



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

EA - NASDAQ	(as of 1/30/18)	\$118.70
Current intra-day price (1/31/18)		\$127.81
Two Year Price Target		N/A
52-Week Range		\$80.40 - \$122.79
Shares Outstanding (mil)		308
Market Cap. (\$mil)		\$36,560
3-Mo. Average Daily Volume		3,940,000
Institutional Ownership		97%
Total Debt/Total Capital (12/17)		20%
ROE (TTM ended 12/17)		30%
Book Value/Share (12/17)		\$13.27
Price/Book Value		8.9x
Annual Dividend & Yield	Nil	Nil
EBITDA Margin (TTM ended 12/17, estim.)		34%

EPS FY 3/31 (non-GAAP figures)

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	\$0.07		\$0.31	A	
2Q	\$0.53		\$0.62	A	
3Q	\$2.48		\$2.18	A	
4Q	\$0.85	\$1.12	\$1.15		
Year	\$3.91	\$4.22	\$4.26	\$4.85	\$5.00
P/E	32.7x		30.0x		25.6x

Note: Quarterly EPS figures may not add to annual figure due to rounding
Note: P/E multiples are based on current intra-day price as shown above

Revenue (\$mm) (non-GAAP figures)

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	\$682		\$775	A	
2Q	\$1,098		\$1,179	A	
3Q	\$2,070		\$1,971	A	
4Q	\$1,092	\$1,201	\$1,230		
Year	\$4,942	\$5,165	\$5,155	\$5,600	\$5,610

Company Description: Electronic Arts Inc., headquartered in Redwood City, California, is a leading interactive entertainment software company. Founded in 1982, EA develops, publishes, and distributes interactive software worldwide for videogame systems, mobile devices, personal computers, and the Internet. Popular franchises include Madden NFL, FIFA Soccer, Dragon Age, Need for Speed, Battlefield, Mass Effect, Star Wars Battlefront, Titanfall, The Sims, Bejeweled, Plants vs. Zombies, and others.

Electronic Arts Inc.

EA — NASDAQ — Neutral-2

Fiscal 3Q Results Don't Tell the Story of Bright Future, Long-term Growth Prospects

Investment Highlights

- **Fiscal 3Q results produced little surprise.** Non-GAAP net bookings (term used for traditional revenue plus the change in deferred revenue for online-enabled games) for the quarter were \$1.971 billion, down 5% from a year ago. The period's major new release, *Star Wars Battlefront II*, sold below the predecessor's level but we believe has a bright future nonetheless. Live services, particularly digitally derived business with franchises such as *FIFA*, *Madden*, *The Sims*, and *Battlefront*, continue to be a strong growth area for EA. Digitally derived revenues now represent 67% of EA's trailing twelve-month total revenue.
- **Earnings met expectations.** Profit margins on a non-GAAP basis were down in the quarter despite growth in digital sales. This was partly due to lower console game sales, including slight *Battlefront* disappointment. Non-GAAP EPS of \$2.18 were down from \$2.48 a year ago, but in line with our and street consensus figures.
- **We have raised our estimates.** The near-term outlook appears favorable, in our view, with meaningful growth potential in digital sales and the e-sports business, as well as global market expansion. Changes to our 4Q and FY18 outlook include slight EPS increases. We are also raising our FY19 EPS estimate, which represents a 17% projected increase from our FY18 figure.
- **We maintain our Neutral rating.** We like company and industry fundamentals, which may be improving. Free cash flow could continue to fund share repurchases and perhaps cash dividends at some point. However, these positive attributes may be largely reflected in the current share price. The multiple on our estimate of forward twelve-month earnings is 26.5x, above recent and historical median levels. We would consider a rating upgrade at a lower valuation, assuming no change in fundamentals. Our Suitability rating is 2.

Note Important Disclosures on Pages 5-6.
Note Analyst Certification on Page 5.

