Activision Blizzard, Inc.
Form 10-Q
August 08, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended June 30, 2008

OR

o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 1-15839

ACTIVISION BLIZZARD, INC.

(Exact name of registrant as specified in its charter)

Delaware	**95-4803544**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3100 Ocean Park Boulevard, Santa Monica, CA	**90405**
(Address of principal executive offices)	(Zip Code)

(310) 255-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x	Accelerated Filer o	Non-accelerated filer o (Do not check if a smaller reporting company)
Smaller reporting company o		

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The number of shares of the registrant s Common Stock outstanding as of August 1, 2008 was 659,219,243.

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ACTIVISION, INC. AND SUBSIDIARIES

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CAUTIONARY STATEMENT

This Quarterly Report on Form 10-Q contains, or incorporates by reference, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements consist of any statement other than a recitation of historical fact and include, but are not limited to, (1) projections of revenues, expenses, income or loss, earnings or loss per share, cash flow projections or other financial items; (2) statements of our plans and objectives, including those relating to product releases; (3) statements of future economic performance; and (4) statements of assumptions underlying such statements. We generally use words such as anticipate, believe, could, estimate, expect, forecast, future, intend, may, outlook, plan, positioned, potential, project, remain, scheduled, set to, subject to, to be, upcoming, will, and other similar expressions to help identify forward-looking statements. These forward-looking statements are subject to business and economic risk, reflect management s current expectations, estimates and projections about our business, and are inherently uncertain and difficult to predict. Our actual results could differ materially. The forward-looking statements contained herein speak only as of the date on which they were made, and we disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this Quarterly Report. Risks and uncertainties that may affect our future results include, but are not limited to, those discussed under the heading Risk Factors, included in Part II, Item 1A of this Quarterly Report . Except as otherwise noted (including in connection with the review and presentation of results of operations for the quarter ended June 30, 2008), all references to we, us, our, Activision Blizzard or the Company in the following discussion and analysis mean Activision Blizzard, Inc. and its subsidiaries.

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PART I. Financial Information

Item 1. Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except share data)

		June 30, 2008 (Unaudited)		March 31, 2008
Assets				
Current assets:				
Cash and cash equivalents	$	1,192,354	$	1,396,250
Short-term investments		60,360		52,962
Accounts receivable, net of allowances of $137,079 and $129,411 at June 30, 2008 and March 31, 2008, respectively		400,989		203,420
Inventories		229,409		146,874
Software development		136,765		96,182
Intellectual property licenses		26,710		18,661
Deferred income taxes		65,538		41,242
Other current assets		30,668		23,804
Total current assets		2,142,793		1,979,395
Long-term investments		88,301		91,215
Software development		17,692		13,604
Intellectual property licenses		63,595		64,890
Property and equipment, net		62,330		54,528
Deferred income taxes		29,997		32,825
Other assets		23,142		15,055
Goodwill		320,706		279,161
Total assets	$	2,748,556	$	2,530,673
Liabilities and Shareholders Equity				
Current liabilities:				
Accounts payable	$	175,587	$	129,896
Accrued expenses and other liabilities		445,971		426,175
Total current liabilities		621,558		556,071
Other liabilities		24,014		26,710
Total liabilities		645,572		582,781
Commitments and contingencies (Note 12)				
Shareholders equity:				
Preferred stock, $.000001 par value, 3,750,000 shares authorized, no shares issued at June 30, 2008 and March 31, 2008				
Series A Junior Preferred stock, $.000001 par value, 1,250,000 shares authorized, no shares issued at June 30, 2008 and March 31, 2008				
Common stock, $.000001 par value, 450,000,000 shares authorized, 298,244,105 and 294,651,325 shares issued and outstanding at June 30, 2008 and March 31, 2008, respectively				
Additional paid-in capital		1,245,982		1,148,880
Retained earnings		831,675		772,660
Accumulated other comprehensive income		25,327		26,352
Total shareholders equity		2,102,984		1,947,892
Total liabilities and shareholders equity	$	2,748,556	$	2,530,673

The accompanying notes are an integral part of these consolidated financial statements.

