

Starbreeze

Sector: Gaming

Turnaround Enters the Second Half

The value in Payday can be equated with the current market cap of Starbreeze

Payday 2 has generated net revenues of SEK 1.1 billion to Starbreeze in less than eight years. An interesting aspect is that Payday 2 only earned 10% of this amount for the first 4-5 months. Payday 2 has over 7 million players on Steam and grew its player base by 10% last year. During Q1'21, the game has had 142,000 daily users on average, which from a historical perspective are high. At the time of this update, the market cap of Starbreeze is, in our opinion, broadly equated with the value of the Payday brand.

High engagement continues to pay off

Starbreeze efforts and strategy to release "Seasonal Content" in Payday 2 continue to pay off. While net sales were below our estimate, the major negative impact came from a weaker dollar and no royalty income from Geminose until the next quarter. During April-June we could track the player activity on Steam which showed an increase of 30-40%. The correlation between activity and net sales on the platform is high due to the fact that net sales on Steam increased 38% in USD.

A long-awaited sequel

Payday 3 will be released on more platforms than PC already at release unlike its predecessor which is expected to increase sales. Other significant drivers for higher sales are the brand's increased strength since 2013, a higher development and marketing budget, and a significantly larger gaming market.

When all direct costs are taken, we expect Payday 3 to give a gross profit of approx. SEK 400 million in 2023. If Starbreeze manages to maintain high recurring revenue in the coming years after launch, this will create good shareholder value nonetheless a significantly higher cost suit and larger payment commitments than at the launch of Payday 2.

Valuation

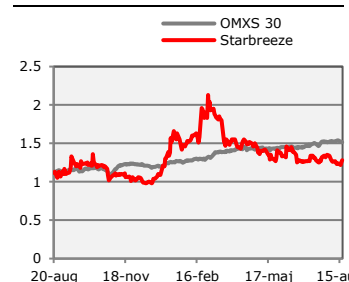
Starbreeze has a solid foundation to stand on after the company strengthened its cash position through its shareholders and has secured a good publishing agreement together with Koch Media

Our fair valuation range is SEK 0.8-5 per share (SEK 0.4-2.5) with a abase case of SEK 2.2 per share.

FAIR VALUE RANGE

BEAR	BASE	BULL
0.8	2.2	5.0

STAR VERSUS OMXS30



REDEYE RATING



KEY STATS

Ticker	STAR.ST
Market	Nasdaq OMX
Share Price (SEK)	1.3
Market Cap (SEKm)	915
Net Debt (SEKm)	190

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Awaiting Payday 3

Shared potential and risks with Koch Media

When the co-publishing agreement with Koch Media was announced, it was also announced that Koch Media would invest up to SEK 500 million (EUR 50 million) in Payday 3 until 18 months after the release. We expect a clear majority of development costs until the 2023 release will be funded by Koch Media.

Payday 3 can still be assumed to be at an early stage of the development process. With the publishing agreement in place, we expect that the company will accelerate its investments moving the game into full production this fall. Because Payday 3 is stated to be a multiplayer-focused game, we expect a so-called AA budget of around SEK 250-300 million. Roughly speaking the development budget ends up in estimated quarterly payments from Koch Media of SEK 30-38 million until the release in 2023.

Of these SEK 500 million, approximately SEK 250 million will thus be invested in Payday 3 before the launch and an additional SEK 150 million after the launch according to our estimate. Like its predecessor, the games have a so-called "Game as a service" business model which means that new content is released continuously even after release. About SEK 100 million is expected to be spent on marketing Payday 3.

Digital Bros has a great interest in Starbreeze

In connection with Starbreeze buying Digital Bros' share of the Payday brand, the company agreed that 505 Games would receive 33% of Starbreeze's net revenue from Payday 3 until it reaches a ceiling of approximately SEK 340 million (USD 40 million).

