

Remedy: Discounted premium growth

Remedy Entertainment Research Update 2022-10-03 08:21

Redeye lowers its expectations and valuation on Remedy. However, we expect a steady build-up period will be initiated at the beginning of 2023 when game projects move into the next phase of development. The Remedy stock is traded at half its value since our research update in April where we lowered our estimates and valuation. As in our initial coverage report in late 2018, we yet again state that Remedy offers investors “Premium at a discount”.



Tomas Otterbeck



Viktor Lindström

Lower expectations

As we have communicated after the profit warning in August and the Q2 report we have lowered our expectations regarding the EBIT levels in 2022 and 2023 and the revenue growth this year. Revenue is expected to be unchanged compared to last year, meaning EUR 45 million in revenue (the previous estimate was EUR 49.3 million). EBIT is expected to be around EUR -3.8 million.

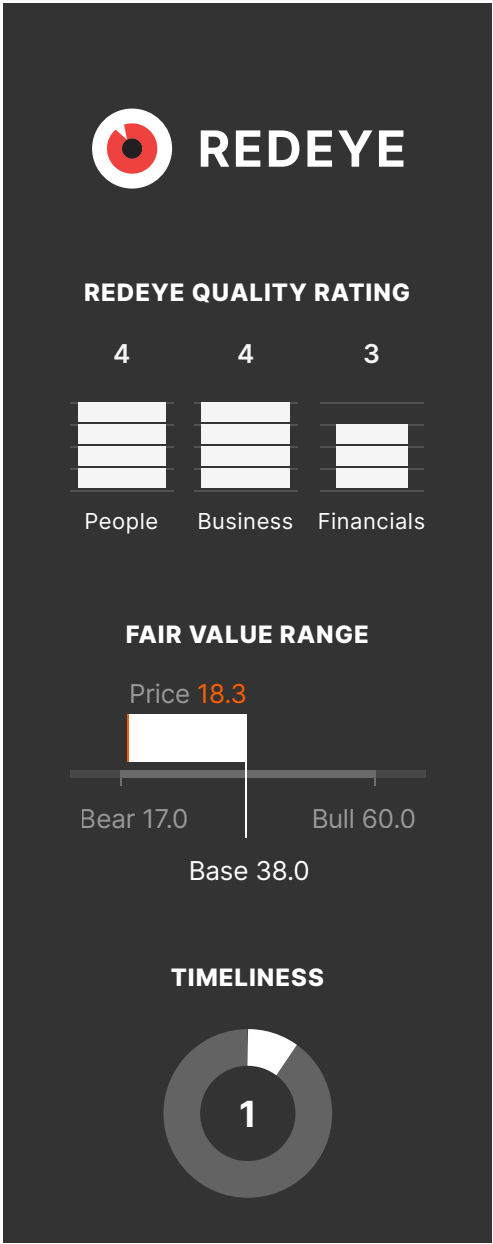
Acquisition target

We believe Remedy is one of the most obvious acquisition targets in the Nordic gaming industry. On the top of our buyer’s list sits Epic Games, and the timing is most likely after the release of Alan Wake 2. Secondly “most likely” we believe one of the three biggest players in the industry is a potential buyer namely Sony, Tencent, and Microsoft (in that order). Thirdly on our buyer’s list, we see Take-Two, the owner of the Remedy-created IP Max Payne.

Valuation

Our base case assumes relatively successful launches of the upcoming new games based on Alan Our base case assumes relatively successful launches of the upcoming new games based on Alan Wake, Control and Max Payne. We have lower expectations of its live-service games, due to a nonexistent track record. Our lowered expected EBIT levels in the upcoming years combined with an increased WACC due to higher interest rates give us a new fair value range of EUR 14-55 per share (17-60) with a base case of EUR 32 per share (38).

