13-Feb-2014

NEXON Co., Ltd. (3659.JP)

Q4 2013 Earnings Call
CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to today's NEXON Fourth Quarter 2013 Financial Results Question & Answer Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Shumpei Kumagai. Please go ahead.

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

Hello, everyone. Welcome. With me today are Seungwoo Choi, CEO and President of NEXON; and Owen Mahoney, CFO.

As we have done in the past, Seungwoo and Owen will each make some opening remarks. After that, they will answer questions that have been submitted by e-mail, followed by any questions that you all may have live on the call.

Before we get started, I’d like to remind you that today's call will contain forward-looking statements, including statements about our results of operations and financial conditions such as revenues attributable by key titles' growth prospects, including with respect to 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 as to 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.

Our financial results for the fourth quarter and fiscal year 2013, as well as our quarterly presentation and letter to shareholders are available on the company's Investor Relations website. A replay of this Q&A session will be available on website following the call.

Also please note that the net income refers to the net 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 but not to solicit or recommend any sale or purchase of stocks or other security of NEXON.

I’d now like to turn this call over to Seungwoo and Owen for a brief introduction and then we will begin the Q&A.

Seungwoo Choi
President & Representative Director, NEXON Co., Ltd.

Thank you, Shumpei, and thank you all for joining us today. Before we take your questions I’d like to make a few comment before handing things over to Owen for some more details on the quarter. As most of you are aware now, I have decided to retire as President and Chief Executive Officer upon completion of my current term following this year’s annual shareholders’ meeting to be held on March 25.

Looking back, my 15 years at NEXON have been characterized by exceptional growth from a small privately held company into a publicly traded multinational industry leader offering nearly 60 online games in more than 100 countries worldwide and recording annual revenues for 2013 of more than ¥155 billion. I am proud of the company that we have built and honored to have served as President and Chief Executive Officer for the last five years.

I believe that NEXON is in a great position to keep capitalizing on the industry’s continued transition to free-to-play and I look forward to continue to contribute to NEXON’s success in an advisory capacity as Honorary Chairman.

I’m happy to announce that Owen Mahoney has been appointed President and Chief Executive Officer to be formalized after the annual shareholders' meeting on March 25. His 15 years of global experience in the games industry and special strategic, financial and operational expertise make him uniquely qualified to lead NEXON into its next phase of growth. And I speak for the entire board when I say we're thrilled that he has accepted this position.

Also, Shiro Uemura, currently the head of the finance and accounting department will take over as the CFO, and Koji Abe, our general counsel will assume the additional role of Chief Administrative Officer. I would like to thank everyone for your support and encouragement over the years.

With that, I would like to hand it over to Owen for comments on the fourth quarter and the fiscal year followed by details on our outlook for the first quarter of fiscal year 2014.

Owen Mahoney
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Thank you, Seungwoo. I’d like to start by thanking Seungwoo for his extraordinary vision and for his years of dedicated leadership to NEXON. Seungwoo has been instrumental in getting NEXON to where we are today,
growing NEXON in Japan and throughout Asia. He’s been both a mentor and a friend to me, and I’m honored to take over the reins from such an exceptional individual.

Turning to our results, our fourth quarter revenues were ¥34.5 billion, an increase of 12% versus a year ago on as-reported basis. Revenues exceeded the high end of our outlook on as-reported basis and were near the high end on a constant currency basis. Our revenues from the China business were ¥12.1 billion, an increase of 9% versus a year ago. That was a decrease of 18% on a constant currency basis. Performance was in line with our internal expectations. As expected, Dungeon&Fighter revenues decreased single digit year-over-year on a constant currency basis.

Our revenues from the Korean business were ¥11.7 billion, an increase of 65% versus a year ago or 24% on a constant currency basis. This strong performance in Korea was written by FIFA Online 3 and existing titles such as Dungeon&Fighter, Sudden Attack and Mabinogi. FIFA Online 3 and Sudden Attack continue to hold the number two and number three spots in the PC Café Rankings, respectively.

