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NEXON Co., Ltd. (3659.JP)

Q1 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to NEXON's First Quarter Fiscal-Year 2014 Financial Results Question-and-Answer Conference Call. Today's call is being recorded.

At this time, I'd like to turn the call over to your moderator, Shumpei Kumagai, Head of Investor Relations. Please go ahead, sir.

Shumpei Kumagai
Head-Investor Relations, NEXON CO., Ltd.

Hello, everyone, and welcome. With me today are Owen Mahoney, President and CEO of NEXON; and Shiro Uemura, CFO. Owen will make some opening remarks before moving on to the results for the quarter. After that, both Owen and Uemura-san will answer any questions that you all may have live on the call.

Before we get started, I'd like to remind you that although this is a stand-alone call, it will be helpful to have our quarterly presentation materials on hand as a reference. Our financial results for the first quarter of fiscal-year 2014, as well as our quarterly presentation are available on the company's Investor Relations website.

Today's call will contain forward-looking statements, including statements about our results of operations and financial conditions such as revenues attributable to our key titles, growth prospects, including with respect to the online games industry, our ability to compete effectively, adapt to new technologies and address new technical challenges, our use of intellectual property and other statements that are not historical facts.

These statements represent our predictions and expectations of the future events, which we believe are reasonable or based on reasonable assumptions. However, numerous risks and uncertainties could cause actual results to differ materially from those expressed or implied in the forward-looking statements. Information on some of these risks and uncertainties can be found in our earnings release. We assume no obligation to revise or update any forward-looking statements.

A replay of this Q&A session will be available on the website following this call. Also, please note that net income refers to the income attributable to owners of the parent as stated in NEXON's consolidated financial results. Furthermore, this conference call is intended to generally provide investors and analysts with financial and operational information about NEXON, not to solicit or recommend any sale or purchase of stock or other securities of NEXON.

Please note; we might be using Japanese/English interpretation during this Q&A session. I'd now like to turn the call over to Owen.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

Thank you, Shumpei, and thank you, all for joining us today. I'd like to start out today's call with a few impressions since assuming the role of President and CEO. Upon taking my new position, I made several internal changes to the management team, especially in the game operations and game development areas. Over the last three months, I and the rest of the new executive team have conducted an extensive bottoms-up review of our business with detailed assessments of each of our new games, our live game operations, and our publishing teams around the world.

Our first observation from this review is that NEXON has massive strengths bigger and more unique than we have ever even acknowledged before. These strengths include unparalleled experience and knowledge in online games that extends at all levels of our company, an extremely compelling free-to-play business model that is ever more in tune with how content is consumed on the Internet, multiple successful partnerships with more on the way, and a strong pipeline of new games through both our internal studios and our external partnerships.

NEXON's slate of existing games is huge, and many of those games continue to grow for years on end. Most of all, NEXON has one of the largest and most experienced collection of online game creators and operators in the world with deep experience in making their games appealing, not just in their own country, but around the world. These are massive strengths.

Our second conclusion is that we need to do better in several areas, and I'd like to briefly walk you through these. First, after a deep review of our games, we found that in some cases, we focused somewhat too much on monetization at higher levels of game play. This helped revenues but hurt balance in player retention, one of our most important metrics. MapleStory is a key game reflecting this theme.

The fact that our business in Korea grew significantly in 2013 despite the MapleStory decline speaks to the strength of our new and our existing titles, and the power of our business model. But I think we can do better. Elsewhere, it appears the decline in MapleStory play balance was a key factor impacting other regions like North America and Europe. In the coming quarters, we will be reengineering some of our games. This will likely have a negative impact on near-term revenue.

But I and the rest of the management team believe it will ultimately improve our growth in all regions, including North America and Europe. Second, in recent quarters, our games teams have tried to put out too many games, especially on mobile. I may sound counterintuitive, but it is meant that we spread our focus too broadly in some areas and not focused enough on our most promising new creative starts. We've not always devoted enough attention in the games that we really believe in as creators because of this diffused attention.

Going forward, we'll be taking a laser-like focus on quality. In my recent visits to our studios around the world, we've decided to cut a number of games, especially in mobile that we simply don't believe strongly enough in. We

are allocating those freed resources to our best games; those that are the most fun and differentiated. We believe this greater focus of our creative attention will result in better games, and therefore much better business down the road.

Next, we want to be a great mobile company. By way of context, the mobile markets in most regions are currently saturated with copycat games and games that do free-to-play poorly. We've made the conscious decision to eschew the low-quality strategy of much of the market, and instead, focus on games that are built to last. As two examples, we'd launched Legion of Heroes and FIFA Online 3 Mobile in Korea during the quarter, and both are off to excellent starts.

