Newsletter

Fundamental Growth and Core Equity

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Investing in Sustainable Growth

Contents

Beyond COVID: Continuation of Secular Themes

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Equity markets globally have continued their recovery, buoyed by improving economic fundamentals, monetary and fiscal stimulus, ongoing low interest rate and inflation expectations and progress on COVID vaccinations.

Rapid distribution of the COVID vaccine has become increasingly urgent as the spread of the virus has accelerated in many parts of the world. We believe the environment for equities remains favorable against a backdrop of unprecedented fiscal and monetary stimulus and continued progress of vaccine deployment. Segments of the market most negatively impacted by COVID may experience some recovery, elsewhere, sustained earnings growth will be necessary to support valuations. Unemployment, output gaps, and central bank intervention are likely to contain inflation and interest rates in our view, limiting any sustained market rotation. Eventually, we expect market focus to turn to the shape of the economic recovery in 2022 and beyond. Current high equity valuations, especially in the US, are a key investor concern. But with a long-term investment horizon, we continue to find opportunities globally on a bottom-up basis that are compelling relative to their sustainable growth potential.

Over the long term, we see a continuation of secular themes that have shaped markets in recent years. An example is the acceleration and spread of technological innovation to all corners of the economy driving productivity growth. One enabler of this ongoing trend is the roll-out of 5G technology, which our analysts explore in this newsletter. We also discuss how we integrate ESG and sustainability into our company analysis with a discussion on the consumer sector. Finally, we close with a highlight of one of our holdings in our Emerging Markets portfolio.

We believe the best way to leverage these secular themes is to take an active, forward-looking approach to investing in companies with Quality, Sustainable Growth, and Reasonable Valuation. This approach has served the Fundamental Growth and Core (FGC) Equity team well over the long term, and more recently in 2020 when seven of our nine strategies outperformed their benchmarks. This is a testament to the depth and commitment of our team, a disciplined process and our long-term perspective.

Understanding 5G and its Investment Implications

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The next generation of mobile network technology known as 5G is quickly becoming a reality. The improved connectivity that 5G will deliver has implications far beyond smartphones and is a key step toward a fully networked economy. At the same time, the rollout of 5G presents challenges that cut across industries and countries. As an investment team, we are seeking to understand the implications of this potentially disruptive technology on the companies in which we invest. We caught up with three of our research analysts who cover the technology and media sectors to discuss developments in this space and get their views on the technology.

Bill, as a starting point, can you explain to us what 5G is?

5G is a fifth-generation mobile network technology that will deliver much more than any previous "G". The first generation (1G) provided analog voice; 2G brought us digital voice; 3G saw the transmission of mobile data; and 4G delivered higher quality mobile broadband or internet. Eventually, the promise of 5G networks is the delivery of multi-gigabit data speeds, ultra-low latency, greater reliability, massive network capacity, flexible scalability and high security — all at lower power than 4G networks today. Once fully built, 5G networks will be more comprehensive and extensive, designed to connect nearly everyone and everything, including machines, appliances and mobile devices. Because of this connectivity, 5G networks will make the "futuristic" Internet of Things (IoT), Smart Cities, Smart Factories and Smart Homes a reality.

So how much better will 5G be compared to 4G?

A lot. In terms of speed, 5G will be 10 to 100 times faster than 4G, providing up to 20 Gigabits-per-second (Gbps) peak data rates and 100+ Megabits-per-second (Mbps) average data rates. That compares to 4G/LTE peak data rates of 300 Mbps and 10–30 Mbps today.[1] Typical download speeds are likely to be in the 2–3 Gbps range, which is fast enough to download an entire HD movie in a few seconds. But faster speeds are only part of it — 5G is also designed to support much higher capacity, likely up to 100 times more traffic capacity and network efficiency. Furthermore, 5G will offer significantly lower latency, which is the time it takes for a signal to complete an end to end trip over the network. In some cases, latency could experience a 10-fold decrease from about 100 milliseconds (ms) to 1ms.

