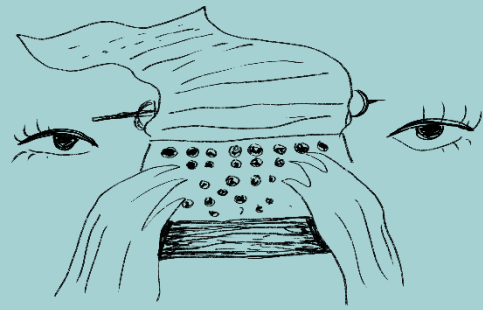




Digital Bros

Qualitative discount



2021/05/15

Analytiker: Peter Westberg

Digital Bros is an Italian gaming company which develops, publishes, distributes, and markets games on a global scale. The company was founded 1989 in Italy by the Galante brothers Abramo and Raffaele - both of which are still holding operational roles and significant amounts of insider ownership. The Galante family maintains 70% of the ownership today. The company has a proven track record of securing publishing rights for valuable intellectual properties. For instance, Digital Bros published Control (Remedy) and Death Stranding (Kojima), during 2020. The company is headquartered in Milan, Italy, but also runs offices in the United States, UK, France, Spain, Germany, China, Hong Kong, and Japan. The company highlights innovation, technology, and creativity in combination with a balanced IP portfolio as the predominant drivers and characteristics as the basis for the company's success. The company can be broken down into five operational business segments.

Premium Games operations consist in the acquisition of content rights from gaming developers and the distribution of the games through a traditional international retail sales network and via digital marketplaces such as Steam, PlayStation, Xbox Live, Epic Games Store, et cetera. Games which are not developed internally are usually acquired with an exclusive license and long-term worldwide rights. The franchise used for worldwide publishing is called 505 Games.

Free to Play stems from the development and publishing of games and/or applications that will be available free of charge on digital marketplaces, and which allow in app purchases. Free to play games usually presents less complexity than Premium Games but, in case of success, usually have a longer life cycle. Further, the distribution of outcomes in terms of revenue and profits from free to play games usually has a wider spread than games which takes an upfront cost. Free to play games are continuously upgraded after the launch to retain players and enhance the life cycle of the game. The publishing brand is called 505 Games Mobile.

Italian Distribution consists of the distribution of games purchased from international publishers in physical stores.

Other Activities is the operating segment that handles all the Group's remaining activities that are consolidated for reporting purposes. It includes the operations of the subsidiary Digital Bros Game Academy which organizes game training and professional courses.

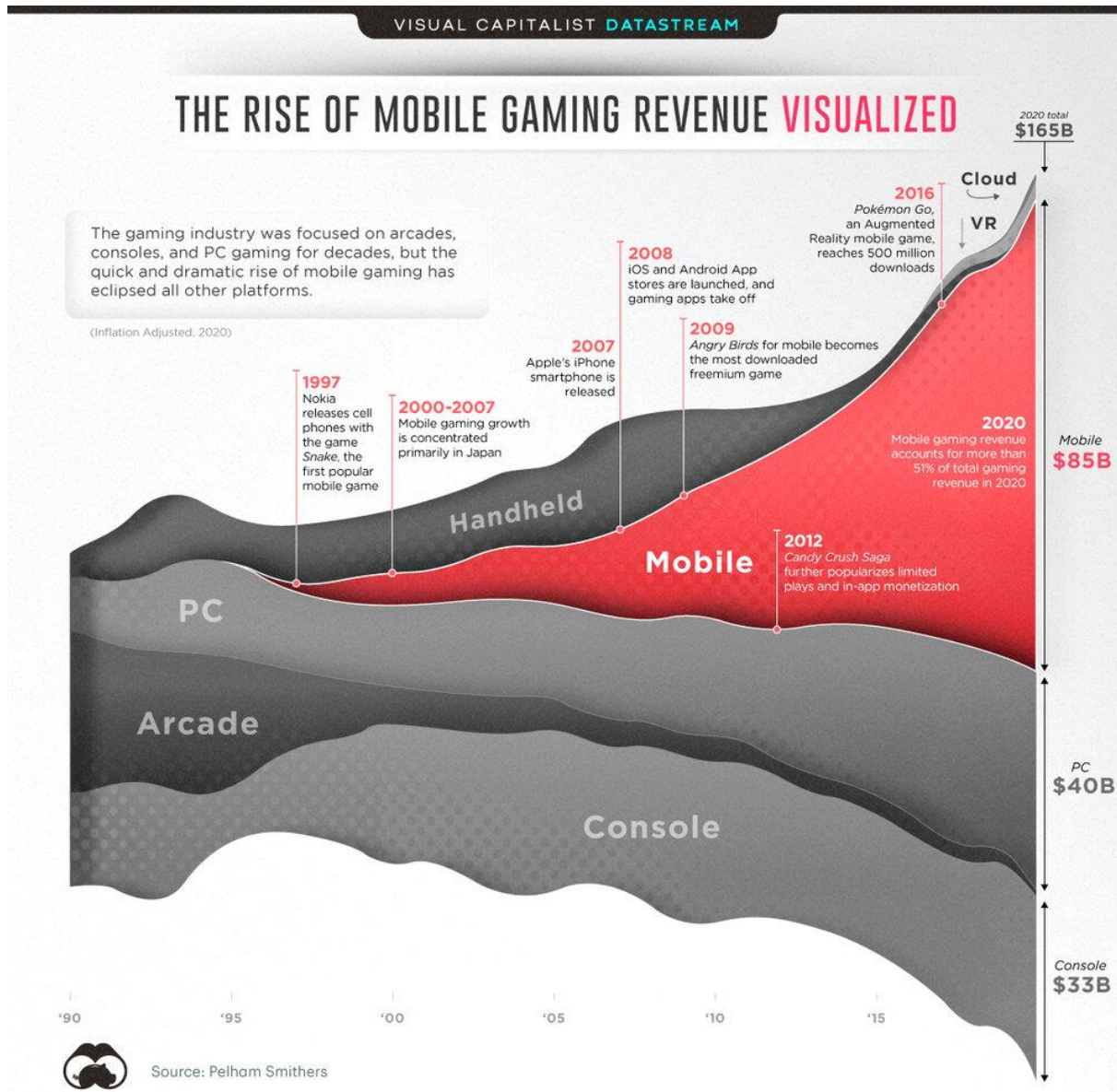
Holding: this includes all the coordinating functions. The holding operating segment handles finance, management control and business development activities.