Additionally, we launched five mobile titles during the quarter, two of which exceeded KRW 1 billion in monthly revenues. Unfortunately, we continue to underperform in Japan and the West. I will be talking more about how we plan to build our business in these regions in a moment.

Operating income was ¥327 million for the quarter. This was due to non-cash impairment charges of ¥9.5 billion primarily from NDOORS resulting from lower than initially forecasted revenues from existing titles and a delay in the development schedule for the new title, Legion of Heroes.

We had a ¥4.4 billion net loss for the quarter primarily due to a ¥2.5 billion impairment loss from equity method affiliate 6waves. Impairment loss from equity method affiliates is included in the financing cost under IFRS which hit the net income line. Both the NDOORS impairment which impacts our OI line and the 6waves loss were non-cash charges to the income statement. Our cash balance increased ¥35 billion from the end of Q3 to Q4.

Next, turning to user metrics. Total MAUs for the quarter were 53.9 million, a decrease of 21% versus a year ago mostly due to a decrease in users in China. Our pay rate remains stable, decreasing by 0.5 percentage points from a year ago to 10%. Our average revenue per paying user was ¥2,617, up 55% versus a year ago. Our constant currency ARPPU was ¥22,181, up 31% versus a year ago. ARPPU increased both on an as-reported and a constant currency basis thanks to successful content updates.

Next, let me make a couple of observations about 2013. Fiscal year 2013 was another double-digit growth year for NEXON. On an as-reported basis, revenues increased 43% to ¥155.3 billion and our operating income increased 7% to ¥50.7 billion. Our cash balance increased by ¥54 billion from FY 2012 to FY 2013, an increase of 64% year-over-year.

2013 was year of significant achievements. Dungeon&Fighter once again consistently ranked as the top performing game in China even as other companies launched high profile titles in the region. Our Korean business successfully returned to significant growth through new and existing titles. FIFA Online 3 in particular outperformed our expectations by considerable margin and we made progress towards our longer term strategic initiatives by investing in several studios headed by industry leading talent.

Looking forward to the first quarter of 2014, we expect PC revenues in the range of ¥35.6 billion to ¥38.6 billion, representing a decrease of 3% to an increase of 5% year-over-year on an as-reported basis. We expect mobile revenues in the range of ¥6.4 billion to ¥7 billion, representing a year-over-year decline OF 15% to 6% on an as-reported basis.
In China, we implemented a Tier 1 content update during the first quarter for Dungeon&Fighter, timed for the Lunar New Year. However, based on early results, we're expecting a low double-digit year-over-year decrease in revenues on a constant currency basis. The key variable for our China outlook include over or under performance of Dungeon&Fighter and Counter-Strike Online.

In Korea, we anticipate double digit constant currency growth to continue supported by content updates, timed for the Lunar New Year. We also plan to launch five new mobile titles in the quarter including FIFA Online 3 Mobile, Legion of Heroes and Candy Coaster for Kakao. The key variables for our forecast in Korea outlook include over or underperformance of key titles such as FIFA Online 3, Dungeon Fighter, and Sudden Attack and better than expected performance of newly launched mobile games.

In Japan, we expect double-digit year-over-year decrease in revenues. PC online and mobile browser markets in Japan are both declining while the mobile native app market is growing. In mobile, throughout the first quarter, we are continuing to shift our focus to the development of native apps. During the quarter, we will be launching Glorious Blades, a game co-developed with Square Enix. A key variable of our Japanese outlook includes a faster-than-expected deceleration of the mobile browser game market and over or under performance of Glorious Blades.

We expect to see continued low double-digit year-over-year revenue decline in North America, Europe and other regions on a constant currency basis. We are focusing our efforts on getting the best team in operations in place so we can capture the opportunities presented by these significant markets.