If all this sounds too good, it is important to realize all of the above represents the "promise" of 5G. To achieve its full potential, 5G has to be built out and many varied applications, many which we can't yet foresee, will have to be created to take advantage of the promise. In the meantime, there is likely to be exaggerated marketing similar to past network upgrades; this could result in the initial customer experience falling short of expectations driven by limited capacity and geographic availability as well as the inherent limitations of high band spectrum, including difficulty carrying signals through walls and inclement weather.

What is needed for 5G to become a reality?

There are three necessary building blocks for 5G: complex multi-layered networks, huge amounts of cleared spectrum and large amounts of capital to fund the building phase. Initially, 5G network buildouts will be overlays on top of existing 4G networks, which will remain as back-up where 5G service is unavailable.

For 5G networks to be more responsive, more reliable, more secure and in some cases consume less power, they will also be built on a stand-alone basis, initially in dense urban areas. In terms of architecture, 5G won't be a single network, but actually consist of three separate physical networks, each running on different spectrum, using different protocols, and having characteristics optimized for three different goals: high speed plus large bandwidth; guaranteed low-latency; and ultra-low power for long life.

Another key building block for 5G is spectrum. Unlike prior generations, 5G will make full use of the entire communications spectrum from low- to mid- to ultra-high band frequencies. Whereas previous generations used low band (600 MHz to 2.5 GHz), 5G will also tap mid band (3 GHz to 6 GHz) and high band (>24 GHz) spectrum, which is necessary to maximize both coverage and capacity. It can be helpful to think of spectrum as a pipe. Low band spectrum is like a long and skinny pipe (great coverage/low capacity), while high band spectrum is like a short but very fat pipe (great capacity/low coverage) whereas mid-band spectrum is somewhere in between.

The final building block is the large amount of capital required to build and maintain these networks; carriers typically spend about $160B in capex each year and it will take at least a decade to build out 5G. These are the primary challenges facing telecom carriers and service providers globally as they begin deploying this latest generation of telecommunications.

1 "What is 5G|Everything You Need to Know About 5G", Qualcomm, https://qualcomm.com/invention/5g/what-is-5g#how-fast-is-5g.

Sandi, can you elaborate on spectrum?

Sure. Spectrum refers to the radio frequencies on which wireless signals are transmitted, enabling mobile devices and other applications. There is a finite amount of it, so supply and demand determine its value. In the US, spectrum is licensed for long-term commercial use by the Federal Communications Commission via auction. The incumbent wireless providers each have a unique collection of spectrum acquired over time. Each carrier's spectrum 'inventory' influences their respective approach to 5G deployment. The C-band spectrum recently auctioned by the FCC is expected to generate proceeds estimated at $80–90B — C-band is considered mid-band given its frequencies in the 4–8 GHz range. This auction may influence 5G strategy for the carriers, depending on who wins what licenses within the C-band frequency range.

How are the US wireless carriers rolling out 5G?

The US market recently consolidated from four to three players. Those three carriers, AT&T, Verizon and T-Mobile, are collectively spending around $50B annually on capital expenditures including 5G deployment. That $50B excludes any spectrum purchases. While the companies are well capitalized, their relative balance sheet strength and existing spectrum holdings influence their approach to 5G strategy. These wireless carriers are augmenting their existing 4G networks with additional spectrum, tower enhancements and small cells to build out 5G capacity, but they are also taking different approaches to deploying 5G — some are striving for ubiquitous 5G capabilities across the network, while others are targeting 5G service in high-density areas. There are also greenfield 5G networks being built by new entrants. The benefits of a newly-built network include clear spectrum and the opportunity to employ the latest technologies, unaffected by legacy congestion and hardware and software compatibility issues. These new networks may thus have a cost and service advantage over the incumbent service providers. If successful, they may be a disruptive force over time.

Am I getting 5G cell service today in the US?

