

# CD Projekt (CDR) (Search for IP Series Post 2)

Today's post is the second in my "search for IP" series (you can find my first post on Games Workshop here). If you have any thoughts on the company or suggestions for new entries in the series, I'd love to hear them!

CD PROJEKT (trades in Warsaw under CDR. I'll refer to them as CDR going forward) is a video game publisher and distributor. The company is mainly known for their blockbuster video game franchise, The Witcher (as of the end of 2017, the trilogy of Witcher games had sold more than 33m copies and received >1k awards worldwide). Long time readers may not be surprised to see me write up the company behind The Witcher: I mentioned Netflix's Witcher show as one of the "IP expansions" that had me most interested in looking for undervalued IP, and I had previously mentioned The Witcher as one of the universes that had the potential for lots of expansion. So this write up is really about scratching my itch / curiosity for the company.

A bit more background on the company because I find it pretty interesting: CDR was founded in 1994 as an importer / seller of Western Video Games. On top of importing games, they started to localize games as well (changing the text from English to Polish; hiring Polish actors to voice the characters) and experienced big success with a localized version of Baldur's Gate (a series that I had.... more than a passing interest in in high school). The company was contracted to localize the sequel to Baldur's Gate: Dark Alliance, but when that game was cancelled CDR decided to develop their own original game. BioWare, the company behind Baldur's Gate, helped CDR, and the end result was The Witcher, which dropped in 2007. The first Witcher game was a relative success, and company immediately began developing The Witcher 2. The Witcher 2 came out in 2011 to critical praise and was a

huge commercial success, selling ~2m copies within the first year of release. The big breakout came from the Witcher 3, which was released in 2015 to massive critical praise (it won almost every major "Game of the Year" award, including IGN's and Game Spot's) and is considered one of the greatest games of all time.

Ok, so that pretty much brings us to today. I think there are three really interesting questions that loom over any potential investment in CDR.

1. New title potential: Clearly, the Witcher franchise has been a success, but the big question for CDR is if they can successfully release games outside of The Witcher Universe (or, if you want to get really granular, if they can release successful Witcher games with a different protagonist (the first three games have all starred Geralt of Rivia, who Henry Cavil will play in the Netflix series)). How durable is the skill of releasing successful video games? Is it like making movies / TV shows, where predicting success is a bit of a crap shoot? Or is releasing video games more of a durable skill where having a great culture / process has an outsized impact on the end game?

1. I don't know the right answer here, but I tend to think making great games is more durable than many of us suspect. I'd point to two things here: first, some companies like Nintendo (Mario, Zelda, etc.), Bioware (Baldur's Gate, Mass Effect), Blizzard (Starcraft, Diablo, Overwatch), Take Two (Grand Theft, Red Dead), and Bungie (Halo, Destiny) have a hit rate that is so high across so many franchises that there's almost no question they have durable skill in "hit making". Second, there's some similarities between video games and animated movies, and I'd point out that multiple animated movie studios (Pixar, Illumination) have

hit rates high enough to suggest they have “skill” in hit making as well.

2. So I think it’s possible to have a durable skill for making hit games. But does CDR have that skill, or did they just catch a bit of fire and luck with the Witcher franchise and it’s unlikely they’ll be able to release good games outside of that franchise? The evidence is inconclusive, but if I had to guess CDR does have skill with releasing hit games. All of their game releases so far have been critical hits, and their reviews have gotten better over time (which suggests to me that they’ve been refining the process). I also take some comfort in the positive early reviews for Cyberpunk (discussed in a second) as well as the super positive reviews for all of the add-on content the company has released for the Witcher (Thronebreaker, a just-released standalone game which expands the Witcher world and centers on the Gwent card game, has gotten fantastic early reviews though sales have been disappointing). We should find out soon if CDR’s has “durable” hit making skills: their next project, Cyberpunk 2077 (adopted from the tabletop game Cyberpunk 2020, which I’ve never heard of before), will likely release in the next year. The early buzz for the game has been extremely good (the trailers have received glowing praise and won multiple awards), but obviously there’s a difference between getting early buzz from releasing a good trailer and actually releasing a successful game.
2. IP value for something they only own a slice of: One of the great things about Disney with something like Marvel is they can own and monetize the whole value stack because they own the underlying IP. So they own the Marvel stories / comics / characters and can then turn those stories into movies, which they can further

monetize by turning them into games / theme parks / merchandise. That's not necessarily the case with CDR: The Witcher is actually based on a cult series of books, so CDR won't directly benefit from future monetization of the IP (i.e. I'm near positive they don't get a revenue / licensing stream from the Netflix Witcher series). I think there are two interesting questions here:

