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NEXON Co., Ltd. (3659.JP)

Q1 2015 Earnings Call

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Owen Mahoney

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to Nexon's 2015 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 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 operations and financial conditions, such as revenues attributable to our key titles; growth prospects, 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 obligations to update or alter any forward-looking statements. Please note, net income refers to net income attributable to owners 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 stock or other securities of Nexon. Please note, we may be using Japanese to English interpretation during the Q&A session.

A recording of this conference call will be available on our Investor Relations website, World Wide Web – ir.nexon.co.jp/en/ following this call. Unauthorized recording of this conference call is not permitted.

Now, I'd like to turn the call over to Owen.

Owen Mahoney

Representative Director, President, Chief Executive Officer

Thank you, Ara-san, and thank you all for joining us today. Uemura-san will review our first quarter performance and second quarter outlook in more detail shortly. Before that, I'd like to offer a few remarks on our first quarter results and where we are in the context of our overall strategy.

In preview, Nexon is on the move and while we have much work to do, especially in Japan, there are a lot of exciting developments to update you on. And all of them fit within the themes we've been talking about for the last several quarters. Specifically, last quarter I talked about how we prioritized quality of the game experience for both new game development and live game operations. I also said that 2015 will be the year when we roll out a slate of high quality new titles worldwide on PC and mobile, both in-house and published on behalf of our partner studios.

As we report our first quarter results today, I'm pleased with where we are, both strategically and operationally, even as we still have a lot of work to do in some regions. We had another quarter of strong execution in both China and Korea in the first quarter, particularly around the important Lunar New Year high season and into March.

As you may recall, at the time of the last earnings call, Dungeon&Fighter in China had slower start in the first couple of days of the Lunar New Year update and our outlook for Q1 reflected our view of how it might perform for the remainder of the quarter. I'm pleased to say, however, that the performance of the game picked up considerably in the latter half of the quarter and China actually ended up ahead of our expectations.

And China's only one piece of our global business. Korea continues to be robust and in an extremely competitive market environment. Revenues were up again as both PC online games and mobile games performed well in Korea, driven by well-received content updates, promotions and item sales, in other words, good execution. We think this solid performance, supported by strong live game operations in Q1, again validates our strategy of focusing on quality.

During the quarter, we also announced the acquisition of an outstanding mobile game studio in Korea, Boolean Games. Boolean Games had a track record of successful global hit titles, including their most well-known Dark Avenger series. This is a part of our ongoing effort to bolster our global pipeline with more top quality titles and we are very excited to be working them.

In Japan, our focus continues to be on bringing our execution in line with what we've accomplished in Korea and other regions. This is still a work in progress. Meanwhile, we had a step forward in Japan this quarter with the announcement of our co-development deal with SQUARE ENIX to develop a mobile game version of the legendary MMORPG FINAL FANTASY XI. We think this is an extremely influential title, especially in the Japanese market. We are huge fans of this game and thrilled to be bringing it to mobile. At the same time, we're also progressing on the commercial launch of LINE Cross Legion, the Japan service of Legion of Heroes, which will be hitting in the market here soon. Pre-registration started on May 1.

Turning to Europe. The financial contribution from this region remains small, but our efforts to reignite the business took a meaningful step forward in Q1. Specifically, we will be relocating Nexon Europe from its current base in Luxembourg to new space in Berlin. This relocation is intended to put us in a better environment for

hiring, as Germany is now a leading talent center in the European game industry. The move should be completed in the third quarter.

Quality titles are also on track to roll out in other regions. And we've started to launch some of these beginning in the second quarter. As most of you know, we officially launched the mobile game DomiNations in North America and Europe on April 2, just after the close of Q1. The game was developed by our strategic partner, Big Huge Games. It's still early to evaluate its results at this point, but it has already achieved 6 million downloads to date, and we've been very encouraged by the retention rate, which is a key metric for long-term health of the game.

After that, Top of Tanker, a mobile title developed by one of our Chinese development partners, was launched on April 14 through KakaoTalk in Korea and has been consistently ranked around the top 10 of Korea Google Play top grossing charts since launch.