OUR MILESTONES



The Market

The entertainment industry includes movies, books, magazines, games and toys et cetera. One could argue that these entertainment types share the same characteristics, brands, features, and intellectual properties. Thus, the main difference is how they are being distributed. The market for digital, interactive entertainment is an important segment of the entertainment industry as whole and keeps being one of the fastest growing segments among the aforementioned ones. The scope for interactive entertainment combined with a digital development- and distribution process arguably makes the gaming industry a playing field for innovation and creativity - with larger opportunities of reaching global scale through digital distribution - which many of the other entertainment format counterparts cannot enjoy to the same extent. Hence, the gaming market is constantly evolving and growing, driven by the continuous technological upgrades. Moreover, gaming is no longer limited to traditional consoles such as PlayStation and Xbox, but has expanded to mobile phones, tablet devices and hybrid consoles like the Nintendo Switch. Widespread low-cost connectivity, fibre optic networks and technologically advanced mobile phones have made gaming increasingly diversified, sophisticated, and interactive and have also expanded the gaming population to adults and women. The gaming market follows the continuous technological evolution of consoles. When a console is first launched, the prices of the hardware and its games are high and relatively small quantities are sold. Over their lifespan, console and gaming prices gradually fall, while the quantities sold and the quality of the games increase.



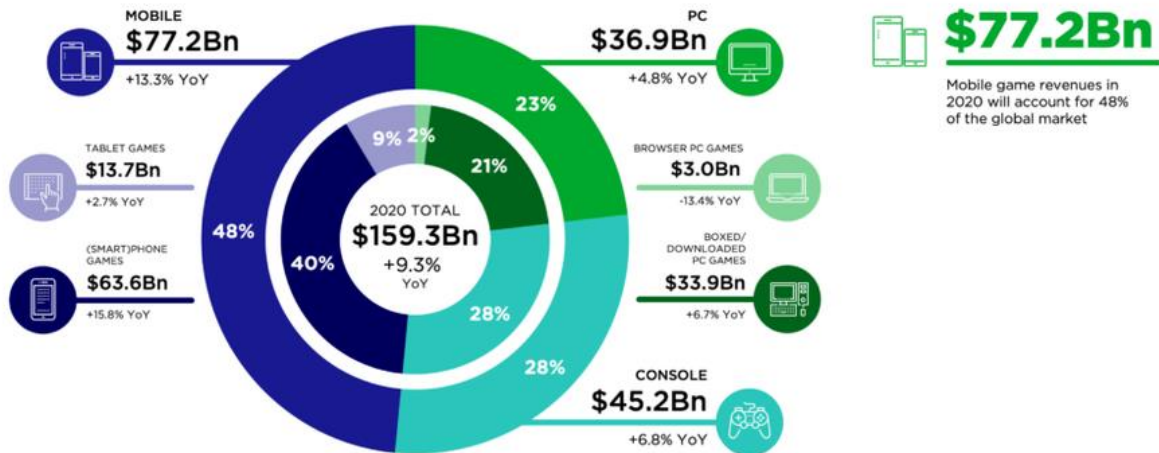
Further, according to several sources, the gaming market is now a bigger industry than movies and north American sports combined. The global gaming market has seen intense growth in the last decade and reached \$165B in 2020, according to Pelham Smithers (2020). This corresponds to a growth of the total market of approximately 10% during 2020. China retains its position as the world's largest gaming market in 2020 with 55% of the total global players (1.5 billion).

Newzoo is considered one of the most trusted sources for gaming and esports research and insights. According to the Newzoo 2020 global games market report, women represent 46% of the total number of gamers worldwide. Further, they claim that the average player is 34 years old, with 70% represented by players older than 18 years. Moreover, Newzoo estimates that total revenues from gaming reached \$145.7 billion in 2019, \$159,3 billion in 2020, and is projected to reach \$200 billion in 2023. Newzoo's estimation of the global market for games 2020.