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ACTIVISION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Amounts in thousands, except per share data)

	For the three months ended June 30, 2008			2007
Net revenues	$	654,203	$	495,455
Costs and expenses:				
Cost of sales product costs		311,941		217,229
Cost of sales software royalties and amortization		40,874		78,252
Cost of sales intellectual property licenses		27,359		32,479
Product development		50,040		32,897
Sales and marketing		86,494		68,712
General and administrative		57,360		35,794
Total costs and expenses		574,068		465,363
Operating income		80,135		30,092
Investment income, net		10,948		11,562
Income before income tax provision		91,083		41,654
Income tax provision		32,068		13,828
Net income	$	59,015	$	27,826
Basic earnings per share	$	0.20	$	0.10
Weighted-average common shares outstanding		296,323		283,563
Diluted earnings per share	$	0.18	$	0.09
Weighted-average common shares outstanding assuming dilution		323,486		311,993

The accompanying notes are an integral part of these consolidated financial statements.

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ACTIVISION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in thousands)

	For the three months ended June 30, 2008	2007
Cash flows from operating activities:		
Net income	$ 59,015	$ 27,826
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	(20,339)	7,306
Depreciation and amortization	7,045	8,730
Realized gain on sale of short-term investments	(105)	
Amortization of capitalized software development costs and intellectual property licenses (1)	23,143	77,661
Stock-based compensation expense (2)	11,944	8,160
Tax benefit of stock options and warrants exercised	17,278	400
Excess tax benefits from stock option exercises	(15,834)	(370)
Changes in operating assets and liabilities (net of effects of acquisitions):		
Accounts receivable	(197,569)	(49,165)
Inventories	(82,535)	(1,298)
Software development and intellectual property licenses	(68,851)	(42,299)
Other assets	(15,660)	(2,931)
Accounts payable	45,691	(26,731)
Accrued expenses and other liabilities	14,710	(783)
Net cash (used in) provided by operating activities	(222,067)	6,506
Cash flows from investing activities:		
Cash used in business acquisitions (net of cash acquired)		(3,659)
Capital expenditures	(14,144)	(7,348)
Increase in restricted cash	(40,298)	(8,413)
Purchases of investments		(187,495)
Proceeds from sales of investments	10,589	
Proceeds from maturities of investments	22,440	145,864
Net cash used in investing activities	(21,413)	(61,051)
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	23,163	11,182
Excess tax benefits from stock option exercises	15,834	370
Net cash provided by financing activities	38,997	11,552
Effect of exchange rate changes on cash	587	2,565
Net decrease in cash and cash equivalents	(203,896)	(40,428)
Cash and cash equivalents at beginning of period	1,396,250	384,409
Cash and cash equivalents at end of period	$ 1,192,354	$ 343,981

(1) Excludes amortization of stock-based compensation expense.

(2) Includes the net effects of capitalization and amortization of stock-based compensation expense.

The accompanying notes are an integral part of these consolidated financial statements.

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ACTIVISION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

For the three months ended June 30, 2008
(Unaudited)
(Amounts in thousands)

	Common Stock Shares	Common Stock Amounts	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Shareholders Equity
Balance as of March 31, 2008	**294,651**	**$**	**$ 1,148,880**	**$ 772,660**	**$ 26,352**	**$ 1,947,892**
Components of comprehensive income:						
Net income				59,015		59,015
Unrealized depreciation on short-term investments, net of taxes					(1,756)	(1,756)
Foreign currency translation adjustment					731	731
Total comprehensive income						57,990
Issuance of common stock pursuant to employee stock options, restricted stock rights and employee stock purchase plan	2,419		23,163			23,163
Issuance of common stock to effect business combination	1,174		39,000			39,000
Stock-based compensation expense related to employee stock options, restricted stock rights, and employee stock purchase plans			17,661			17,661
Tax benefit associated with employee stock options			17,278			17,278
Balance as of June 30, 2008	**298,244**	**$**	**$ 1,245,982**	**$ 831,675**	**$ 25,327**	**$ 2,102,984**

The accompanying notes are an integral part of these consolidated financial statements.