Another significant upcoming title is, of course, MapleStory2, our in-house-developed PC online game. We are particularly excited about this game. It recently completed its final closed beta test in Korea and we're getting ready for its commercial launch in the third quarter. We've also announced the release of the mobile version of Dungeon&Fighter in China through Tencent. This is one of the largest PC titles in China and we think people are going to love the mobile version.

These quality titles are only a part of the pipeline, which, as I've said before, is as rich as it's ever been. It is just the beginning of what we're going to roll out in 2015 and beyond. We're very much looking forward to announcing further new launches and updating you on how these titles are performing in the upcoming quarters.

With that, I'd now like to turn the call over to Uemura-san.

Shiro Uemura

Representative Director & Chief Financial Officer

Thank you, Owen. Let's start with the Q1 results. Revenues were ¥52.0 billion, up 9% on an as-reported basis, and down 1% on a constant currency basis. Operating income was ¥22.2 billion, up 5% year-over-year on an as-reported basis. Operating margin was 43%. Our first quarter revenues and operating income both exceeded the high end of our outlook.

Revenue outperformance was primarily driven by strong results from China and Korea in the latter half of February and into March. Operating income outperformance was the result of three main factors. The first was, again, the revenue outperformance. The second was lower than planned spending on marketing. And the third was lower than expected HR costs, particularly for recruiting and employee benefits. Net income was ¥18.5 billion, up 15% year-over-year, which exceeded the high end of our outlook. Primary factor of net income outperformance is stronger than expected operating income.

Turning to our performance by platform, our first quarter mobile revenues were ¥8.4 billion, up 16% year-over-year. Within mobile, native game revenues were ¥4.6 billion, 2.8 times year-over-year and accounting for 55% over the first quarter mobile revenues. Our first quarter PC online game revenues were ¥43.6 billion, up 8% year-over-year.

Continuing with first quarter regional highlights. Our revenues from the China business were \$22.7 billion, up 7% year-over-year on an as-reported basis and down 5% on a constant currency basis. As you know, we conducted a large-scale tier one update for Dungeon&Fighter on February 10 in time for the Lunar New Year, which had a slower early start than we had forecast.

However, as Owen noted, we ended up seeing strong performance in revenues in the latter half over the first quarter due to an improvement in the reception of the update the Lunar New Year holidays, which began on February 18, as well as well-received additional update and stronger item sales in the latter half of February and into March.

MAUs for Dungeon&Fighter decreased quarter-over-quarter, as the number of users has not recovered from the decrease in November and December last year. Having said that, the number of paying users was flat quarter-over-quarter.

The revenues from the Korea business were ¥20.5 billion, up 34% year-over-year on an as-reported basis and up 19% on a constant currency basis. Strong results in Korea were primarily driven by good reception of the content update, promotions and item sales of our existing PC online games, such as Dungeon&Fighter and Sudden Attack, as well as the strong Lunar New Year item sales of FIFA Online 3M and the great reception of the large scale first anniversary update [ph] into the year (11:24) for Legion of Heroes on February 12.

Revenues from our Japan business were ¥5.9 billion, a 28% decrease versus a year ago. Mobile revenues were ¥4.5 billion, down 26% year-over-year and down 17% sequentially. The decrease in browser game revenues was primary reason for the decrease in mobile revenue. PC online revenues were ¥1.4 billion, down 32% year-over-year and down 11% sequentially.

Revenues in North America were ¥1.7 billion, a 26% increase versus a year ago on an as-reported basis and a 9% increase on a constant currency basis. The increase in revenues was primarily driven by positive year-over-year growth of existing PC online game titles, such as Vindictus and Dragon Nest.

Our revenues in Europe and other regions were ¥1.3 billion, a 15% decrease versus a year ago on an as-reported basis and a 19% decrease on a constant currency basis.

Now, turning to our Q2 2015 outlook. For the second quarter of 2015, we expect revenues in the range of ¥40.3 billion to ¥43.0 billion representing a 9% to 17% increase year-over-year on an as-reported basis. We expect mobile revenues in the range of ¥10.2 billion to ¥11.2 billion representing a year-over-year increase of 21% to 33% on an as-reported basis and a quarter-over-quarter increase of 22% to 34%. We expect our operating income to be in the range of ¥8.8 billion to ¥11.1 billion. We expect net income to be in the range of ¥7.2 billion to ¥9.5 billion.