Exhibit 1**Non-GAAP Consolidated Statements of Income** (figures in millions except per share d:

	Fiscal 3Q Ended		% chg.
	<u>12/31/17</u>	<u>12/31/16</u>	
Net Revenue	\$1,971	\$2,070	(4.8%)
Cost of Good Sold	500	498	0.4%
Gross Profit	1,471	1,572	(6.4%)
Total Operating Expenses	616	587	4.9%
Operating Income	855	985	(13.2%)
Interest and Other Income, net	5	(2)	
Income Before Taxes	860	983	(12.5%)
Taxes	181	206	(12.5%)
Net Income	<u>\$679</u>	<u>\$777</u>	(12.5%)
Diluted Earnings Per Share	<u>\$2.18</u>	<u>\$2.48</u>	(12.0%)
Avg. Diluted Shares Outst.	311	313	(0.6%)
% of Net Revenue:			<u>bp chg.</u>
Gross Profit	74.63%	75.94%	(131)
Marketing & Sales	9.39%	8.94%	45
General & Administrative	4.36%	4.15%	21
Research & Development	12.18%	11.59%	58
Operating Income	43.38%	47.58%	(421)
Net Income	34.47%	37.52%	(305)
Tax Rate	21.00%	21.00%	0

Source: Electronic Arts Inc.

Note: March fiscal year

Further comments on fiscal 3Q. Fiscal 3Q revenues declined nearly 5%. This was slightly below our and street consensus estimates, but not to a concerning degree, in our view. The quarter's major new release, *Star Wars Battlefront II*, had some negative press regarding microtransactions but corrective measures were taken and the game seems to have a bright future nonetheless, in our opinion. As in recent quarters, we were impressed by the strength of live services/digital business. This includes full game or add-on content downloads, in-game purchases (known as microtransactions), subscriptions, etc. This has been a notable industry trend for the past few years, and EA has been a leader in this movement. Digital sales represent about two-thirds of total company sales on a trailing twelve-month basis. We expect this percentage to rise in the future, consistent with industry trends. Given the attractive margin nature of this business, we believe EA can steadily improve operating margins in the coming years.

We are particularly impressed with EA's sports games and how naturally they lend themselves to online, multi-player, mobile, and competitive gaming. The *FIFA* franchise has particular global strength and contribution potential, in our view. *FIFA Mobile* added 26 million players to its previous level of 113 million. *FIFA Ultimate Team* is an increasingly popular game mode that has led to meaningful growth of the franchise over the past few years. We believe *Madden* and *The Sims* franchises also have major online/digital growth potential on a global basis.

Financial condition. We consider the balance sheet strong. Total cash and short-term investments at 12/31/17 was \$4.884 billion, while debt of \$992 million represented 20% of total capital. Inventory and accounts receivable were at satisfactory levels, in our view. Stockholders' equity at quarter end was \$4.086 billion. During the quarter, the company repurchased 1.4 million shares for \$150 million, leaving \$778 million on the current authorization.

Outlook. We remain bullish on the industry in general and EA in particular. Gaming consoles are technologically pleasing to consumers and adequately capable of providing high-level, online gaming experiences, including multi-player modes and competitive activity. As for EA, we believe it has one of the strongest portfolios of game franchises in the industry, with significant growth potential in areas such as digital, mobile, and competitive gaming.

For 4Q FY18, we expect an overall healthy industry environment and some exciting new releases from EA. We are particularly interested in the company's upcoming game based on the *UFC* fighting league, which has a loyal following; we are also mindful of EA's proven expertise in the sports genre. Two upcoming titles created by independent developers include *A Way Out* and *Fe*. Also, the *Sims Mobile* will launch worldwide on iOS and Android formats. Management guidance for the final quarter of FY18 was a bit higher than we anticipated, which could reflect the company's general bullish views on its current operations and business trends. We have raised our estimates for 4Q non-GAAP revenue and EPS. For all of FY18, company guidance includes non-GAAP net bookings of \$5.150 billion and EPS of \$4.25. Our current estimates are modestly above those figures.