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ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

1. Background and Basis of Presentation

The accompanying Consolidated Financial Statements as of June 30, 2008 and for the three month period ended June 30, 2008 include the accounts of Activision, Inc. and its subsidiaries (Activision or we or the Company). The information furnished is unaudited and the adjustments included consist of only normal recurring adjustments that, in the opinion of management, are necessary to provide a fair statement of the results for the interim periods presented. The accompanying unaudited Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008 as filed with the Securities and Exchange Commission (SEC) on May 30, 2008.

Certain financial information that is normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP), but is not required for interim reporting purposes, has been condensed or omitted.

Management must make estimates and assumptions that affect the Consolidated Financial Statements and the related footnote disclosures. While management makes its best judgment, actual results could differ from those estimates.

Significant Transactions

Subsequent to the quarter ended June 30, 2008, we consummated our previously announced business combination (the Business Combination) pursuant to the Business Combination Agreement (the Business Combination Agreement), dated as of December 1, 2007, by and among the Company, Sego Merger Corporation, a wholly-owned subsidiary of the Company, Vivendi S.A. (Vivendi), VGAC LLC, a wholly-owned subsidiary of Vivendi (VGAC), and Vivendi Games, Inc., a wholly-owned subsidiary of VGAC (Vivendi Games). Upon the closing of the Business Combination, which occurred on July 9, 2008, Activision was renamed Activision Blizzard, Inc. (Activision Blizzard). Activision Blizzard continues to operate as a public company traded on the NASDAQ under the ticker symbol ATVI. Activision Blizzard now conducts the combined business operations of Activision and Vivendi Games including Blizzard Entertainment, Inc. (Blizzard). In connection with the Business Combination, we issued approximately 358 million shares of common stock to VGAC. Following the consummation of the Business Combination, VGAC owned approximately 54% of Activision Blizzard s issued and outstanding common stock. While we are the surviving entity in this Business Combination, because the transaction is treated as a reverse acquisition , Vivendi Games is deemed to be the acquirer for accounting purposes. Accordingly, Activision Blizzard will apply purchase accounting to the assets and liabilities of Activision as of July 9, 2008. Also, for all future Exchange Act filings, the historical financial statements of Activision for periods prior to the consummation of the Business Combination will be those of Vivendi Games. Activision s businesses will be included in Activision Blizzard s financial statements for all periods subsequent to the consummation of the Business Combination only.

In accordance with the terms of the Business Combination Agreement, on July 16, 2008, Activision Blizzard commenced a tender offer to purchase up to 146.5 million shares of its common stock at a price of $27.50 per share. The tender offer will expire on August 13, 2008 unless extended.

Upon consummation of the Business Combination, the senior unsecured credit agreement with Vivendi (as lender) became effective upon terms substantially similar to those previously disclosed in Activision s Annual Report on Form 10-K for the fiscal year ended March 31, 2008 and Activision Blizzard s Current Report on Form 8-K dated July 9, 2008. Under that credit agreement, we have access to funds for the tender offer and for general corporate purposes as previously disclosed.

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Prior to the closing of the Business Combination, Activision s fiscal year ended March 31st. Effective July 9, 2008, Activision Blizzard changed its fiscal year end to December 31st. Accordingly, Activision Blizzard s current fiscal year will end on December 31, 2008.

All information included in this report reflects only Activision s results on a stand alone basis for the relevant periods and does not reflect any impact of the Business Combination.