EURm	2020	2021	2022E	2023E	2024E
Revenues	41.1	44.73	44.96	54.57	75.92
Revenue Growth	29.88%	8.83%	0.51%	21.38%	39.12%
EBITDA	14.33	13.63	-1.67	0.99	17.79
EBIT	13.2	12.32	-3.82	-1.2	14.04
EBIT Margin	32.12%	27.54%	-8.5%	-2.19%	18.5%
Net Income	13.2	10.08	-3.33	-0.96	11.24
EV/Revenue	10.95	10.35	5.77	4.96	3.51
EV/EBIT	34.08	37.57	-67.93	-226.2	18.99



KEY STATS	
Market Cap	235.9 MEUR
Entprs. Value (EV)	186.3 MEUR
Net Debt	-49.5 MEUR
30 Day Avg Vol	19 K
Shares Outstanding	12.9 M
EV / Sales	4.1
EV / EBIT	15.1
Price / Earnings	24.1
PEG	N/A
Dividend Yield	0.9%

IMPORTANT INFORMATION

All information regarding limitation of liability and potential conflicts of interest can be found at the end of the report.

Redeye, Mäster Samuelsgatan 42, 10tr, Box 7141, 103 87 Stockholm. Tel. +46 8-545 013 30
E-post: info@redeye.se

Case

De-risked high quality

Remedy is one of the last legendary independent game studios left in the world. The founder and top management own more than 30% of the company. The biggest gaming platforms are screaming for quality content and Remedy will continue to grasp this opportunity. The studio has therefore a lucrative risk-reward in its coming projects and is an obvious takeover target that de-risk the case further.

Evidence

An "Epic" release in 2023

In 2023 Alan Wake 2 will be released, Remedy's strongest self-owned IP. We expect the total budget is approximately EUR 60 million (in comparison to the game Control with a budget of EUR 30 million). The higher budget, the financially strong publisher Epic Games, and the strength from the Alan Wake IP are three strong arguments that the game will likely sell at least twice as much as the game Control. For these reasons, we believe investors should have high expectations of the company's growth prospects.

Supportive Analysis

Remedy is one of three critically acclaimed game studios that have been hand-picked by Epic Games for the first strategic "publishing push" with favorable terms almost unheard of for developers. The agreement between Epic Games and Remedy announced at the end of March 2020 is fully funded by Epic with at least a 50% profit share for Remedy and full ownership of the IP.

Challenge

A big budget for a niched game

Remedy creates relatively niched games. In its upcoming game (Alan Wake 2), which will be released in 2023 the budget is double as high as in its latest game. We estimate the game must sell 2.15 million copies before Remedy can receive a 50% profit share. For a relative niche product, this is a rather high sales number.

Challenge

Uncertain profitability in 2025

In 2024-2025 Remedy will launch two online multiplayer games according to our assumptions. This is new territory for Remedy and at least one of the games (Vanguard) will be free-to-play. The immediate financial impact will therefore likely be protracted, meaning lower revenue for a longer period of time for both of these live-service games. This could hurt the profitability in 2025 according to our estimates regarding the game pipeline.

Valuation

An obvious takeover target

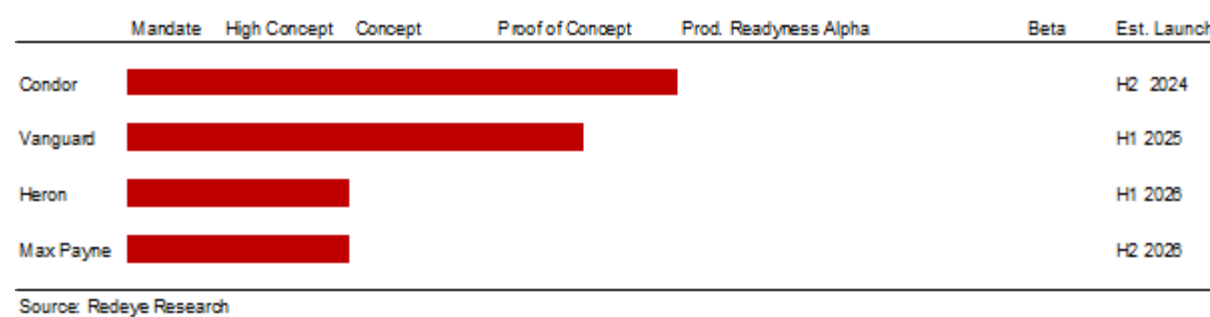
Only a few independent major game studios are left after the recent years accelerated consolidation in the industry. We are certain that Remedy has a high position in the shopping list amongst many major players. Potential buyers are Epic Games, Sony, Microsoft, and Take-Two Interactive we believe. This fact considerably de-risks an investment in Remedy we argue despite the relatively high valuation multiples in a short-term perspective.

