FY2018 Q1 Earnings Conference Call (Held on May 10, 2018)

Q&A Summary

【Q】 Regarding Q2 Operating Income outlook, HR costs and Others (cost) are expected to increase by ¥3.1 billion and ¥1.7 billion year-over-year respectively. Do these cost increases include any one-time factor? Why do you expect so much of increase in HR costs and Others (cost)?

【A】 HR costs increase include increase in ordinary payroll and stock option expense. Increase in stock option expense accounts for more than one-third of ¥3.1 billion increase. In order to retain key talents, we had issued stock options as needed. The increase is mainly due to new stock options we issued, which we expense proportionally over the next three years. Q2 HR cost level is expected to continue and so, it should be considered rather as fixed cost.

Others (cost) include variable costs, outside service fees, and various small items. Increase includes nothing to be worthy of special attention.

【Q】 How long do you think it will take to complete the transition for *EA SPORTS™ FIFA ONLINE 4*? Do you think you will be able to enjoy positive impacts from World Cup on revenues during Q2?

【A】 Regarding *EA SPORTS™ FIFA ONLINE 4*, based on our past experience, we believe post World Cup is even more important than the actual World Cup season. In the past, the game gradually gained momentum towards the end of the World Cup event, and received very positive impact for several months after the World Cup.

We will launch PC service in May, support users' smooth transition, build a solid user base, launch mobile service in late July, and then would like to start growing the game.

In Q2 the game will undergo transition period, therefore, we do not expect any major upside or downside on our revenues. With close look at condition of the game, we would like to start encouraging the growth of the game beginning in Q3.

【Q】 You’ve touched on the reorganization of your development studios in Korea. I understand you can promote creativity and leadership by making each studio more independent, but I get the impression that it will become harder to manage these studios as each gets more independent. What is your plan for the overall studio management?

【A】 First of all, running a studio as one central organization with a lot of major decisions flowing up to a key studio leadership is one way to do things, but it doesn't scale that well. And as our studios get bigger and bigger and we put out more and more products, we try a variety of different things that gets more difficult to do.

Another thing about game development is that the very best ideas come from people who are closest to users and closest to games. And so, we want to put more the creative decision-making autonomy in the hands of people who are closest to users. That doesn't mean we hand over everything to the individual game leaders, but it does mean we want them to be closer to customers.

Over the last few years, a new generation of leaders has been gradually coming up in Nexon. They have gotten more experiences. And we think that this is a great way to put more autonomy in that next generation of leaders.

Having said that, we will be monitoring very closely from the central studio leadership as we have in the past.

【Q】 I would like to understand the dynamics between MAUs, paying ratio and ARPPU for Q1 China *Dungeon&Fighter*. When do you think you will hit a level where you want to delve back on ARPPU and focus more on MAUs?

【A】 In Q1, for *Dungeon&Fighter* in China, MAUs were down year over year. The number of the paying users was almost flat and ARPPU significantly increased year over year.

The game was in a very healthy condition supported by our focus on the daily operation and the content updates throughout last year. In addition, in Q4 last year, we did not have any major monetization measures and focused on building solid user base. As a result, the appetite of the users buying motivation in Q1 this year was very strong. During Q1, we delivered great content update and had strong package sales. As a result, ARPPU increased while MAUs decreased year over year.

The decline of the MAUs in Q1 was due to high comparison with Q1 last year, when many users came in driven by Level Cap update. If we compare this year's MAUs with regular Q1, MAUs were about the same level. Therefore it simply means that the last year's MAUs were exceptionally high.

The reason why revenues grew significantly year over year while paying users were flat and MAUs were down is because of the higher ARPPU. This higher ARPPU was driven by great content update and strong avatar packages sales under a very good in-game situation. More specifically, core users instead of buying one package, bought multiple packages and light paying users also bought packages.

So we had a very good in-game environment and our measures were very effective, which led to revenue growth. We were able to control the game as we expected and were able to deliver great results.

Most recently in Q2, MAUs are stable, paying users are increasing and ARPPU is slightly down compared to the same period last year. Q2 will be a quarter in which we focus on user engagement. The ARPPU level is already below last year's level.

We pay close attention to the in-game environment and decide on what measures to take. It is not the case that ARPPU continues to rise. We see China *Dungeon&Fighter* continues to be very solid.

【Q】 Regarding *Durango: Wild Lands*, I'm wondering how the underlying KPIs look from your perspective and if we can envision this as a game that can continue to grow over two, three, four-year timeframe. Should we be assuming a relatively soft launch overseas as well and then progressively growing? How do we think about this title longevity-wise?

【A】 When we launched it, the interest level greatly exceeded our expectations, even though our expectations were pretty high given the significant numbers of pre-registrations. That level of interest from customer base was also fueled by the great support from Google and Apple that we got. And I think what was driving these things was *Durango: Wild Lands* is not like any other game in the mobile market right now or very few mobile games.

