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NEXON Co., Ltd. (3659.JP)

Q1 2016 Earnings Call

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Owen Mahoney

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to NEXON's 2016 First Quarter Earnings Conference Call. Today's call is being recorded.

At this time, I would like to turn the call over to Maiko Ara, Head of Global Investor Relations. Please go ahead, ma'am.

Maiko Ara

Head of Global Investor Relations, NEXON Co., Ltd.

Hello, everyone, and welcome. Thank you for joining us today. With me are Owen Mahoney, President and CEO of NEXON; and Shiro Uemura, CFO.

Today's call will contain forward-looking statements, including statements about our results of operation and financial conditions, such as revenues attributable to our key titles; growth prospect, including with respect to online game 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, projections and expectations about 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-related IR documents. We assume no obligation to update or alter any forward-looking statements.

Please note net income refers to net income attributable to owner of the parent, as stated in NEXON's consolidated financial results. Furthermore, this conference call is intended to provide investors and analysts with financial and operational information about NEXON, not to solicit or recommend any sale or purchase of the stock or other securities of NEXON.

Please note, we may be using Japanese-English interpretation during the Q&A session. A recording of this conference call will be available on our Investor Relations website, www.ir.nexon.co.jp/en/ following this call. Unauthorized recording of this conference call is not permitted.

I'd now like to turn the call over to Owen.

Owen Mahoney

Representative Director, President and Chief Executive Officer

Thank you all for joining us today. Uemura-san will review our first quarter results and second quarter outlook shortly. Before that, I'd like to share a few highlights of the first quarter and our recent progress on some of our longer-term initiatives.

In Q1 we delivered another great quarter, with revenues coming in ahead of our expectations. This was primarily driven by strong execution, especially in China, around the important February Lunar New Year season, which continued into March.

Last quarter, we mentioned Dungeon&Fighter in China was performing well after the strong start of the Lunar New Year Update introduced in late January. Throughout the quarter, the game continued to perform well and ended up exceeding our revenue expectations. Korea also outperformed our expectations, driven by better-than-expected results by key titles in both PC and mobile.

On the other hand, while we delivered solid performance in most of the regions, our Japan business continued to face difficulties. As you're all aware, Gloops had been focusing on preparing for the April launch of its highly anticipated mobile title LAPLACE LINK. Their focus has been on improving the user experience, based on feedback from the open beta test last December. However, in the process of doing this work, it became clear that we need to spend more time to get the game to the quality standards we set for ourselves. So, rather than launching the game before we think it's as good as it needs to be, we made the decision to postpone the launch by a few months. We're focusing on game quality because that is the best determinant of long-term success for our games and our company.

As a result of this delay, in addition to the absence of new growth drivers for Gloops, we recorded a ¥22.6 billion impairment loss on Gloops' goodwill in the first quarter. While we take these charges for accounting reasons, it's important to know that Gloops will continue to focus on the development of high-quality mobile games.

Now, I want to shift gears a little and touch on two partner announcements we made recently and what they say about our long-term opportunities.

First, let me talk a bit about the acquisition of Big Huge Games, which we announced in March. Big Huge Games is a U.S.-based game studio co-founded by industry veteran Brian Reynolds and Tim Train, renowned developers behind Civilization II and Rise of Nations. We entered into a strategic partnership with them on July 2013 that included a minority investment and began working with them on the debut title, DomiNations.

The game has achieved international success with over 20 million downloads worldwide since its launch in April 2015. Several months ago, we determined that we could build on its success to date by deepening our relationship with the team and by adding additional expertise in live game development, operations, user support and marketing. The acquisition also establishes a beachhead of in-house game development in the West. As a result of this transaction, Big Huge Games became a consolidated subsidiary of NEXON Group in the first quarter of 2016.

Another announcement was a strategic partnership with NAT Games, the developer of the mobile blockbuster RPG HIT through a 22.4% equity investment. This makes us the second largest shareholder of NAT Games. NAT Games is a Korean mobile studio, led by a Lead Producer Yong-Hyun Park, who developed the popular PC online MMORPGs, Lineage II and TERA. We were the regional publisher for their debut title, HIT, which became the top selling game on both Korean Google Play and iOS Store following the launch in November 2015, and it has already surpassed 5 million downloads to-date within Korea.

Through the equity investment, we aim to strengthen our relationship with NAT Games and we're expecting a successful launch of HIT in the global market. In conjunction with the strategic partnership with NAT Games, we also made a convertible bond investment in Barunson E&A, NAT Games' major shareholder as a way to reinforce the relationship with NAT Games. These are great examples of our partnership model with which I know you're all familiar, and we continue to seek more opportunities to work with leading game developers and IP holders around the world.

I will now turn it over to Uemura-san to run through the first quarter results and second quarter outlook.

Shiro Uemura

Representative Director and Chief Financial Officer

Thanks, Owen. Now, let's move on to the Q1 results. Revenues were ¥57.5 billion, up 11% on an as-reported basis and up 23% on a constant currency basis. Operating income was ¥3.7 billion and net loss was ¥6.3 billion.