Since we have no large title schedule for launch in the first quarter, key variables versus our outlook would be the over or underperformance of existing PC online game titles in respective regions.

In the first quarter, we expect operating income to be in the range of ¥15.6 billion to ¥18.7 billion, a decrease of 25% to 10% versus a year ago, representing an operating margin range of 37% to 41%. We expect operating margin to decrease by 6 points from 47% a year ago to 41% at the high end of our outlook, primarily due to an increase in royalty costs associated with third party IPs such as FIFA Online 3 and an increase mainly from personnel cost due to increased head count for development and support.

Finally, I’d like to discuss our priorities for 2014. Looking back at fiscal year 2013, we’re proud of much of what we’ve achieved. At the same time, we’re disappointed by our performance in Japan and the West and by the slow start of some of the new titles we launched during the year.

Earlier today, I sent a message to our employees letting them know that I and the new management team will focus on three key priorities that we believe are essential to significant new growth. These three areas are products, people and partnerships.

First, I’d like to talk about products. We believe that across all platforms, only the highest quality, most original games will be truly successful. We will be taking a laser-like focus on pure better games, games that get us really excited and that we think will attract and retain huge numbers of players. Sounds obvious but in my experience, it's the crucial difference between success and failure in our business.

Second is people. In order to create radically innovative and entertaining games, we need to attract or retain the best people in the industry from around the world. We will take a new approach to recruiting and people management to set ourselves apart as an attractive workplace in a highly competitive industry.
At the same time as announcing our corporate level management changes, we announced changes in key management positions in our studios and operations in Korea. Min Seo will be stepping down as CEO of NEXON Korea and will remain in the NEXON family as an adviser for special projects. Jiwon Park will become CEO of NEXON Korea and will focus in particular on live game development and operations. Sangwon Chung will lead new game development in Korea and [ph] Tae Won Kim (13:22) will lead the worldwide corporate and business development. We’ve also announced other management changes around the organization.

Third is partners. We have a uniquely strong track record in our industry of successful partnerships with leaders around the world and a reputation for being a great partner. We’ll continue to enter new significant partnerships in 2014.

I believe that we have all the parts with which to build significant growth, great IP, a massive audience, a substantial global footprint, several of the biggest game markets and outstanding people who are leaders in online games. I believe that 2014 will be a year of change as we refocus the company on these three areas to unlock substantial new growth for the company, increase value for our shareholders and further growth of our industry.

With that, we’d be happy to take your questions.

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

Thank you, Owen. We don’t have questions submitted through e-mails prior to this evening’s call. Therefore, next, we would like to open up the lines for the live Q&A.

**QUESTION AND ANSWER SECTION**

Operator: Thank you. Today’s question and answer session will be conducted via live lines. [Operator Instructions] Our first question is from Han-Joon Kim with Deutsche Bank. Please go ahead.

Han-Joon Kim
Analyst, Deutsche Securities Korea Co.

Great, thank you guys. Just two quick questions from my end. First one, in your SG&A, can you just help us walk through the other expenses or some of the one-off impairments that we had and quantify that for us for the fourth quarter?

And then sort of the second question is on your guidance for the first quarter. The revenue number seems to suggest normal seasonality into 1Q but your operating margin, given the leverage that you have in China, doesn’t seem to match as much, and I’m still having a hard time even with all of the SG&A increases that you’ve had over the past years. So, can you maybe just help us walk us through maybe – is first quarter revenue a little bit more coming from Korea, the lower margin Korea or much better from the higher margin China? Thank you.

Owen Mahoney
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Hi, Han-Joon. This is Owen here. First, I’ll talk about your first question. If you refer to the investors’ deck on page 1 – excuse me, on page 11, there’s a breakdown of some of the key impacts with a year-over-year comparison. The main two that impacted the operating income line and the net income line were in order impairment for
goodwill and — impairment loss from goodwill and intangible assets which is mainly from our NDOORS subsidiary.

