

INVESTMENT THESIS

LONG: THQ, Inc. (THQI: \$3.95)

Company	THQ, Inc.	FY1 PE (Consensus)	N/A	YTD % Change	-5.7%
Ticker	THQI	FY2 PE (Consensus)	197.5	52 Week High	22.81
Stock Price	\$3.95	FY1 EV/EBITDA	N/A	52 Week Low	2.23
Mkt Cap	263	FY2 EV/EBITDA	1.0x	200-Day	8.69
Enterprise Value	119	FY1 FCF Yield	12.8%	50-Day	3.01
Net Debt	-144	ROE	-7.6%	RSI	60.13
Credit Ratings	N/A	ROIC	-5.0%	Avg. Daily Vol. (000s)	1,022.0
Cash/Share	\$2.16	Dividend Yield	N/A		

Source: Company reports, PAA Research LLC estimates, Yahoo Finance

Investment Thesis Overview:

Over the past 15-months, THQI's stock has declined in excess of 80% in large part due to poor execution by the company in its efforts to target "core gamers" and decreased receptivity among young consumers for traditional video games from established brands such as Nickelodeon and Pixar. The stock currently reflects substantial concerns about THQI's ability to remain economically viable. Consensus estimates for FY10 (March FYE) have been revised down sharply and the street has no confidence in management. We think the stage has been set for a sharp recovery in THQI shares in the next 3-6 months based on the following:

1. **Bankruptcy concerns are unfounded.** The street has given the company no credit for the restructuring actions taken in FY09, which should lead to a \$220 million reduction in costs in FY10 and return the company to the type of FCF generation THQI has demonstrated over the past decade.
2. **THQ's remaining studio system is quite strong.** Concerns have been raised about THQI's ability to develop and publish industry leading video games following the sharp reduction in the size of the company's studio system. It is our view, that THQ has cut a great deal of "fat" and retained most of the "muscle" in its development system.
3. **The street has underestimated the demand for THQI's upcoming video game based on the UFC and the stock could trade up into its release in May.** The game will represent the first video game published based on UFC since 2004. There is a great deal of pent-up demand. External indicators and comparable analysis suggest substantial upside to current street expectations for the game.
4. **Management will likely guide above street consensus for both 1Q10 and FY10.** Although management credibility has been significantly damaged due to poor execution over the past two holiday seasons, we expect initial guidance for 1Q10 and FY10 to buoy shares when the company reports results in early May.

RISKS:

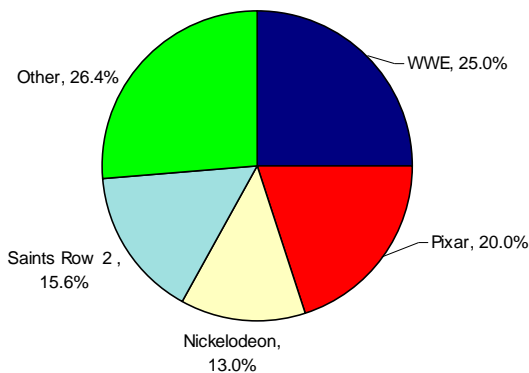
The risks to our investment thesis are the following:

1. The UFC game is not well received, which would substantially hamper the company's free cash flow generation over the next 3-6 months and increase street concerns about liquidity for the remainder of FY10.
2. Red Faction: Guerilla and Darksiders, new owned intellectual property developed by THQI are not received well, which would further confirm the bear view that THQI is exclusively a kids and "license" shop.
3. The company loses its arbitration hearing with JAKKS Pacific, which would require the company to make a "true-up" payment related to its licensing agreement with WWE of approximately \$50 million.

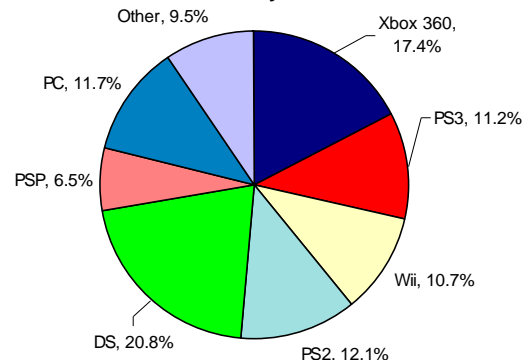
BRIEF COMPANY DESCRIPTION AND TRADING HISTORY

THQ, Inc. is a leading worldwide developer and publisher of interactive entertainment software for all popular video game systems. The company publishes titles across all genres including: action, adventure, fighting, racing, role playing, simulation, sports and strategy. The company competes with first-party publishers such as Sony, Microsoft and Nintendo, as well as third-party publishers such as Activision, Electronic Arts, Take-Two Entertainment, Ubisoft, Sega and others. The following tables outline THQI's revenues by game title/license and platform/console:

THQI FY09 Revenue Mix by Game/License



THQI FY09 Revenue Mix by Platform/Console



Source: Company reports, PAA Research LLC estimates.