Game pipeline

Our financial projections are of course very much dependable on our assumptions regarding game releases. As illustrated in the table below the estimated time in all development stages has broad ranges. When a game is in full production the alpha stage for example can be 12-24 months.

Both Vanguard and Condor are multiplayer online games. Those types of games often are released during its alpha stage in so-called "Early Access". Both these games could therefore be launched earlier than our estimates. The development is partly financed by Tencent and 505 Games (Digital Bros) in Vanguard and Condor respectively.

Vanguard had a team of 40 people in August. According to CEO Tero Virtala the postponed Vanguard scale-up with better process efficiency, was positive from a corporate perspective he told us in Remedy's earnings call. During Q2 Condor moved from "proof of concept" to the "product readiness phase". Approximately 50 people can now scale up to 70 people.



The single-player game codenamed "Heron" is a sequel to Control. The game will be a collaboration between 505 Games and Remedy. However, we believe Remedy will likely collaborate with another publisher or platform owner, like Sony.

Financials

Q2-report comments

Revenue was somewhat weaker than expected, approximately 6% weaker. The cost-base was relatively in line with our expectations. With no production capitalization during the quarter the EBIT was below our estimate. Redeye estimates the development fees and thus the revenue will increase gradually from this level.

Remedy: Estimates vs Result (EURm)			
(EURm)	Q2E	Q2	Diff
Revenue	10.0	9.4	-6%
Capitalization	2.1	0.0	-100%
COGS	-3.5	-3.5	-1%
Gross Profit	10.4	5.9	-43%
Personnel Expenses	-6.9	-6.2	-10%
Other OPEX	-1.5	-1.4	-7%
EBITDA	2.0	-1.7	-186%
D&A	-0.5	-0.6	20%
EBIT	1.5	-2.4	-261%
Gross margin	104%	63%	
EBITDA margin	20%	-18%	
EBIT margin	15%	-26%	

Source: Redeye Research

In our table below we lowered our previous communicated revenue estimate with 15%. Shortly after the profit warning on August 1 we wrote that revenue will probably be 5-10% lower in 2022 than our previous estimate. And Q2 will be the weakest quarter of them all, due to gradually unticking development fees in all the game projects according to our assumptions.

Financial projections

As we have communicated after the profit warning in August and the Q2 report we have lowered our expectations regarding the EBIT levels in 2022 and 2023 and the revenue growth this year. We have also lowered personnel expenses in 2022-2024 while we have increased our estimates regarding external development costs (shown as COGS). Meaning more game development is expected to be outsourced.

Estimate changes

2022: Revenue is expected to be unchanged compared to last year, meaning EUR 45 million in revenue (the previous estimate was EUR 49.3 million). EBIT is expected to be around EUR -3.8 million compared to our previous estimate of EUR 6.3 million. We however already have noticed that revenues were expected to be around break-even levels following the Q2 result.

2023: We still estimate a revenue level of around EUR 55 million in 2023. The majority of the revenue boost comes from development fees from Max Payne Remake but also from Vanguard we assume. We expect Max Payne is entirely financed by Rockstar Games and around 80% of Vanguard is financed by Tencent.

According to our estimates, EBIT will be around EUR -1.2 million in 2023 (EUR 4.9 million).

2024: Remedy will acquire royalty income from Alan Wake 2 (released in 2023) during 2024 we assume. The majority of the revenue boost will come from this royalty according to our estimates.

As always, it is hard to predict the optionality in Remedy. It is, however, quite certain that Remedy will continue to make platform deals, which will lower the risk further in this already somewhat de-risked business case.

