BSVI - CAPCOM EQUITY RESEARCH

Analysis Date: 11/20/2022

Head of S&S division:
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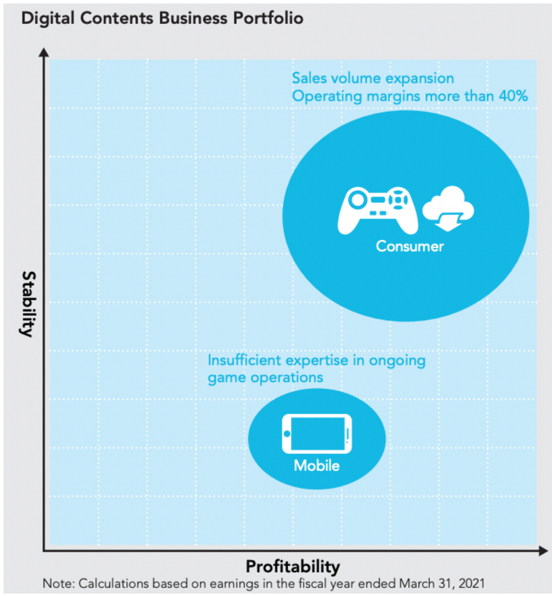
COMPANY OVERVIEW

Capcom Co., Ltd is a Japanese video game developer and publisher. It has created a number of multi-million-selling game franchises, with its most commercially successful being Resident Evil, Monster Hunter, Street Fighter, Mega Man, Devil May Cry, and Dead Rising. Established in 1979, it has become an international enterprise with subsidiaries in East Asia (Hong Kong), Europe (London, England), and North America (San Francisco, California).
The name Capcom is a clipped compound of "Capsule Computers", a term coined by the company for the arcade machines it solely manufactured in its early years, designed to set themselves apart from personal computers that were becoming widespread.
Capcom has three internal Consumer Games Development divisions:

- ***Division 1***, headed by Jun Takeuchi, covering *Resident Evil*, *Mega Man*, *Devil May Cry*, *Dead Rising*, and other major franchises (usually targeting global audiences).
- ***Division 2***, headed by Ryozo Tsujimoto (who is also the head of the Mobile Online Development Division) covering *Monster Hunter*, *Ace Attorney*, *Onimusha*, *Sengoku Basara*, and other franchises with more traditional IP (usually targeting audiences in Asia).
- ***Division 3***, covering *Street Fighter*, *Marvel vs. Capcom*, *Lost Planet*, *Dragon's Dogma*, and other online franchises (games focused on online multiplayer and/or tournaments).

In addition to these teams, Capcom developed a net of commissions outside its development studios to ensure a steady output of titles.

Production of games, budgets, and platform supports are defined during development approval meetings, attended by the company management and the marketing, sales, and quality control departments.
The international Capcom Group encompasses 15 subsidiaries in Japan, the rest of East Asia, North America, and Europe. In addition to home, online, mobile, arcade, pachinko and pachislo games, Capcom publishes strategy guides maintains its own Plaza Capcom arcade centers in Japan; and licenses its franchise and character properties for tie-in products, movies, television series and stage performances. Suleputer, an in- house marketing and music label established in cooperation with Sony Music Entertainment Intermedia in 1998, publishes CDs, DVDs, and other media based on Capcom's games. Captivate (renamed from Gamers Day in 2008), an annual private media summit, is traditionally used for new game and business announcements.



SECTOR & STRATEGY ANALYSIS

The company operates in 4 different major markets, below is a prospective analysis of each market provided by the company.