Digital Bros also has a convertible loan to Starbreeze of approximately SEK 215 million. Towards the end of the Starbreeze reorganization, both parties extended this loan for another four years (end of 2024), to a fee that was calculated at around SEK 160 million (credit USD 15.9 million). This money is to be repaid from the potential free cash flow that Starbreeze generates. According to our calculations, Starbreeze can repay this loan around the launch of Payday 3, however, given that they have no interest on this debt, the less favorable loans will probably be repaid first.

Digital Bros also has a right to convert the convertible loan into 131.9 million Class B shares in Starbreeze for SEK 1.63 per share (the same amount as the convertible loan of SEK 215 million). The dilution in such a conversion of the shares would be approximately 15,4% based on the current number of shares in the company.

Currently, Digital Bros is the second-largest shareholder in Starbreeze, after Swedbank Robur Fonder. Digital Bros owns almost 12% of the capital and has almost 29% of the votes, due to the majority of their shareholding is in A-shares. If Digital Bros converts all its shares in accordance with the terms of the convertible loan, a bidding obligation arises where the company must offer a price per share to all owners in Starbreeze. This occurs when a shareholder has 30% of the votes in a company. Digital Bros can, however, choose to convert A shares to B shares if they want to use the convertible without triggering a bid obligation.

Q2-Comment: Increased Engagement Continue to Pay Off

Starbreeze efforts and strategy to release "Seasonal Content" in Payday 2 continue to pay off. While net sales were below our estimate, the major negative impact came from a weaker dollar and no royalty income from Geminose until the next quarter. During April-June we could track the player activity on Steam which showed an increase of 30-40%. The correlation between activity and net sales on the platform is high due to the fact that net sales on Steam increased 38% in USD.

Payday 2 showed peak numbers of 800 000 monthly players during the quarter. The activity amongst players shows a positive momentum despite COVID19-boosted engagement in 2020. Both monthly active users and monthly active users showed a growth of 16-35% during the quarter. And the community around Payday 2 keeps on growing with new players, in Q2 net sales for the base game Payday 2 increased on Steam by 21%. This of course builds an even stronger foundation of potential players in Payday 3.

Payday 3 is now in full production. Starbreeze has already been investing a relatively big amount in Payday 3 which means its co-publisher will invest the majority of the remaining development budget according to our estimates.

During the quarter Starbreeze also reported its entire development expenses as direct costs for its mobile Payday-game. This means Starbreeze will only have a positive impact from Payday Crimewar in the future in terms of royalty income.

Speaking of royalties we also expect some money will come from the launch of Geminose on Nintendo Switch released on May 18. We however see no indications this game will generate more than a few million SEK during the next quarter.

Stable cash flows and good financial position

Loans of SEK 51 million have been repaid to Nordea which means all Nordea loans have now been fully amortized. This is good news according to us (but in line with our expectations) due to the terms and interest rate was disadvantageous on this loan. A clear majority of the total loans is currently the convertible loan of SEK 215 million to Digital Bros, a loan that will most likely be paid in shares.

During Q2, the company received funding from its co-publisher Koch Media of SEK 37.8 million. This was at the upper end of our estimated interval of SEK 30-38 million. We estimate Starbreeze will continue to receive at approximately the same amount each quarter until the release of Payday 3 in 2023.

Total cash flow from the period was SEK -34.8 million. Total cash and cash equivalents were SEK 113.5 million at the end of the quarter. We estimate Starbreeze will show stable positive cash flows from this point with quarterly payments from its co-publisher and no major disadvantageous loans left to pay.

As a conclusion to this initial comment on the Q2-report, we will only do minor changes to our 2021 estimates where we continue to see quarterly net sales somewhat above SEK 30 million from Payday 2. Starbreeze is according to us in a good place right now with a healthy balance sheet, stable cash flows going forward, Payday 3 in full production, and a growing community of players.

Financial Projections

Estimates 2021-2022

Full Year 2021: We expect stable growth for the full year, which should be considered as strong with the challenging comparables of a COVID-19 boosted 2020. External payments to finance Payday 3 increase towards the end of the year where Koch Media is expected to pay approximately SEK 30-38 million when Payday 3 is put into full production. However, this only has a positive cash flow effect as these investments in game production are not reported in the income statement.

