



Yoichi Wada

President and Representative Director

I am pleased to present the SQUARE ENIX annual report for fiscal 2005, ended March 31, 2006, to our shareholders and other stakeholders.

In fiscal 2005, on a consolidated basis, net sales rose 68.5%, to ¥124,473 million, operating income declined 41.4%, to ¥15,470 million, recurring income decreased 39.9%, to ¥15,547 million, and net income climbed 14.3%, to ¥17,076 million.

The operating income margin was 12.4%, and return on equity (ROE) was 14.9% in fiscal 2005.

When we inaugurated SQUARE ENIX, I've laid out the actions to be taken as follows. The first two fiscal years were to be largely devoted to building up strength and stamina. Our primary focus for the third year—the year under review—and fourth year was to modify our physique. In addition to accomplishing structural reforms, we would work toward a significant leap forward through the completion of our new structure in fiscal 2010.

In fiscal 2005, we met the challenges of a changing operating environment and the change of the industry structure by preparing a stronger than ever product lineup. *FINAL FANTASY XII* and *KINGDOM HEARTS II* became record-setting game titles in the industry during the fiscal year under review, while the release of the computer-generated imagery (CGI)-animated film *FINAL FANTASY VII: Advent Children* gained considerable attention in both the United States and Japan for its unprecedented success. Although our major products performed as strongly as anticipated, changes in the operating environment were even harsher than initially expected, and therefore other products were unable to mirror our major-product successes. As a result, we were unable to avoid a decline in operating income.

While committed to reassessing the current circumstances and modifying our approach, based on our firmly held philosophies, we will continue to push forward, our resolution firm, until we

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achieve our goal of becoming the world's leading company in our chosen sphere.

### **2005: "Year Zero" for the "Video Game Industry"**

In the twenty or so years since its emergence, the video game industry has enjoyed extremely favorable growth. Although it almost goes without saying that this growth was driven by the advent of completely new and revolutionary content, at the same time, another key ingredient has been the industry's unique structure.

In the industry's early phase, video game console manufacturers developed and marketed both game consoles and game software. The source of the growth of the industry was their careful move recognizing the benefit of the network externality. As a result, an enormous base of independent software developers flourished. Each new generation of hardware produced by game console manufacturers spawned a complete ecosystem comprising software development and distribution channels. The ecosystem rapidly grew to become a massive industry.

Simply stated, one could say that this industry developed not as the "video game industry" but as the "game console industry." This setup has fostered a positive climate for risk-taking by game software developers, and in some ways has been a comfortable environment in which to grow.

However, in recent times several of the prerequisite conditions necessary to maintain this ecosystem have begun to crumble. From such physical media as read-only memory (ROM) cartridges and DVDs, the industry is moving toward online networks. This is not only altering the industry's distribution structure but also transforming the business model itself.

Furthermore, changes are occurring in the competitiveness of game consoles. In particular, in terms of graphics capabilities,

game consoles that had enjoyed an overwhelming cost performance advantage are now facing a raft of competitive challenges. On the one hand, consumers have been oversupplied with features, while on the other, general-use terminals have achieved a remarkable jump in performance.

Of course, it is not the case that the conventional business model has become generally obsolete. Apple Computer, Inc.'s iPod and Nintendo Co., Ltd.'s NINTENDO DS demonstrate the successful experience of the conventional model. What I am referring to is the fact that it has become difficult for a single game console manufacturer to sustain a market worth several trillion yen. My point here is not to debate the fate of a particular game console maker, but to explain the kind of problems briefly that we must grapple with as a game software producer.

On reflection, if we focus our attention on the content itself, over the past twenty years, millions of people around the world have grown familiar with video games, while the assets we have accumulated are vast. It would be fair to say that video games have already become a recognized genre of entertainment.

If the ecosystem that has existed until now breaks down, the content itself must become self-sustainable. In other words, our basic cognizance of the operating environment is that a "video game industry" in the true sense is beginning to take shape.

As well as being a significant opportunity, this juncture also represents a huge challenge. We must examine at the most fundamental level a whole array of points that—until now—we have not needed to be directly involved with.

