We would now like to begin the Financial Results Briefing session of SQUARE ENIX HOLDINGS (the “Company”) for the first half of the fiscal year ending March 31, 2021 (“1H FY2021/3”).

Today’s presenters are:
Yosuke Matsuda, President and Representative Director, and
Atsushi Matsuda, General Manager of Finance and Accounting Division.

First, Mr. Matsuda, General Manager of the Finance and Accounting Division, will give an overview of the Company’s financial results for 1H FY2021/3, and then our president Mr. Matsuda will discuss the progress made by each of the Company’s business segments.

Good afternoon. I am Atsushi Matsuda.

In 1H FY2021/3, the Company booked net sales of ¥172.7 billion (up ¥52 billion YoY), operating income of ¥31.6 billion (up ¥15.7 billion), ordinary income of ¥30.5 billion (up ¥14.9 billion), and net income attributable to parent company shareholders of ¥16.0 billion (up ¥5.1 billion).
I will next break down our results by segment.

The Digital Entertainment segment posted net sales of ¥142.4 billion (up ¥57 billion YoY) and operating income of ¥33.8 billion (up ¥17.2 billion).

The HD Games sub-segment saw sales rise YoY and a turn to profitability thanks not only to the release of major console titles such as “FINAL FANTASY VII REMAKE” and “Marvel’s Avengers,” but also to brisk sales of catalog titles and licensing income.

The MMO sub-segment saw sales decline YoY given that the “FINAL FANTASY XIV” expansion pack had been released a year earlier, but YoY growth in paying subscriber numbers for that title resulted in higher profits.

The Games for Smart Devices/PC Browser sub-segment saw YoY growth in both sales and profits. In addition to solid performances from titles launched in FY2020/3 such as “DRAGON QUEST WALK” and “WAR OF THE VISIONS: FINAL FANTASY BRAVE EXVIUS,” earnings were also helped by “DRAGON QUEST TACT,” which had a strong start following its July launch.

The Amusement segment generated net sales of ¥13.9 billion (down ¥8.2 billion YoY) and an operating loss of ¥1.6 billion (vs. operating income of ¥1.3 billion a year earlier). The Company temporarily closed its amusement facilities in Japan in 1Q in response to the government’s state of emergency declaration, resulting in a sharp YoY sales decline and an operating loss.

The Publication segment booked net sales of ¥12.3 billion (up ¥3.3 billion YoY) and operating income of ¥5.3 billion (up ¥2.1 billion). Sales in digital formats, such as from “MANGA UP!” manga application and e-books, grew substantially. Sales in printed formats were also brisk, resulting in YoY growth in net sales and operating income.

The Merchandising segment posted net sales of ¥4.8 billion (up...
¥300 million YoY) and operating income of ¥1.5 billion (up ¥900 million). The YoY growth in sales and profits owed to brisk sales of character goods and soundtracks based on the Company’s IP.

This concludes my overview of our 1H FY2021/3 financial results.

I am Yosuke Matsuda. I will be discussing the progress made by each of our business segments.

The HD Games sub-segment posted an operating loss as initial sales of “Marvel’s Avengers” were lower than we had expected and unable to completely offset the amortization of the game’s development costs. In the second half of the fiscal year (“2H”), we hope to make up for slow initial sales by offering ample additional content to grow our sales.

The MMO sub-segment is performing well.
The plans, forecasts, strategies and ideas described in this material are descriptions of forecasts of future results. These descriptions rely on information available as of the date of production of this material and are based on assumptions and judgment made by the Company’s management. Readers are advised not to rely solely on these forecasts. Readers should not assume that these forecasts are accurate or valid information, even after the date of public release. There are many factors that may cause actual results to vary considerably from the forecasts, and in some cases actual results may be inferior to forecasts.

The information on the future forecasts described in this material is current as of November 6, 2020. The company is not obliged to update or correct forecasts concerning the Company’s future results, including forecasts or outlook, if new information becomes available and/or events occur after November 6, 2020.

Next is the Games for Smart Devices/PC Browser sub-segment. “DRAGON QUEST TACT,” which we launched in July, contributed to 1H earnings with an initial performance that has beaten our expectations.

“OCTOPATH TRAVELER: Tairiku no Hasha,” which we launched in October, is off to a good start. We are looking forward to its earnings contributions in 2H.

The Amusement segment faced harsh conditions in 1Q, as we temporarily closed our amusement facilities in Japan in order to help prevent the spread of the coronavirus. However, customer numbers began to pick up in 2Q. We are working to reshape the business based on what we think the world will look like while it is living with the coronavirus and once it has beaten it. These efforts are not limited to rethinking our fixed-cost base.
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The Publication segment continued to perform well in 2Q, and we expect a similar trend to persist in 2H.