THQI publishes a combination of both owned and licensed properties. The company's better known owned intellectual properties include: Saints Row, Red Faction, MX vs. ATV, Company of Heroes, DeBlob, Frontlines, and Darksiders. Following the company's most recent restructuring, THQI owns and operates eight individual studios and maintains relationships with key outside studios such as Yukes (THQ is a minority owner), Heavy Iron and Incinerator.

In addition to its owned intellectual property THQI, has secured a number of key licenses, which give the company the right to develop and publish video games based on the licensed intellectual property. The company's key licenses include:

- **World Wrestling Entertainment (WWE)** – Through 2014
- **Ultimate Fighting Championship (UFC)** – Three year license starting in 2009, but has automatic extension provisions based on minimum performance benchmarks
- **Disney/Pixar** – THQI has the rights to develop and publish games for *Finding Nemo*, *Cars*, *The Incredibles*, *Ratatouille*, and *Wall-e*. The license includes the rights to two more feature films: *UP*, to be released 5/29/2009 and an un-announced Pixar film to be released in calendar 2011.
- **Warhammer 40,000** – Through 2013
- **Nickelodeon** – Through 2010
- **Marvel Super Hero Squad** – Beyond 2012
- **Dreamwork's Mastermind** – Single picture license deal

Company History and Trading Background:

THQ, Inc. was founded in 1991 and over the 10-year period ending 2007 was the fastest growing company in the interactive entertainment sector. Historically, the company has been known for its kids oriented video game titles based on licenses from Nickelodeon and Pixar. Over the past 4-5 years the company has acquired a number of studios to enhance its product portfolio for core gamers. Thus far the company's efforts to target core gamers have been mediocre at best, with Saints Row being the lone notable exception.

THQI's stock peaked in early 2007 on the heels of a successful launch of Saints Row, which was newly created owned intellectual property (IP) for the core gamer and the release of video games tied to the movie *Cars*, which sold over 8 million units in the first 12-months following its release. Since that time the company's stock has declined approximately 90% due to two primary factors: 1) Mis-steps in the development in new, owned IP and a decline in demand for traditional kids-oriented video games, which some in the industry like to label "shovelware". The death of traditional shovelware and the explosion in popularity of Nintendo's first party titles on the Wii has substantially reduced THQI's revenues and profitability.



Short Dynamics and Insider Trading

The short interest on THQI shares peaked in June 2008 at approximately 13.5 million shares and a short interest ratio of 15 days. The current short interest stands at 5.1 million shares and 4.9 days to cover.

Over the past two months, Brian Farrell, President and CEO purchased 50,000 shares on the open market at a price of \$2.34 and recently appointed CFO, Paul Pucino purchased 10,000 shares at a price of \$2.49. These were the first purchases of stock by insiders in several years.

INVESTMENT THESIS IN DETAIL

Our investment thesis is predicated on the following:

- 1. Bankruptcy concerns are unfounded.** There has been some chatter among sell-side analysts following THQI that the company is at risk of filing for bankruptcy within the next 12-months. We think these concerns are largely reflected in the stock at this point and are a primary reason why THQI shares trade at a 50%+ discount to TTWO even though the two companies have similar balance sheets and TTWO has a less consistent track record of profitability over the past 10 years.

As of 12/31/08, THQI had approximately \$144 million in cash on hand and no debt (this excludes \$25 million of debt which is backed by \$30 million in auction rate securities that is not captured in the \$144 million in cash). The company will certainly not generate any free cash flow in 4Q09 (March) based on a relatively tepid title offering slate and severance and studio closing costs associated with the final phases of restructuring. We estimate the company will finish the march quarter with approximately \$100-\$130 million in cash on hand.