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## Strategic Options Needed

I have provided a brief overview above of the current situation in the video game industry. The changes taking place have implications far beyond the video game industry alone. I would argue that it is natural to view what is happening in the video game industry as part of a much broader industrial revolution sweeping the economy as a whole. In our industry and in many others, a process of trial and error is being repeated, with the consensus on the next generation of business models not yet within reach.

I believe the strategy suited to such a fluid period of transformation should involve management developing a diverse and effective range of tactical options. In particular, what kind of management options should we prepare?

At the heart of the current revolution is a power shift from companies to consumers. There are many very hasty arguments about the meaning of this phenomenon; however, I would propose a reasonable definition along the following lines. The power of consumers was not recognized in the past, but now consumers are getting involved in one end of the supply chain.

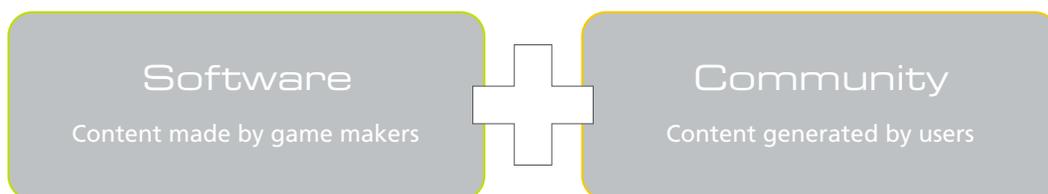
A fundamental policy must be to make this power shift toward consumers an anchor within our menu of strategic options. Simultaneously, we need to ensure that the Company has a sufficient level of maneuverability. For this reason, we decided to raise ¥50 billion in convertible bonds with warrants in November 2005.

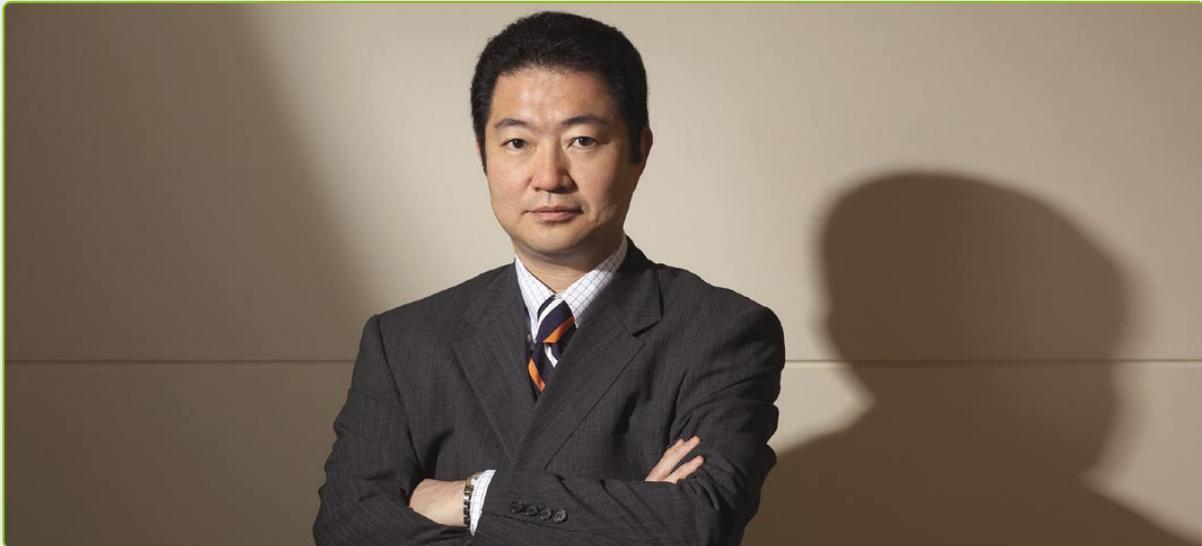
## Becoming the World's Leading Community Management Company: Three Key Approaches

Our goal is to become the best community management company providing the best content in the world. When I talk about "community," I do not limit it to just net-based communities, but use it to mean any group of customers that share a common set of tastes and interests. By serving each community organically with the highest quality content and services, we aim to make these communities even stronger.