The latest cellphones are the first to be compatible with 5G service. That said, the enhanced service is not yet ubiquitous across carriers and locations. It is only available where the carrier has upgraded their network to 5G. Beyond day-to-day consumer wireless usage, there have also been targeted 5G deployments to address surge capacity, including over 20 NFL stadiums. So while you may have a 5G phone, you may not always be getting the benefits of 5G service just yet.

Are there any ancillary benefits to the US carriers?

It is still early days, but 5G network operators are planning to offer residential fixed wireless broadband as a new product. This would compete with existing wired residential broadband in areas where the 5G network is built out and has excess capacity. Absent a viable product in the market, it is unclear how attractive it would be to consumers and hence how much of a threat to incumbent broadband providers.

Cable operators currently have ~70% share of the residential broadband market, with a cost-efficient roadmap to get to 10 Mbps symmetrical service employing DOCSIS 4.0 technology. It is worth noting that the cable industry has for a long time effectively managed competition from 'overbuilders', including the likes of Alphabet, who halted the geographic expansion of their Google Fiber product after a limited rollout.

Diego, how quickly will 5G be rolled out across the world?

Asia is expected to be ahead in the rollout of 5G networks, followed by the US and Europe. Korea launched the first 5G network in early 2019 and leads globally in 5G coverage — it had more than 1,400 5G base stations per million capita in 2019 versus 80 in China, 60 in the US and only 8 in Europe. In absolute terms, China is already the largest 5G market with 200 million 5G subscribers accounting for more than 70% of the global 5G subscriber base.

Why is there a large difference in timing in the roll out of 5G networks across the world?

Regions where carriers have strong capitalization and government support will be early adopters. For instance, Korea's 5G spectrum auctions in 2018 facilitated the 5G rollout in early 2019. In contrast, many other countries have yet to have 5G spectrum auctions.

Healthy balance sheets and market dynamics are also factors. The low 5G base station coverage in Europe is partially explained by relatively weak European telco balance sheets that have resulted from consistent price declines for their services and increased industry competition over the last 10 years.

What are the 5G killer applications?

Telecom, technology and services companies will develop 5G applications for both consumer and enterprise markets. For the consumer market, 5G applications include Fixed Wireless Access, enhanced mobile gaming solutions and Smart Home devices. In the enterprise market, applications mainly revolve around the "Internet of Things" technologies, which will be adopted throughout the economy, including health care, auto and the public sectors.[2]

Importantly, 5G will serve as a catalyst for the improvement of other technologies like Artificial Intelligence that rely on vast quantities of data to enhance the effectiveness and efficiency of processes and machines.

Can you give some examples of 5G application for Enterprises?

The most visible revenue opportunities for 5G are considered to be in the Enterprise segment where IoT solutions will be used to connect and manage billions of devices. Some estimates suggest that the number of connected devices may increase from ~20bn to ~50bn by 2030 (Statista).[3]

5G networks will be essential for autonomous cars as these are expected to generate more than 1 Terabyte of data per month by 2025 to provide safety, navigation and high definition entertainment, up from 30GB from the advanced connected cars available in the market in 2018 (Gartner).[4]

Kansas City is rolling out Smart City solutions to connect street lighting and cameras, water sites, and other infrastructure via 300 connectivity spots with the aim of improving resource management, public safety and mobility.[5] Similarly, Mercedes-Benz is rolling out Smart Factory solutions for the manufacturing of its S-class model — IoT solutions using 5G networks may help improve factory efficiency by 25%.[6]

2 Gartner Survey Results, December 2018.
3 IoT Connected Devices Worldwide 2030, Statista.
4 5G Networks have paramount role in Autonomous Vehicle Connectivity, Gartner, June 2018.
5 Cisco, Sprint, and Kansas City, MO., Announce Agreement to Deploy Smart+Connected City Framework, press release June 2015.
6 Daimler Installing Own 5G Network, Hanover Messe July 2019.