Historically, THQI has drawn down on its cash balances during the first half of its fiscal year and then generated FCF in the back half of the year. The sharp seasonality of FCF generation can be directly attributed to the historical practice of releasing the majority of video games during the holiday season. Going forward, we expect THQI to deviate from this pattern as the last few holiday seasons have been crowded with major releases and its has become increasingly difficult for new titles to gain traction. For FY10 in particular, three of THQI's most important titles for the year will be released in its fiscal first quarter – UFC 2009, UP, and Red Faction: Guerilla. This should enable the company to generate consistent FCF over the course of the year.

THQI's rapid build in accrued liabilities in the past quarter also has raised concerns about a pending liquidity crunch at the company in the next 3-6 months. The headline numbers certainly draw a red flag: accrued liabilities on

the balance sheet increased 24% YOY for 3Q09 to a record high \$255 million. However, upon closer review the numbers do not appear to be that alarming. The table below provides a little more detail on THQI's accrued liability balances. Two line items stand out – accruals for JAKKs and deferred revenue. These two line items have been the primary drivers behind the large increase in accrued liabilities. Starting in CY08, all video game makers were required to defer a component of revenue for any title that had a significant component of its game play online and amortize them over a six-month period.

Additionally, THQI's accrual for JAKKs has been growing consistently over the past two years following the company's decision to refuse the increase in royalty payments to JAKKs for its WWE license. The dispute between THQI and JAKKs is currently in arbitration and a decision on the issue could be rendered within the next few months. If the arbitrator rules in favor of THQI, the company's cash position would not change, however the accrual would be reversed and royalty expenses on a going forward basis for its WWE license would be reduced substantially. Alternatively, if the arbitrator rules against THQI (which we view as highly unlikely at this stage) then THQI would be forced to make a cash payment in excess of \$50 million to JAKKs. Excluding the accrual for JAKKs and the increase in deferred revenue, other accruals had only increased 2% YOY for 3Q09.

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09
Accrued Liabilities	40.1	54.6	49.0	39.9	32.2	41.6	48.7
Accrued Compensation	38.2	33.0	38.4	39.9	41.3	37.1	38.3
Accruals for JAKKs	16.1	17.2	35.5	37.8	39.2	40.1	52.8
Deferred Revenue	0.0	0.0	0.0	30.9	14.3	0.9	28.4
Accrued 3rd party software dev.	0.0	22.4	11.0	10.6	27.2	27.9	20.8
Accrued royalties	45.6	40.8	71.6	43.0	58.8	55.7	66.0
Total Accruals	140.0	168.0	205.6	202.1	213.0	203.3	255.0
Accruals ex-JAKK, deferred revenue	123.9	150.8	170.0	133.4	159.5	162.3	173.8
% Change YOY							
Accrued Liabilities	6.3%	14.3%	-4.4%	28.1%	-19.7%	-23.7%	-0.7%
Accrued Comp	69.8%	31.8%	16.0%	9.1%	8.0%	12.2%	-0.1%
Accruals for JAKK's	2237.0%	2018.9%	160.9%	147.6%	142.8%	132.4%	48.6%
Deferred Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Accrued 3rd party software dev.	N/A	N/A	N/A	12.9%	N/A	24.6%	88.5%
Accrued royalties	2.5%	-0.3%	0.8%	-15.7%	29.1%	36.6%	-7.8%
Total Accruals	32.9%	46.7%	21.7%	40.9%	52.1%	21.0%	24.1%
Accrual growth ex-JAKKs, deferred rev	18.4%	32.6%	9.4%	4.1%	28.7%	7.6%	2.2%

Source: Company reports

- THQI's remaining studio system is quite strong.** THQI has embarked on an ambitious restructuring plan over the past 6-9 months which included the closure of 5 studios (Paradigm, Mass Media, Locomotive Games, Sandblast, Helixe Studios) and spin out of two others (Incinerator and Heavy Iron). Overall headcount was reduced by approximately 600 (on a base of 2,400) and management now estimates that these actions along with other steps taken to improve efficiency in the development process could enable the company to reduce costs by approximately \$220 million in FY10.