In the world of entertainment, if the people in the audience are not enjoying themselves, they will refuse to pay the entertainer a dime. To say it another way, the fact that people have paid shows that they have already made quite a significant commitment to what we are offering. Through the development of the network environment and the formation of virtual and real communities, the relationships built up between content and customers, as well as the relationships among customers, will become even stronger.

In a networked society, content providers and customers will develop content together





Our fundamental strategy is to leverage this energy skillfully as the driving force for a business. I believe the real engine for growth will be the vitality of communities formed by customers.

At the kernel of a community is a shared worldview, whether that springs from a common interest in video games, manga or some other pursuit. Communities are thus defined by such attributes as a video game's worldview or a certain taste in design. Conventional methods of grouping customers—such as by age, gender or nationality—are hardly useful.

Seen from the customer's perspective, each person has a multitude of tastes, so each person can belong to several communities without any incompatibility. The important point is to avoid generalization of communities. Regardless of the community size, we should be conscious of the fact that each community is unique and irreplaceable.

However, if we analyze customer lifestyles, we find that there is some level of uniformity across such marketing parameters as age group or occupation, and further, that the type of terminals people use and their media exposure patterns have a close correlation with lifestyle.

Therefore, it becomes important to prepare a diverse array of content and service entry points. To enhance a community's gravitational pull as well as increase profitability, it is necessary to cater to a wide range of lifestyles. One of the reasons we decided to bring TAITO into the SQUARE ENIX Group was the addition of amusement arcades to our existing lineup of customer entry points, which includes video game consoles, personal computers (PCs), mobile phones and magazines.

What specific measures are needed to implement the strategies I have outlined? We have formulated three key approaches.

### 1. Bolstering the performance of existing communities

To reiterate, customers belonging to a particular community exhibit few common attributes outside of their shared interest in the community. Consequently, their lifestyles tend to be many and varied. By utilizing many types of terminals across a large number of media, it is possible to bolster the contact points with customers belonging to a community. As well as increasing average revenue per user (ARPU), this is also aimed at seeking out potential customers. An example of how we might increase ARPU is releasing a movie in response to customer demand for ways to revisit the emotion they experienced when playing a video game.

Our definition of potential customers may be a little different than the typical one. Seen from the customer point of view, since the communities to which the customer belongs and their own lifestyle may be unrelated, if there are no content or services catering to their particular lifestyle the opportunities for purchasing behavior are limited. For example, a busy office worker may belong to a particular band's fan club, but he may not have the time to go to their concerts, and is therefore unable to purchase tickets through the club. However, he can buy their CDs, which he can listen to whenever he likes. What we mean by potential customers are those whose tastes or interests

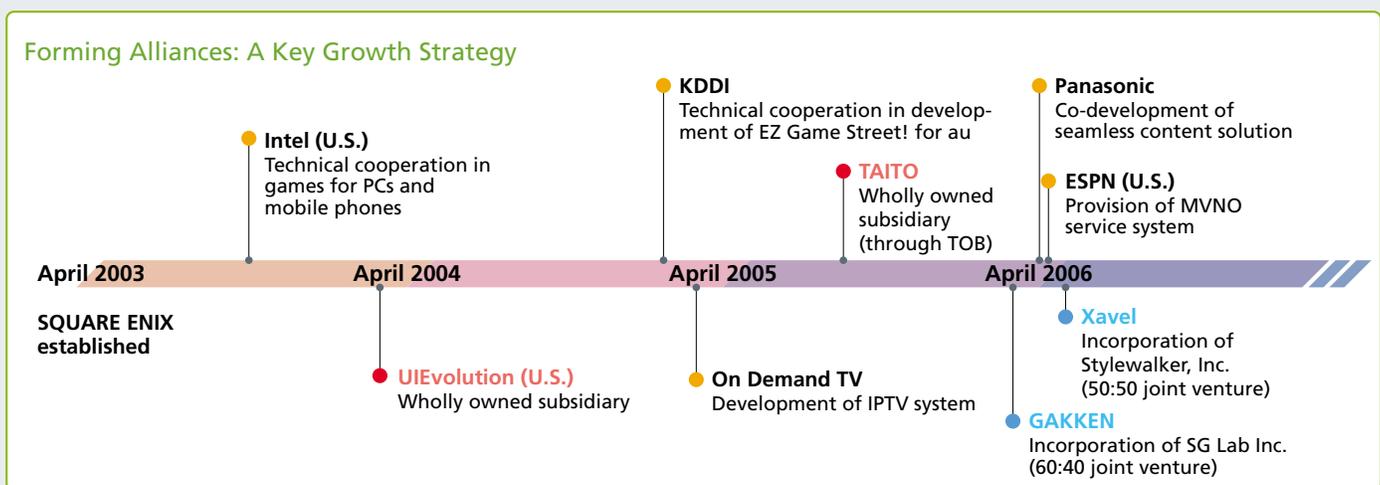
match the community's but have not been able to contribute to revenue. A point to be noted is that while trying to grow the community, the introduction of people with unrelated interests should be avoided. If a community's raison d'être is diluted, it is very hard to resurrect.

