

FY2019 Q3 Earnings Conference Call (Nov 7, 2019)

Q&A Summary

【Q】 In terms of the decline in the paying users for Q3 China *Dungeon&Fighter*, was there a misexecution or a content update which did not do well and had led to the decrease? Is this why the company is preparing for a remedy to fix this? Or was this a side effect of over-monetizing in the very strong first half 2019, which has taken a bit of a hit in the second half 2019?

【A】 Shiro Uemura (Chief Financial Officer)

We started observing weakness in KPIs including paying users beginning in the end of Q2, as both the June 11th anniversary update and the July Summer update did not resonate well with our users. The recent weakness in KPIs including paying users is primarily due to the two unsuccessful updates, and not because of over-monetization in the first half of 2019 while we did deliver strong results in both Q1 and Q2.

【Q】 Regarding China *Dungeon&Fighter*, given that you are planning the new key update in mid 1H 2020, should we be expecting a relatively muted quarter for Q1 2020 when typically the Lunar New Year tends to be a peak quarter?

【A】 Shiro Uemura (Chief Financial Officer)

Let me explain the flow from the past to the present.

We started to observe declines in *Dungeon&Fighter's* KPIs beginning in the end of Q2 and decided to address the short-term challenge through series of updates extending over multiple quarters. The new key update which addresses the primary feedback of players is set to launch in mid 1H 2020.

While we did not expect to experience a substantial improvement in Q3, we conducted series of in-game events, aiming to improve the number of active users and paying users. However, we were unable to obtain the benefits we had hoped for.

Meanwhile, subsequent to these, the National Day update, including content and avatar design, was well received by the existing users. As a result, we are starting to see some recovery in the KPIs and the percentages of the year-over-year decline are getting smaller now compared to those in Q3. Our Q4 guidance reflects the latest KPIs.

In Q4, we continue to give a series of small events to improve the existing users' engagement. We will need to see how things will turn out in Q4 before thinking about the KPIs for Q1 next year. So, as of now, it is difficult to give more color on next year's Q1. However, again, the new update will launch in mid 1H 2020. Also, this year's Q1 was very

strong, so given the current momentum and KPIs, we expect declines to continue in the Q1 2020.

Owen Mahoney (Chief Executive Officer)

Just to add a couple of points, in a massively multiplayer online game like *Dungeon&Fighter*, we are constantly experimenting and innovating in the game, especially when we introduce major updates. Sometimes it goes better than we had hoped and sometimes does not go as well as we hope. And we have a long history of listening to customer feedback.

We listen to our customer feedback very carefully when they do not appreciate something, and then we reflect that feedback into the game. And this is what we are doing right now and why we think it will take two to three quarters for this to play out.

【Q】 What are the reasons for year-over-year decrease in Q3 HR costs? Is the decrease due to your efforts in cost cutting given how the environment is unfolding in China or is this related to your streamlining efforts? Also, is the reason for the year-over-year decrease in Q4 marketing costs due to fewer new game launches?

【A】 Shiro Uemura (Chief Financial Officer)

The primarily reason for the year-over-year decrease in Q3 HR costs is decrease in stock option costs. In addition, while the headcount increased year-over-year, we benefited from stronger yen since the majority of our employees are based in Korea.

For marketing costs, the primarily reason for the expected year-over-year decrease in Q4 2019 is fewer new title launches. We had multiple new launches in Q4 2018, while it will only be V4 in Q4 2019.

【Q】 What is the expected impact on your P&L related to the consolidation of Embark Studios?

【A】 Shiro Uemura (Chief Financial Officer)

Embark Studios is currently developing the new products and not generating revenues at this moment. We expect approximately 500 million yen of HR cost which falls into R&D costs per quarter.

【Q】 Can you elaborate on how would the revenue or the business model of *Dungeon&Fighter 2D Mobile* would look like, especially when you compare with PC *Dungeon&Fighter* in partnership with Tencent?