In China, for second quarter revenues, we expect a year-over-year high single digit to high teens percent increase on an as-reported basis. Our major PC title, Dungeon&Fighter, received a tier one content update on April 23, in time for Labor Day holiday. Another tier one content update in time for the seventh anniversary from its launch in China is also scheduled in June. Also, a new PC title Counter-Strike Online 2 was launched on April 22.

In Korea, we anticipate year-over-year high teens 20+% increase on an as-reported basis for the second quarter revenue. Major PC titles such as Sudden Attack, Dungeon&Fighter and MapleStory are scheduled to receive tier one content updates. As for mobile games, Top of Tanker was published on KakaoTalk on April 14. In addition, Mabinogi Duel, Tian Long Ba Bu and Gwanggaeto the Great are scheduled to launch in second quarter.

In Japan, we expect second quarter revenues to decrease 30+% year-over-year on an as-reported basis. On the mobile side, LINE Cross Legion, the Japan service of Legion of Heroes, is scheduled to launch in the second quarter.

In North America, we expect to see a year-over-year growth of over three times on an as-reported basis. In Europe and other regions, we expect to see a year-over-year low teens percent decrease on an as-reported basis. In North America and Europe, DomiNations were launched on April 2.

In the second quarter, we expect an operating margin in the range of 22% to 26% representing a year-over-year decrease. Factors of a decline in operating margin includes increase in variable costs, such as royalty costs associated with third-party licensed games, including DomiNations and Top of Tanker; and platform fees due to growth in mobile business. But particularly in the second quarter, we expect an increase in marketing costs due to the launch of multiple new titles, including DomiNations to have the greatest impact.

Lastly, I'd like to give you an update on the status of our share buyback program of up to ¥10 billion, which was announced on February 26. The period of acquisition is three months ending May 27. And as of April 30, we had acquired 6.2 million shares for ¥8.2 billion. Details of the share buyback program will be disclosed separately from the first quarter earnings and will be available on our IR website.

Now, we'll be happy to take your questions.

Maiko Ara

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

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, Deutsche Bank. Please go ahead.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Hi, guys. Hope everything is well and thanks for taking my questions. I do have three sets of questions, and maybe we'll just go through them one by one. But the first one really just revolves around DomiNations. I think your guidance is just – you're going to be doing a marketing push for it, but I actually didn't get the impression that the benefits of the revenue implied in the U.S. numbers was factoring in growth there. So, first off, I just want to confirm if that's the case in terms of what's implied in your guidance.

Maiko Ara

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

A

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

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Sure.

Shiro Uemura

Representative Director & Chief Financial Officer

A

Thank you very much for your question. I would like to respond to your question. In terms of the outlook for North America, we have factored in the growth that can be realized via the advanced investment, which is the marketing expense that we will be spending for DomiNations.

But having said that, we do not only do that expecting the growth in Q2 only, but rather we will be investing with a long-time horizon in mind, so that we can have DomiNations to be a big title in the future. And of course, we will be looking at the KPIs, so that we will be able to make effective investment in this title in the future as well.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. I guess it's – on that note, yeah, I think that's helpful. But on that note, I mean the best reference we have I think is [indiscernible] (20:34) which has been growing over the past few years. And I'm just trying to get a better sense – they've obviously been doing marketing. I don't know if you've been doing benchmark analysis or seeing how they've been able to grow that over the past few years. What is the ultimate sort of end goal or what would you like to really sort of scale this to? I just wanted to get a sense of what your ambitions are for the game.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Han-Joon, this is Owen. Let me answer the question because I think you're asking more a conceptual question about how we think about marketing for a game like this. Our view is that – how do I say this the right way? So when we see a ROI-positive opportunity to invest in marketing, where it's clearly an ROI-positive situation, we will go about doing that.