First quarter revenues exceeded the high end of our outlook. Our revenues grew double digits on an as-reported basis despite the strong foreign exchange rate headwind, with Japanese yen appreciating year-over-year against major currencies in our business, including the Korean won, Chinese yuan and U.S. dollar. PC online game revenues exceeded the high end of our outlook, mainly driven by Dungeon & Fighter in China, as Owen mentioned. Mobile game revenues also exceeded the high end of our outlook. This was driven by the solid performance of the key titles, especially in Korea.

The primary reason for the operating income underperformance was the impairment loss on Gloops' goodwill. Since we follow International Financial Reporting Standards, impairment loss is recorded as other expenses in the calculation of consolidated income statement, and that has an impact on operating income. We recognized ¥22.6 billion of impairment loss on Gloops' goodwill. And as of the end of the first quarter, there is no remaining balance in Gloops' goodwill. Excluding the impact of impairment loss on Gloops' goodwill, which is a one-time factor, operating income would have been ¥26.3 billion, exceeding our outlook.

Net loss was ¥6.3 billion, below our outlook. This was mainly due to foreign exchange losses from foreign currency-denominated cash deposits and trade accounts receivables, in addition to the impairment loss.

Turning to our performance by platform. First quarter PC online game revenues were ¥45.1 billion, up 3% year-over-year. Please refer to the reference material Investor Presentation for our selected performance metrics for PC online games.

First quarter mobile revenues were ¥12.4 billion, up 49% year-over-year. Within mobile, native game revenues were ¥9.5 billion, up over two times year-over-year. Revenues from native games accounted for about 80% of the first quarter mobile revenues.

By region, revenues from the China business were ¥25.8 billion, up 14% year-over-year on an as-reported basis, and up 28% year-over-year on a constant currency basis.

We conducted a large scale update, the Lunar New Year Update, for Dungeon&Fighter on January 26, which was well-received by users. Revenue performance was especially strong from mid-February to March, driven by extremely favorable item sales for the Lunar New Year Update.

First quarter MAUs for Dungeon&Fighter increased quarter-over-quarter. Paying users slightly decreased quarter-over-quarter, simply due to the difficult comparison with fourth quarter of 2015 when the number of paying users was exceptionally high. As for Dungeon&Fighter, we continue to prioritize and focus on game stability and longevity.

Revenues from the Korean business were ¥22.6 billion, up 10% year-over-year on an as-reported basis, and up 25% year-over-year on a constant currency basis. Mobile game revenues in Korea were up 96% year-over-year. Key titles such as HIT, DomiNations and Legion of Heroes contributed to the significant year-over-year growth. During the first quarter, we conducted a closed beta test of our in-house title, MapleStory M. As for PC online games, we started servicing a popular MMORPG, TERA.

Revenues for our Japan business were ¥4.6 billion, a 22% decrease versus a year ago. Mobile revenues were ¥3.6 billion, a 21% decrease year-over-year, and a 1% decrease quarter-over-quarter. PC online revenues were ¥1.0 billion, down 22% year-over-year, and down 14% sequentially.

Revenues in North America were ¥2.2 billion, a 28% increase versus a year ago on an as-reported basis, and a 33% increase on a constant currency basis. Our revenues in Europe and other regions were ¥2.4 billion, a 90% increase versus a year ago on an as-reported basis, and an increase of over two times on a constant currency basis.

Now, turning to our Q2 2016 outlook. For the second quarter of 2016, we expect revenues in the range of ¥37.5 billion to ¥40.3 billion, representing a 12% to 6% decrease year-over-year on an as-reported basis. On a constant currency basis, we expect revenues in the range of ¥42.7 billion to ¥45.9 billion, representing a flat to 8% increase year-over-year.

We expect operating income to be in the range of ¥11.5 billion to ¥13.9 billion, and net income to be in the range of ¥10.3 billion to ¥12.3 billion.

We expect the foreign exchange rate of the major currencies in our business, including the Korean won and Chinese yuan against Japanese yen to depreciate by 14%, respectively, year-over-year. As you are all aware, depreciation of these currencies against Japanese yen will have a negative impact on our revenues, operating income and net income.

As for foreign exchange sensitivity, we expect every one Japanese yen move against the U.S. dollar would have an impact of ¥0.3 billion on our revenues and ¥0.1 billion on our operating income. For simplicity, forex sensitivity is calculated based on assumptions that Korean won and Chinese yuan move similarly against Japanese yen when there is an exchange rate movement in U.S. dollar and Japanese yen.

In China, for second quarter revenues, we expect a high single digit to low single digit percent decrease year-over-year on an as-reported basis, and a high single digit to high teens percent increase year-over-year on a constant currency basis.

Our major PC online game Dungeon&Fighter received a Tier 1 content update on April 21, in time for the Labor Day holiday. Another Tier 1 content update in time for the eighth anniversary from its launch in China is also

scheduled in June. As for our new title, we conducted a closed beta test for the PC online game, MapleStory2, in April.