And I've really hit our operating income line. And then the next is the — in addition below the operating line was the ¥2.5 billion impairment loss for equity method affiliates which was mainly 6waves. As you recall, a couple of years ago, we made a minority investment in game company, 6waves, which was focused on the Facebook platform. We think the management team has done is a good team but the Facebook platform is a tough platform in which to do business so we had to take the impact for that.

As for Q1, the way our operating margin really works is, in quarters when we have a stronger China relative to the rest of our business, our margins will — our operating income margins will expand. And that's because we recognize the royalties that we receive in China as revenues which makes it look on our P&L like almost pure profit. So it really depends on the mix between China and our other regions.

And as we look out in Q1, we see China — that a larger portion than in previous quarters is coming from regions outside China. So really what you see is a strong Korea quarter there and a little bit less strong in the China quarter. And so that means that our margins look a little thinner than they do in other quarters when we have a very strong or a surge in China. So that's basically what the flex is there.

Han-Joon Kim
Analyst, Deutsche Securities Korea Co.

Okay. Great. Can I just follow up with a quick follow-up?

Owen Mahoney
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Sure.

Han-Joon Kim
Analyst, Deutsche Securities Korea Co.

Just in terms of, I see the 6waves ¥2.5 billion impairment, but can we get the number for NDOORS as well?

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

As far as NDOORS, we released a separate [indiscernible] (18:40) after today's earnings, but it's ¥8.6 billion, NDOORS.

Han-Joon Kim
Analyst, Deutsche Securities Korea Co.

Thank you.

Owen Mahoney
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Thank you. Next question please.

Operator: [Operator Instructions] Our next question is from Ansel Lu with Owl CAM. Go ahead, please.
Ansel Lu  
Analyst, Owl Creek Asset Management

Hi, I have two questions. One, can you talk about the MAU decline? Is that related more to Dungeon&Fighter in China or is that CS Online? And also can you talk about the split between -- revenue split between Dungeon&Fighter and CS Online in China? Thank you.

Owen Mahoney  
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Sure. Thanks for your question. This is Owen. Yes, the MAU decline was -- Dungeon&Fighter is by far the biggest title on China. And it has an enormous number of MAUs. So, really the big story here was about a decline in MAUs from Dungeon&Fighter relative to CSO.

Okay. Next question, please

Ansel Lu  
Analyst, Owl Creek Asset Management

And what about the revenue split?

Owen Mahoney  
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Sorry, from a revenue perspective as well, Dungeon&Fighter is a much bigger game. We don't break it out by title per region, but, yes, Dungeon&Fighter has a substantial portion.

Ansel Lu  
Analyst, Owl Creek Asset Management

Okay.

Owen Mahoney  
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

All right. Next question.

Operator: Our next question is from Masaru Sugiyama with Goldman Sachs. Go ahead please.

Masaru Sugiyama  
Analyst, Goldman Sachs Japan Co., Ltd.

Thank you for taking my questions. This is Sugiyama from Goldman Sachs. I have two questions, one is on impairment. Given you have taken a rather large impairment this quarter, could you walk us through the health and sort of composition by company of the rest of the goodwill intangibles that you have on the balance sheet? That is my first question.

And my second question is on live development. You've mentioned you're focused on live development for the year. Could you tell us how this year's live development trends are going to be different from other years in terms of frequency or quality or the focus or the area? Thank you.
Okay. I'm going to take your second question, but I'm going to ask Uemura-san to take your first question.

Yes, thank you for the question. We are taking for impairment every quarter and IFRS. Right now, our BS shows ¥45 billion in goodwill and ¥26 billion in intangible assets. But these have passed the impairment test, and so we don't have to worry about impairment at present. As for potential risk, assuming that our BS going forward as planned, I think there is lower risk so far.

