

FY2018 Q3 Earnings Conference Call (Nov 8, 2018)

Q&A Summary

【Q】 You've record impairment loss related to NAT Games. NAT Games have titles such as *HIT* and *OVERHIT*. Was the impairment loss related to these titles or were there any other major items?

【A】 The impairment loss was on *OVERHIT* (i.e. game IP). At the time of the acquisition, we evaluated the titles including *HIT*, *OVERHIT* and another new title in their pipeline. We initially had very high expectations for *OVERHIT* Japan service, and while it had some achievement, it was not as high as our expectation. Therefore, we made a review on its value and recorded the impairment loss of approximately 7 billion yen.

【Q】 Why did MAUs increase quarter over quarter?

【A】 MAUs increased quarter over quarter mainly due to the seasonality. We have major content updates along with National Day Holiday in China and Chuseok Holiday in Korea, and so Q3 is a high season. In terms of titles, *MapleStory* in Korea and *Dungeon&Fighter* in China primarily pushed up the MAUs.

【Q】 Even considering the fact that you don't have any major updates in Q4, the year-over-year decline for your Q4 China guidance still looks very large. Is the weak guidance related to any regulatory noises in China or is it simply because you had stronger-than-expected results in Q3 with revenues weighted more to Q3 this year? Do you continue to see resilience in your China business?

【A】 The year-over-year decline in Q4 China guidance is not only due to *Dungeon&Fighter*, but is also partly due to *MapleStory2*. *MapleStory2* had a very good start and was performing very well in last Q4, while it is now struggling.

As for *Dungeon&Fighter*, it is doing very well. One of the reasons behind the year-over-year decline is due to the balance of how much revenues were generated from National Day update in Q3 and Q4. Last year revenues were generated relatively well balanced between Q3 and Q4. However, this year, revenues from the National Day update weighted more to Q3 than Q4 driven by the strong start of the National Day update. Thus we had more contribution

to Q3 and less to Q4 than we initially expected. If we look at *Dungeon&Fighter's* revenues in 2H, we expect revenues to grow year over year in 2018. From this too, you will also know that it is just a matter of the balance between Q3 and Q4.

In terms of the regulatory noises, we have not observed any changes to our business. Our China business continues to do well.

【Q】 If you add back the impairment loss, you exceeded the high end of your guidance by more than 5 billion yen. What were the specific measures that pushed up operating income? Is it because of strong sales of items with high unit price? Can you elaborate more specifically on the reason behind this?

【A】 Q3 is the second highest quarter and we conducted a large content update and avatar package sales in China. The avatar design was well received by users and packages sold very well. As a result, it led to the revenue and operating income (adjusted for impairment) outperformance.

【Q】 You mentioned that China *Dungeon&Fighter's* revenues in 2H 2018 are expected to grow year over year. Because you did so well in Q3, when you came up with Q4 plan, did you decide to pull monetization in Q4? Is this the reason for the soft Q4 outlook?

【A】 National Day update went very well both in 2018 and 2017. But in 2017, the steady trend continued throughout the National Day update period, whereas in 2018, it started strong and gradually slowed down. This is just the difference of pattern, and we do not think there are major fundamental differences between 2017 and 2018.

We did not intentionally lower Q4 guidance. National Day update started very well in Q3 and, if we look at the KPIs, we expect revenues to slow down in Q4. Q4 is a slow season and we try to focus on enhancing the user engagement so that we can be well prepared for 2019. Therefore, we don't focus on monetization during Q4.

And if you recall, last Q4 we were able to grow approximately 50% year over year. So Q4 last year is a high hurdle. Having said that, we expect *Dungeon&Fighter's* revenues in the 2H 2018 to grow year over year. We believe *Dungeon&Fighter* in China continues to be in healthy shape.

【Q】 I understand that you have not seen any impact from China regulations up to this point. However, I hear that Tencent will lower their marketing budget or reinforce the user identification system. Is there any concern regarding these changes?

【A】 Regarding our key title in China, *Dungeon&Fighter*, we have already been diligently complying with voluntary requirements. We will be in close discussion with Tencent for any update when necessary. And so, we think any additional measures for user identification would have minimal impact on our business.