Remedy: Estimates (EURm)							
(EURm)	Q1	Q2	Q3E	Q4E	2022E	2023E	2024E
Revenue	12.7	9.4	10.9	12.0	45.0	54.6	75.9
Capitalization	0.0	0.0	0.0	0.0	0.0	0.0	0.0
COGS	-2.4	-3.5	-3.8	-4.3	-15.3	-17.5	-18.1
Gross Profit	10.3	5.9	7.1	7.7	29.7	37.1	57.8
Personnel Expenses	-5.7	-6.2	-6.5	-6.9	-25.3	-28.8	-32.3
Other OPEX	-1.4	-1.4	-1.4	-1.6	-6.0	-7.4	-7.7
EBITDA	3.2	-1.7	-0.8	-0.8	-1.7	1.0	17.8
D&A	-0.6	-0.6	-0.5	-0.6	-2.2	-2.2	-3.7
EBIT	2.7	-2.3	-1.4	-1.4	-3.8	-1.2	14.0
Growth	56%	0%	47%	-39%	1%	21%	39%
Gross margin	81%	63%	65%	64%	66%	68%	76%
EBITDA margin	26%	-18%	-8%	-7%	-4%	2%	23%
EBIT margin	21%	-25%	-13%	-12%	-8%	-2%	19%

Source: Redeye Research

Valuation Scenarios

WACC has been increased to 9.5% (9%) in all scenarios due to higher interest rates.

Base Case EUR 32 (38)

CAGR of about 21% between 2022-2026 with EBIT margin expanding to 27% (34%).

Terminal growth of 2% with terminal EBIT margin of 33%.

Our base case assumes relatively successful launches of Alan Wake, Control and Max Payne. We have lower expectations of its live-service games, due to a nonexistent track record.

Bear Case EUR 14 (17)

CAGR of about 12% between 2022-2026 with EBIT margin expanding to 22% (30%).

Terminal growth of 2% with terminal EBIT margin of 25%.

Our bear case assumes mixed commercial results in launches of Alan Wake, Control and Max Payne. We have lower expectations of its live-service games, due to a nonexistent track record.

Bull Case 54 (60)

CAGR of about 26% between 2022-2026 with EBIT margin expanding to 30% (36%).

Terminal growth of 2% with terminal EBIT margin of 36%.

Our bull case assumes successful launches of Alan Wake, Control and Max Payne. We also have relatively high expectations of its live-service games.

Estimates 2022-2025	2022E	2023E	2024E	2025E
Base				
Revenue growth	0.5%	21.4%	39.1%	14.0%
EBIT margin	-8.5%	-2.2%	18.5%	24.0%
Terminal EBIT: 33%				
Bull				
Revenue growth	2.0%	25.0%	55.0%	12.0%
EBIT margin	0.0%	5.0%	30.0%	25.0%
Terminal EBIT: 36%				
Bear				
Revenue growth	(1.0%)	15.0%	22.0%	8.0%
EBIT margin	(10.0%)	(5.0%)	15.0%	18.0%
Terminal EBIT: 25%				
Source: Redeye Research				

Redeye financials					
EURm	2020	2021	2022E	2023E	2024E
Revenues	41.1	44.73	44.96	54.57	75.92
Operating Expenses	25.29	31.08	31.35	36.12	40.02
EBITDA	14.33	13.63	-1.67	0.99	17.79
Depreciation	0	0.26	0.46	0.55	1.25
Amortizations	0	0.79	1.69	1.64	1.25
Non Recurring Income Expense	0	0	0	0	0
EBIT	13.2	12.32	-3.82	-1.2	14.04
Shares in Associates	0	0	0	0	0
Net Financial Items	0	0	0	0	0
Exchange Rate Differences	0	0	0	0	0
EBT	13.2	12.32	-3.82	-1.2	14.04
Income Tax Expenses	0	2.24	-0.49	-0.24	2.81
Net Income	13.2	10.08	-3.33	-0.96	11.24
Cost of Revenue	1.49	0.02	15.28	17.46	18.11
Interest Expenses	0	0	0	0	0