What are the killer 5G applications for the consumer?

Fixed Wireless Access is a 5G application with potential to further replace fixed-line broadband connections. The rollout of 5G wireless networks can only improve FWA adoption in countries like Finland, where Barclays noted that 40% of the population already use 4G mobile only connections.[7]

Mobile gaming will require large amounts of data and low latency to take full advantage of games using new technologies like "augmented reality" and "virtual reality". Telcos like EE in the UK have started to make 5G data packages available to gamers for around $10 per month.[8]

Last but not least are Smart Home devices which use IoT technologies to connect speakers, alarms, video cameras and sensors around the house. This is a $40bn market that is growing rapidly and telcos have home solutions starting at around $5 per month.[9]

The promise of all these new applications in a 5G world is great. According to a 5G economic study prepared by IHS Markit for Qualcomm, 5G could enable up to $13.2 trillion of gross economic output and create 22.3 million new jobs by 2035, resulting in $2.1 trillion in GDP growth.[10]

Bill, of the stocks you cover which do you believe will benefit from 5G?

While it is important to identify beneficiaries of major secular growth trends like 5G, for stocks to make it into our concentrated portfolios, we employ a fairly rigorous screening process to identify high quality companies with sustainable growth at a reasonable price. One of the ways we identify high quality companies is through our unique proprietary CQ process, which includes a Market Position subscore. Many companies with high Market Position scores tend to benefit from strong secular growth trends like 5G.

Telecom equipment providers Ericsson and Nokia are among the more obvious beneficiaries of 5G deployment in my coverage. Along with Huawei (which is a private Chinese company) and the telecom equipment arm of Samsung, these represent the sole providers of 5G base stations and related equipment globally. American Tower, which is the largest global public tower company, will also likely see increased growth of cell towers, driven by the expected 5G capacity needs.

One of the purest plays on 5G in my coverage is Qualcomm, which is the leading provider of advanced wireless technology, particularly 5G modems in smartphones and other mobile devices, but also 5G technology in adjacent markets like radio frequency (RF) filters, autonomous vehicles and IoT.

Other beneficiaries of 5G include Corning, the world's largest vertically integrated fiber optic solutions provider, since 5G will require up to 100 times the fiber of 4G. Keysight Technologies, which makes R&D and field test and measurement tools for 5G equipment is another company well placed for growth.

Finally, there are many semiconductor companies that provide significant content in 5G smartphones and network equipment, such as NXP Semiconductors and Texas Instruments, as well as connector/sensor companies like Amphenol.

7 Telecom Services and Tech Hardware: 5G — The Return of Fixed Substitution. Barclays, September 2019.
8 Global 5G Primer — Looking for the Killer App. Bank of America Merrill Lynch, September 2019.
9 Forecast Size of Global Smart Home Market 2016–2022.
10 IHS Market with OMDIA, *The 5G Economy in a Post-Covid-19 Era*, November 2020.

Sandi — what are some other names in your coverage that will benefit from 5G?

There are several companies making long-term investments in autonomous driving, including Alphabet's Waymo unit, which has been trialing vehicles in Arizona. Meanwhile, Lyft and Uber envision autonomous driving as part of their platform of services down the road.

Facebook and Google are pursuing consumer and commercial applications of AR and VR. Facebook continues to evolve its Oculus headset for VR gaming and entertainment enthusiasts. As price points fall and applications grow, more widespread consumer adoption of these devices should follow.

And finally, Diego—what are some names in your coverage that will benefit from 5G?

As is the case with American Tower, the rollout of 5G will benefit European tower companies like Cellnex, which specializes in building wireless infrastructure.

The adoption of 5G networks across industries will help facilitate the digitization of sectors that still rely on analog or manual processes, such as construction and agriculture. Software companies that facilitate this digital transformation like Dassault, Hexagon, Capgemini, CGI and Shopify will benefit as they develop new and enhanced solutions around the 5G ecosystem.