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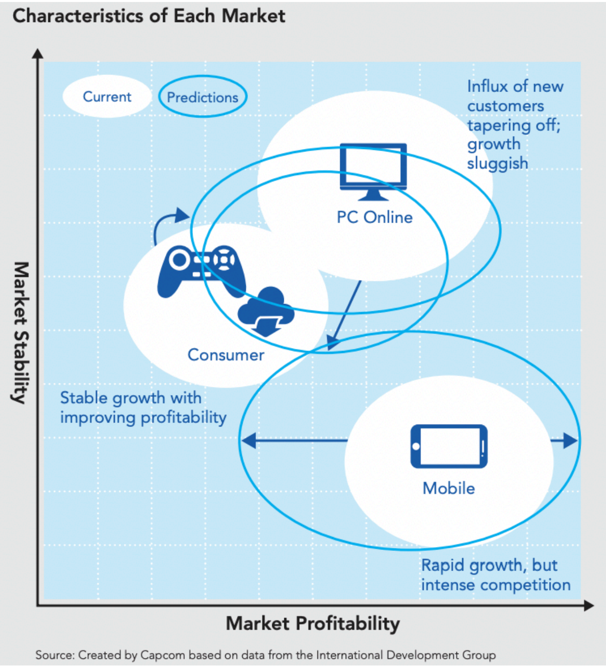
CONSUMER MARKET: In 2020, the consumer (package + digital) market grew to 42.9 billion dollars (up 22.2% from the previous year). This was due primarily to favorable packaged and digital sales. The highly profitable digital contents market now accounts for roughly 71% of the consumer market. In the medium term, we see the digital market expanding rapidly in Southeast Asia and other developing regions.

ARCADE OPERATIONS MARKET: Domestic arcade facilities market grew during the previous fiscal year (ended March 31, 2019) for the fifth year in a row to 540.8 billion yen (up 4.0% from the previous year). The market was severely impacted by COVID-19, which forced stores to suspend operations or shorten operating hours during states of emergency.

GAMING MACHINES MARKET: Japan's gaming machine market shrank for the seventh consecutive year to 564 billion yen (down 16.1% from the previous year). This was due to diminishing investment appetite for gaming machines at halls and performance of machines with gambling restraints. Next fiscal year (ending March 2022), we expect some demand for new machines replacing older types but believe the situation will remain harsh.

ESPORTS MARKET: In 2021, we expect the market to grow to 1.08 billion U.S. dollars (up 14.5% from the previous year) owing to increased sponsorship and media rights fees, primarily in China. The future remains unclear due to the prolonged COVID-19 pandemic, but the growth of live broadcasts has resulted in an increase of viewers.



FIVE FORCES ANALYSIS

Customer Power: medium negotiating power due to the appeal of original games, but it strictly depends on their quality. Buyers' bargaining power rounds out the external forces that pose the most serious threats to EA. Video games are **highly discretionary purchases**. Consumers can be selective about where they spend their money. Moreover, gamers tend to have a pack mentality when it comes to the games they purchase and play. Buyers hold a lot of say over the industry, and one bad or disappointing offering that causes a revolt from the gaming community can devastate a company. The video game console manufacturer Sega learned this the hard way when its Dreamcast console was widely panned, leading to gamers taking their dollars elsewhere and ultimately decimating the brand. **We think that there is a medium negotiating power with the customers.** As we said before, the player is not related to the manufacturer, but to the single game and the market is tough because everyday something new can be a new trend among the young players. However, if industries like Capcom continue to produce high-quality video games with a kind of history behind, they can maintain their status.

Supplier Power: Medium negotiating power due to the flexibility in choosing the distribution platform. **We think that there is a medium-low negotiating power** because there aren't many external suppliers for the creation of Capcom's products, but still, they need microchips, semiconductors ecc. for the technology they produce so even if not a threat, it would depend on the changes of context of the economy they're in.

New competitors' entry: **Low Threat** due to the large amount of capital and technologies required to differentiate as game consoles become more advanced.

The **threat of new entrants is high in the multimedia and graphics software industry** and particularly in the video game production segment. The segment's barriers to entry are low, with minimal government regulation and manageable costs. Programming video games does not require expensive or hard-to-find materials; more critical is the intellectual capacity to develop a new or innovative concept and bring it to life through effective programming and coding. **One brilliant idea that leads to a blockbuster game is all it takes for a new company** to catapult itself into the top echelon of video game producers [ex: Fortnite]. **We think that the threat is not that low, in fact is more to a medium-high level.** The danger is increasing considering that barriers to entry depend on a key force: the engineers. In fact, with technological

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development, industries like the ones in the video-game sector invest a lot on the minds beyond the programs that support and generate the game per se. Moreover, fame comes and goes quickly when it comes to new videogames, so even the small industry or freelancer can drop a game that becomes famous and creates a trend. So, even if the big ones like Capcom invest a lot in perfectioning the details and creating reliability with the clients, there is still the risk to be posed from trends.