Redeye financials					
EURm	2020	2021	2022E	2023E	2024E
Revenues	41.1	44.73	44.96	54.57	75.92
Operating Expenses	25.29	31.08	31.35	36.12	40.02
EBIT	13.2	12.32	-3.82	-1.2	14.04
Change in Working Capital	1.33	-11.93	0.76	-3.36	0.12
Capital Expenditures	0	-9.6	-9.54	-9.82	-11.24
Free Cash Flow	11.81	-5.47	-9.97	-11.96	3.86
Operating Cash Flow	11.81	5.18	-0.42	-2.14	15.1

Redeye financials					
EURm	2020	2021	2022E	2023E	2024E
Accounts Receivable	14.22	17.11	15.74	19.1	18.98
Average Inventories	0	0	0	0	0
Other Current Assets	0.55	10.12	8.99	10.91	7.59
Total Current Assets	38.46	78.61	63.93	57.92	58.53
Property, Plant and Equipment (Net)	0	2.58	11.66	20.94	30.93
Invested Capital	14.45	34.18	40.82	51.82	60.44
Goodwill	2.22	0	0	0	0
Right-of-Use Assets	0	0	0	0	0
Other Long Term Assets	0	3.6	3.6	3.6	2.6
Total Non-Current Assets	9.89	21.29	28.68	36.32	44.06
Total Assets	48.35	99.9	92.61	94.24	102.59
Short Term Debt	0	0	0	0	0
Accounts Payable	0	0	0	0	0
Other Current Liabilities	10.21	10.74	8.99	10.91	7.59
Total Current Liabilities	10.21	10.74	8.99	10.91	7.59
Long Term Debt	2.76	1.84	1.84	1.84	1.84
Other Long Term Lease Liabilities	0	0	0	0	0
Shareholder's Equity	35.39	87.33	81.78	81.49	92.91
Non Controlling Interest	0	0	0	0	0
Total Liabilities and Equity	48.35	99.9	92.61	94.24	102.34
Cash Equivalents	23.69	51.38	39.2	27.91	31.96
Revenues	41.1	44.73	44.96	54.57	75.92
Operating Expenses	25.29	31.08	31.35	36.12	40.02
EBIT	13.2	12.32	-3.82	-1.2	14.04
Change in Working Capital	1.33	-11.93	0.76	-3.36	0.12
Capital Expenditures	0	-9.6	-9.54	-9.82	-11.24
Free Cash Flow	11.81	-5.47	-9.97	-11.96	3.86
Operating Cash Flow	11.81	5.18	-0.42	-2.14	15.1

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 longterm 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.