Telcos have a great opportunity to capitalize on 5G technologies by introducing higher value-add services in addition to the current connectivity services that are less differentiated.

Sustainability: A Key Differentiator in the Consumer Staples Sector

Jonathan Cook, CFA
Research Analyst

Increasing demand for sustainable products creates risks and opportunities in the consumer staples sector. We expect the most successful companies to embrace sustainability and to be rewarded by both consumers and investors.

The Fundamental Growth and Core equity team has built "sustainable growth" into its investment process for many years. In assessing the consumer staples sector, we view sustainability from the perspective of demand and supply. Not only must companies develop products that appeal to consumers' evolving tastes, but they must also produce them in a planet-friendly way. The most successful companies, such as Nestlé, can do this whilst also delivering a satisfactory financial performance.

Adapting to Change

In the consumer staples sector, we view sustainability from the perspectives of both demand and supply. Increasing demand for "better-for-you" products (e.g. gluten-free food; paraben-free personal care) creates new market opportunities. Products or brands can be developed to serve these new markets, and existing brands can be stretched into these emerging segments; this creates closer connections with existing as well as new consumer groups. Most companies have been investing more in marketing and innovation in response to the changing landscape. This enables them to remain relevant to consumers and should be a positive driver of the long-term health of their businesses.

There is an increased desire among consumers to know that the products they're buying are made in a way that is not detrimental to the natural world. Indeed, the consumer-facing nature of the industry means that there can be major reputational risks for any company that fails to manage their business effectively and responsibly. Increasing transparency of global supply chains means that firms must take responsibility for the full scope of their operations; in the consumer products industry, the main issues lie in water usage, agricultural and labour practices, ingredient processing, recycling of plastic and packaging material, and greenhouse gas emissions.

Nestlé: Leading by Example

Nestlé, the world's largest food & beverage company, has been delivering well from both perspectives. On the demand side, it has a formidable product portfolio, including 34 billionaire brands (which generate annual revenue in excess of $1bn) such as Nespresso, Perrier and Purina. It has also taken steps recently to make use of merger and acquisitions (M&A) to align its portfolio even more closely to long-term consumer trends, with acquisitions in Health Science and the sale of businesses in the confectionery and processed foods space.

On the supply side, Nestlé has long been committed to sustainable production — its 'Creating Shared Value' programme is highly regarded. Looking forward, we believe that Nestlé can extend further its leadership position through initiatives such as the recently-announced investment of c.$3.6bn to address climate change.

The project to create a market for food-grade recycled plastic is a good example of the company's progress in the supply chain. Nestlé has set itself a target for 100% of its packaging to be recyclable or reusable by 2025. Because the packaging industry does not currently supply recycled plastic of sufficiently high quality to be used for food products, Nestlé needs to drive change across the whole supply chain to achieve its goal. The company announced in January 2020 that it would invest up to CHF 2bn (USD $2.2bn) to accelerate the development of alternative packaging solutions. Nestlé will pay a premium to incentivize suppliers to switch from virgin plastic to food-grade recycled plastics. The company will also launch a CHF 250m sustainable packaging venture fund to invest in start-up companies that focus on these areas. Few companies have the resources, vision and commitment to drive such meaningful change across the ecosystem.

This holistic development is a great example of the kind of quality characteristic that leads us to rate the company highly on our Confidence Quotient (CQ) scale. We use the CQ framework to assess the quality of the company under the key headings as summarized in the table below:

CQ Pillar	Why Nestle Scores Well	Supporting Evidence
Management	Long track record with sustainability. Ambitious, detailed plans to 2050	Creating Shared Value reports
Market Position	Enhanced competitive advantages. Deeper supply chain relationships	Market share gains. Net zero roadmap
Fundamental Momentum	Product renovation to enhance nutrition. Portfolio mix into faster growing categories	Improving sales growth. M&A strategy
Transparency	Comprehensive, high-quality reporting and engagement with stakeholders	Integrated report. Chairman's Roundtable
Financial Condition	Committed to funding major sustainability efforts through internal efficiencies and business growth	Limited impact on consensus estimates