Threats of substitution: users in this industry are different from Mobile and PC Online users because their motivation for playing is different, for that reason we assessed a **Medium threat level**. Mobile Apps represent the major threat but as of now they are clearly not on the same level. Medium threat because on one side stands the fact that there aren't many choices when it comes to consoles, but on the other side computer gaming puts at risk the position of the console players.

Competitive Rivalry: game brands are differentiated, but competition for user money and time is intensifying. Gamers simply want the best games and are not typically concerned with who makes them. A gamer who, for example, is all in on CAPCOM but shuns Activision is rare. Unlike Coke or Nike, CAPCOM cannot rely on its brand name to give it an edge over competitors. The company must continue to develop the most cutting-edge video games and effectively market them to the gaming public. **We think that there is a fierce competition** for the reasons we already said like the threat of substitutes or the availability of software's and programs even for the small industries.

BUSINESS MODEL ANALYSIS

Business Definition: Capcom business deliver **value to customer** offering both physical packages and digital downloads. It generates most of its value from the creation and selling of its video games for both consoles and mobile devices, with a growing portion of its revenue coming from mobile sales. **Target consumers** are video gamers both on mobile and computer devices. The main **Geographic targets** are Japan, North America, Europe, Southeast Asia (digital market is growing). **Expected revenue** for 2023: 4,800 mld yen (from all 4 revenue streams).

Consumer Segment: the **average buyer age** is 35 for the market. The **gender distribution** shows a small prevalence of male video gamer over female (around 55:45 in Japan) Consumers are evenly distributed across **social class** (if intended as average income).

Profit Logic: Capcom business generates revenues mainly form net sales (80%) while a 20% of their revenues come from arcade operations (manufacturing machines and developing machines for other companies) and merchandise. The main costs are from the development of videogames and the workforce of engineers and developers but fortunately, the other side of the coin is that technology innovation can create transversal synergies.

Value Proposition: CAPCOM doesn't only propose video games based on its IPs, it also provides the consumer a whole environment and digital world around its own IPs, producing movies, operating arcades, and producing amusement equipment. The **"Single Content Multiple Usage strategy"** is the strategy that enables the company to reach such high returns on its investments in the development of its own IPs.That said the critical factors to achieve the company's goal comprehend both the development of the digital contents (the IPs, which require most of the company's resources) and the development of all the other related business lines (Arcade Operations, Amusement Equipments and Other Businesses such as producing movies and promoting esports competitions)

ACTIVITY SYSTEM:

Content: the primary activities comprehend the production of digital contents. The secondary ones, instead, are the production of amusement equipment (based on videogames they develop) and arcade operations (merchandise or books). Then, there are `other businesses such as the creation of events or movies.

Structure: for sure the secondary activities like the production of arcades and gaming machines are related to things CAPCOM develops in their digital contents. So, synergies are given at first by technology achievements and developments throughout the entire business but, then, what is made on the other activities is entirely related to the main product: the video game.

Governance and risks: the customer's actions mostly involve playing the video games that the business sells and taking pleasure in the supplemental materials that CAPCOM uses to attract new clients. It aims to cultivate client loyalty in some way so that they continue to use the company's goods and services. Given that the firm operates in a market where demand and supply are very flexible, failing to meet customer expectations would be immensely harmful to the business since, if expectations were not satisfied, the customer would have little trouble switching to the competition.

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COMPETITIVE ANALYSIS:

Novelty: are there any new activities in this system of activities? Not in particular. We think that the main key to be competitive in this market is to differentiate not only the videogame, but also the secondary activities that surround it.

Lock-in: are there activities that retain customers? Mainly the popular content is related to home video games and CAPCOM has a precise philosophy in bringing high quality entertainment. They want to create a culture, to excite people and stimulate their senses, arriving at a new level of game entertainment.

Complementarities: are there activities that generate more values? Yes, for example CAPCOM put during these last year's ESG initiatives at the ground base of their pyramid to the creation of value.

Efficiency: are there activities that help reduce costs? They search for sustainable growth in order to invest in education and utilization of developers, keeping relationships with the society, investing in Governance and intellectual properties. Thus, they can generate value in a medium-long term.

PEST ANALYSIS

POLITICAL FACTORS:

Government resource allocation and time scale: The Japan new government policies can improve the investment sentiment in the Technology sector. Given the wider acceptance of the suggested policies among population, it is safe to assume that the time scale of these policies will be longer the mandated term of the present Japan government.