We have also raised our FY19 outlook to reflect a continuation of current favorable business trends and a strong product pipeline. The year will see a game based on new intellectual property, *Anthem*, which has been getting favorable word-of-mouth while in development stages. A new *Battlefront* (non-*Star Wars*) game will also be released, along with new iterations of the company's annual sports franchises. We expect operational refinement and new content for *Star Wars Battlefront II*, which we believe can improve and grow into a highly significant profit center for EA. We expect the shift to digital sales to continue, which could allow for further margin improvement. Compared to our FY18 estimates, our FY19 outlook includes a projected 9% increase in net bookings (often referred to as non-GAAP revenue) to \$5.610 billion and an approximate 17% gain in non-GAAP EPS to \$5.00, representing increases from our previous figures.

The recent industry trend of e-sports continues to hold significant long-term potential, in our view. This essentially entails competitive gaming with key roles coming from participants, event organizers, team leaders/owners, viewers, and advertisers. This is a nascent initiative that is beginning to grow rapidly, and the videogame industry's size and demographics could help this turn into a meaningfully positive business model, in our view. Further, we believe EA has numerous videogame franchises well-suited for competitive dynamics and global viewership—primarily its *FIFA* and *Madden* sports franchises but also various action/shooter games. At this time, it is difficult to quantify the near-term impact of e-sports, including revenue and expense levels, but we are bullish on the long-term potential. We will be closely monitoring this development.

Valuation. Based on the current intra-day price, EA shares are trading at roughly 30.0x and 25.6x our FY18 and FY19 non-GAAP EPS estimates, respectively. The multiple on our projection of forward twelve-month EPS is 26.5x. EA's median forward P/E multiple over the past ten years is 22.5x and over the past five years is 21.7x. On a relative valuation note, EA shares are currently trading at 1.4x the forward multiple on the S&P 500. This compares to a median multiple of 1.3x over the past ten years and 1.2x over the past five years.

Opinion. With meaningful price appreciation over the past twelve months (EA share price up over 50%) valuations have risen and the share price is out of our preferred buying range. Current valuations are above recent and historical median levels, perhaps reflective of strong recent results and a favorable outlook that includes new growth opportunities based on new games, expanding geographies, and new business models, in our view. Still, we find current valuations a bit rich and therefore prefer the sidelines at this time.

Suitability. Our Suitability rating on EA is 2 on a 1-to-4 scale (1=most conservative, 4=most aggressive). This is based on factors such as earnings history, market capitalization, financial condition, product portfolio, and market leadership positions.

Risks. We believe factors that could affect the outlook for the company and the stock price include: financial management during various stages of the industry's hardware cycle; success and availability of new consoles in the marketplace; investment spending to sustain market leadership positions; product development costs related to coming platforms; creative and financial abilities to bring popular games to market; healthy relationships with the major console manufacturers; and maintenance of key entertainment property licenses.

Exhibit 2

Non-GAAP Consolidated Statements of Income (figures in millions except per share data and percentages)

	<u>FY19E</u>	<u>FY18E</u>	<u>FY17</u>	<u>FY16</u>	<u>FY15</u>
Net Revenue	\$5,610	\$5,155	\$4,942	\$4,566	\$4,219
Cost of Good Sold	1,350	1,295	1,252	1,305	1,153
Gross Profit	4,260	3,860	3,690	3,261	3,066
Marketing & Sales	680	625	642	598	626
General & Administrative	415	400	386	357	352
Research & Development	1,220	1,160	1,096	1,006	1,012
Total Operating Expenses	2,315	2,185	2,124	1,961	1,990
Operating Income	1,945	1,675	1,566	1,300	1,076
Interest and Other Inc. (Exp.), net	3	7	(12)	6	(1)
Income Before Taxes	1,948	1,682	1,554	1,306	1,075
Taxes	409	353	326	288	269
Net Income	<u>\$1,539</u>	<u>\$1,329</u>	<u>\$1,228</u>	<u>\$1,018</u>	<u>\$806</u>
Diluted Earnings Per Share	<u>\$5.00</u>	<u>\$4.26</u>	<u>\$3.91</u>	<u>\$3.14</u>	<u>\$2.51</u>
Avg. Diluted Shares Outst.	308	312	314	324	321
% change:					
Net Revenue	8.83%	4.31%	8.23%	8.22%	4.92%
Gross Profit	10.36%	4.61%	13.16%	6.36%	12.06%
Marketing & Sales	8.80%	(2.65%)	7.36%	(4.47%)	(4.28%)
General & Administrative	3.75%	3.63%	8.12%	1.42%	6.67%
Research & Development	5.17%	5.84%	8.95%	(0.59%)	(2.22%)
Operating Income	16.12%	6.96%	20.46%	20.82%	50.07%
Net Income	15.81%	8.24%	20.60%	26.26%	50.98%
% of Net Revenue:					
Gross Profit	75.94%	74.88%	74.67%	71.42%	72.67%
Marketing & Sales	12.12%	12.12%	12.99%	13.10%	14.84%
General & Administrative	7.40%	7.76%	7.81%	7.82%	8.34%
Research & Development	21.75%	22.50%	22.18%	22.03%	23.99%
Operating Income	34.67%	32.49%	31.69%	28.47%	25.50%
Net Income	27.43%	25.78%	24.84%	22.30%	19.11%
Tax Rate	21.00%	21.00%	21.00%	22.05%	25.00%