Okay, and then going to your second question relative to live game development, Sugiyama-san, on page 31 of the investors' deck you can see an outline of our live game development, the major content updates from live game development. If I were to sort of give us a grade for how we did in 2013 and how things will be – how we plan to change in 2014, I'd say that really what we need to do is be more consistent in how we execute in live game development.

We did this well in several cases and we had a couple of challenges. Two examples of where we did really well in live development were Sudden Attack and Dungeon & Fighter in Korea as an example. But as you recall in 2013, we also had challenges in Maple Story 1 where our experiments in play balancing drove up monetization for some users but drove other users away.

And another example would be Combat Arms in North America and Europe where we frankly just had too many hackers and bots. So, as we think about going forward live game development, our emphasis will be on consistent execution live game development, and of course, that has a big impact on immediate revenues. So that's how we think about it differently.

Thank you very much.

Thank you. Next question, please?

Good evening. Quick question on your Q1 trends, what impact have you seen from the tier 1 updates? Has that been achieved?

Thank you. Next question, please?
Well, let’s see. So our Q1 outlook reflects what we know as of today based on what we see today for our tier 1 updates in Q1. I’d say that updates have been received well, but as you could see from our outlook, we’re not planning on exceeding what we did last year. And so we’d say strong but not stronger than what we saw before. So that’s really where you see there. It’s still early but, of course, the lunar year holiday season is largely over and February and March are not in yet. But that’s the key impact so far.

**Martin Dullaart**
Investment Analyst, Orbis Investment Advisory

You’ve generated an impressive amount of free cash. What do you intend to do with that?

**Owen Mahoney**
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Well, we believe that having a strong cash position provides us with a lot of strategic flexibility. We like that flexibility in being able to move aggressively for business development or perfect development opportunities as they arise, and oftentimes they will arise under very short notice. That means that we want to go after them quickly. So we like a large cash position. Having said that, we also believe in proper and strong shareholder returns so we look at that as a balance. But right now we continue to believe that we want the strategic flexibility that a large cash position gives us.

**Martin Dullaart**
Investment Analyst, Orbis Investment Advisory

And lastly, can you give us an update on gloops?

**Owen Mahoney**
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Well, I’d say gloops in 2013 was — basically, we’re in the middle of two transitions with gloops as we exit 2013 and go into 2014. The transition number one is about switching from browser-based games to native applications. In the Japanese market traditionally browser-based games have been a very strong component but the shift is really on right now to native applications. So we’re shifting our development capabilities, that’s number one.

Number two is, in 2013, gloops put out a number of games. But as we review how those games launched, I think we would say internally that we felt that not all of those games hit the quality bar that we really wanted. Some did such as SKYLOCK and then we have the kind of results that we wanted when we put out games at very high quality that we’re very proud of.

So as we look at 2014 slate of games, it’s really about focusing on fewer bigger titles meaning fewer titles with better quality and focusing our development and resources on that. So that’s the — those are the two main changes. And I think as you see us go through the year, we’ll reap the benefits of that, but those are two main focuses that we’re doing from a development perspective.

**Martin Dullaart**
Investment Analyst, Orbis Investment Advisory

Great, thank you.

**Owen Mahoney**
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Thank you.
Operator: [Operator Instructions] 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.

So, thank you. If there are no further questions, okay, I will like to take this opportunity to thank you for all of your participation in this call. So please feel free to contact the NEXON IR Team should you have any further questions or comments about the fourth quarter and fiscal year results or regarding NEXON in general.

We appreciate your interest in NEXON and I look forward to meeting with you whether it will be here in Tokyo or in any corner of the world.

Owen Mahoney
CFO, Director, GM-Administration & IR Contact, NEXON Co., Ltd.

Thanks, everybody.

Seungwoo Choi
President & Representative Director, NEXON Co., Ltd.

Thank you.

Operator: The conference has now concluded. Thank you for attending today’s presentation. Please disconnect your lines.