Closing Thoughts

Sustainability presents a huge opportunity for companies and brands to increase their relevance with consumers. A key challenge will be to do all of this and also deliver on the expectations of shareholders. We view Nestle's commitment to self-funding its sustainability initiatives positively, but it is also true that any cost savings could have been re-cycled in different ways, e.g. into further marketing and research and development spending or simply paid back to shareholders through dividends and share buybacks. This challenge is one faced by all companies in the sector, and many, such as Unilever and Danone, have also made bold choices in favor of sustainability. The most successful companies will be those who can demonstrate that their business is better placed as a result of the choice to invest in sustainability initiatives. The question, perhaps, is not whether these companies should be making such investments, but rather — if they really want to remain aligned with consumers — can they afford not to make them?

An EM Stock Story: CD Projekt

Michelle Middleton
Research Analyst

The Fundamental Growth and Core Equity team's research process focuses on five key attributes that are likely to lead to sustainable growth. Viewed through the lens of that research process, Poland-based gaming firm CD Projekt is a stock to watch.

We published the first version of this article prior to the release on December 10, 2020 of the highly anticipated Cyberpunk 2077 game. This article is updated based on that release.

Emerging market (EM) equities were volatile in 2020 in an environment of slower global growth and greater economic uncertainty caused by the COVID-19 pandemic. Around the world, however, gaming companies appear to have benefited greatly from changing lifestyle and mobility trends, which could accelerate as the northern hemisphere enters the winter season. In general, the video game industry appears to be entering a high secular growth phase, one in which game developers that provide high-quality content, leading to long-term sustainable growth, are valued at a premium versus the market.

The Fundamental Growth and Core Equity (FGC) team's research process helps identify investment opportunities using a framework called Confidence Quotient (CQ), which focuses on five key attributes of a company that are likely to lead to sustainable growth (see Figure 1). These attributes are qualitative and forward-looking, relying upon the expertise and judgment of our analysts. Viewed through the lens of the FGC research process, the Polish video game creator and distributor CD Projekt could be a stock to watch.

Figure 1
Confidence Quotient: Fundamental Growth and Core Equity's Framework for Assessing Company Quality

Management team	Conviction in leadership
Market position	Sustainable competitive advantage
Fundamental momentum	Current business trends
Transparency	Visibility of the business model
Financial condition	Strength of the financial model

Video Game Industry

Video game publishers are experiencing strong secular growth in consumption of video game content across platforms. Newzoo, the world's most trusted and quoted source for games and esports analytics and market research, forecasts the global video game industry to grow at a 9% CAGR (compound annual growth rate) over the next three years. Demand growth is also being fueled by an increase in cloud gaming, which lowers consumers' barriers to entry (no need for an expensive console) and could lead to greater industry consolidation. There is also a scarcity of creators of games IP (intellectual property); therefore, companies that can retain top talent should be expected to perform better over time.

CD Projekt Franchises

After achieving extraordinary success with The Witcher[11] video game franchise, Poland-based CD Projekt released Cyberpunk 2077 in December after several delays. It has the potential to become one of the biggest franchises in a secular growth industry. Cyberpunk 2077, is an open-world, action-adventure role-playing game (RPG) set in a dystopian future that is heavily reliant on hi-tech robotics. Hollywood actor Keanu Reeves plays an integral character within the game and has been key to the game's marketing strategy.