Taxation policies: Over the last two decades Capcom Co Ltd has benefitted from lower taxation policies throughout the western hemisphere. It has resulted in high profits and increasing spending in the research and development.

The increasing inequality in Japan can lead to changes in the taxation policies. Secondly local governments are also looking into Software & Programming specific taxation policies to contain the carbon footprint of the Technology sector.

ECONOMIC FACTORS:

Inflation rate: The easy liquidity in the market after the great recession of 2018 will lead to increasing inflation in the Japan economy as it is already happening in EU and USA.

Exchange rate: the volatility of the exchange rate of Japan with other currency can impact Capcom Co Ltd investment plans not only in the short term but also in the long run.

Economic Cycles: The performance of Capcom Co Ltd in Japan is closely correlated to the economic Performance of the Japan's economy. The growth in last two decades is built upon increasing globalization and utilizing local resources to cater to global markets.

SOCIAL FACTORS:

Education level: the education level is high in Japan especially in the Capcom Co Ltd sector. Capcom Co Ltd can leverage it to expand its presence in Japan. **Migration:** the broader attitude towards migration is negative in Japan. This can impact Capcom Co Ltd ability to bring international leaders and managers to manage operations in the country.

TECHNOLOGY FACTORS:

1. **Technology transfer and licensing issues for Capcom Co Ltd:** In the Technology sector there is no strong culture of technology transfer and companies often are reluctant to transfer or license technologies for the fear of creating competitors out of collaborators.
2. **Intellectual property rights and patents protection:** If Japan have higher safeguards for IPR and other intellectual property rights then more and more players are likely to invest into research and development.
3. **5G and its potential:** Capcom development and enhancement of user experience with increasing speed and access. This can completely transform the customer and user experience in the software and programming an industry.

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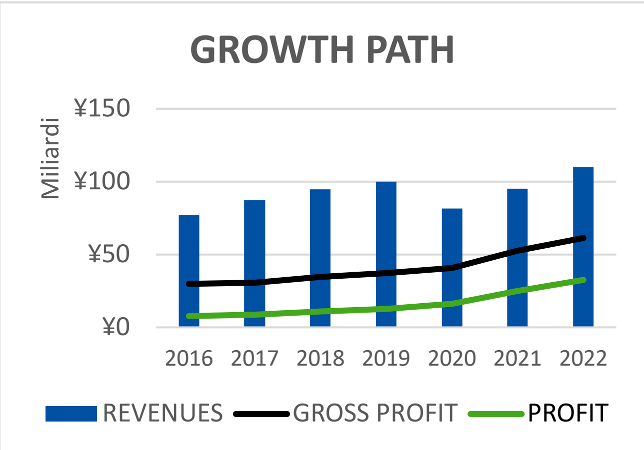
FINANCIAL STATEMENTS ANALYSIS

Head of FSA division:
Name and surname - email

Financial Statement Analysis division members:
Name and surname – email
Name and surname – email
Name and surname - email

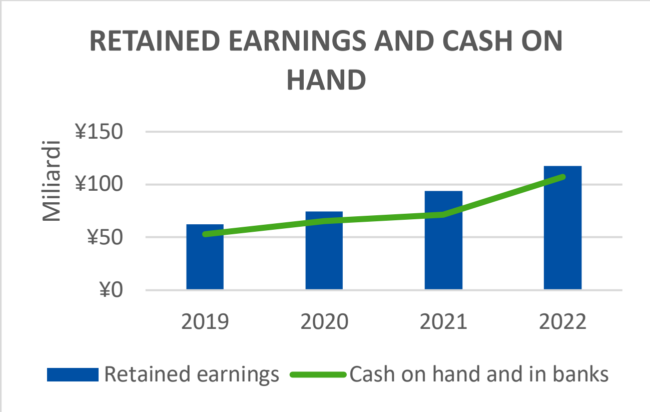
GROWTH PATH



Income statement: During the past years the company always managed to increase its profits, even though revenues declined in 2019. This is mainly due to the dismissal of the Amusement equipment's segment. In fact, while this division is becoming less important, a higher margin one, digital content, is gaining shares of revenues and therefore driving up profits.

Balance sheet: In the last year the company has improved operational management also in terms of commercial working capital passing from around 41 billion Yen in 2017 to 13 billion Yen in 2022. In fact, the company has been able to reduce mainly the trade receivables from customers and increase the supplier debts.