2020 Global Games Market

Per Device & Segment With Year-on-Year Growth Rates

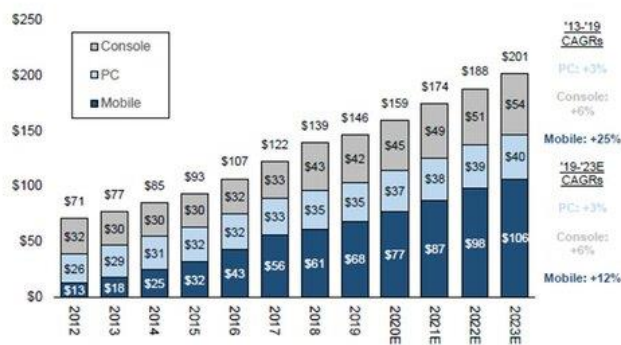


\$77.2Bn
Mobile game revenues in 2020 will account for 48% of the global market

Source: ©Newzoo | 2020 Global Games Market Report | April Update
newzoo.com/globalgamesreport

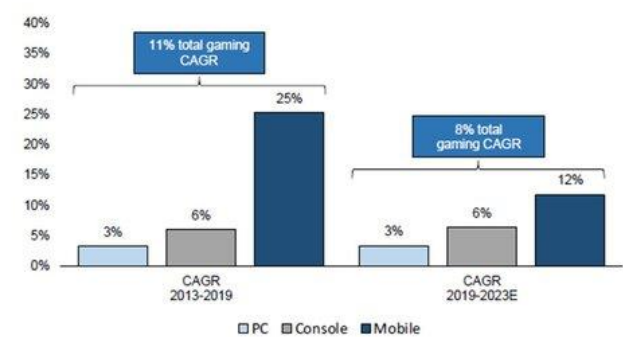
Observe that mobile gaming revenue of 2020 exceeds the entire gaming market of 2013, according to Newzoo and Goldman Sachs.

Exhibit 9: Mobile gaming revenue grew at a +25% 2013-2019 CAGR... (\$ bn)



Source: Newzoo, Goldman Sachs Global Investment Research

Exhibit 10: ...and is expected to grow at a +12% 2019-2023E CAGR



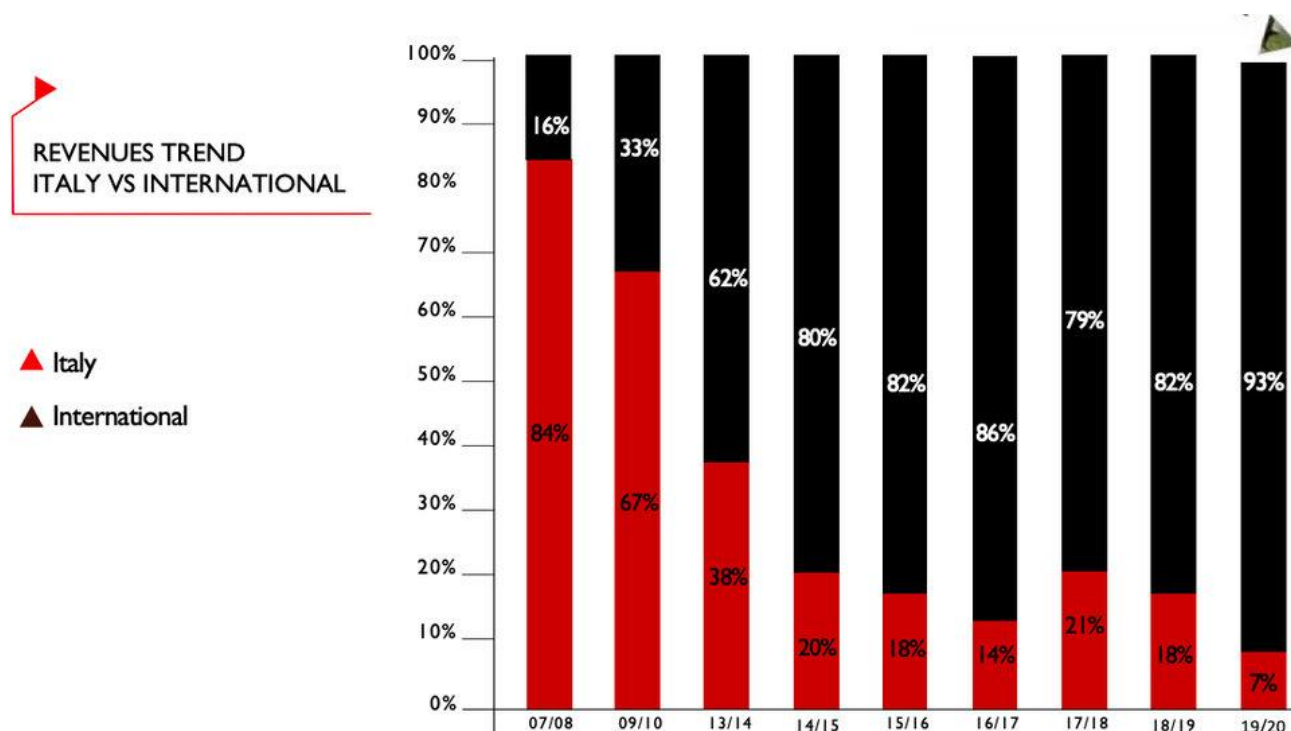
Source: Newzoo, Goldman Sachs Global Investment Research