These games are unique in the market and extremely fun. And because of their depth, they are not easy to copy. We will do more like these in the coming quarters. As game makers, we are in a creative industry. We view games as an art form alongside novels, cinema, and music. It's been my experience that the sustainably successful games around the world; the ones that are built to last, are the ones that are deeply focusing on building a rapidly – are deeply committed to quality in their creative products. In online games, we are focusing on building a rapidly growing company by delivering highly fun games that are unique in the market.

Now, I'd like to highlight three of the risks that may have impact over the next few quarters. First, I'd like to discuss Dungeon&Fighter in China. As you know, we generate a significant portion of our revenues from Dungeon&Fighter in China, and it also contributes significantly to our profitability. As we've explained in our previous conference calls, Dungeon Fighter has been experiencing a challenging period in China from the second half of 2013.

The next key milestone in DNF is the tier-1 content update in June. Our focus on that update is to cultivate our current user base and expand the appeal of the game through content focused on player longevity. We have a long history of implementing content that has been previously released in Korea. And our development team will be using their experience and knowledge obtained from successful launches in the past. We are watching Dungeon&Fighter update closely, given its importance to our business.

Second, I'd like to discuss the likelihood of further compression in our operating income margin going forward. In the near term, the margins will be affected by a combination of Dungeon&Fighter China performance and some of the operating decisions I mentioned above. Longer-term, it's really about our revenue mix. As we work to broaden our base of revenues geographically, leverage partnerships with third-parties who have world-class content and grow our business on mobile, our operating income percent could decline to the mid-20%s to high-20%s.

Our margins will depend on what our mix is between these two factors, of course. If our China business continues to perform and the PC remains our dominant platform, our margins will be higher. If conversely, we have more hit games on mobile and grow more rapidly outside of China; our margins will decline as a percentage of revenue. While our margin percent may decline, we believe we can grow our aggregate operating income more quickly by pursuing these strategies.

Third, I'd like to discuss the possibility of a potential impairment. We acquired gloops in the second half of 2012 and currently have about ¥31 billion of goodwill on our balance sheet. As you're aware, gloops is currently going through a period of transformation as they shift their development efforts from browser games to native games. We're in the process of improving our native development capabilities to create the type of high-quality and differentiated games that gloops is known for, but in the meantime, there's a chance that we may have to recognize impairments for gloops' goodwill in the future.

Our laser-like commitment to quality games that are unique requires us to redeploy some of our resources and will result in near-term pressure on revenues and margins. But we believe this will position us for better downstream combination of sustainable revenues, profit and cash flow. With that, I'd like to turn the call over to NEXON's CFO, Shiro Uemura to take us through the first quarter performance and second quarter outlook.

Shiro Uemura

Chief Financial Officer, NEXON Co., Ltd.

Thank you, Owen. Turning to the first quarter performance, our first quarter revenue was ¥47.5 billion, an increase of 7% versus a year ago on as-reported basis. Revenues exceeded the high-end of our outlook on both, on as-reported basis, and at constant-currency basis.

This quarter, we hit the key milestone by delivering our first quarter-over-quarter increase in mobile revenues. Mobile growth came primarily from native games, including Legion of Heroes and FIFA Online 3 M. Revenues from native games tripled year-over-year.

Operating income was ¥21.2 billion, up 2% versus a year ago. Our operating margin was 45%. Net income was ¥16.1 billion, an increase of 7% versus a year ago. Both operating income and net income were above the high-end of our outlook for the quarter.

One factor behind the outperformance in operating income was lower-than-expected HR cost and marketing costs. We spent less than what was expected for the quarter, as we were shifting the process and operations in line with the new management strategy. Some of these costs have been delayed to Q2.

Turning to our performance by the region, our revenues from the China business were ¥21.3 billion, an increase of 4% versus a year ago. This represents a decrease of 8% on a constant-currency basis, which was above the high-end of our internal expectation; the stable performance of Dungeon&Fighter supported by Lunar New Year update. Chinese Dungeon&Fighter MAUs were steady quarter-over-quarter at this time, following the last quarter's sequential decline.

Our revenues from the Korean business were ¥15.3 billion, an increase of 44% versus a year ago or 28% on a constant currency basis. This strong performance in Korea was driven by existing PC titles and additional new mobile titles. In particular, we had a strong start to Legion of Heroes, a full 3D MMORPG mobile game we launched on Google Play on February 14.

Legion of Heroes is consistently ranking in the top 10 of the Google Play Top Grossing apps in Korea. Its KPIs are more similar to PC games, showing us that users definitely want more in market engaging content on the mobile platform. This is a key theme of us, which you'll be hearing more from us in the coming quarters.

For PC games, FIFA Online 3 had another strong quarter, supported by the building excitement ahead of the World Cup and the release of FIFA Online 3 Mobile in February. Sudden Attack set a record during the quarter by taking 17.6% of the PC café market share and recording 230,000 MCCU.