2. Inventories

Inventories are valued at the lower of cost (first-in, first-out) or market. Our inventories consist of the following (amounts in thousands):

	June 30, 2008	March 31, 2008
Finished goods	$ 208,396	$ 144,549
Purchased parts and components	21,013	2,325
	$ 229,409	$ 146,874

3. Goodwill

The changes in the carrying amount of goodwill for the three months ended June 30, 2008 are as follows (amounts in thousands):

	Publishing	Distribution	Total
Balance as of March 31, 2008	$ 273,067	$ 6,094	$ 279,161
Issuance of contingent consideration	41,390		41,390
Effect of foreign currency exchange rates	140	15	155
Balance as of June 30, 2008	$ 314,597	$ 6,109	$ 320,706

Issuance of contingent consideration consists of additional purchase consideration of approximately $41.4 million related to the acquisition of RedOctane, Inc. (RedOctane) which became payable in shares of our common stock, as a result of achievement of targeted net income levels. The additional consideration has been recorded as an accrued liability as of June 30, 2008, and was subsequently paid by the issuance of approximately 1.2 million shares of our common stock to the former shareholders of RedOctane.

4. Income Taxes

The income tax provision of $32.1 million for the three months ended June 30, 2008 reflects our effective income tax rate for the quarter ended June 30, 2008 of 35.2%. While our effective income tax rate for the period equals our statutory rate there are certain items that would normally generate a variance between the two rates. Those items are the federal and state research and development tax credits and the impact of foreign tax rate differentials partially offset by state taxes. However, the net effect for this period is approximately zero.

The aforementioned effective income tax rate for the three months ended June 30, 2008 of 35.2% differs from our effective income tax rate of 33.2% for the three months ended June 30, 2007 due to the expiration of the federal research and development credit on December 31, 2007.

The income tax expense of $13.8 million for the three months ended June 30, 2007 reflects our effective income tax rate for the quarter of 33.2%, which differs from our effective tax rate of 35.0% for the year ended March 31, 2008 due to (1) an increase in the federal research and development credit for the year ended March 31, 2008 over the amount originally anticipated for the quarter ended June 30, 2007 and (2) an increase in the nondeductible portion of annual cash bonuses determined for the full year ended March 31, 2008 under Section 162(m) of the Internal Revenue Code of 1986, as amended, and the establishment of tax reserves for these credits and other deferred tax assets.

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5. Software Development Costs and Intellectual Property Licenses

As of June 30, 2008, capitalized software development costs included $127.3 million of internally developed software costs and $27.2 million of payments made to third-party software developers. As of March 31, 2008, capitalized software development costs included $97.8 million of internally developed software costs and $12.0 million of payments made to third-party software developers. Capitalized intellectual property licenses were $90.3 million and $83.6 million as of June 30, 2008 and March 31, 2008, respectively. Amortization of capitalized software development costs and intellectual property licenses were $26.1 million and $77.7 million for the three months ended June 30, 2008 and 2007, respectively.

6. Comprehensive Income (Loss) and Accumulated Other Comprehensive Income (Loss)

Comprehensive Income (Loss)

The components of comprehensive income (loss) for the three months ended June 30, 2008 and 2007 were as follows (amounts in thousands):

	Three months ended June 30, 2008	2007
Net income	$ 59,015	$ 27,826
Other comprehensive income (loss)		
Foreign currency translation adjustment	731	2,722
Unrealized depreciation on short-term investments, net of taxes	(1,756)	(407)
Other comprehensive income (loss)	(1,025)	2,315
Comprehensive income	$ 57,990	$ 30,141

Accumulated Other Comprehensive Income (Loss)

For the three months ended June 30, 2008, the components of accumulated other comprehensive income (loss) were as follows (amounts in thousands):

	Foreign Currency	Unrealized Depreciation on Investments	Accumulated Other Comprehensive Income

Balance as of March 31, 2008	$ 29,116	$ (2,764)	$ 26,352
Other comprehensive income (loss)	731	(1,756)	(1,025)
Balance as of June 30, 2008	$ 29,847	$ (4,520)	$ 25,327

Comprehensive income is presented net of taxes of approximately $1.1 million related to unrealized depreciation on investments for the three months ended June 30, 2008. Income taxes were not provided for foreign currency translation items as these are considered indefinite investments in non-U.S. subsidiaries.