Digital Distribution and Free to Play

The incrementally digitization of the gaming market has led both Microsoft and Sony to create digital platforms on which, rather than purchase a single game, consumers can access the entirety of the marketplace by paying a subscription fee. Revenues that are attributable to these marketplaces are recognized to publishers based on the usage of their games. Recently, Amazon and Google have set up similar competing structures, the Stadia and Luna platforms respectively. Furthermore, Apple has launched Apple Arcade, a platform dedicated to mobile games. The digitization and the rise of these enormous gaming marketplaces/platforms has also entailed significant increase of growth in the free to play genre. Free to play is only available in digital format and has served as a strategic move in terms of increasing both engagement and revenues within the gaming market. Consequently, digital distribution and free to play have both significantly extended the lifespan of individual games. The availability of a game is no longer strictly limited to its launch period as it was when the game was distributed solely through physical retail. Rather, the product remains available on the aforementioned marketplaces for a longer period, thus generating a continuous flow of sales. Further, this shift has also made it easier to extend the life cycle for games through the release of additional episodes or just added functionalities. The ongoing mentioned trends, namely digital distribution and free to play games, is something that Digital Bros is eager to catch, as digital distribution incrementally keeps getting larger as percentage relatively to the company as whole. Digital revenues in H2'20 was 85% of the consolidated total compared to 48% in H2'19. In addition, digital sales in the last period ended March 31st represented 87% of the total consolidated revenues in respect of the 59% achieved in the same period previous year. Although, of course boosted by the ongoing pandemic.

Revenue Breakdown

The Premium Games segment now represents 89% of the consolidated gross revenues and significantly increased the gross revenues of the period by €16 million and net revenues up by €21 million. Foremost, this stems from sales of Death Stranding, the Steam version of Control, Ghostrunner, but also great performance of Assetto Corsa. The free to play segment showed a 65.2% increase, from €5.1 million to €8.5 million by revenue. Gems of War, a free to play game launched by the company approximately five years ago, is continuously outperforming quarter after quarter. This game recently became part of the IP portfolio due to the acquisition of the Australian studio Infinity Plus Two in January 2021. The Italian Distribution operating sector revenues decreased significantly, impacted by the continuing decline of retail distribution during the pandemic. Moreover, 96% of total consolidated revenues for the last fiscal period came from international markets and 87% of sales came from digital sales. Thus, the company seems to have overcome the questions marks regarding its possibilities to succeed outside of Italy in a larger scale.



The table below portrays a breakdown by the operating segments within the group for the period ended March 31st, 2021 compared to the period ended March 31st, 2020:

Euro thousand	Gross revenue				Net revenue			
	2021	2020	Change		2021	2020	Change	
Premium Games	102,842	86,764	16,078	18.5%	101,589	81,275	20,314	25.0%
Free-to-Play	8,455	5,117	3,338	65.2%	8,455	5,117	3,338	65.2%
Italian Distribution	3,724	6,811	(3,087)	-45.3%	3,502	6,298	(2,796)	-44.4%
Other projects	406	451	(45)	-9.8%	406	451	(45)	-9.8%
Total gross revenues	115,427	99,143	16,284	16.4%	113,952	93,141	20,811	22.3%

Total net revenue growth was +22.3% compared to the same period last year and thus performed significantly better than gross revenue growth due to the increased portion of digital sales that do not require revenue adjustments in comparison to the traditional retail sales.

However, the key insight for the revenue structure and how it has developed during the last five years is paradoxical found in the weakest business segment by growth, Italian Distribution. In 2015, the company decided to implement a restructuring of the whole group. The restructuring was made to move from an organization based on its distribution channels, to an organization based on the type of games published. This translates to a narrower focus towards the premium games and free to play segments as well as digital sales. Nonetheless, Italian distribution accounted for 26% of net revenue in 2015 and makes up roughly 3% of net revenue today. This means that the Italian distribution, which predominantly consists of physical retail, has had a constantly negative impact on the overall topline for the last five years. In fact, Digital Bros grew net revenue by 38% in the last quarter of 2020 and 27.2% during the last quarter, if we subtract the Italian Distribution segment from the income statement for these periods.

Furthermore, digital revenues in H2'20 was 85% of the consolidated total compared to 48% in H2'19. In addition, digital sales in the last period ended March 31st represented 87% of the total consolidated revenues in respect of the 59% achieved in the same period previous year. Nonetheless, since Italian distribution made up only 9% av net revenue during 2019 - the same period where the company states that physical sales made up 52% of total sales - we can also state that a big portion of the premium games segment consists of physical retail sales. This implies that an even bigger portion than just the Italian distribution segment, which is reported separately, consists of a weaker margin profile and growth. Before the pandemic, the premium games segment performed a normalized EBITDA margin of 20%. Now, EBITDA margin for the premium games segment is close to 50%.

The aforementioned variables provide color to the fact that the normalized growth and margins are partly masked and inhibited by the physical retail segment(s). This should be viewed as a crucial part for this investment case as whole.

