To Our Shareholders

Yoichi Wada

President and
Representative Director

I am grateful to our shareholders for the opportunity to present the Company's annual report for the fiscal year ended March 31, 2011.

On a consolidated basis, net sales for the fiscal year ended March 31, 2011 totaled ¥125,271 million (a decrease of 34.8% from the prior fiscal year), operating income amounted to ¥7,325 million (a decrease of 74.1%) and recurring income amounted to ¥5,390 million (a decrease of 80.6%); and a net loss of ¥12,043 million was recorded.

The Company's operating income ratio stood at 5.8%.

In the fiscal year ended March 31, 2011, latent vulnerabilities surfaced as a result of incomplete reform. I must apologize that corrective actions stated as nearly complete in prior years were not sufficient to avoid this situation.

In order to ensure new development going forward, we made a reassessment of the year-end balance sheet. While these actions resulted in the recording of a net loss, our financial position continues to be strong, allowing us to set dividends applicable to the fiscal year ended March 31, 2011 at ¥30.00 per share.

The game industry is under a major transformation. In this environment, our Group is pursuing a dual operational approach by which we simultaneously protect profit generated from existing business models while also transforming the framework of our businesses in anticipation of a new industry ecosystem. For the year under review, I regret that we did not sufficiently achieve the former of these goals.

While the rapid pace of change in the operating environment is ongoing, developments are in-line with our prior expectations. Therefore, our basic strategy remains unchanged.

1. Globalization
2. Becoming "Network Centric"
3. Strengthening Own-IPs

I would like to discuss each of these strategic pillars later.

The Year's Shortcomings

We did not have success from our new releases during the year.

Amid the intensification of competition in the console game software market, a polarization has emerged between the very best games and those which do not earn a profit. Our mistake was not reacting with sufficient regard to such an environment. We failed to thoroughly perfect certain products in the rush to launch new IPs. The release of mid-class debut titles with an intention to raise quality in future iterations can be seen as our failure. Further, we stumbled in the launch of our "FINAL FANTASY XIV" online game, a title which held our utmost confidence.

Weakness was discovered in the management of the development organization. For this, we must apologize to our customers and our shareholders. However, instead of giving up and shutting down, we have renewed the team and are working hard to recover the FINAL FANTASY brand and rebuild our presence in the MMORPG space. Progress is taking place at an extremely high rate, and we are enthusiastic about the revival to "top-title" status in the near future.

Learning from these mistakes, we decided to concentrate our focus on approximately 10 new and existing key franchises from the second half of the fiscal year under review. For these titles, we have established a development system without compromise. As a result, we delayed the launch of the upcoming "DEUS EX: HUMAN REVOLUTION" from the fiscal year under review upon our decision to spend more time in further polishing the quality of the title.

The weakness of new releases, a stumble in "FINAL FANTASY XIV" and the delay of "DEUS EX: HUMAN REVOLUTION" were the primary factors resulting in operating income of ¥7.3 billion, substantially lower than forecast at the start of the fiscal year and the lowest level in our company history.

Preparation for Recovery

First of all, at the time of preparing our year-end financial statements, we conducted a thorough reassessment of our balance sheet.

From operating income of ¥7.3 billion to a net loss of ¥12.0 billion, excluding a foreign exchange loss of ¥2.1 billion, there is a difference of ¥17.2 billion.

51% of this amount, or ¥8.8 billion, was the result of a goodwill write-down. The amounts of goodwill previously recorded for EIDOS and TAITO were based on assumptions of industry conditions at the time of their respective acquisitions. While the underlying value of each business continues to be high, we decided it necessary to more conservatively value future earnings generation from planned business models given the dramatic industry transformation.
Further, certain development cancellations and related losses amounted to ¥4.4 billion, or 26% of

the aforementioned difference. These losses were recorded as we decided to refocus our attention on fewer, stronger titles.

While the balance of the content production account increased from ¥16.0 billion to ¥19.9 billion, the composition is changing dramatically as we pursue global development. At present, already more than 40% is recorded at development studios outside Japan (Figure1).

Including taxes of ¥2.0 billion yields a total of about 90% of the difference explained above.