The Merchandising segment experienced quarterly earnings fluctuations, but these were due to the launch timing of major console titles.

Our consolidated financial forecast for FY2021/3 is for net sales of ¥290 billion, operating income of ¥40 billion, ordinary income of ¥40 billion, and net income attributable to parent company shareholders of ¥24 billion.
We are forecasting FY2021/3 operating income of ¥40 billion, as we believe we will be able to reach our medium-term target range of ¥40-50 billion. However, at ¥290 billion, our net sales forecast is slightly below our ¥300 billion medium-term target, given factors including changes to our game development timelines resulting from the COVID-19 pandemic.
Q&A

Q: I estimate that the HD Games sub-segment booked an operating loss of around ¥7 billion in 2Q. Would the sub-segment have turned a profit if sales of “Marvel’s Avengers” had covered the amortization of its development costs? The loss seems too great to be explained solely by costs associated with that title outweighing its sales in 2Q. Are there any other factors we should assume contributed to the operating loss? Also, should we assume that there is still a fair amount of that title’s development costs to be amortized in 3Q?

A: Absent factors associated with “Marvel’s Avengers,” the sub-segment would have been in the black. In addition to the amortization of that game’s development costs, another significant factor associated with the title was the fact that we undertook a major advertising campaign at the time of its launch to make up for delays in our marketing efforts resulting from the COVID-19 pandemic. There is a certain amount of development costs still to be amortized in 3Q, but we want to recoup it by growing our sales going forward.

Q: What do you expect the profitability of “Marvel’s Avengers” to look like in 3Q?

A: Our intention is first and foremost to work to expand sales in order to improve its profitability.

Q: How would you assess the forthcoming smartphone game “NieR Re[in]carnation” at present, and when do you expect it to contribute to earnings?

A: Our current assessment is that our team has created a good game. We have not made an official announcement regarding a launch date, but the team is working hard on its development efforts to get the game to customers as soon as possible. However, we believe that it is extremely important that we are able to ensure that the game is of a level of quality that will keep customers playing for a long time. As such, we will consider how to strike the best balance between speed and quality in order to finalize the launch date.
Q: How much of a write-down is included in your cost of sales in this results release?

A: It was ¥1.1 billion in 1H.

Q: You say that initial sales of “Marvel’s Avengers” were lower than you had expected. Were the reasons for that not something you could have anticipated and done something about?

A: We engaged in ample preparations ahead of the launch, but it is true that there were aspects in which we were wanting. We intend to leverage the lessons we learned from this experience in future game development efforts.

Q: The quarterly earnings in your HD Games sub-segment strike me as highly volatile. What is your view on that?

A: We think of the totality of the Digital Entertainment segment rather than of the HD Games sub-segment in isolation. By this, I mean that we consider our ability to offset the volatility in HD games with stable recurring income from sources such as MMO and smartphone games. We therefore undertake our HD game development efforts with the expectation that there will be a certain level of volatility. However, it naturally goes without saying that we also intend to improve profitability within the HD Games sub-segment by promoting digital sales and other measures.

Q: If you ramp up your efforts to address the next generation of consoles going forward, it seems like the cost of developing HD games will be even greater than it is now. Will you be able to control earnings volatility with sources of stable recurring income other than HD games?

A: Cost inflation will be unavoidable if we maintain our traditional development style. We therefore need to strike a good balance in terms of overall development costs by sharing development resources, utilizing procedural content generation techniques, and automating quality assurance processes. In addition, we need to keep a close watch on the efforts of the development teams that will be making such initiatives a reality. We have been working to shore up our base of stable recurring earnings so that we will be able to continue to invest in the development of major AAA titles and in the creation of new IP. We believe that we have grown that base to a considerable level, but we will work to grow it further.

Q: One of your stated strategies is to use new IP to grow your customer base. I can see how that would result in major hits and misses. However, does digitization not give you the option of conducting multiple pre-launch beta tests and deciding whether to release the product based on the users’ reaction?
A: That is a tough question. It is difficult to decide the scope of a beta test for a single-player action-adventure game or an RPG (role-playing game) because of the risk of spoilers. You cannot unveil the finished product too far ahead of launch. However, it is becoming increasingly important to offer beta tests and demo versions of games as part of pre-launch promotion efforts, so we will continue to explore what kind of pre-launch promotions fulfill our customers’ expectations.

In regards to growing our customer base by creating new IP, I have to say that creating new IP is extremely challenging and that the difficulty involved has definitely increased. However, continuing to work to create new IP is essential to our further growth, so we will continue to do so. In addition, it is our intention to continue to expand our stable recurring earnings so that we will be able to stand up to that challenge.