The cuts have been significant, which begs the question: will THQI be able to compete with larger players in an increasingly competitive landscape? First, it is necessary to look at the type of games the five studios that have been closed worked on. For the most part, these studios have been responsible for developing games or ports to mobile platforms for THQI's Pixar and Nickelodeon licenses. They had little involvement with developing "core gamer" franchises and relatively less experience in working on next generation platforms (Xbox 360 and PS3). In the case of Incinerator and Heavy Iron, these studios have been a key part of developing games for THQI's Pixar license and will continue to work with the company. Only time will tell, but at first glance it appears that THQI has removed a "layer of fat" from the organization rather than cannibalized development talent. THQI's decision to sell or shutter Big Huge Games is the lone exception. That studio has an excellent track record, but THQI management likely was not willing to fund that operation another two years before a new commercially viable title was ready to be released.

The table below compares the remaining THQI studio network to that of the other four major third party video game publishers in North America based on their size and the average Metacritic rating their games have received over the past 7-8 years (legacy Activision only). Clearly, THQI has a significant amount of talent remaining in its studio portfolio. It is our view that THQI should be able to fulfill the needs of its major licenses and develop compelling owned IP over the next several years with this studio network.

Company	ERTS	ATVI	THQI	TTWO
Studios	15	12	9	4
Employees	7000	2125	1800	1900
# of Games Rated Above 80	57	34	21	26
# of Studios w/Avg. Rating Above 80	4	3	2	1
# of Studios w/Avg. Rating Above 75	9	5	4	1
Owned IP Above 80	30	24	16	19

Note: Activision statistics exclude the contribution of Blizzard
Source: Metacritic, PAA Research analysis

3. **The street has underestimated demand for the company's upcoming game based on the UFC.** The UFC has been a phenomena amongst 18-45 year old males for the past 4-5 years. Surprisingly enough, despite the sizeable demographic overlap between the UFC's core fan base and video gamers there has not been a game published for the UFC since 2004. Part of the reason for the delay has been the inability of prior generation consoles to handle the physics necessary to create a realistic representation of the various fighting styles in UFC. THQI secured the UFC license in 2007 and will release its first UFC game on 5/19/09. The license lasts for three years, but is automatically extended if THQI achieves minimum unit sales benchmarks. The company placed the development of UFC 2009 in the capable hands of Yuke's Media Creations; the company responsible for creating THQI's WWE based video games for the last several years. The WWE franchise generates 4-5 million in

unit sales annually.

Up until this point, the street has been "cautiously optimistic" about the sales prospects for the UFC video game. Most analysts have modeled approximately 2.0 million units in their FY10 forecasts (to the extent they even build their models on a per title basis). We have used 3.0 million units in our forecast, which we view as conservative given the pent-up demand and the willingness of the UFC fan base to spend money on products related to the brand. The following external indicators lead me to believe that unit sales of UFC 2009 could eclipse 3.0 million units:

- UFC 2009 is consistently among the top 25 bestsellers on gamestop.com, even though the game is 2-months from being released
- The original trailer for UFC 2009 from E3 2007 has been downloaded 1.4 million times on Youtube
- UFC is now the largest pay-per view (PPV) franchise in North America, surpassing both HBO Boxing and WWE. In 2008, UFC had approximately 5.7 million PPV buys. UFC 91 alone had over 1.0 million buys, surpassing Wrestlemania in demand in North America. The table below compares the PPV buys for WWE to that of UFC over the past three years:

Pay-per-view buys	2006	2007	2008
WWE	5,744,000	5,218,000	5,034,000
UFC	5,270,000	4,895,000	5,715,000

Source: WWE, Inc., MMA Insider

- As previously mentioned, the annual WWE based video game sells approximately 4-5 million units. Fight Night Round 3, a boxing video game published by ERTS sold approximately 4.5 million units. If UFC is receives reasonable reviews it seems likely it could sell 3-4 million units, in our view.

4. Management will likely guide above street consensus for both 1Q10 and FY10.

THQI's senior management has made several public statements that it plans to be both profitable and FCF positive in FY10. Thus far, the street has not factored that outlook into consensus. Understandably, based on the performance of the past two years, the street remains highly skeptical. We anticipate management could guide to EPS of \$0.20-\$0.40 for FY10, which we think will put a floor in THQI shares at a minimum until the company releases UFC 2009, the video game based on UP and Red Faction Guerilla. We am encouraged by stock purchases made by management over the past several months, which were the first in many years.

VARIANCE VS. CONSENSUS

For the time being we have not included our estimates for 4Q09. For the most part expectations are remarkably low for 4Q09 given the sizable amount of restructuring charges the company will take. The only issue of investor concern is likely to be the amount of cash used during the quarter, which we expect to be \$25-\$40 million. The table below compares our estimates for 1Q10 and FY10 to that of consensus.