Over 13 million units of the game were sold by December 20th, including pre-orders and refunds. This makes it one of the top-selling games of 2020 and has already allowed CD Projekt to recoup all developmental and marketing spend on the game to date. Unfortunately, execution on the launch was poor, and the game disappointed many gamers with numerous glitches and performance issues. Performance was most affected in older Xbox and Playstation gaming systems, while new generation console and PC users reported much higher satisfaction levels with the game. The company is working on patches for the game across all platforms and we expect to see reviews improve in the first quarter of 2021. Due to this huge misstep, we downgraded our Confidence Quotient on the company, as our process dictates. However, although the launch was flawed, the game still has significant potential to grow into a very profitable franchise to sit alongside its very successful Witcher franchise. The potential of the multiplayer version, due in 18–24 months, is massive, and would allow the game to be featured in e-sports competitions in the future. The company also has a mobile version of game in the testing phase, and has plans for a new Witcher game, so there are multiple avenues to restoring investor and market confidence in the company. We maintain a positive view on the stock, but expect higher than normal volatility for the next 4–6 months.

We believe this release will propel CD Projekt from a single-IP company with long gaps between new games to one with a more regular release schedule. After the release of Cyberpunk 2077, we expect 3–4 expansions for the game over the next couple of years, including a multi-player version in 2022. This will likely be followed by a new Witcher game in 2023 and possibly another Cyberpunk game in 2025. A third franchise may also be in the works, but it is too early to speculate. Furthermore, the company is developing a mobile game, The Witcher: Monster Slayer, which will be the firm's first step into mobile devices, the fastest-growing segment of the video gaming industry.

Key Company Attributes

Management's philosophy is to deliver top-quality AAA[12] games in the RPG genre with complex, nonlinear and deep storylines. CD Projekt has a strong reputation among gaming fans for ultra-high-quality work — The Witcher series has won more than 800 awards, including the prestigious "Game of the Year" titles in 2015 and 2016, and was included in *Game Informer's* Reader's Choice Top 300 Games of All Time. This reputation took a hit with recent Cyberpunk release issues, but we expect it to recover as the glitches are resolved.

11 The Witcher is an action role-playing game (RPG) based on a very popular fantasy book series (which has recently been adapted into a popular Netflix series).

12 AAA is an informal classification used for video games created by a large studio with a large development and marketing budget that results in a high-quality video game experience.

CD Projekt's stellar reputation generated substantial enthusiasm for the Cyberpunk 2077 franchise. Having a proven track record of creating deep and engaging content and not burdening customers with microtransactions in the games has earned them a very strong and loyal customer base. In the gaming industry, we believe that customer satisfaction and loyalty are key to driving long-term sustainable earnings growth.

With the release of Cyberpunk 2077 in December, and increased video game demand due to the pandemic-related lockdowns, momentum for CD Projekt is strong. Secular growth in the industry is a positive force for the company as well. The firm's transformation from a single-franchise video game developer to a multi-franchise player should ensure a more stable revenue and earnings stream. Entry into the mobile games market in 2021 with the release of The Witcher: Monster Slayer will further solidify their position in the fastest-growing segment of the video games industry. The firm's current marginal presence in the Asian video game market represents another potential growth opportunity.

The video game industry is notoriously secretive about future business plans due to the high level of competition between developers. As a result, visibility into the business model isn't ideal, but the pipeline of announced releases by CD Projekt provides some measure of anticipated revenue growth. CD Projekt also has a very strong balance sheet with no debt. Margins are strong and on an improving trend, while cash flow generation is expected to pick up substantially with the release of Cyberpunk 2077. Although the company's current valuation appears to factor in a successful launch of Cyberpunk 2077, it does not fully price in a sustainable pipeline of large AAA titles.

Closing Thoughts

Emerging European countries have very few technology-driven investment options. Poland-based CD Projekt is a unique investment opportunity, given that most of its competitors are in the United States and Asia. With the release of Cyberpunk 2077 in December 2020, we believe the company will become a multi-franchise developer with many avenues to revenue and earnings growth. The firm's large base of loyal fans will likely grow with this latest project. We therefore feel positive about the long-term potential of this company as it transforms into a global player.

This information should not be considered a recommendation to invest in a particular security or to buy or sell any security shown. It is not known whether the securities shown will be profitable in the future.

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