### 2. Developing new communities

To expand the business without diluting communities, we need not only to grow existing communities, but also develop new ones. Up to now, we have concentrated on developing our own original content and have produced a number of major hits. In the future, we aim to respond to the expectations of our customers by further refining our creativity. I believe that our diverse creative capabilities across several genres, including game software, publication and animation, will continue to bolster our competitive advantage.

At the same time, in a departure from our past practices we will actively seek to approach outside communities. This may involve providing value added to third parties, who have already developed communities with strong drawing power, and helping invigorate these communities. We are confident that we can nurture such businesses to become new revenue sources. Services provided to EZ Game Street! and On Demand TV are our initial foray into this area. Our joint venture with Xavel, Inc., is also part of this strategy. In both cases, rather than our own brands we will work in the background to enhance our partners' brands.

#### Forming Alliances: A Key Growth Strategy



From a slightly different perspective, I would also like to discuss our joint venture with GAKKEN Co., Ltd. here. The creative media of video games may not only be harnessed for entertainment, but may also be utilized effectively for a wide range of other purposes, including education, training and welfare. Our joint venture with GAKKEN has the objective of embarking on these other potential applications for video game software. By utilizing the advantage of widespread familiarity with video games, we are aiming to foster a completely new market.

### 3. Strengthening technology development to build a common platform

Be creative and innovative—that is the essence of our spirit. Having strengths in both artistic and technological fields is the core of our competitive advantages. We will do whatever we can to maintain our world-leading capabilities in the game development. We will also focus on complementary themes.

To cater to the needs of diverse lifestyles, it is necessary to foster capabilities across a wide range of terminals and media. For this reason, it becomes essential to develop middleware to function on a cross-platform basis. We are currently pursuing a joint project with a team at UIEvolution, Inc., a U.S.-based subsidiary we acquired three years ago, which has recently led to a business alliance with Matsushita Electric Industrial Co., Ltd. In addition to video game consoles, PCs and mobile phones, this project also expands development to cover a wide variety of digital consumer electronic devices.

### Our Mission and Contribution to Society

Within our business, we have set a number of precedents in the development of the “networked society.” This stems from the fact that at present, only online games have realized a completely “virtual society.”

If the pioneers in a new field do not properly define key issues and begin a steady process of dealing with them, there is a danger that the foundations laid for the next generation will be undermined. We must bear this mission in mind, and I believe it is our duty to voice our views on these issues to society. By directly offering our wisdom and labors, I wish to make a proactive contribution to society.

My assumption of office as chairman of the Computer Entertainment Suppliers’ Association—Japan’s video game industry body—from fiscal 2006 is also part of this contribution. Furthermore, for three years from fiscal 2006 we have secured a research base at the University of Tokyo covering intellectual property issues. We hope to utilize this research grouping as the hub for in-depth discussions in this field.

We believe that our business creation will benefit from such efforts to contribute to the development of solid foundations for a prosperous future.

In these endeavors, we look forward to your continued support.

July 2006



Yoichi Wada  
President and Representative Director