【Q】 This is not a question, but just a proposal or maybe advice that I can give to you. You say that game business must be evaluated from a mid to long-term perspective, however you only give quarterly guidance, which can be misleading. Do you internally have discussion about giving mid-term plans instead of quarterly guidance so that market can have a better sense of the longer-term view of your business?

【A】 It is true that we manage our business on a mid to long-term horizon. And it will be great if we can provide you with numbers accordingly, but in terms of the game industry, it will be quite challenging because the speed of change is very fast. And given that situation, to-date we think we can provide accurate outlook for the next quarter, but it will be quite challenging to do so for the longer-term horizon, for example full year plan as a guidance. Having said that, we will try to think about what will be the better way to provide the guidance to the market. And I will take your advice and we will look into the matter.

【Q】 I was hoping to ask Patrick a question. You've talked about the idea that you're trying to make a game that's innovative and leveraging a lot of the technologies that's coming on board. Will you elaborate a little more on how you're seeing the video game growth evolve and what it will achieve?

And alongside that, I think you've just recently started your firm as well. So is this something that we should be expecting two, three, four years from now? How do we think about the fact that you may be working on some new technology today but there might be tectonic shifts that come from other competitors over time? So, how do you think about the timing and immediacy of what you're trying to achieve at the current juncture?

【A】 Regarding the technology component, I think it's important to think about this from a couple of perspectives. I look at it from the perspective of new technology coming out, whether it's machine learning, whether it's cloud compute or the fact that you can talk into a computer and it responds intelligently back to you today. I just look at these technological advancements as incredible segues to new types of experiences in games and that's where you have to start.

So, I'll be honest with you. I don't know exactly what technology we are going to build because this is the first basically week we're open for business, but what I do know is that we have a vision that I think spans away from what's currently in the market and utilizes some of these technologies.

I think it's important also to acknowledge that we would never build technology for the sake of building technology. It starts with the experiences that we want to build and the experience that we want players to experience as they play our products. So that's kind of the approach we take on tech.

When it comes to timing, your question is accurate if we were to build tech, and at the same time try and build a game, it would take us a very long time to do that. So, our approach will be one of probably utilizing existing technology that's available to license today with our maybe first or even second product. And at the same time add to that technology base the things that we want to prove out for the long term. So, it could be a game that may appear to be traditional in its formula but have a couple of components that we want to test or it could be something like we spoke about like speech recognition, it could be immense scale, it could be a neural network based AI system that we want to try and build.

So, for us, it's like we're going on a journey where we start, and we start maybe smaller but we evolve over time with the vision of building something and creating something that is – it will make a mark in this industry. That's our approach.

My last point would be, the way I look at it is, we didn't build Embark to go away for five years and hide in a corner and then show up with something that may or may not work. We want to be very transparent with players, with people in the press, and we want to show things hopefully earlier than people can anticipate from us. So that's going to be our approach, and we'll see how we do. But I think we're going to be fine.

【Q】 In terms of Q4 guidance for “North America” and “Europe and Others” regions, I've noticed that your guidance implies that “North America” is flattish quarter over quarter, whereas “Europe and Others” is down and I presume this is due to *MapleStory M*. Please help us understand why the North American operations are more flattish, and European operations seems to be a little bit down quarter over quarter?

【A】 *MapleStory M* and *Dark Avenger 3* did very well in Q3. However, as time passes toward Q4, we expect these titles to slow down. While we expect “North America” to be flattish quarter over quarter as we expect to benefit from *MapleStory2*, we expect “Europe and Others” to decline quarter over quarter due to slowdown of the mobile business.

【Q】 Depreciation picked up a little this quarter. What is the right level to think about in terms of depreciation and what's causing the movement?

【A】 Quarter-over-quarter increase in depreciation was related to NAT Games' IP amortization. However, recognized impairment loss on NAT Games' intangible assets. The amount we recorded as impairment loss will no longer deemed as the amount to be amortized. Therefore, depreciation expense will decrease quarter over quarter in Q4.