

Games Workshop (GAW) (Search for IP Series Post 1)

In my last post I introduced my new “search for IP” series. Today’s post is the first entry into the series: Games Workshop (GAW; trades in London). If you have any thoughts on the company or suggestions for new entries in the series, I’d love to hear them!

Games Workshop popped on my radar when a friend sent me this Guardian article, which I’d encourage you to read for some background. The company makes miniature table top toys (here’s an example). The first thing that probably pops into your mind when you hear “miniature table top toys” are legos or army men (or maybe Dungeons and Dragons if you’re as nerdy as I am), but Game Workshop’s figures are much more than that: the “toys” have a high production value and are quite costly (starter kits cost >\$100). In addition, the toys don’t come premade; instead, collectors / players assemble and paint the toys themselves (the Guardian article notes an imperial knight has more than 220 parts to glue together that take hours of work to complete). Once a player has collected a bunch of figures, they can use them to play in one of Games Workshops tabletop battlefield games. The most popular game is Warhammer 40K, which one gamer described as “10-fold more complicated than chess”.

Games Workshop as a standalone business is interesting (even ignoring the potential upside from IP monetization I’ll focus on in a second). The business is growing quickly (reported sales were up almost 40% in their most recent fiscal year) and I’d guess that growth continues over the next few years due to continued growth in the company’s store count (they increased their store count by >5% in their last fiscal year, and their goal is to maintain similar growth in 2019) and strong reviews for their most recent version (version 8) of Warhammer 40k

(which was released in summer 2017 and apparently cleaned up a bunch of legacy rules that made the game impossibly complex). At today's share price (~£32.50), I have them trading at ~14x LTM EBIT / ~17x unlevered free cash flow. That's not the cheapest valuation, but it's certainly not unreasonable for a company generating decent growth in what should be a pretty non-cyclical business that whose future is reasonably predictable.

If the toy side of the business was the only piece of Games Workshop, I'd say the company was interesting but probably fairly valued. What's really interesting about Games Workshop is they own the IP underlying their biggest game, Warhammer, and I think the IP is relatively unexploited currently.

What is Warhammer? I'd suggest reading this quora article and this guardian article, but a simple synopsis is Warhammer has two settings: Warhammer 40K and Warhammer Age of Sigmar (Fantasy). Both take place in the same universe, but Warhammer 40k takes place 40,000 years into a dystopian future (hence 40k) (here's an article with a bit more on the differences). 40k is actually a bit more popular, so I'm going to tilt my description a bit more towards that setting, but overall the universe has heavy elements from both the fantasy and sci-fi realms (hostile aliens, supernatural creatures) and has a deep history, with decades worth of books, spin off games, etc. behind it. Hallmarks of the overall universe include its over the top nature (40K includes space marines whose weapon of choice is basically a chainsaw sword, and one character one-ups that by wielding a chain-axe) and a generally grim tone. Both universes are darker than your typical fantasy setting, though the 40K universe appears to take the darkness to a new level (one commentator says it makes Game of Thrones look like sunshine and rainbows in comparison; you can find a list of some of the really dark stuff here).

So it's that massive Warhammer Universe / IP that really interests me. In GAW's 2017/2018 annual report (found here),

GAW's said the following about the Warhammer IP, "We believe our IP to be among the best in the world." Admittedly, a CEO may be just a bit biased when talking about his company's IP, and it's tough to tell just how "popular" a form of IP is, but I see plenty of evidence that the Warhammer IP is extremely strong. Here are just a few examples of where their IP is / attempts at quantifying the strength of the IP:

- Video games: Warhammer has had multiple extremely successful video games released using their IP.
 - Total War (set in Warhammer Fantasy): Total War has released two games based on Warhammer (Game 1 and Game 2), with plans for a third. The games have received very positive reviews and have sold quite well (Wikipedia notes the first game sold more than half a million copies in its first few days on sales, and I believe the second game was a bit behind that pace but still sold hundreds of thousands of copies in the first few days of its release).
 - Vermintide (set in Warhammer fantasy): Two Warhammer: Vermintide games have been released (Game 1 and Game 2). Like the total war series, these games have been extremely successful. The first game sold over 500k units in ~6 months, and the sequel sold 500k copies in four days after its PC release.
 - Warhammer 40,000: Dawn of War: A real time strategy game series. The first of this series was a breakout hit, with more than 7m units sold since its release in 2004. The sequel was released in 2009 and the third was released in 2017; both had good reviews but didn't sell nearly as well as the original.
 - App store: I searched for Warhammer and found "dozens" of Warhammer games on there, including multiple apps / games with thousands of reviews

and at least three games that were “editors’ choice” for iOS.

- Books: There have been dozens of books released in the Warhammer universe
- General feel: again, it’s tough to measure how popular non-super mainstream IP is (how would you judge the popularity of Game of Thrones before the TV series was released?), but if you’re willing to google a bit you can find plenty of articles focused on niche groups and how popular Warhammer is with them (for example, here’s one from 2012 on Warhammer’s popularity with soldiers, and here’s an Economist article on tabletop gaming’s popularity which centers on the rising popularity of Warhammer).

So it certainly seems like the IP is pretty popular, and GAW is just beginning to tap into its potential. Royalty income (from licensing the Warhammer IP) increased from £2.4m in FY17 to £9.9m in FY18 (driven by Total War 2 and Vermintide 2), and the company is clearly looking to continue to improve their royalty / IP stream: the annual report notes they’ve formed a small team of senior management looking to “find new partners to bring Warhammer to life like never before” including exploring opportunities in “animation, live action and more.” In an upside case, GAW manages to license the Warhammer IP to a streaming service that turns it into a Game of Thrones like TV epic (similar to what Amazon is looking to do with Lord of The Rings).