The revenues from our Japan business were ¥8.1 billion, an 18% decrease versus a year ago, or 2% quarter-over-quarter. Both PC online and mobile revenues decreased year-over-year with PC being a small market, and most of our Japan mobile revenues continuing to come from browser games. During the quarter, we launched five new mobile titles, including two native games.

Revenues in North America were ¥1.3 billion, a 5% decrease versus a year ago, or 15% on a constant currency basis. Our revenues in Europe and other regions were ¥1.5 billion, a 27% decrease versus a year ago, or 36% on a constant currency basis. As Owen mentioned at top of this call, we are continuing to focus on realigning our operations and preparing to expand our footprint, both through our existing titles, as well as publishing AAA titles, secured through partnership.

As many of you know, these regions have lagged the rest of NEXON's business for some time now. We believe that we now have the right partners, a great deal of exciting development under way, and we are quickly building our teams there.

Continuing with user metrics, total MAUs for the quarter were 55.9 million, a slight increase quarter-over-quarter. As a management team, we are focused on the sequential trends, given the volatility that MAUs have shown in recent quarters due to our efforts to eliminate illicit activity, which we believe have been successful. Our pay rates remain stable decreasing by 0.5 percentage points from a year ago, to 11%, but up 1 percentage point from 10% in Q4.

Our ARPPU was ¥3,639, up 44% versus a year ago. Our constant currency ARPPU was ¥3,333, up 28% versus a year ago. ARPPU increased both on as-reported and constant-currency basis with successful content update and as a function of a smaller denominator from decreased MAU count, summarizing while we are watching it closely, it appears our MAU count has stabilized, while the other KPIs have been advancing as our core user base remains very engaged.

Looking forward to the second quarter 2014, we expect PC revenues in the range of ¥26.1 billion to ¥27.6 billion, representing an 11% to 6% decrease year-over-year on as-reported basis. We expect mobile revenues in the range of ¥7.4 billion to ¥8 billion, representing a year-over-year increase of 2% to 10% on as-reported basis. Overall, we expect group revenues to be down 9% to 3% on as-reported basis, and down 14% to 9% on a constant-currency basis.

In China for Q2, we expect a double digit decrease on a constant-currency basis. A tier-1 content update for Dungeon&Fighter was announced at the Tencent Games Conference on April 16. And there will be a nation-wide marketing campaign to promote the update. We also expect to launch at least one new mobile title in China during the quarter. The key variables for our outlook for China are the performance of Dungeon&Fighter and other existing titles. No new PC launch has been announced in China, and we will continue to actively work with developers and publishers to seek opportunities in the market.

In Korea for Q2, we anticipate a double-digit increase on a constant-currency basis, supported by the continued strength of FIFA Online 3. We will be holding promotions and updates, timed for the World Cup in June. Additionally, the full three-month revenue contribution by FIFA Online 3 and by Legion of Heroes will also contribute to continued growth. Additionally, we expect to launch five new mobile titles during the second quarter. The key variables for our outlook for Korea are the revenue contribution of FIFA Online 3 and its mobile version, especially around the World Cup, and the continued performance of existing titles such as Sudden Attack and Dungeon&Fighter.

In Japan, we expect a double-digit year-over-year decrease in revenue. The PC online market remains a niche market in Japan. And as we have not announced new major PC titles, we expect most of our Q2 revenues to continue to come from existing games. For mobile, most of our Japan mobile revenues come from the mobile browser end-market, which continues to steadily decline. Although the rate of decline seems to be slowing, our focus remains on improvement of native games development capability.

We plan to launch five mobile titles during the quarter, including browser games, newly developed native games, and games from Korea. As an example, you might recall, we acquired a studio called inBlue in 2012. inBlue was totally focused on mobile browser games, but their most recent game is a native title called Magia Break. The pace of this shift to native development and the performance of our titles launched during the quarter are the key variables for our Japan outlook.

For North America, Europe and the other regions, we expect to see continued double-digit year-over-year revenue decline in Q2. We plan to launch three mobile titles in the U.S. during Q2 in addition to publishing United Eleven in Europe, a cross-platform soccer management game.

In the second quarter, we expect operating income to be in the range of ¥6.3 billion to ¥8.0 billion, a decrease of 53% to 41% versus a year ago, representing an operating margin range of 19% to 22%. Factors for margin compression include lower year-over-year revenue, increase in royalty costs associated with third-party IP such as FIFA Online 3 and FIFA Online 3 M, HR costs, including salary and head count increase, as well as the grant of stock options, our revenue mix due to the change in the geographical revenue contribution, as we have increased contribution from Korea, which has lower margin than China.

