Lindsell Train

Nintendo

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"Nintendo dealt a blow to rivals last week by unveiling its groundbreaking new console. Gamers will be spellbound by the possibilities." Sunday Times, 12th June 2011.

This represents just one example of the typical enthusiastic press reaction following the announcement of the launch of Nintendo's new home console, the Wii U, last week. Yet Nintendo's share price fell another 10%, to Y16,000, now down a staggering 75% from its high in 2007. We are, frankly, flabbergasted. And we are keen to explain to you, our clients, why Nintendo remains a cornerstone investment in many Lindsell Train portfolios and, indeed, why we are buying more.

First, some history. We began buying Nintendo in 2001, for three reasons. First, our appreciation of the extraordinary economics of the company. Nintendo is exceptional in many ways – for instance its revenues per employee amount to $2.7m, operating margins averaged 23% over the last 20 years and capital investment averaged just 8% of free cash flow over the last 20 years. Next, the company offers, we thought, a relatively low risk means to participate in an important emerging global industry. With annual revenues of over $65bn gaming is now bigger business than the film industry. Finally, for reasons we will explore in more detail below, we analysed the company to be systematically undervalued. We thought then and think now that other investors fundamentally misjudge the long term sustainability of Nintendo's extravagant cash flow.

Recent share declines are all the more galling for us, because our original analysis seems to have been vindicated. Since the early 2000's, the company has been wildly successful. Annual sales have doubled, annual operating profits have more than doubled and book value has grown by 45%. Proof of its cash generative capacity is demonstrated by balance sheet cash of Y6,000 per share in 2004 growing to Y9,000 per share today (yes, of Nintendo's current share price of Y16,000, 60% is accounted for just by the net cash it holds on the balance sheet). In 2004 Nintendo's home console, GameCube, was ranked third behind Sony's Playstation 2 and Microsoft's X-Box with just 20% market share. Today Nintendo has the leading position in both the handheld and home console markets.

But to investors today all this apparently counts for little. The bears argue that Nintendo's established hardware products are fast losing their appeal. Although replacements have been launched or announced, pessimists predict that Nintendo will surrender their installed base of customers to other platforms, including smartphones, tablets and social networking sites that offer simple games to casual gamers for rock bottom prices. In other words, the transformation of the business Nintendo engineered, which expanded its customer base and the industry so successfully over the last decade, is expected to fully reverse with the company retreating to the position of a niche participant.

Clearly, we strongly disagree - although, at its current valuation Nintendo would likely prove a perfectly acceptable investment, even as a niche player. But before we explain why below we should acknowledge that our accumulation of the shares over the last four years was clearly a misjudgement. In doing so we dismissed too lightly the risks, both perceived and real, the company faces when console cycles mature. We

underestimated the uncertainty surrounding the release of new consoles, yet untested in the market. We too readily dismissed the virulent nature of competition enticed by the growth and profitability of the market. Whether these threats prove real over the long term is to an extent immaterial. In retrospect we invested too much too soon and have thus created a steep gradient for our performance to climb.

Our argument is, in essence, that we think other investors are wrong about Nintendo because they value it as a cyclical hardware company, with no forward visibility on cash flows. In contrast, we view it as a software company with the superior economics of software over hardware and good repeat predictability. Our belief is that the majority of the business value of Nintendo is in the franchises it creates. These are many and they are growing. Whether it is Mario, Pokemon, Zelda, Wii Fit, or Super Smash Brothers, Nintendo's customers have a loyalty to these modern day icons – much in the same way as Disney's customers do with their 20th century equivalents. Having been delighted and entertained once, customers come back for more, they recommend it to friends and then the community of supporters becomes more prolific. Over the last four years Nintendo software sales have broken successive records selling to more people than ever before. Nintendo knows that when it releases a new version of these titles it can guarantee strong sales. These games are designed to be played on Nintendo devices with gadgetry and functionality that enhances the entertainment of the game and enriches the gaming experience for sophisticated or novice gamer alike. It is a unique business model with high barriers to entry. No one else in the game industry has succeeded in building so many record selling first party (games played on proprietary systems) franchises. Nintendo's ownership of both the title and the consoles has earned the company high margins and prolific cash flows. Annual growth in net worth was 8% over the last twenty years and, if we include dividends paid to shareholders, this would amount to 10.8% p.a. This compared to a 0.1% p.a. rise in inflation (CPI index) in Japan, resulting in exceptional real returns.

The success of the next cycle of devices, the Nintendo 3DS handheld and the recently showcased Wii U, will be based on how well the established franchises combine with this innovative new hardware to make the gaming experience that much more entertaining as compared to what else is on offer and what else has been experienced before. We are encouraged by what we see and the reaction of the third party gaming companies who can quickly conceive how their existing franchises can be made more fun using the hardware features and functionality of the new consoles.

There is no doubt that these new consoles will face a more competitive landscape with a proliferation of participants attracted by the growing market. But that comes with the territory. Aside from Sony's and Microsoft's consoles, none of the other hardware is dedicated to gaming and thus none has the same commitment as Nintendo to the quality of entertainment. Thus, as long as Nintendo offers more intuitive and more entertaining games we believe followers will return again to the familiar franchises, perhaps in greater numbers than before in recognition of the expansion of the gaming population.

In pricing Nintendo shares so low we think the market is failing to recognise the quality, durability and predictability of the Nintendo franchises and at the same time it is underestimating the inherent demand on the part of an ever expanding audience for the best game entertainment there is to buy. We think the new generation of consoles has every chance of being as, if not more, successful than the last. There is no doubt that short term results will be difficult until top software titles for the new consoles are released. But even so, most companies would rejoice forecasting operating profit margins of 16% at the bottom of the cycle as Nintendo is today. Coincidentally at the bottom of the last cycle, in 2004, margins troughed at 16% and the shares bottomed when net cash accounted for 60% of market capitalisation, as it does currently. The company's enterprise value is just 80% of its current sales, which are anyway depressed whilst the console changeover progresses. We think the full intrinsic value of Nintendo should be 4x its sales given the average profits margins it generates and the returns on capital it achieves. Today, this would equate to a price of Y49,000, up 3x from here.

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NOTES: Financial data quoted in this report is obtained from Bloomberg and the companies mentioned and is subject to change without notice.

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