A so-called soft launch of the mobile game Payday Crimewar is expected to be released in Q4. We expect more visible royalty income from the game in 2022.

Full Year 2022: Game sales of Payday 2 are expected to continue at stable levels through investments in new content. As Payday 3 is in full production during the year, we estimate revenue at SEK 92.5 million from Koch Media. As cash flow is likely to be strong during the year, we expect that Starbreeze will pay off parts of its more unfavorable loans.

We have chosen to take a conservative stance regarding the game sales of Payday 2 during the "last year" of its cycle. When the release of Payday 3 gets closer and the company intensifies the marketing of Payday 3 the community can of course play Payday 2 more and then sales are increasing, but it can also lower interest in the predecessor as players instead decides to wait for the sequel. The net effect is hard to predict.

Full Year 2023: The release of Payday 3

We expect Payday 3 to be released in conjunction with its predecessor's 10th anniversary which is August 13, 2023. Starbreeze has previously indicated that the game may be released earlier in the year, but we expect the game development to take slightly longer than expected.

Initial sales of Payday 3

Unlike Payday 2, Payday 3 will be released on more platforms than PC on the day of release. This is an important argument as to why the game has a higher sales potential at launch. Other significant drivers for higher sales are the brand's increased strength since 2013, a higher development and marketing budget, and a significantly larger gaming market.

There are of course, also risks that can dampen sales, which all ultimately lies upon the perceived quality of Payday 3. The game concept that Payday 3 is built upon was perceived as new and different when it was launched in 2013, but that does not have to be the case when the sequel comes 10 years later. Most of the key people who developed the first two games are not operating within Starbreeze any longer, which also creates uncertainty regarding the product in our opinion.

The following assumptions have been made when we made our estimates on Payday 3.

We estimate that Payday 3 will sell 3 million copies by the end of 2023. The list price is USD 50, we anticipate that the game will provide Starbreeze with revenue at an average price of USD 40 when VAT and international variations in the list price have been deducted during the initial first months.

For the full year, including a discount of approximately 10% for the game during Q4, the average list price will be SEK 325, with today's exchange rate which would give Starbreeze revenue of SEK 974 million during 2023.

Payday 3 Sales Estimates			
SEKm	Q3E	Q4E	2023E
Steam Sales	672	302	974
Distribution	176	60	237
Net Sales	496	242	738
Engine Cost (3%)	15	7	22
Koch Recoup (Excl)	270	50	320
Sum	481	235	715
Koch Media (50%)	105	92	198
Net Net Sales	375	142	518
505 Games (33%)	40	40	80
Profit	335	102	438

Source: Redeye Research

We have calculated about 26% in distribution costs according to today's "cost ladder" from the digital sales channel Steam, where most of Starbreeze's revenue comes from. At present, a so-called platform war is being fought between the largest sales channels within gaming, which has started a price pressure. A distribution fee of 26% is thus seen as a relatively pessimistic scenario in 2024.

After distribution costs, Starbreeze generates a cash flow of SEK 738 million. After repayment of the investment (so-called recoup) and license fees from the graphics engine remains SEK 396 million. However, the recoup is not expensed instead the investment in game development from both Starbreeze and Koch Media is reported in the balance sheet. The development cost will be reported as a depreciation over a longer period. We expect the depreciation to be made on a straight-line basis over a five-year period, which should reflect the game's estimated life. This leads to a quarterly depreciation of SEK 35 million (assuming that the initial total gaming budget is SEK 420 million).

We estimate that Koch Media will take 50% of the generated revenue, which means that Starbreeze will have approximately SEK 518 million left. However, according to our calculation, Starbreeze will generate a positive cash flow of SEK 198 million after the initial investment from Koch Media of SEK 320 million has been taken.