Going forward, our dedication to game quality may be reflected in our revenue outlook over the next few quarters, as we reallocate resources, organize costs, and revamp our pipeline. Additionally, we have announced plan for a ¥10 billion share buyback. This buyback reflects our cash usage policy, which is to hold sufficient cash to enable strong strategic flexibility but also to return money to shareholders. This buyback is in addition to our currently planned dividend of ¥5 per share every six months. More details are available in our disclosure materials, which you can find on our IR webpage.

As Owen mentioned in the beginning, we will be focusing our efforts on creating the most fun and most original games to delight and surprise our users. We are confident that with a deep focus on creating the best games, games that make us proud, we can achieve significant long-term growth.

With that, we'll be happy to take your questions.

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

Thank you, Uemura-san. We will now be moving on to the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] The first question we have is from the line of Han-Joon Kim from Deutsche Bank. Please go ahead.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Great. Thank you very much. Can you guys hear me?

Q

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

Yeah, we sure can. Go ahead.

A

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Great. Thanks. I just wanted to ask a few questions, but the first one is for your share buyback; can you help confirm whether stocks will be canceled or be held in treasury shares?

Q

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

Please hold on a moment while we do the translation to Japanese.

A

Shiro Uemura

Chief Financial Officer, NEXON Co., Ltd.

[Foreign Language] (24:13 – 24:41)

A

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

Thank you very much for the question. So I think your question is how we are going to use the shares that we bought back? What we could say right now is that basically, we haven't really decided how we are going to use the shares yet. But just talking about the possibility of – possible usage of these shares which we bought back includes – we could use it for stock options, and we could terminate the shares, and we could also use it for the M&As. So what I could say is that we haven't really determined how we will use the shares yet, but we will judge accordingly in the future period.

A

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Understood. Great, thank you. If I can just move on to my second question, your presentation on page 15 for the China portion says that the June tier-1 update is not going to have a significant impact on 2Q. Is this mostly because the tier-1 update is expected for extremely late June? Or is there any other reason for this?

Q

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

Thank you for the question. Please wait a moment while we translate into Japanese.

A

Shiro Uemura

Chief Financial Officer, NEXON Co., Ltd.

A

[Foreign Language] (26:03 – 26:30)

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

A

Thank you for the question. So your question about the June, tier-1 content update for China Dungeon&Fighter; so the most important intention of this tier-1 content update is to cause a positive impact on the user metrics. And having said that; our intention is not to put strong monetization right after the update, so having said that, assuming that tier-1 content update in June would do well, if we have to see the – more of the revenue impact from the update, it shall be more likely in the Q3 or Q4.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Okay. My last question revolves around FIFA 3, and then there's two parts to this. The first part – I'll just ask both; but one, with the launch of FIFA Online 3 M, are you seeing any cannibalistic impact on your PC usage trends? And if so, if not, can you please help elaborate? And the second part of FIFA is – does the royalty cost for FIFA Online 3 M fall within the existing IP licensing for FIFA Online 3 PC version? Or is it a separate licensing agreement? Thank you.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

This is Owen. So first of all, about your question about cannibalization; actually, no, it's interesting, it's actually the opposite. The games are complementary, and they're designed to be as such so the – both games are very strong. We're not seeing cannibalization. In fact, it actually – one fosters the other.

As far as royalties go, we don't break out or disclose what these royalties are, because of the terms of our agreement with Electronic Arts, but there is additionally a separate agreement that covers the mobile version of things, and it's within line of what works economically for both companies. So there's nothing out of line there from what was already in place with our PC agreement. Of course, the specifics of the agreement are different, but they're within line with reasonable means for both parties.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Great. Thank you very much.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

All right. I just want to go back to one other thing regarding your question about the buyback; we – Uemura-san mentioned several different uses or ways to use the buyback. Let's say, although we have many different uses, it's fair to say that it's more likely that we would retire the shares than any other use at this time. So I would just add that on to his answer.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Just this as one follow-up, guys, is there any particular reason why the company cannot commit to that at the current juncture?

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

We just haven't made any announcement on that, but I think it's fair to say it's more likely that we would retire them.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Understood, understood. Thank you very much.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

Thank you.

Operator: This concludes the question-and-answer session. Mr. Kumagai, at this time, I'd like to turn the conference back over to you for any additional or closing remarks.

Shumpei Kumagai

Head-Investor Relations, NEXON CO., Ltd.

Thank you. If there are no further questions, I would like to take this opportunity to thank you for your participation in this call. Please feel free to contact NEXON IR team at ir.team@nexon.co.jp should you have any further questions or comments about the first quarter results and second quarter guidance, or regarding NEXON in general.

We appreciate your interest in NEXON and look forward to meeting with you, whether it is here in Tokyo, or in your corner of the world.

Operator: Thank you. That concludes today's conference. Thank you for your participation. You may now disconnect.

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