1. If the Netflix series comes out and drives overall interest in The Witcher Universe, how beneficial is that for CDR? Yes, they won't get a direct fee stream from the show... but an increase in interest in the universe likely leads to more fans who might buy the old games or be willing to give new releases a shot. So does the universe growing benefit them in that way?
2. CDR licensed The Witcher IP for videogames (and, fortunately for CDR, paid the author everything upfront instead of offering a % of profits (something the author now regrets!)). Cyberpunk 2077 is based on a tabletop game; has CDR structured something similar to their Witcher agreement where they can only make video games in the Cyberpunk realm, or does their Cyberpunk deal allow them to capture more upside if the game proves a success (i.e. CDR basically owns all the IP and can make / license movies / TV shows / merchandise etc.)? Is the cyberpunk deal similar to the Witcher deal (flat fee, no profit cut) or will whoever owns the Cyberpunk IP take a profit share?
3. Valuation: CDR releases blockbuster video game titles. Similar to smaller movie studios, results spike in the years CDR releases a game (assuming it's successful) and then are middling in the intervening years. Those "lumpy" financials make CDR very difficult to value: trailing financials are generally meaningless (if you

use trailing financials in a year the includes a major release, you're using peak results; if you use trailing financials in a non-release year, you're using trough results), and any forward metrics need to include estimates for how frequently the company will launch games and how successful those games will be.

1. An interesting thing to note here: videogames today have much longer lives thanks to updates / add-ons that can be sold over the internet. Grand Theft Auto 5 has retained massive interest and profitability thanks to GTA Online, which is free but offers lots of potential for microtransactions. While The Witcher doesn't have anything like GTA Online currently, CDR's projects are big / sweeping enough to think an online world is possible. Adding an online world like GTA would drastically increase the tail end earnings for CDR's games and make them slightly less "hit" dependent.

So today, CDR trades at ~140 PLN (Poland Zloty), giving them a market cap of around \$3.5B USD (I'm going to convert everything to USD going forward, as I'm guessing most of my readers are more familiar with thinking about things in USD). That market cap / valuation looks crazy expensive if you look at the company simply on a trailing basis: they've only earned ~\$31m in EBIT over the past year, so they're trading at >100x LTM EBIT. However, CDR is a hit driven business, and the last major Witcher title launched in the middle of 2015. CDR earned almost \$110m in EBIT in 2015 and about \$80m in EBIT in 2016, so the business / profits can clearly ramp up when the company releases a major title. With Cyberpunk on the horizon for next year, it's almost certain that profits will ramp up in the near future.

Rather than look at CDR on a trailing basis, I think the appropriate way to value CDR is to value it almost like a

pharma company: value the Witcher franchise as a whole, and then value each of their "pipeline" titles on a probability basis by assigning different odds and values to different outcomes (i.e. there's a 20% chance Cyberpunk is a smash hit and is worth \$2B, there's a 40% chance it's a regular hit and it's worth \$1B, etc.).

That's a really tough task and involves a lot of estimates / guess work. But I do think one thing is instructive here: The Witcher 3 was a mammoth hit released in 2015, and CDR earned a total of ~\$180m in operating income combined in 2015/2016. Let's say they averaged \$90m/year in operating income over those peak years. CDR's enterprise value today is approaching \$3.5B, so the market is effectively valuing them at 40x peak earnings from the year they released an unbelievable smash hit. When you look at it that way, it becomes pretty clear the market is pricing in a relatively good shot of Cyberpunk being an absolute smash hit. Given CDR's track record, I wouldn't want to bet against them, but I think it's tough to argue there's much margin of safety built into today's price.

One last note before I wrap the piece up: CDR is clearly an attractive acquisition target (in fact, part of the high valuation is almost certainly the market pricing in some "potential acquisition" premium). One of the bigger studios would have an insane amount of synergies if they bought CDR; expanding the Witcher Universe (more mobile games, better monetization, improved distribution, etc. Distribution in particular is an interesting angle; CDR blamed early poor sales of Thronebreaker in part on their proprietary distribution outlet, which would be a very quick fix for an acquirer with their own system) alone could generate significant value. However, the acquisition math really changes if Cyberpunk is a hit: at that point, an acquirer isn't just valuing CDR based on their financials; they'd be valuing CDR for both their game franchises and as a strategic acquisition of a studio with proven hitmaking capabilities. If

you look at the record of selling companies with a “proven” hitmaking ability to strategic buyers (Disney’s acquisition of Pixar, Comcast’s acquisition of Dreamworks, etc.), hitmaking studios go for a mammoth premium. There aren’t a ton of acquisition targets at the high end of the video gaming space, so if Cyberpunk is a massive success, I think the multiple that CDR trades at becomes near irrelevant as the stock will start pricing in the massive acquisition premium CDR would get if they ever decided to sell.

Disclosure: I currently have no position in CD PROJEKT, though that may change in the future. Do your own research / consult proper advisors, and note that CD PROJEKT 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)!