Short Introduction of Core IPs

Death Stranding has been a big contributor to the revenues for the last year. The game was released November 8, 2019 and has been contributing massively to the company's top- and bottom-line during 2020. Death Stranding is an action-based game developed by Kojima and published by Sony on PS4. The games have a Metacritic score of 86 on PC. One of the most important IPs other than Death Stranding is Control.

Control is a cinematic third person action game developed by Remedy Entertainment, a finish developer of triple A games such as Max Payne, Alan Wake and Quantum Break. The game had its worldwide launch on August 2019 and its launch on Steam in August 2020. In other words, the game has not been available on the market for long, but still contributed to 38% of net revenues during 2019 and 20% of net revenues for 2020. Digital Bros has worldwide publishing rights on PC, PS4 and Xbox One, and a publishing partnership with Epic Games for the IP. The last version of Control has a Metacritic score of 83.

Ghostrunner is a cyberpunk action game developed by the Polish studio One More Level, whereas Digital Bros acts as a publisher through 505 Games along with All in! Games. Ghostrunner will be released on PS5 and Xbox in 2021. The games have a Metacritic score of 81 on PC.

Assetto Corsa is a racing game, designed with emphasis on realistic racing. The game supports a range of peripherals like keyboard, mouse, gamepads, VR head-mounted displays as well as Nvidia 3D vision system. The games have a Metacritic score of 85 on PC, and often makes the list of the best racing games in the world.

Outlook

The free to play operating segment will market worldwide numerous new products starting from the third quarter with the launches of Pocket Pioneers and Puzzle Quest 3, while the new version of the game Hawken will be available starting from the fourth quarter of 2021.

Following the global market's positive forecasts, the Group continues to reinvest much of the free cash flow generated in the acquisition and development of new IPs and intends to keep high investment levels also in the future.

During the second half of 2021. The company will launch the game Control on PlayStation 5 and Xbox. Great potential.

Digital Bros communicated in the Q4'20 report that they are currently investing in 21 new IPs for €83 million, without considering the costs for internal studios currently developing new games. Continuously, the company stated that 2024 will be starter point for a completely new pipeline of IPs where numerous new productions will be released, including the second version of Assetto Corsa, created by the internal studio Kunos Simulazioni, as well as several other IPs that will be communicated closer to their respective launch dates.

Lastly, the management stated in the last report that they expect an increase in revenues for 2021 and a further increase in operating profit at the end of the year, significantly above the previous. As of now, analyst consensus forecasts a negative growth for Digital Bros for 2021. This will most likely change shortly given this guidance.

M&A

In recent years, the company has been modernized and now no longer solely act as a publisher for games developed by other companies. In 2015, Digital Bros started an IP acquisition strategy to implement its product portfolio through both studio acquisition and long-term agreements primarily with indie studios. This took off when Digital Bros acquired DR Studios, a development studio based in Milton Keynes, UK, in 2015. DR Studios is now responsible for the free to play operating segment. In the same year, Digital Bros acquired 49% of Ovosonico (now called



Avangarden), an Italian Development Studio, which was fully acquired in 2020. Two years later, in 2017, the Group acquired Kunos Simulazioni, an indie developer headquartered in Rome.

Further, some may recognize 505 Games from Starbreeze, as 505 Games have been a publisher of Payday 2. The business segment for international distribution within Digital Bros is 505 Games. Digital Bros has bought shares in Starbreeze multiple times during the last five years. On December 31st, 2020, because of these minor purchases, Digital Bros holds 61,758,625 Starbreeze A shares and 24,890,329 Starbreeze B shares representing 11.96% of capital and 28.57% of voting rights in the company. This consequently makes Digital Bros the most influential owner. Despite the continuing contractual relations and the equity interest held in Starbreeze, Digital Bros does not seem to view Starbreeze as an operational part of the Group for now - since Digital Bros classify the equity interest under other investments instead of portraying them among the other companies under the company structure umbrella. I believe it is reasonable to believe that these circumstances might change, and that Digital Bros eventually will end up buying the whole company.

Kunos Simulazioni is surely one of the more interesting acquisitions - the studio behind the car game Assetto Corsa, which were acquired for €4.3 million in 2017. With this acquisition, Digital Bros intended to grow more as a publisher and developer of games that can achieve world success. Moreover, this acquisition highlights the M&A strategy that was implemented in 2015. The intent of this M&A strategy was, and still is, to implement the product portfolio through both studio acquisitions and long-term agreements with developer studios, predominantly through globally applicable brands and IPs. For clarification, the acquisition of Kunos Simulazioni enabled full control over IP rights and the thus entails the opportunity for the Group to invest in the future development of new versions of Assetto Corsa.

Furthermore, Digital Bros acquired 100% of Infinity Plus Two and Infinite Interactive, two interesting acquisitions which were made in January 2021. Infinity Plus Two controls IP rights such as Warlords, Puzzle Quest and Gems of War. The payment scheme foreseen was €3.5 million as a fixed component and a variable fee on future sales between 0/9% on current and prospective sales. The variable part starts from May 2022, with four variable installments until 2025.