In Korea, for second quarter revenues, we expect a low single digit percent decrease to low single digit percent increase year-over-year on an as-reported basis, and a low teens to high teens percent increase, year-over-year, on a constant currency basis.

On the PC online side, we conducted a closed beta test for our new in-house title, Sudden Attack 2, in April. We are currently preparing for its launch in the summer of 2016. We do not have any major new mobile title launches scheduled in Korea during the second quarter.

In Japan, we expect second quarter revenues to decrease 30-plus percent to 20-plus percent year-over-year.

In North America, for second quarter revenues, we expect 30-plus percent to 20-plus percent decrease, year-over-year, on an as-reported basis, and 20-plus percent decrease year-over-year on a constant currency basis.

In Europe and other regions, for second quarter revenues, we expect a high teens to low teens percent decrease year-over-year on an as-reported basis, and a high single digit percent decrease to flat on a constant currency basis. In April, we conducted the second closed beta test for a new PC online game, Riders of Icarus, in North America, Europe and other regions.

In the second quarter, we expect an operating margin in the range of 31% to 34%, showing a year-over-year increase from 27% last year.

While we expect revenues to be reduced by depreciation of major functional currencies, including the Korean won and Chinese yuan against Japanese yen, we expect this decline to be more than offset by significant decrease in amortization year-over-year due to the completion of amortization associated with Dungeon&Fighter IP and the decrease in marketing costs year-over-year, as we do not have any major new titles scheduled for launch during the second quarter.

We also expect a year-over-year decrease for other operating expenses primarily in Korea, due to a depreciation of the Korean won against Japanese yen. As for HR costs, we expect a year-over-year increase due to an increase in head count of approximately 400, mainly in Korea. However, Japanese yen appreciation positively impact foreign currency-denominated cost items, partially offsetting the increase in HR costs.

Having shared that context on our performance and our outlook, we'll be happy to take your questions.

Shiro Uemura

Representative Director and Chief Financial Officer

Thank you, Uemura-san. Next, we would like to open up the lines to live Q&A.

QUESTION AND ANSWER SECTION

Operator: Today's question-and-answer session will be conducted live over the phone. [Operator Instructions]
Our first question comes from Han-Joon Kim from Deutsche Bank. Please go ahead.

Han-Joon Kim

Deutsche Bank AG, Hong Kong Branch

Q

Hi, guys. Great. Thank you very much. I just want to get an update on your game pipeline. I get the impression that we might have had some production delays, so if you could just help us sort of walk through some of your key titles for 2Q. And I think last quarter you guys mentioned that you guys wouldn't have any titles, so I think we were pretty clear on that. This quarter, just wanted to get a little bit more clarifications on what we do have?

Maiko Ara

Head of Global Investor Relations, NEXON Co., Ltd.

A

Thank you very much for your question, Han-Joon. Please give us a moment while we translate.

A

Hi, Han-Joon. Thank you very much for your question. I assume you're asking about some delay or time schedule of pipeline that we have. It is indeed true that it so happens that we do not have any major title in Q2 and some titles have been delayed. But basically, we are the company that pursues quality and we do not want to launch any title if the quality is [ph] still low (22:55). Therefore, we will put our effort to come up with a very robust quality, so we can be sure that it is indeed in the right situation to release into the market.

So we do have titles in our pipeline and our pipeline is quite rich and as a matter of fact, starting in the second half of this year, we will be [ph] steadily (23:26) launching new titles. And since we are talking about the games, some games development might be delayed in some instances, that's a given.

Han-Joon Kim

Deutsche Bank AG, Hong Kong Branch

Q

Okay. I mean – sorry, maybe I might have missed your commentary at the beginning. So, we probably will not have any major mobile games launched in 2Q, just to confirm.

A

Yes, you're right. In Q2, we do not have any schedule to launch a major mobile title.

Han-Joon Kim

Deutsche Bank AG, Hong Kong Branch

Q

Got it, got it. Just want to get – so my follow-up question. Just wanted to get your impressions and thoughts about Overwatch, it's obviously getting a lot of [ph] global traction (24:22). And the reason why I ask is obviously you guys operate Sudden Attack, the leading first-person shooter in Korea, how you guys are approaching it, how do you think about Sudden Attack 2, it's supposed to come out, I think around June-ish. So just your perspective and thoughts today would be appreciated.

Owen Mahoney

Representative Director, President and Chief Executive Officer

A

Hi Han-Joon, this is Owen. There does not appear to be any impact that we can discern on Sudden Attack or our first-person shooter titles in Korea at that time. They're very, very different titles and they're for a different type of customer base. Beyond that, we don't really have a comment about how the game itself [ph] goes (25:03), but it doesn't appear to be having any impact on our game.

Han-Joon Kim

Deutsche Bank AG, Hong Kong Branch

Q

Okay. Understood. That's it for me. Thank you.

Owen Mahoney

Representative Director, President and Chief Executive Officer

A

Thank you.

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

Maiko Ara

Head of Global 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 the NEXON IR team at investors@nexon.co.jp, should you have any further questions. 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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