, in a matter of weeks. With the virtual reality technology also already at the doorsteps of the video-game industry, entertainment media has never appeared this exciting, both for developers and consumers alike.

Credit News

Bond market's big illusion revealed as US yields turn negative

Aug 8. Japanese and European bond buyers purchasing US Treasuries are faced with rising conversion costs as heightened demand for USD, driven by the unconventional monetary policies in Japan and Europe, has resulted in a stronger USD. Consequently, these foreign bond buyers are faced with negative yields. According to BlackRock, at present, the 10 year yields in the US is approximately 0.23 percentage points below a basket of bonds from various countries which is in contrast to the 1.4 percentage points higher yield on an unhedged basis. For Japan, the benefit from purchasing US Treasuries has declined from a percentage point at the start of the year to 0.1 percentage point now. With declining benefits for overseas investors, a lower possibility of a continued, strong foreign demand driving Treasuries to new records is expected amid the Federal Reserve's move to gradually raise rates. (Bloomberg)

Singapore faces risk of more oil bond defaults

Aug 8. The tumbling oil price has taken a toll on many companies in the industry as they face shortfalls in liquidity, potentially sparking a "cascade" of defaults. From data compiled by Bloomberg, oil-related firms face SGD 1.4bn of Singapore dollar bonds maturing through 2018 with SGD 325mn due by the end of the year. Crude prices have plunged about 19% from its peak for the year in June and the borrowings that had aided in the development of Singapore's biggest export industries has displayed signs of strain, paralleling the global trend of smaller, independent oil and gas companies heading towards insolvency. An analyst at UOB Kay Hian Securities (M) Sdn Bhd mentioned that Perisai Petroleum Teknologi Bhd, an oil and gas-related firm that has the nearest-term bond repayment and possessing outstanding Singapore dollar bonds, would experience difficulty in repaying its short-term obligations based on its current cash balance. (Bloomberg)

Mongolia faces a debt crisis

Aug 4. Mongolia, a mineral resource-abundant nation experienced double-digit growth rates in 2011 and 2012. In order to support the real estate and construction sectors, Mongolia borrowed intensively to finance its large budget deficit, with total debt to GDP ratio reaching 70%. Consequently, money supply expanded exponentially and non-performing loans started to build up. By 2014, with rising concerns of deteriorating economic fundamentals, the central bank slowed monetary expansion and tightened budgets as foreign investment collapsed and there was a steady decrease in global mineral prices amid China's growth slowdown. This led to a sharp decline in the country's growth to 2.3% in 2015, and an expected 0%, or even negative growth in 2016. The state-owned company, Mongolian Mining Corporation defaulted on its USD 500mn bond and the country must service USD 1.2bn worth of commercial debt in the next two years. (WSJ)

UAE plans to seek credit rating once debt law is issued

Aug 2. The United Arab Emirates (UAE) aims to finalize the federal debt law by the end of the year. The discussion, which has been ongoing for several years, has one remaining article left, with regards to the discussion of the debt ceiling and debt servicing with the central bank. Upon the authorities' approval of the law, the UAE will seek a sovereign credit rating and tap the bond market, selling as much as USD 27.2bn worth of bonds. (Bloomberg)

International Shipholding files for Chapter 11 bankruptcy relief

Aug 2. The International Shipholding Corp. recorded a USD 8.4mn loss in Q1 2016, leading to a failure to comply with lender requirements. Despite facing challenges in its debt and capital structure, the core business segments of International Shipholding Corp. have yielded satisfactory performance and the company vowed to continue providing the same high quality and reliable shipping services to their customers. The firm had filed a series of first-day motions with the US Bankruptcy Court in order to continue its daily operations, covering payment to its employees and vendors. It has also arranged a USD 16mn bankruptcy financing to support its restructuring effort. (Ship & Bunker)

Dutch bankruptcy rate continues to decline, despite Brexit fears (Dutch News)

Logan's Roadhouse said to plan bankruptcy amid restaurant slump (Bloomberg)

Global Geophysical Services files for bankruptcy protection (WSJ)

Regulatory Updates

Junk bond issuers may snub Europe exchanges to sidestep EU rules

Aug 5. The new disclosure rules in Europe require junk bond issuers to disclose more information to investors, which was previously only required from businesses with shares on major exchanges, potentially spurring some junk bond issuers to consider listing overseas to avoid costs. The Market Abuse Regulation

(MAR) introduces reporting requirements to previously unregulated exchanges, such as Ireland's Global Exchange Market and Luxembourg's Euro MTF. Bond issuers are now legally required to publish material information, including the names of key insiders and their families, and to adhere to tougher trading rules. These legal requirements also apply to bonds issued on an unlisted basis, such as those issued through the London Stock Exchange's Admission to Trading Only platform. (Bloomberg)

Renzi: Italy fighting to avoid bail-in rules, 'disaster' for economy

Aug 2. Following Italy's most troubled bank evading a part-nationalization, Prime minister of Italy Matteo Renzi said that his government will not implement the EU bail-in rules that would impact investors during bank restructurings. He stated that following through with the EU bail-in laws would be a "disaster" for the economy. This statement came on the back of Monte dei Paschi's 11th-hour rescue deal by a consortium of investment banks led by JP Morgan. (FT)

Chinese regulator acts to curb bogus banks (FT)

EBA says all banks should face minimum leverage ratio (FT)

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