Of the remaining revenue, Starbreeze will pay 505 Games 33%. However, this revenue cut is done after ongoing costs for the game development for Payday 3 are taken. We expect a single fee of around SEK 80 million during the first two quarters. Starbreeze's profit will be around SEK 438 million for Payday 3 in 2023 according to our estimates. The positive cash flow is expected to be SEK 118 million.

Of course, there are a lot of uncertainties in these assumptions, we have therefore excluded revenues from Payday 2 in our estimates for 2023, about SEK 50-70 million, given that the game continues to earn SEK 20-40 million on a quarterly basis. In our base case, Payday 3 will continue to sell well over the next five years.

Starbreeze Group: Estimates 2021-2023							
SEKm	Q1	Q2	Q3E	Q4E	2021E	2022E	2023E
Net Sales	27.9	32.0	30.5	32.3	122.7	126.7	974.4
Direct Cost	11.6	14.2	12.4	12.6	50.8	54.3	571.7
Gross profit	16.3	17.8	18.1	19.7	71.9	72.4	402.7
<i>Gross margin</i>	<i>59%</i>	<i>56%</i>	<i>59%</i>	<i>61%</i>	<i>59%</i>	<i>57%</i>	<i>41%</i>
Marketing Cost	2.4	3.0	2.6	3.0	10.9	11.5	33.0
Admin Cost	10.7	12.6	10.3	11.6	45.3	44.6	46.4
Other Revenue	4.9	69.6	5.0	5.0	-54.7	15.4	13.6
EBIT	8.1	-67.4	10.2	10.1	-39.0	31.7	336.9
<i>EBIT margin</i>	<i>29%</i>	<i>-211%</i>	<i>33%</i>	<i>31%</i>	<i>-32%</i>	<i>25%</i>	<i>35%</i>
Financial expenses	12.5	12.7	12.2	12.4	49.8	32.4	28.6
Net Profit	-4.4	-80.1	-2.0	-2.3	-88.8	-0.7	308.3

Source: Redeye Research, Starbreeze

During the period 2024-2028, we estimate average sales of SEK 539 million and an average operating profit (EBIT) of SEK 115 million in Starbreeze. This results in an average operating margin of 14%.

Explanation of income and cost items in the table above.

Net Sales: Revenue from game sales

Direct Costs: Costs associated with the game development and game production. The net effect of capitalized development costs and the amortization of these intangible assets is included in direct costs.

Within this cost item, we have also included distribution costs from platform owners such as Steam. In 2023, when Payday 3 is released, we have also included costs related to Payday 3 game sales.

Marketing Cost includes sales costs and marketing costs, which mainly consist of personnel costs. For 2023, campaign costs related to the launch of Payday 3 are also included.

Admin Cost is administrative costs such as rental fees and staff salaries for those who do not work with game development.

Other Revenue mainly consists of income or expenses related to currency changes currently.

Financial Expenses: Financial expenses related to Starbreeze loans and liabilities. In Q1'20 the convertible loan was renegotiated and extended, which resulted in a reported cost of SEK 90.9 million. This item is now a liability in the company's balance sheet. This cost has thus largely been taken, which means that SEK 70 million (160-90) remains to be expensed.

Investment Case

Starbreeze was founded in the late '90s and created a name in the industry with a number of so-called "work for hire" projects such as "Chronicles of Riddick". In 2012, the company acquired Overkill Software and its owned brand Payday. This was the start of the company's new strategy to self-finance its games. The investment was a success and Payday 2 was profitable even before release due to all pre-bookings in August 2013. The game generated a net income to Starbreeze of SEK 120 million during the first five months. Since then, the game has generated SEK 25-30 million on a quarterly basis over eight years.

Starbreeze proved with its game "Payday 2" that it is one of a few western game developers who have understood how to generate many years of income linked to an individual game title according to the business model "Game as a Service". Payday is a strong brand. Payday 2 has generated net revenues of SEK 1.1 billion to Starbreeze in less than eight years. An interesting aspect is that Payday 2 brought in approximately SEK 120 million in net income during the initial period after launch (in this case four and a half months) which shows how well the game has aged with the help of continuously releasing new content. Payday 2 has over 7 million members on Steam and grew by 0,7 million members by 2020. In the past year, the game has had 40-45,000 simultaneous daily players on average. Currently, we believe the market cap of Starbreeze can be broadly equated with the value of the Payday brand.