So that’s your upside case. I think there are clearly some issues with that case though. First, Warhammer is not Lord of The Rings or some other super premium fantasy series (i.e. its pull is much smaller / less proven), so it’s much more of a lottery ticket landing someone to make a big bet on the universe. Still, that’s true of all potentially undervalued / unexploited IP, and I think Warhammer has as good a chance as anyone on landing a media company willing to make a big bet

given Warhammer's proven pull (to sell literally millions of copies of video games across multiple franchises is really impressive). My bigger worry is that Warhammer is so dark / gruesome that most big companies are going to decide the IP simply isn't for them. HBO frequently deals with headaches from the more gruesome stuff in Game of Thrones, and a quick read through some of the plotlines for Warhammer shows that Warhammer regularly does stuff that would put Game of Thrones to shame / result in a corporate PR nightmare. Apple's media strategy is focused on "PG-rated" shows to appeal to a wide audience; I wonder how many big brands would want to associate with something as dark as Warhammer.

But just because the mammoth brands might not touch Warhammer doesn't mean it can't be a big winner. There's clearly an audience for darker / grittier stuff (DC's streaming service is certainly betting on it, and apparently even their comic books are getting in on the act), and someone will talk themselves into making a really dark Warhammer show if they're convinced Warhammer's audience is big enough and that they can immediately grab a huge swath.

That brings me to my last and biggest concern: just how big is Warhammer's audience? Clearly the board game has a worldwide diehard fan base, and a lot of people know the Warhammer Universe / IP from the video games... but I'm wondering how many of those video games are selling because they're solid games in known franchises (the ratings of all of the games have been quite high, and the Total War franchise is very popular) versus specifically because they are Warhammer universe games (i.e. how many people are buying the games because the Warhammer universe is pulling them versus just because they are good games).

I can't find any great estimates of how large the Warhammer fanbase is, but GAW's financials might give us some idea. Games Workshop did ~\$300m in sales in their most recent fiscal year, with ~\$90m of it coming in North America. It's tough to

narrow that down into a direct fan number (Warhammer is a relatively expensive hobby. Super fans might be spending thousands a year to get everything, while newcomers might just be buying a starter kit or long term fans might just buy one new kit a year), but if I play around with the numbers a bit in my head I get somewhere between 100-250k fans in the U.S. and something like 1-5m fans worldwide. I could be way off, though the number seem roughly reasonable to me and I'd point out that the official Warhammer 40k Facebook page has <150k fans. It's possible that there's a much large base of "lapsed" fans who are familiar with the property and would be drawn in by an easier to access offering (i.e. someone who doesn't play anymore but was a fan ten years ago and would give a TV show set in the Warhammer world a chance).

Let's be generous and say there are ~250k active fans of the Warhammer universe in the U.S. Throw in another 3m people who are familiar with the Warhammer Universe from the games and other venues. No doubt the IP is solid... But is that a big enough group that the IP passes my "elite" IP test of being something that could single-handedly launch a network / theme park? My guess here is no.

Still, the stock looks interesting. The valuation is undemanding, the company is growing, I like the management team, and there's clearly upside if they can continue to license the IP (particularly if they land a big budget TV series or movie). The Warhammer Universe is vast, and if the company does a good job licensing out the IP, I could easily see it building out a large enough fan base that it one day could qualify as "elite" IP. But I think the IP is a level or three below the type of "elite" IP I want to be investing in / finding in today's world, and I'd rather wait for more signs that the Warhammer IP is gaining more mainstream popularity before investing.

Other odds and ends

- I noted above that royalty income had increased to almost £10m in GAW's most recent fiscal year. Royalty income growth was driven by royalties on Total War 2 and Vermintide 2, and I think there's reason to believe royalty income could remain strong looking forward. Vermintide 2, for example, released on Windows in early March and didn't release on Xbox until July 2018 (after GAW's fiscal year had already closed) and still hasn't come out on Playstation. As Vermintide ramps up across all platforms, I think you'll see continued strong royalty growth. Given royalties are generally extremely high margins, that pending royalty growth could suggest GAW is even cheaper than I highlighted here.
- One thing I like about Games Workshop: as our culture moves to an increasingly screen / internet dominated world, I have a thesis that live experiences (whether they are events like concerts or simple board games) that bring people back into the real world will gain increasing popularity. Everything about GAW's board games (both the social / strategic element and the element of assembling and painting the pieces) qualifies for that "live experience" trend in a big way.
 - I mentioned D&D earlier; Warhammer reminds me of D&D in a lot of ways. D&D is riding similar "live" trends and is currently enjoying a renaissance / its best sales in years.
- Aside from the just overall over the top / violence aspect of Warhammer, another thing that worries me is Warhammer is not the easiest universe to get into. The game itself is pretty complicated (complicated games discourage casual fans / gameplay), and having two universes both named Warhammer (the 40k universe and the Age of Sigmar universe) makes it tough to tell what universe to get into / follow. When I was doing research it was tough (as a casual fan) to remember the difference between the two universes and which game was set in which.

- Games Workshop has a policy of “returning truly surplus cash to shareholders”. I’m generally dividend agnostic (honestly, I’d rather see companies repurchase shares if I’m invested in them), but I do like the dividend policy because it shows management is willing to return excess capital to shareholders versus reinvesting it into non-economic projects. The annual report shows the company is very focused on ROIC.
- Speaking of the annual report, I’d (again) encourage you to read the company’s most recent annual report. I’m really impressed with how GAW’s CEO talks about the business and his vision for it.

Disclosure: I currently have no position in Games Workshop, though that may change in the future. Do your own research / consult proper advisors, and note that Games Workshop is both small and trades on a foreign exchange, which increases risk and potential tax complexity (though I’m not a tax advisor and that’s not tax advice)!