Redeye Equity Research Team

MANAGEMENT



Björn Fahlén
bjorn.fahlen@redeye.se



Martin Nilsson
martin.nilsson@redeye.se



Tomas Otterbeck
tomas.otterbeck@redeye.se

TECHNOLOGY TEAM



Alexander Flening
alexander.flening@redeye.se



Anton Hoof
anton.hoof@redeye.se



Danesh Zare
danesh.zare@redeye.se



Douglas Forsling
douglas.forsling@redeye.se



Forbes Goldman
forbes.goldman@redeye.se



Fredrik Nilsson
fredrik.nilsson@redeye.se



Fredrik Reuterhäll
fredrik.reuterhall@redeye.se



Henrik Alveskog
henrik.alveskog@redeye.se



Hjalmar Ahlberg
hjalmar.ahlberg@redeye.se



Jacob Svensson
jacob.svensson@redeye.se



Jesper Von Koch
jesper.vonkoch@redeye.se



Jessica Grunewald
jessica.grunewald@redeye.se



Mark Siöstedt
mark.siostedt@redeye.se

EDITORIAL



Joel Karlsson
joel.karlsson@redeye.se

LIFE SCIENCE TEAM



Christian Binder
christian.binder@redeye.se



Ethel Luvall
ethel.luvall@redeye.se



Filip Einarsson
filip.einarsson@redeye.se



Fredrik Thor
fredrik.thor@redeye.se



Gustaf Meyer
gustaf.meyer@redeye.se



Johan Unnerus
johan.unnerus@redeye.se



Kevin Sule
kevin.sule@redeye.se



Mats Hyttinge
mats.hyttinge@redeye.se



Oscar Bergman
oscar.bergman@redeye.se



Richard Ramanius
richard.ramanius@redeye.se



Sebastian Andersson
sebastian.andersson@redeye.se



Mattias Ehrenborg
mattias.ehrenborg@redeye.se



Niklas Sävås
niklas.savas@redeye.se



Rasmus Jacobsson
rasmus.jacobsson@redeye.se



Viktor Lindström
viktor.lindstrom@redeye.se

Disclaimer

Important information

Redeye AB ("Redeye" or "the Company") is a specialist financial advisory boutique that focuses on small and mid-cap growth companies in the Nordic region. We focus on the technology and life science sectors. We provide services within Corporate Broking, Corporate Finance, equity research and investor relations. Our strengths are our award-winning research department, experienced advisers, a unique investor network, and the powerful distribution channel redeye.se. Redeye was founded in 1999 and since 2007 has been subject to the supervision of the Swedish Financial Supervisory Authority.

Redeye is licensed to; receive and transmit orders in financial instruments, provide investment advice to clients regarding financial instruments, prepare and disseminate financial analyses/recommendations for trading in financial instruments, execute orders in financial instruments on behalf of clients, place financial instruments without position taking, provide corporate advice and services within mergers and acquisition, provide services in conjunction with the provision of guarantees regarding financial instruments and to operate as a Certified Advisory business (ancillary authorization).

Limitation of liability

This document was prepared for information purposes for general distribution and is not intended to be advisory. The information contained in this analysis is based on sources deemed reliable by Redeye. However, Redeye cannot guarantee the accuracy of the information. The forward-looking information in the analysis is based on subjective assessments about the future, which constitutes a factor of uncertainty. Redeye cannot guarantee that forecasts and forward-looking statements will materialize. Investors shall conduct all investment decisions independently. This analysis is intended to be one of a number of tools that can be used in making an investment decision. All investors are therefore encouraged to supplement this information with additional relevant data and to consult a financial advisor prior to an investment decision. Accordingly, Redeye accepts no liability for any loss or damage resulting from the use of this analysis.

Potential conflict of interest

Redeye's research department is regulated by operational and administrative rules established to avoid conflicts of interest and to ensure the objectivity and independence of its analysts. The following applies:

- For companies that are the subject of Redeye's research analysis, the applicable rules include those established by the Swedish Financial Supervisory Authority pertaining to investment recommendations and the handling of conflicts of interest. Furthermore, Redeye employees are not allowed to trade in financial instruments of the company in question, from the date Redeye publishes its analysis plus one trading day after this date.
- An analyst may not engage in corporate finance transactions without the express approval of management and may not receive any remuneration directly linked to such transactions.
- Redeye may carry out an analysis upon commission or in exchange for payment from the company that is the subject of the analysis, or from an underwriting institution in conjunction with a merger and acquisition (M&A) deal, new share issue or a public listing. Readers of these reports should assume that Redeye may have received or will receive remuneration from the company/companies cited in the report for the performance of financial advisory services. Such remuneration is of a predetermined amount and is not dependent on the content of the analysis.

Redeye's research coverage

Redeye's research analyses consist of case-based analyses, which imply that the frequency of the analytical reports may vary over time. Unless otherwise expressly stated in the report, the analysis is updated when considered necessary by the research department, for example in the event of significant changes in market conditions or events related to the issuer/the financial instrument.

Recommendation structure

Redeye does not issue any investment recommendations for fundamental analysis. However, Redeye has developed a proprietary analysis and rating model, Redeye Rating, in which each company is analyzed and evaluated. This analysis aims to provide an independent assessment of the company in question, its opportunities, risks, etc. The purpose is to provide an objective and professional set of data for owners and investors to use in their decision-making.

Duplication and distribution

This document may not be duplicated, reproduced or copied for purposes other than personal use. The document may not be distributed to physical or legal entities that are citizens of or domiciled in any country in which such distribution is prohibited according to applicable laws or other regulations.

Copyright Redeye AB.