Starbreeze has a debt of around SEK 290 million. This includes a convertible loan of SEK 215 million owned by Digital Bros. We expect Digital Bros to convert this loan into shares, which means that the liabilities rather amount to around SEK 75 million. However, we currently count the entire loan as a liability in our DCF model for prudential reasons.

Valuation

In our DCF-model we have a WACC of 9%. The discount rate is relatively low due the fact that Starbreeze has large liabilities in its balance sheet in relation to market capitalization.

Bear Case SEK 0.8

In our bear case, Starbreeze will sell around 1 million units of Payday 3 in 2023. Our long-term forecasts are as follows:

2024-2028

Average Net Sales	314 m
Average EBIT	27 m
Average EBIT margin	9%

Terminal

Growth	2%
EBIT margin	15%

Base Case SEK 2.2

In our base case, Starbreeze will sell around 3 million units of Payday 3 in 2023. Our long-term forecasts are as follows:

2024-2028

Average Net Sales	539 m
Average EBIT	115 m
Average EBIT margin	14%

Terminal

Growth	2%
EBIT margin	20%

Bull Case SEK 5.0

In our bull case, Starbreeze will sell around 4-5 million units of Payday 3 in 2023. Our long-term forecasts are as follows:

2024-2028

Average Net Sales	1173 m
Average EBIT	310 m
Average EBIT margin	27%

Terminal

Growth	2%
EBIT margin	25%

Redeye Rating and Background Definitions

Company Quality

Company Quality is based on a set of quality checks across three categories; PEOPLE, BUSINESS, FINANCE. These are the building blocks that enable a company to deliver sustained operational outperformance and attractive long-term earnings growth.

Each category is grouped into multiple sub-categories assessed by five checks. These are based on widely accepted and tested investment criteria and used by demonstrably successful investors and investment firms. Each sub-category may also include a complementary check that provides additional information to assist with investment decision-making.

If a check is successful, it is assigned a score of one point; the total successful checks are added to give a score for each sub-category. The overall score for a category is the average of all sub-category scores, based on a scale that ranges from 0 to 5 rounded up to the nearest whole number. The overall score for each category is then used to generate the size of the bar in the Company Quality graphic.

People

At the end of the day, people drive profits. Not numbers. Understanding the motivations of people behind a business is a significant part of understanding the long-term drive of the company. It all comes down to doing business with people you trust, or at least avoiding dealing with people of questionable character.

The People rating is based on quantitative scores in seven categories:

- Passion, Execution, Capital Allocation, Communication, Compensation, Ownership, and Board.

Business

If you don't understand the competitive environment and don't have a clear sense of how the business will engage customers, create value and consistently deliver that value at a profit, you won't succeed as an investor. Knowing the business model inside out will provide you some level of certainty and reduce the risk when you buy a stock.

The Business rating is based on quantitative scores grouped into five sub-categories:

- Business Scalability, Market Structure, Value Proposition, Economic Moat, and Operational Risks.

Financials

Investing is part art, part science. Financial ratios make up most of the science. Ratios are used to evaluate the financial soundness of a business. Also, these ratios are key factors that will impact a company's financial performance and valuation. However, you only need a few to determine whether a company is financially strong or weak.

The Financial rating is based on quantitative scores that are grouped into five separate categories:

- Earnings Power, Profit Margin, Growth Rate, Financial Health, and Earnings Quality.

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Redeye Rating (2021-09-01)

Rating	People	Business	Financials
5p	19	14	3
3p - 4p	96	77	36
0p - 2p	6	30	82
Company N	121	121	121

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Tomas Otterbeck owns shares in the company : Yes

Danesh Zare owns shares in the company : No

Redeye performs/have performed services for the Company and receives/have received compensation from the Company in connection with this.