Within the context of M&A and gaming, it is impossible to not mention the Swedish giant Embracer Group, which has been extremely successful within this area. The founder and CEO of Embracer, Lars Wingefors, stated that the market for M&A within gaming is more active than ever before in his last letter to shareholders. It seems like Digital Bros is striving to resemble the strategy of Embracer by building up a broad and diversified IP portfolio which in turn limits the business risk and lowers the dependency from individual game releases. Further, just like Embracer, Digital Bros seems to play to long-term game here by reinvesting cash flows into new acquisitions or in-house studio development. Another aspect that seems to bring similarities to Embracer to mind is the enormous amount of skin in the game.

Management – Founder Led

As aforementioned, Digital Bros has a founder led managed which controls 70% of the ownership even though the company has been publicly traded for over twenty years. The Company was founded by Abramo "Rami" and Raffaele "Raffi" Galante in 1989, driven by their passion for technology and

innovation and their interest in the entertainment industry. The Company started its activity under the brand Halifax, predominantly through video game distribution, taking major international publisher's successes to the Italian market. Some of these games, including Pro Evolution Soccer, Tomb Raider and Resident Evil, contributed to the creation and development of the gaming market in Italy. Digital Bros could certainly be viewed as a pioneer and a first mover regarding digital entertainment in Italy.

Abramo Galante is now President and CEO of Digital Bros. Thanks to the strong entrepreneurial ability and the far-sighted vision on the transformation of the market, Abramo Galante, together with his brother Raffaele, managed to guide Digital Bros through the different evolutionary phases of the gaming industry, bringing it from a company focused on distribution in Italy to a reality characterized by global presence and digital sales. In 1989, the strong passion for the world of innovation pushed the Abramo brothers to found Halifax in Milan, the first name of the Group Digital Bros. To support the strong innovative soul of the Group and strengthen its international presence, the parent company Digital Bros was listed on the stock exchange Borsa Italiana in the year of 2000. Over the years, the company has gradually been able to adapt its internal know-how to the evolution of the entertainment market - focusing on the creation of game content for all platforms.

Ownership Structure

Abramo Galante	34%
Raffaele Galante	33%
Davide Galante	2%
Free float	14%

Valuation

The stock currently trades at compelling key figures such as a LTM P/E ratio of 12, EV/S 2.3 and EV/EBITDA 5.9. These multiples are most likely a function of the current market skepticism regarding future growth. However, the company recently communicated that the growth would keep being positive during 2021, albeit at a lower rate than in the previous fiscal year. As aforementioned, this is not compatible with the current consensus. Further, the company contributed with interesting guidance in the last report, conveying that they now invest in 21 new IPs for €83 million, without considering the costs for internal studios currently developing new games.

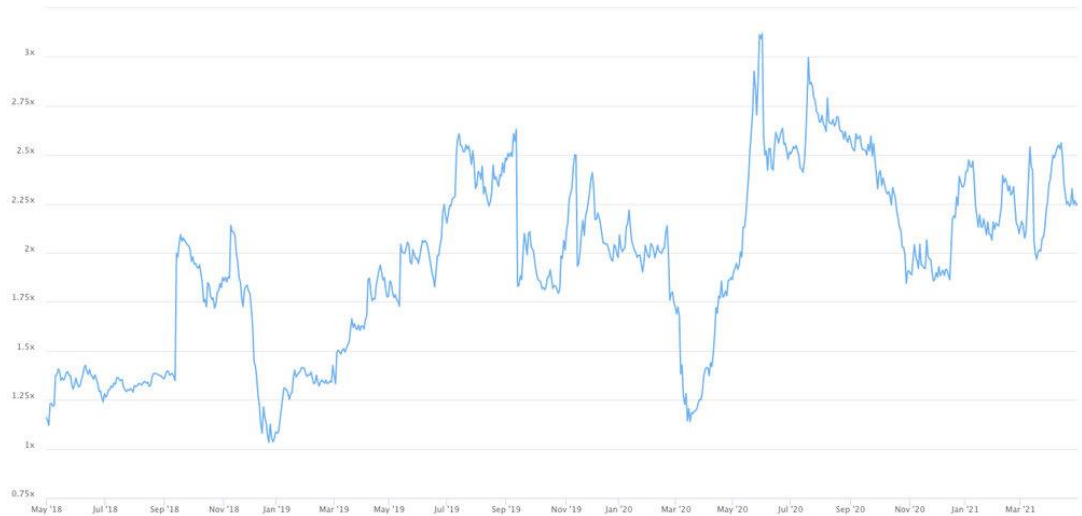
Multiples	20-03-31	20-06-30	20-09-30	20-12-31	21-05-12
Forward Multiples					
NTM Total Enterprise Value / Revenues	1,18	2,31	2,37	2,15	2,25
NTM Total Enterprise Value / EBITDA	7,39	15,50	14,26	14,20	8,73
NTM Total Enterprise Value / EBIT	11,85	23,14	21,82	15,97	16,44
NTM Market Cap / Free Cash Flow	13,33	177,33	17,10	13,92	20,48
Trailing Multiples					
LTM Total Enterprise Value / Revenues	1,20	2,46	2,37	2,11	2,28
LTM Total Enterprise Value / EBITDA	5,73	9,46	6,90	5,43	5,87
LTM Total Enterprise Value / EBIT	8,32	15,32	11,33	8,73	9,43
Price Factors					
Price	10,56	21,45	21,40	21,60	23,84
Enterprise Value	156,44	327,99	320,81	319,40	345,34
Market Cap	150,59	305,89	305,18	308,03	339,98