During the same period, also thanks to the nature of the business, fixed assets didn't increase and a big change in the balance sheet can only be seen in cash and cash equivalent, which improved passing from around thirty billion Yen in 2016 to more than one hundred billion in 2021. During the same period, on the liabilities side, we can see that the growing amount of cash was obtained mostly thanks to retained earnings.



RATIO ANALYSIS

LIQUIDITY RATIOS		
YEAR	Quick Ratio	Cash Ratio
2021	3.75	3.49
2020	2.96	2.19
2019	2.28	1.83
2018	2.89	2.28

Liquidity: Balance sheets are solid. The company has no liquidity issues: it could pay off all its financial obligation, with cash and cash equivalents. Considering accounts receivables and short-term debt, the situation is also fully under control, especially considering the amount of liquids available.

SOLIDITY RATIOS		
YEAR	Cost of liabilities	Cash ratio
2021	3%	0.31
2020	5%	0.43
2019	2%	0.58
2018	5%	0.8

Solidity: Also considering what just mentioned in the liquidity section, there are no doubts arising regarding whether the business is capable of staying afloat in the long term. The amount of cash and cash equivalents can however seem excessive and a sign of poor management, unable to allocate resources efficiently. However, by looking at other companies, located in Japan we can see that this is a common trend.
The BOJ expansionary monetary policies have allowed companies to expand their balance sheet at almost no costs, moreover the lack of growth in the Japanese economy didn't allow for many reinvestments.

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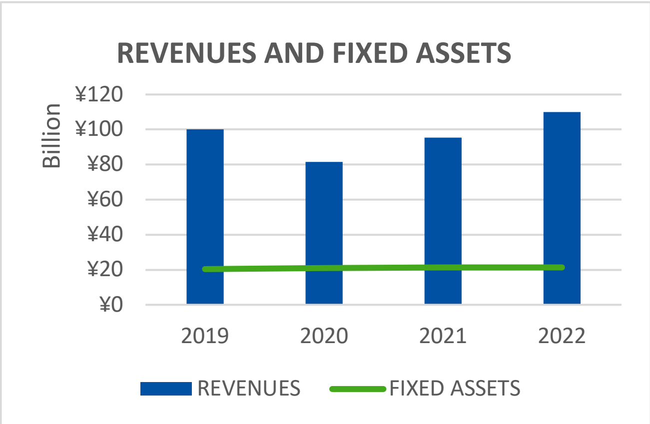
PROFITABILITY RATIOS		
YEAR	ROS	ROE
2021	39%	22%
2020	36%	21%
2019	28%	16%
2018	18%	14%

Profitability: As can be derived from the solid balance sheet presented above, the company is highly profitable, with ROE and ROS well above 20%. The company managed to steadily increased its revenues, other than for 2019 due to the dismissal of the Amusement equipment's segment, this also helped to increase margins and therefore profits.



Capcom has been growing revenues at a 5.9% CAGR from 2019 to 2023 (Financial times). Meanwhile net income tripled, showing that the company managed to increase its margins incredibly. In the same period, those improvements were reflected in the asset side of the balance sheet by the doubling of the cash and cash equivalents, instead PPE stayed flat, showing that the company does not rely heavily on fixed assets to generate revenues. Those increments in the assets side of the balance sheet were financed almost completely by an equivalent increase in retained earnings and an increase in short term debt.
From what mentioned above we can say that to follow the increase in revenue the company had to proportionately acquire more PPE. Moreover, the company managed to decrease long term debt.
For what concerning dividends, the payout ratio stayed around 20% during the observed period and Capex also increased.

CONCLUSION

In conclusion, it is evident that the company is exceptionally robust, as demonstrated by its solid balance sheet and the absence of any concerning factors. The likelihood of the company going bankrupt in the next decade is exceedingly low. Furthermore, the substantial cash reserves provide opportunities for future acquisitions or investments, which can further enhance revenue generation.
Over the past decade, the company has consistently achieved commendable growth rates in both revenues and profits. Considering the projected growth of the industry, the foundations for successful investments are undeniably in place. However, an important aspect that remains to be addressed is whether the company's current valuation accurately reflects its true worth, as analyzed by the finance division below.

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COMPANY VALUATION

(under the finance division)

Head of finance division:
Name and surname - email

Finance divisions members:
Name and surname – email
Name and surname – email
Name and surname - email

THE GROWTH RATE

In order to decide what growth rate to use in the DCF model, both historical and fundamental growth were analyzed.