While I regret concerns that may have been caused by our swing to a loss during the fiscal year ended March 31, 2011, the real nature of the loss is as described above. Finally, the vast majority of the decline in total assets was due to goodwill and the planned payback of capital for corporate bond redemptions, while extraordinary loss items were related to valuations and did not materially impact capital flows. As a result, our cash balances have not fallen (Figure 2).

Financial treatment is important, however, in the end this is accounting for the past. It goes without saying that our business and how we energize our vital human resources are more important. In addition to reorganization and a review of the chain of command, we also improved our internal communication methods from those based on a hierarchical organization to a system in which management can communicate directly with all employees as a tool for conveying Group vision as well as business directives. Moreover, in order to promote the active and honest exchange of views among employees, we have begun holding workshops on various topics and information exchange events. I believe that the transformation of our Group's culture is our most critical issue and the fastest road to success.

New Signs

While fundamentally changing Group culture is not an easy task, we have already started to see some teams leading the way with good results. At the E3 game show held in June 2011, the quality of our various titles earned extremely high praise (Figure 3). With enhancing brand value a top priority for the Group, these are certainly very encouraging examples.

In addition, we are starting to see the fruits of our labor in the creation of new genres. Our browser game launched in August 2010 called "SENGOKU IXA" has already grown to become a significant earnings generator. In addition, several of our social game releases have also achieved success in the market. Using the feedback we are receiving in these new genres, we are further strengthening our development capabilities.

Figure 1 Content Production Account by Region

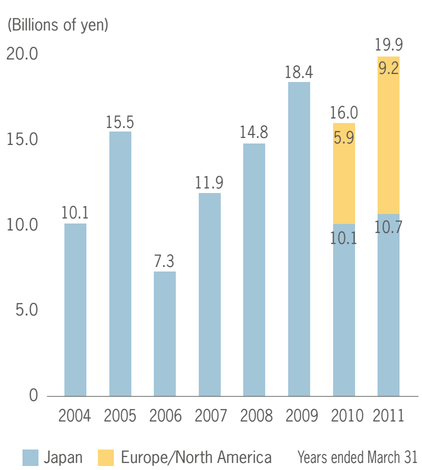


Figure 2 Comparison of Total Assets

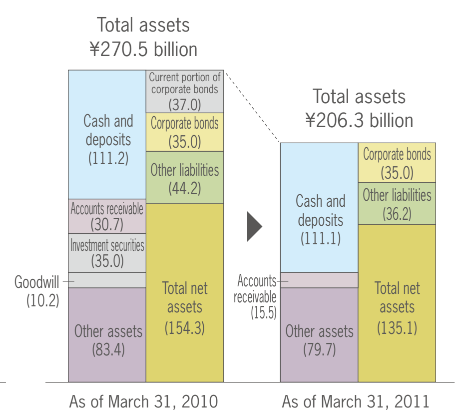
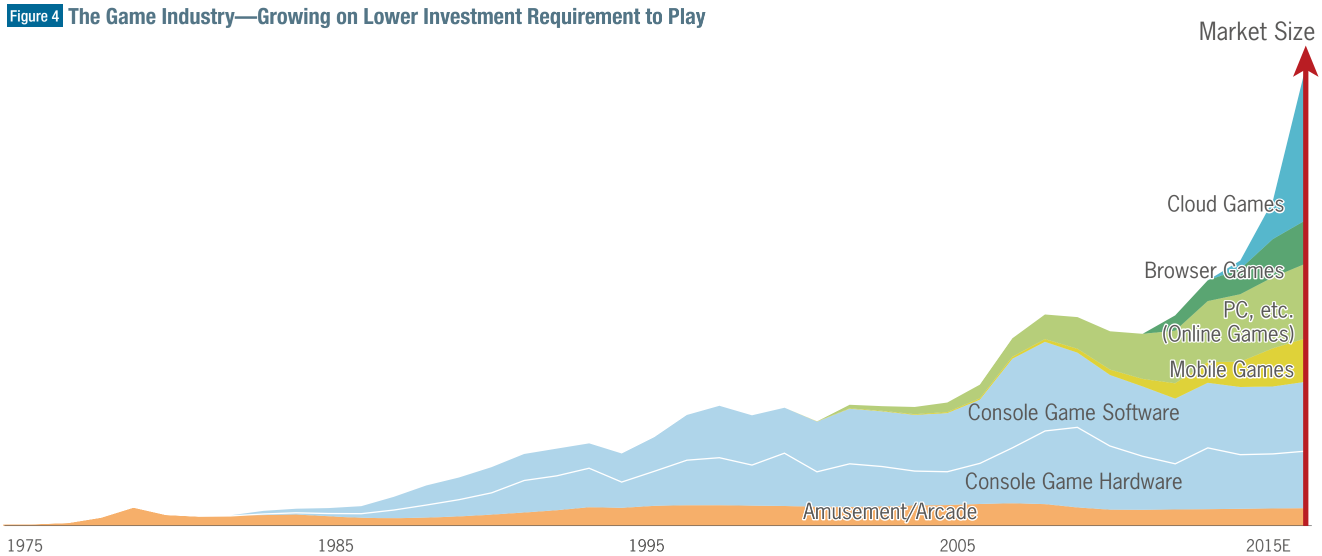