	Consensus		PAA Research	
	1Q10E	FY10E	1Q10E	FY10E
Revenues	\$154.8	\$815.8	\$210.3	\$921.8
% Change	12.5%	2.3%	52.9%	14.5%
EPS	-\$0.10	\$0.02	\$0.25	\$0.30

Source: Yahoo Finance, proprietary estimates

At this stage we would characterize our estimates as fairly conservative. The three or four games where there is likely to be the greatest variability are: UFC 2009, UP, Red Faction and Darksiders. We have forecast 3 million units sold for UFC, a combined 2.5 million for Red Faction and Darksiders, and 2.5 million units for UP. We view the forecast for UP as highly conservative. The video game published for Wall-e has sold through 3.75 million units thus far, and that for Ratatouille sold over 4 million units. We think UP could have a broader appeal to children compared to Wall-e, which was more of an adult oriented cartoon. Red Faction and Darksiders are critical titles in order for THQI to break-out of the perception that it is a publisher of kids titles and fighting oriented games.

	Owned/Licensed	Units (MM)	ASP	Revs	% of Total
UFC	Licensed	3.00	\$50	\$150	16.4%
WWE	Licensed	4.00	\$45	\$180	19.7%
Up!	Licensed	3.00	\$40	\$120	13.1%
Red Faction	Owned	1.50	\$50	\$75	8.2%
Darksiders	Owned	1.00	\$50	\$50	5.5%
MX vs. ATV	Owned	0.75	\$45	\$34	3.7%
Nickelodeon	Licensed	2.00	\$35	\$70	7.6%
BIG Family Games	Owned	0.50	\$40	\$20	2.2%
Marvel Super Hero Squad	Licensed	0.70	\$35	\$25	2.7%
Total Revs. From New Titles		16.45	\$44	\$723	
Catalog/Core/Other		5.50	35	\$193	21.0%
Total Revenues				\$916	

Source: PAA Research LLC

CATALYSTS

There are several catalysts for THQI over the coming months, which we think can cause the shares to trade to \$6.50 within 6-months.

- 1. 4Q09 Results and Initial 1Q10 and FY10 guidance (First week of May).** THQI recently announced that it has completed its restructuring plan, which the company expects to generate \$220 million in incremental cost savings commencing in FY10. For 4Q09 THQI will incur \$45 million in impairment charges and an additional \$4 million in cash severance costs. More importantly, management will provide initial FY10 guidance. Management has every incentive to keep the bar low at this point, but we still think the company will guide above current street consensus of \$0.02.
- 2. Release of UFC 2009 (5/19/09).** In all likelihood, the game only needs to receive a metacritic rating of 75 or better in order for it to achieve sell through of 3.0 million over the course of FY10.
- 3. Release of Pixar's latest movie, UP (5/29/09).** Sell through for the video game based on Wall-e was a huge disappointment for THQI (they comped down about 15% relative to Ratatouille). The street expected that video game sales for Wall-e would eclipse that of Ratatouille given that the principal character was a robot instead of a rat that cooks. It has become obvious now that Wall-e was far less kid-oriented despite the potential appeal of a robot as a lead character. While we have modeled a 20%+ decline in sell-through for the video game based on UP, early signs are that this could prove to be conservative. The movie appears to be much more kid focused than Wall-e.
- 4. Release of Red Faction: Guerilla (6/9/09).** Red Faction and Darksiders are THQI's most important owned IP's to be released this year. To the extent Red Faction generates commercial success it could help change the perception of the company as a kids title and fighting game publisher. That would likely result in substantial multiple expansion for the stock and eliminate the valuation gap between THQI and its key competitors: ATVI, ERTS and TTWO.
- 5. Arbitration ruling on dispute with JAKKs (next few months).** THQI and JAKK entered into an operating agreement in 1999 that governs their license with WWE. As part of the agreement, starting 7/1/2006 JAKKs was to be paid an amount that would be determined based on agreement between the two companies, or failing that, arbitration. It is important to note that THQI bares all of the costs of developing, publishing and marketing WWE-based video games, JAKKs does not contribute anything financially or strategically at this point. The two companies agreed on an arbitrator in 2008 and an arbitration schedule was set to begin in February 2009. Since 7/1/06, THQI has been accruing for a preferred payment to JAKK, as of 12/31/08 the accrual amounted to \$52.8 million. We expect a ruling to come forth in the next several months. In the best case scenario, THQI will no longer have to accrue for preferred payments to JAKKs which would increase the annual profitability of the WWE licensee by \$15-\$20 million, result in a reversal of the existing accrual, and no cash outlay for THQI. It is possible that the arbitrator could rule in favor of JAKKs or in part, which would require some cash outlays on the

behalf of THQI. Irrespective of the near-term cash implications, it appears highly likely that the arbitrators ruling will substantially increase the profitability of THQI's WWE license going forward.