However, there was a flood of new users in the opening hours that created some server problems for us and, therefore, some customer experience problems. We were very happy with high level of user interests, but then it went down in terms of app store rankings.

The major thing, I would say about *Durango: Wild Lands*, is that in an open-world MMORPG, you don't judge the success of the game from the first one or two months or quarters after launch. We think it's very early days to tell.

All the games that we've launched that have done well over a period of years and also many of the games from other companies that we've noticed that have done very well on a worldwide basis, they oftentimes start as very small or they've had rocky launches. What matters is not this quarter or next quarter, even the quarter after. What matters is that we're all talking about this game 5 or 10 years from now. That's what we're designing it for. And we think we are on track to be doing that.

【Q】If we take the midpoint of your second quarter guidance for revenue and operating profit, we have virtually zero revenue growth against about a 26% year-over-year declining operating profit. How do we think about the dynamics where the cost is growing faster than the revenues and at what point costs are going to stabilize?

【A】We expect HR costs to increase significantly year over year, of which over one-third is due to increase in stock option expense. We issue stock options in order to retain the key talents. While stock option expense accumulates whenever we issue new stock options, the expense for those stock options we issued in the past will gradually decrease. Net, we expect Q2 level to stay for the next three years.

Another factor for HR cost increase is increase in marketing cost. We need to make prior investment in marketing for major launches. Compared to Q2 last year, marketing cost is expected to increase significantly. However, this is upfront investments. In Q2, this will suppress operating income, however, we expect these investments will lead to revenue increase in the future quarters.

【Q】In Q1, you had factored in some increase in HR costs, but the actual cost was lower than you planned. In Q2, you expect year-over-year increase in HR cost primarily due to increase in stock option expense. Does this mean you need to pay more compensation in order to hire talents in regions like Korea?

【A】Q1 HR costs were lower than expected due to lower-than-planned headcount increase. However this does not mean that we need to increase compensation in order to hire great talents. We are issuing stock options in order to retain the key talents as well as management.

【Q】Historically in the quarters you had multiple launches, you spent roughly 5 billion yen for marketing per quarter. Given that you will be accelerating *EA SPORTS™ FIFA ONLINE 4* beginning in Q3, should we think your marketing cost could potentially become bigger than what you guided for Q2?

【A】We don’t expect Q2 marketing cost to exceed our outlook. We have *EA SPORTS™ FIFA ONLINE 4*, *OVERHIT* Japan service, and *KAISER* Korea service launch in Q2 and will be investing in marketing depending on KPI performance. Q2 outlook is our best estimate as of today.

【Q】 Can you tell me what will be the pace of mobile launches in Japan?

【A】 We are planning to launch 10 titles in 2018 in Japan. We will launch *OVERHIT* in Q2, *GIGANT SHOCK* and *DURANGO: Wild Lands* in 2018. In Japan, we have many highly-anticipated titles and we expect we have more launches later in 2018.

【Q】 Given that you have a 10-year anniversary for *Dungeon&Fighter* in June and also had successful Labor Day update in April, shouldn't year-over-year revenue growth for China in Q2 be stronger?

【A】 It is not possible to continuously monetize in PC online games. Users will become fatigue and this will ruin the in-game balance. Q1 is the most important quarter for China *Dungeon&Fighter* and Q3 is the second important quarter as we have National Day update. Q2 and Q4 are the quarters when we focus on user engagement in order to prepare for the next important quarter.

Dungeon&Fighter continues to be solid, however, Q2 is not a quarter in which we have major monetization measures. It's a quarter in which we focus on user engagement. The most recent KPI trend in Q2 is that ARPPU is lower than that of last year, paying user is increasing, and MAU is stable. We are not simply trying to achieve year-over-year growth in every quarter. It is important that we maintain good game balance and grow the game over time. Longevity is the most important in PC online games.

【Q】 Any update on *Dungeon&Fighter 2D mobile*?

【A】 We do not have any updates on *Dungeon&Fighter 2D mobile*.

【Q】 Can you comment on the competitive backdrop for *Dungeon&Fighter* in China with regards to the increasing popularity of the Battle Royale genre or whether you're seeing any kind of shift from PC to mobile? What is your outlook on the PC market?

【A】 *Dungeon&Fighter* is very unique in terms of game genre. There are very popular titles in the market. But since the genre is very unique, we are not observing any impact from other titles on *Dungeon&Fighter*. And in terms of Chinese PC market, some people see it challenging, but China *Dungeon&Fighter* is doing very well. We do not have any concerns over *Dungeon&Fighter*. We will continue focusing on longevity so that we can operate the game over the long term.