What we're not on the business of doing is buying near-term revenue regardless of the cost. We're very conscious of the cost and, therefore, the right way to think about it is ROI. And what we've been seeing so far with DomiNations both in the pre-launch betas and since the launch is that the retention rates are very good. And when the retention rates are good and you can count on the user to retaining, then it drives the ROIs of the marketing efforts up. And that gives you a green light to invest in marketing and that's how we're thinking about it. So, so far what we've seen is exactly what we want to see. So that gives us the green light to put the kind of marketing dollars into it that we want to see. Hopefully, that makes sense.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Sure. That makes perfect sense. Should I wait for an interpretation to follow on or...

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

No. There's no need for interpretation for that.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. I guess a follow-up to that. I mean I think one of the things about DomiNations is – or in comparison, you have some other companies that have done a little bit more guild battles, basically, [indiscernible] (22:28) on the content you can do within the game as that increases monetization of the game, midway through and longer term. So, and in terms of that, so, first stage, we do the marketing, we get the ROI up on the game. Do you see if like there's a lot more room to do in terms of improving the monetization and content development around the game as well?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

I'd say that we're at the very early stages of content development for this game.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. Fair enough. Fair enough. And my second question is really around your tax. I don't know if you've had a chance to see it. We've done a report just [indiscernible] (23:04) we think the Neople transition to Jeju Island, you should have had some tax on the benefits. From your 2Q guidance, I don't seem to see that reflected as much, especially if we consider that there should be some interest income coming boosting the pre-tax profit numbers. So if you could just help clarify what you think is the right tax rate, effective tax rate, I think that will be helpful.

Maiko Ara

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

A

Okay. Thank you for very much for question. Please give us a moment while we translate.

Shiro Uemura

Representative Director & Chief Financial Officer

A

In terms of our tax for 2014, we did not recognize ¥2.1 billion which we did in Q1. Therefore, as this is a one-time tax that we paid up. And so in terms of the consolidated tax rate, we believe that it will be just slightly above 15%. And when you talk about tax rate, it does not only comprise our corporate tax, but it contains some other tax elements as well. So all in all, on a consolidated basis, we believe that the tax rate will fall sometime in the range of 20%.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Sure. I mean is that 20% for the full year or is it 20% for 2Q to 4Q?

Shiro Uemura

Representative Director & Chief Financial Officer

A

Full year.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Full year. Understood. And then sort of my last question is really just around a lot of the beta testing that you guys done in the past few months. I mean there's a lot, the Ghost in the Shell, MapleStory2, et cetera, et cetera. Just wanted to get a sense of which ones you felt was – ended up being a little bit getting better response from your gamers, which one you feel like maybe need a little bit more enhanced some development, even if that means pushing it out a little bit further.

Shiro Uemura

Representative Director & Chief Financial Officer

A

In the deck, you see the slide that talks about the pipeline titles. And all the titles indicated on this slide are of high quality, fun to play with. Thus, we believe that those titles will be a major differentiating factor for us vis-à-vis others. Having said that, I do have great expectations towards each and every title.

But if I were to choose the ones that are promising and then I should mention names such as MapleStory2 or Durango, which I have been talking about for some time and these are the mobile titles that are really well-known and are very popular at the IPs. And I believe that both MapleStory2 as well as Durango are the titles that did not exist within our portfolio in the pack. But having said that, once again let me repeat that I believe that all the titles in the pipeline deck are very fun to play and are very promising.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

And, Han-Joon, this is Owen. Just to add one small point to that. I think one of the things that we feel pretty strongly is we don't control the output. We don't control how well a game will resonate with users outside of marketing when we're developing a game. So what we do control though very much is the input, in other words, the quality of the title, whether we ourselves consider it fun and different from other things that are out there. And I think what we think in a very qualitative sense is that we move the needle pretty significantly in terms of the quality, the fun level of the games that we've put to market. So that's very important for us. And that's what we're really [ph] solving (29:05) for in the development studios. We think we've made significant strides there. How well they do in the market, of course, will depend on how well they resonate with users.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. That's good. Okay. I hate to put you on the spot, but one thing that I just noticed in your deck is that you're still expecting Japan to fall 30% or more year-over-year, even with the launch of Cross Legion. So I just wanted to confirm that that's mostly because we're not going to get a lot of contribution from Cross Legions in the 2Q?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Yeah, I think that's fair to say.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. Great. That's all I have. Thank you very much.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Thank you.

Operator: [Operator Instructions] As there are no more questioners, 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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