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based on not only current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 75%

A quick look at valuation: THQI shares trade at a sharp discount to its peer group due in large part to poor-execution over the past 2-years, the lack of clearly identifiable owned IP (like GTA for TTWO), and the perception of bankruptcy risk. THQI trades at a meager 0.6x current book value, which already reflects the write-down of all of the company's goodwill. Historically, leading video game publishers have traded between 15-30x FY1 EPS estimates depending on the stage of the console cycle and the popularity of each publisher's title slate.

		Shares			Book	Price/	Price/			Price/
		Out.	Price	Mkt Cap	Value	FY1 Revs	FY2 Revs	FY1 PE	FY2 PE	Book
Electronic Arts	ERTS	322	\$18.77	\$6,040	\$3,053.0	1.5x	1.4x	N/A	20.0x	2.0x
Activision	ATVI	1310	\$10.07	\$13,192	\$11,527.0	2.8x	2.5x	16.0x	13.8x	1.1x
Take Two	TTWO	80	\$9.37	\$751	\$552.3	0.6x	0.6x	66.9x	9.8x	1.4x
THQ, Inc.	THQI	67	\$3.95	\$263	\$403.1	0.3x	0.3x	N/A	197.5x	0.7x

Source: Yahoo finance

We think THQI can trade to \$7, maybe higher in the next 6-months: Historically, THQI shares have traded in a range of 15-30x FY1 EPS estimates. At \$7 THQI shares would trade at 17x our FY10 EPS estimate of \$0.30, plus the \$2.00 in cash per share. To the extent that consensus EPS estimates are revised upwards towards \$0.30 for FY10 over the next 6-months, we think THQI shares could trade much higher.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. Overall, we think there's a 75% chance that THQI shares will trade above \$5.25 within the next 6-months. For practical purposes, we think there's a strong chance that THQI shares will trade above \$5.25 heading into the release of UFC 2009, in mid-May. If either UFC 2009 or Red Faction achieve commercial success, then we would expect THQI shares to trade north of \$7.00 by 3Q09 (CY).

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	\$3.95	\$7.00	40.0%	77.2%	0.5x	154.4%	36.4%
Base	\$3.95	\$5.25	35.0%	32.9%	0.5x	65.8%	
Downside	\$3.95	\$3.00	25.0%	-24.1%	0.5x	-48.1%	

Source: PAA Research

MACRO DRIVERS

Macro Drivers:

- o THQI competes in the global \$21.3B software market. In 2008 software sales increased 19% YOY according to NPD
- o Although video game sales are somewhat dependent on consumer sentiment, console cycles have a much bigger impact on the rate of growth of software sales
- o The installed base of next-gen consoles (Xbox 360, PS3, Wii) should eclipse 100 million this year
- o Overall, most industry forecasters expect industry-wide software sales to increase mid to high single digits this calendar year, despite the weak consumer environment

HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: We would consider going long THQI fully unhedged. If one is looking for a hedge, we would consider going short a combination of ATVI and ERTS shares. In the case of ATVI, the company could underperform THQI shares due to concerns about a decline in sales for its largest franchise, Guitar Hero. For ERTS, the company has not delivered a differentiated, new, owned IP in quite some time. There is also mounting evidence that demand for its core sports franchises has peaked. That being said, ERTS has commanded a significant valuation premium to the group over the past 10-years and could be primed for multiple expansion if the company can deliver on its financial goals in FY10.

Relevant upcoming events:

First week of May

Relevant upcoming events:

5/19/09

Relevant upcoming events:

5/29/09

Relevant upcoming events:

6/9/09

Relevant upcoming events:

Next few months

4Q09 Results and initial 1Q10 and FY10 guidance

Release of UFC video game

Release of Pixar's UP

Release of Red Faction: Guerilla

Arbitration decision on royalty dispute between JAKKs and THQI