YEAR	REVENUES (in million ¥)	HISTORICAL GROWTH RATE
2017	¥ 87,170	13.3%
2018	¥ 94,520	8.50%
2019	¥ 100,030	5.9%
2020	¥ 81,591	-18.4%
2021	¥ 95,308	16.8%

Historical Growth: Other than for 2020 and 2019, the company grew between the high single digits and middle double digits as shown below.

Japanese GDP growth	1.6%
US GDP growth	5.7%
Japanese Risk-Free Rate	0.3%
US Risk free	3.8%
Japanese Inflation	3%
US Inflation	7.7%
Nikkei225 Mkt return	6%
S&P Mkt return	11%

Fundamental Growth: We considered the industry CAGR expected growth between 2021 and 2026 of 7.3% and the macro situation both in the US and Japan.

Conclusion: We therefore decided to consider a growth rate of 10% for the first five years and 4% after that.

WACC

Beta: Given the source of revenues for capcom, to compute the WACC an average of the US and Japan Cost of Equity were computed and therefore the Beta between capcom and the **S&P 500** and the **Nikkey225** were both used, which respectively were **0.97** and **0.29.**

Cost of equity: Using the Beta computed above and the risk-free rates illustrated in the first section of this page, the US cost of Equity for Capcom was computed to be 10.8, while the Japanese one 1.9%. Considering the average of the two the **Cost of Equity** used for the DCF was **6.35%**

WACC: Weighting cost of debt and equity, we obtained the weighted average cost of capital of 6.31%. It must in fact be considered that the company finances itself almost absolutely through equity and therefore the WACC depends mainly on the cost of equity.

DISCOUNTED CASH FLOW MODEL

After deciding the growth rate to apply, and the discount rate to use we managed to run a Discounted cash flow model to compute Capcom's intrinsic value. Also thanks to the free cash flow projection illustrated below we can see that the **enterprise value** derived from the DCF is of **¥ 625,991.10**. After subtracting the net financial position and dividing by the number of shares we obtained the **share price of ¥2740.**

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DISCOUNTED CASH FLOW MODEL

Year	2022	2023	2024	2025	2026	Termina Value
FCFF	¥ 10,847	¥ 11,932	¥ 13,125	¥ 14,437	¥ 15,881	¥ 718,108
Disc. Rate (WACC based)	1.06	1.13	1.20	1.28	1.36	1.36
Discounted F CFF	¥ 10,204	¥ 10,559	¥ 10,928	¥ 11,306	¥ 11,703	¥ 529,188
ENTERPRISE VALUE						¥ 583,889

MULTIPLE ANALYSIS

CAPCOM'S MULTIPLES	
BOOK TO MARKET	0.13
P/E	34.18
PEG RATIO	3.42
EV/FCFE	85.37

Here below are the comments we would like to present for each of the four multiples listed in the table above:

- **Book to market**, is extremely low, showing that Capcom stock is trading many times more than its book value, suggesting it might be overvalued.
- **Price to Earnings** is well above 30, a number usually associated with overvalued stocks especially if free cash flow growth is expected to lie in the high single digits.
- **PEG ratio:** Associating the PE with the growth rate as already mentioned above we again reach the conclusion that Capcom's shares are overvalued.
- **The EV/FCFE** multiple is however lower than the median of comparable due to the high quality of the cash flows, making the stock look fairly valued.

CONCLUSION

Considering the results of both the multiple analysis and the Discounted cash flow we reach the conclusion that **on 11/16/2022 the stock is 58% overvalued** and therefore we take the decision of selling the stock.
Moreover, we also believe that an additional risk resides in the Japanese macroeconomic environment. A stagnant economy, with negative interest rates and a particular monetary policy can hide different risks for a potential investment in the "Land of the Rising Sun". A particular concern for the BSVI team is the **exchange rate risk**. The Japanese Yen has more than halved its value in the last 12 months and this can drastically affect an investment outcome. Factoring those risks we believe a Margin of Safety of 45% being appropriate. Therefore, starting from the fair value of ¥ 2,740, an investment can be considered when the stock reaches ¥ 1,507, a target price which probably will not be reached soon.

OVERVALUED

Fair Price = ¥ 2740

VS

Current Price = 4345

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