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7. Investment Income, Net

Investment income, net is comprised of the following (amounts in thousands):

	Three months ended June 30, 2008	2007
Interest income	$ 10,859	$ 11,586
Interest expense	(16)	(24)
Net realized gain on investments	105	
Investment income, net	$ 10,948	$ 11,562

8. Supplemental Cash Flow Information

Non-cash investing and financing activities and supplemental cash flow information is as follows (amounts in thousands):

	Three months ended June 30, 2008	2007
Non-cash investing and financing activities:		
Change in unrealized depreciation on investments, net of taxes	$ (1,756)	$ (407)
Common stock payable related to acquisition	41,390	22,521
Supplemental cash flow information:		
Cash paid for income taxes	$ 33,332	$ 3,572
Cash paid for interest	16	24

9. Operations by Reportable Segments and Geographic Area

Based upon its organizational structure, Activision operated two business segments: (i) publishing of interactive entertainment software and peripherals and (ii) distribution of interactive entertainment software and hardware products.

Publishing refers to the development, marketing and sale of products, either directly, by license or through our affiliate label program with certain third-party publishers. During the periods covered by the financial statements included in this report, in the U.S., Activision primarily sold products on a direct basis to mass-market retailers, consumer electronics stores, discount warehouses, and game specialty stores. Activision conducted its international publishing activities through offices in the United Kingdom (UK), Germany, France, Italy, Spain, Australia, Sweden, the Netherlands, Norway, Canada, South Korea, and Japan where products were sold on a direct-to-retail basis and through third-party distribution and licensing arrangements and through our wholly owned distribution subsidiaries.

Distribution refers to Activision s operations in the UK, the Netherlands, and Germany that provided logistical and sales services to third-party publishers of interactive entertainment software, Activision s own publishing operations and manufacturers of interactive entertainment hardware.

The accounting policies of these segments are the same as those described in the Summary of Significant Accounting Policies in our Annual Report on Form 10-K for the year ended March 31, 2008. Revenue derived from sales between segments is eliminated in consolidation.

Information on the reportable segments for the three months ended June 30, 2008 and 2007 is as follows (amounts in thousands):

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	Three months ended June 30, 2008		
	Publishing	Distribution	Total
Total segment revenues	$ 578,562	$ 75,641	$ 654,203
Revenues from sales between segments	(31,464)	31,464	
Revenues from external customers	$ 547,098	$ 107,105	$ 654,203
Operating income	$ 79,170	$ 965	$ 80,135
Total assets	$ 2,560,845	$ 187,711	$ 2,748,556

	Three months ended June 30, 2007		
	Publishing	Distribution	Total
Total segment revenues	$ 429,222	$ 66,233	$ 495,455
Revenues from sales between segments	(22,847)	22,847	
Revenues from external customers	$ 406,375	$ 89,080	$ 495,455
Operating income	$ 29,117	$ 975	$ 30,092
Total assets	$ 1,700,149	$ 138,917	$ 1,839,066

Geographic information for the three months ended June 30, 2008 and 2007 is based on the location of the selling entity. Revenues from external customers by geographic region were as follows (amounts in thousands):

	Three months ended June 30,	
	2008	2007
North America	$ 392,916	$ 309,536
Europe	229,381	170,014
Other	31,906	15,905
Total	$ 654,203	$ 495,455

Revenues by platform were as follows (amounts in thousands):

	Three months ended June 30,	
	2008	2007
Console	$ 507,460	$ 401,874
Hand-held	119,633	75,732
PC	27,110	17,849
Total	$ 654,203	$ 495,455

We had two customers, Wal-Mart and GameStop, that each accounted for 11% of consolidated net revenues for the three months ended June 30, 2008, and 14% of consolidated gross accounts receivable at June 30, 2008. We had two customers, Wal-Mart and GameStop, that accounted for 21% and 15% of consolidated net revenues for the three months ended June 30, 2007, and 27% and 10% of consolidated gross accounts receivable at June 30, 2007. These customers were customers of our publishing business.

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10. Computation of Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share (amounts in thousands, except per share data):

	Three months ended June 30, 2008	2007
Numerator:		
Numerator for basic and diluted earnings per share - income available to common shareholders	$ 59,015	$ 27,826