【A】 Owen Mahoney (Chief Executive Officer)

We cannot speak directly to what the terms of relationship are for obvious reasons, however we can tell a couple of things. One is that we have a big fan base of *Dungeon&Fighter* in China, and an even larger group of people who own high-end mobile phones in China. So, we are very excited about this opportunity. We also feel the product is coming along very nicely. The other big thing is that we have a fantastic partner Tencent. They have been a wonderful partner to us, we are very happy with the relationship and how we structured the relationship for this project specifically.

【Q】 Why did you need to invest in Wonder Holdings? The fact that it helped bring in Mr. Hur to the company is understandable, however, Wonder Holdings focuses more on e-commerce business than games. How does this investment work towards investing into your core business?

【A】 Shiro Uemura (Chief Financial Officer)

We believe there is a value in Wonder Holdings. Wonder Holdings not only has the game business, but also has the e-commerce business as well as the property business. Among all, we are mostly interested in their game studios. We believe there will be collaborations between the two companies.

Min Hur is the founder of Neople and is well versed into the games industry, both in Korea and across Asia. We believe he can be a great advisor to us. Therefore, we decided to have him as an external advisor.

Like other business, we have conducted thorough analysis before we made the investment and deemed that there was some upside. We are confident that we made the investment at the appropriate level.

Owen Mahoney (Chief Executive Officer)

Adding a couple of other comments to our CFO's. From the management perspective, there are a few things. Number one is that we like their products in their game studios and are very excited about what they are bringing out. Number two is that we think they can add a lot of value to us and to what we are doing. Min Hur, the founder and the head of Wonder Holdings, is the legendary head of the team that created *Dungeon&Fighter*, which is one of the largest franchises in the entire video games industry, possibly the largest in life-to-date terms. So, he is the creator of one of the biggest games in the entire industry.

We are in people business and so, part of the job is to surround ourselves with smart people who can help us as you think through product development. I had the opportunity to work

closely with Min as has the executive team as we have done studio reviews and am extremely happy with what we are doing as well as think that he and his team can add a lot of value to what we are trying to do.

The business experience that has accrued to Min and his team after they created *Dungeon&Fighter* and created the other components of Wonder Holdings is very valuable to us. So, from a variety of different perspectives, we are excited about what they are doing and think they can help us with what we are doing.

【Q】 You touched on the studio reviews in your remarks and alluded that there may be some changes going on. Would it be fair to say that we might see a bit of a shift in the density or the quantity of pipelines you will be releasing in coming months or quarters? What are some of the incremental new things that you are prioritizing and some of the ones that you are de-emphasizing?

【A】 Owen Mahoney (Chief Executive Officer)

A short answer to the question is that you will see fewer games come from our studio pipeline. We are just finishing up the studio review process right now, so we are not ready to announce what those games are. There are also some games which will not be announced due to marketing concerns. However, the themes which we are focused on are fewer but bigger games which are about deeply immersive online virtual worlds on multiple platforms with IPs that we would consider very powerful.

If you step back and think about what makes a great game company in the future, it is about massively multiplayer online virtual worlds. This is clearly the future which a lot of people are talking about now, and is Nexon's core competency where we got our start. Nexon invented the category with the first MMORPG, *The Kingdom of the Winds*. Nexon also invented free-to-play business model with *QuizQuiz* – the first free-to-play game that anybody knows.

As we thought back as a management team, we allowed ourselves to step away from the core competency in the effort to do a lot of experimentation as the rest of the industry was doing. What we found in the process over the last couple of years is a lot of red oceans where we did not bring anything particularly special to the party.

It is abundantly clear that multiplayer virtual worlds are the future and is growing fast. The explosion of devices that can play these games is going from the hundreds of millions to the billions. It dramatically increases our market and is an area where we bring a lot to the table, which is reflected in games such as *MapleStory*, *Dungeon&Fighter* and *KartRider*.

It is rare in life that the future is so obvious and that you have such a massive competitive lead that is hard to replicate. So, our view is that everything else is a waste of time and the viewpoint informs every decision we are making about products now.