Ratios	16-06-30	17-06-30	18-06-30	19-06-30	20-06-30	LTM
Ratios + Margins:						
Return On Equity %	30,5 %	18,8 %	(4,6 %)	(2,3 %)	20,7 %	35,8 %
Margin Analysis:						
Gross Profit Margin %	51,8 %	39,5 %	45,0 %	43,9 %	50,3 %	58,7 %
SG&A Margin %	32,4 %	24,2 %	41,4 %	36,8 %	26,0 %	21,2 %
EBITDA Margin %	23,4 %	14,6 %	6,1 %	7,8 %	25,1 %	38,8 %
EBIT Margin %	19,9 %	8,4 %	(4,9 %)	0,9 %	16,1 %	24,1 %
Net Income Margin %	11,7 %	9,0 %	13,0 %	(2,0 %)	11,2 %	19,1 %
Long-Term Solvency:						
Total Debt / Equity	61,2 %	7,5 %	10,1 %	39,3 %	29,0 %	18,3 %
Total Debt / Capital	38,0 %	6,9 %	9,2 %	28,2 %	22,5 %	15,5 %

As stated above, the margins saw a positive rapid change under 2020. This stems predominantly from two factors: 1) Operating costs decreased due to lower advertising expenditure. Although, the decrease in operating costs were partially offset by higher labor costs. 2) Digital revenues in 2020 has been > 80% of the consolidated total compared to ~50% in 2019. In other words, the impact of the pandemic has been net positive. The significant growth of the digital revenue portion of sales consequently pushed EBIT to a 2.5x jump, for instance. This were possible since digital sales show much better profitability.