Source: Electronic Arts Inc. and Hilliard Lyons estimates

Note: March fiscal year

Additional information is available upon request.

Prices of other stocks mentioned:

The Walt Disney Co. (owner of Star Wars franchise) - DIS - \$110.11 - Long-term Buy

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months.

Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history

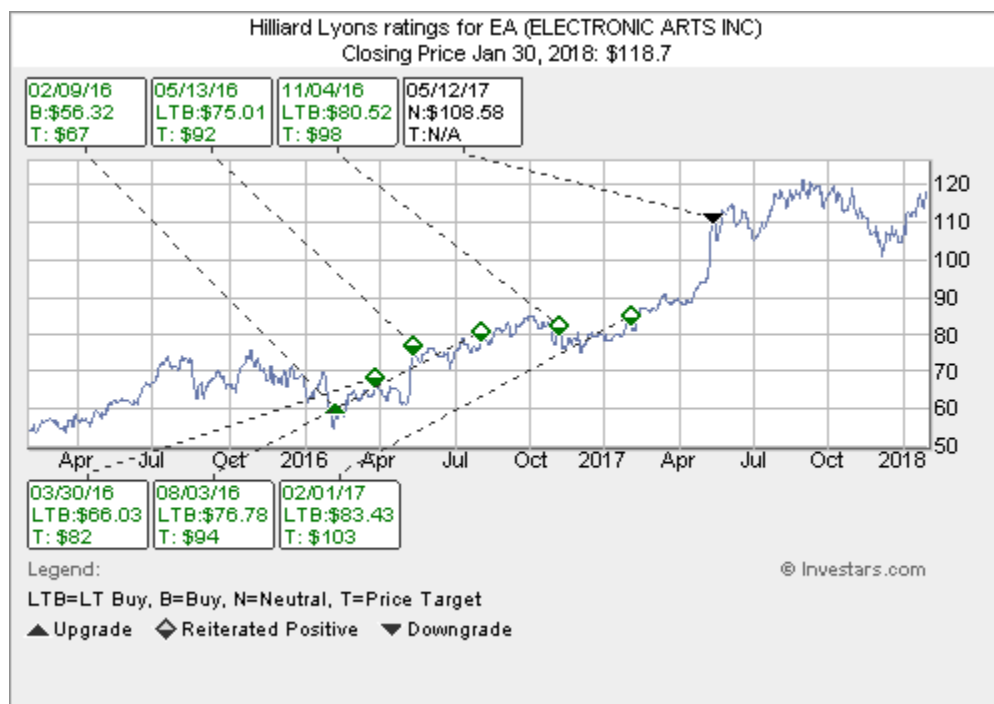
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons		Investment Banking	
	Recommended Issues		Provided in Past 12 Mo.	
	# of	% of		
Rating	Stocks Covered	Stocks Covered	Banking	No Banking
Buy	31	28%	10%	90%
Hold/Neutral	75	67%	9%	91%
Sell	6	5%	0%	100%

As of 8 January 2018



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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