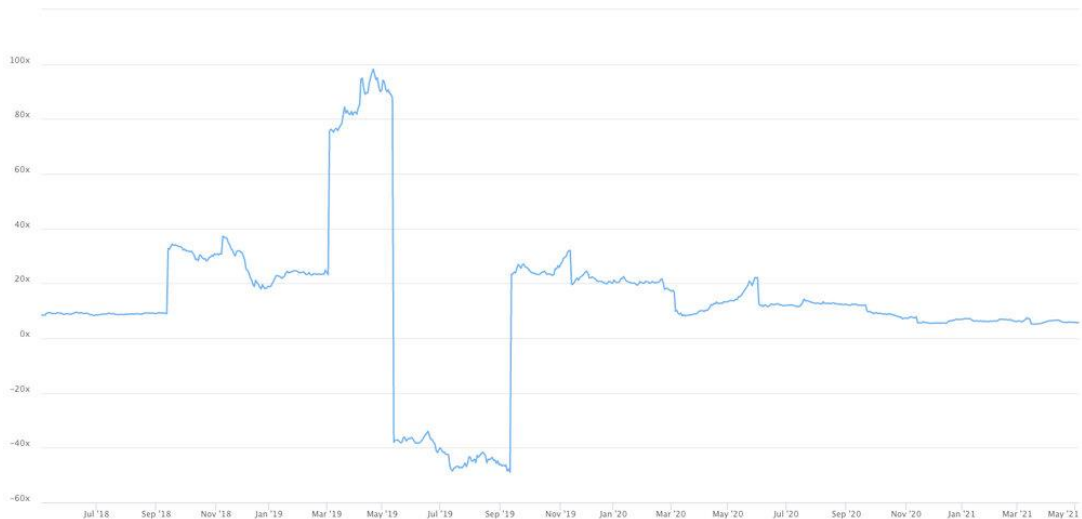
Last three years LTM EV/S valuation

Low: 1x
 Mean: 1.9x
 High: 3.1x
 Current: 2.3x



Last three years LTM EV/EBITDA

Low: -49x
 Mean: 13x
 High: 98x
 Current: 5.9x



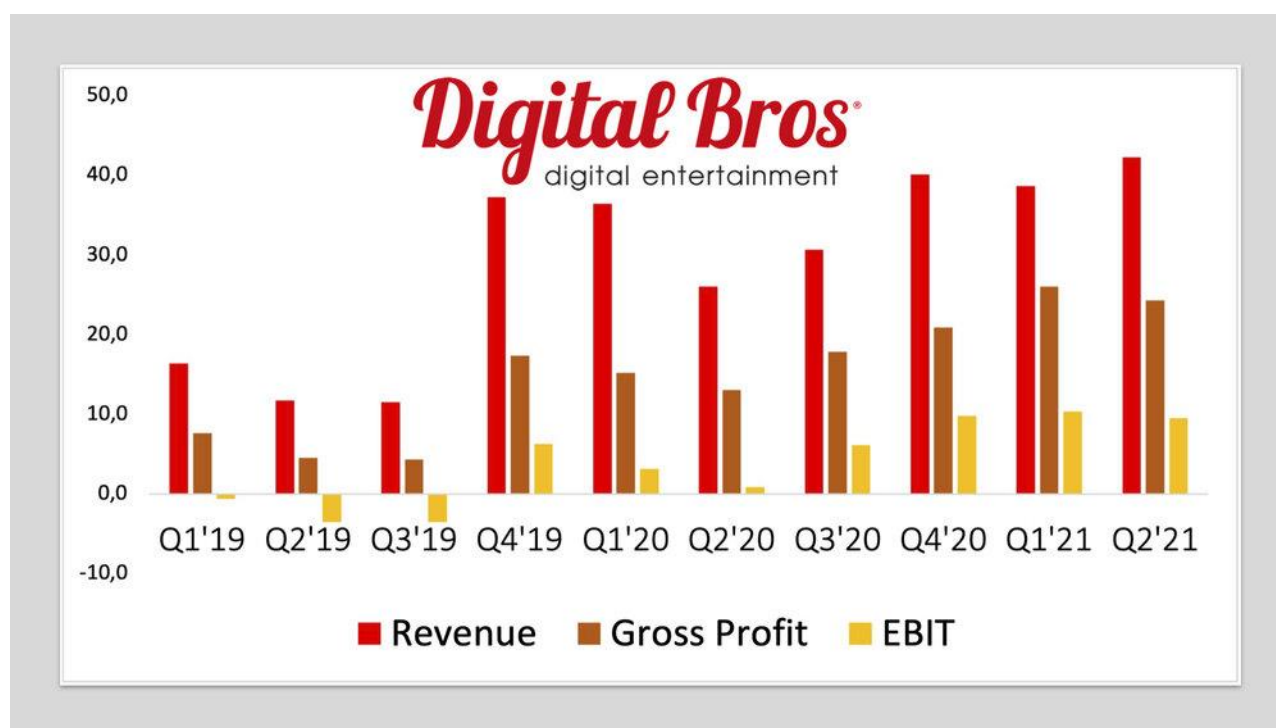
Net Cash

The company currently holds €20.9 million in net cash, which accounts for 11.5% of the balance sheet total. This is more cash than has ever been used in an acquisition for the company. With the proved ability of high-quality M&A, this portion of cash should be viewed as an option for increased M&A activity and thus, a great opportunity for the company to increase its operating metrics going forward through M&A. I do not think that current analyst forecasts are taking this into enough consideration. Nonetheless and as previously mentioned, the company also holds €11.8 million in Starbreeze shares.

Peer table (LTM numbers)

Company	EV/S	EV/EBITDA	One Year Revenue Growth	One Year Growth Amount of Shares
Embracer	9.3x	26.5x	45.4%	35.2%
Electronic Arts	6.2x	24.4x	5.2%	-1%
Ubisoft	4.9x	13.8x	-13.6%	9.9%
Stillfront	6x	16.8x	101.4%	34.7%
Paradox	10.6x	18.5x	39.1%	0%
Enad Global 7	10.8x	145x	290.4%	145.5%
Zordix	15.4x	96.5x	121.3%	19.6%
Digital Bros	2.3x	5.9x	36.3%	0%
Mean	8.2x	17.7x	35.6%	

The calculated mean of EV/EBITDA and One Year Revenue Growth does not take the outliers Enad Global 7 and Zordix into consideration. Also note that growth can be volatile for many of the companies in the table.



Summary and conclusions

First, Digital Bros currently trades significantly lower than its peer group mean and in line or lower with its own historical multiples judging from the last three years - albeit the ongoing pandemic - which has had a significant positive impact on the company's operations and its financials.

Second, the company's strong net cash position, compelling pipeline, and the upcoming lower business-related and geographical risks makes the stock look even more compelling.

Third, Digital Bros communicated in the last report that they are currently investing in 21 new IPs for €83 million, without considering the costs for internal studios currently developing new games. Continuously, the company stated that 2024 will be a starter point for a completely new pipeline of IPs where numerous new productions will be released, including the second version of Assetto Corsa. This provides even more color to the fact that the management are playing a long-term game which strengthens my positive take on the company.

Fourth, the normalized growth and margins are partly masked and inhibited by the physical retail segment(s). This should, as aforementioned, be viewed as a crucial part for this investment case.

Fifth, referring mainly to the high ongoing M&A-activity for gaming companies and the multiples companies are getting acquired for, Digital Bros could certainly be viewed as an acquisition candidate.

Lastly, primarily referring to the peer valuation. If the growth remains double digit positive for the upcoming years, and if Digital Bros keeps executing well in the M&A territory - this stock is most likely a great catch and has potential for a big upswing.

Investment Case

- A large part of the IP portfolio is still generating zero or low income. This will most likely change during the coming years.
- The business-related risks will steadily become lesser in parallel to the broadening of income generating IPs.
- Operationally active founders with large amounts of insider ownership.
- Strong net cash position and larger-than-ever IP portfolio.
- Misleading normalized growth and margins.
- Attractive peer valuation.
- Acquisition candidate.

Investment Risks

- As of now, the majority of income is concentrated to a few IPs.
- Hard and rising competition within the M&A territory.
- Management dependency - as much as I love a long-term oriented management with large amounts of insider ownership - the business is heavily reliant on a few key individuals.

Disclaimer

The writer does not hold shares in the company and are not allowed to enter a position during the following month. Nothing you read on Kalqyl.se should be viewed as investment advice. Further, some of the research presented in the article can be wrong or not up to date. Most of the information presented in the article is from the company's own investor relations, and partly from stock analysis websites such as Börldata, Koyfin and TIKR. The research provided in this article was provision-based.