Figure 3 E3 Expo, U.S. (June 2011) Future Titles Earn Wide Acclaim

(Announced June 30, 2011)

- **"TOMB RAIDER"** (Due: Autumn 2012)
  21 Awards, 68 Nominations
  Best Action Game (*IGN*), etc.
- **"HITMAN ABSOLUTION"** (Due: 2012)
  19 Awards, 50 Nominations
  Best of Show (*GameSpot*), etc.
- **"DEUS EX: HUMAN REVOLUTION"**
  4 Awards, 19 Nominations
  (Due: August 2011 N. America/Europe; September 2011 Japan)
- **"FINAL FANTASY XIII-2"**
  1 Award, 12 Nominations
  (Due: December 2011 Japan; January 2012 N. America; Early 2012 Europe)

Figure 4 **The Game Industry—Growing on Lower Investment Requirement to Play**



Various sources compiled by the Company

Historical Development of the Game Industry

For a deeper understanding of our basic strategy, I would now like to describe our outlook for the gaming industry while reviewing historical developments to date. Our Group created, and is now implementing, a strategy based on a clear understanding of the game industry's history.

Within the growth of the games industry, there is a clear trend appearing.

Games are an incredibly complex application, and making them work requires an environment of incredibly high capabilities. In order for a customer to play a game, such application software requires an investment in the operating environment, namely hardware. As the required investment in the environment is reduced, the entry barrier for consumers is lowered and the game industry grows (Figure 4).

In the early stages of the video game industry, making a game run was difficult and each individual game required its own unique hardware. To that end, arcade owners purchased machines, and the business model saw these owners spread the investment cost to their customers in the form of coin operations.

Next, Nintendo developed its Nintendo Entertainment System (NES), and the investment cost for the average consumer to own a game machine was greatly reduced. This was the birth of the home video game console industry.

From there, the console game market grew quickly as the capabilities of each game console advanced and third-party developers increased the overall supply of software.

In 2000, when the PlayStation 2 System was released, the concept of the game console as a games-only device disappeared. At one price, you gained both a game console and a DVD player, which had the effect of dramatically reducing the consumer's investment in the environment specifically to play games.

In the years following, people gained the ability to play games on mobile phones in Japan. With this, we entered the age of general purpose devices capable of playing games. While PCs had been capable of playing games for some time, PCs with such extremely high specifications required by games began to serve as de facto game consoles. Now, however, we find that even average PCs are capable of allowing people to enjoy games as well.

Since the 2007 debut of the iPhone, smartphones and tablet PCs have spread rapidly, fully establishing the lifestyle of playing games on general purpose devices. Furthermore, around 2006, all game devices became connected to the Internet, which can be viewed as a critical aspect of the industry's subsequent expansion.

As it became possible to play games on all devices, the barrier in form of investment required for hardware began to disappear. From now on, we must focus our attention on software as the platform for playing game applications.

In the next stage of development, the focal point becomes whether games are playable on application software, such as browser and Flash, as standard features in PCs.

In the coming years, I believe the capabilities of this software will grow tremendously and allow the market to expand to customers who lacked awareness of games in the past (this is already happening).

The dramatic expansion of the customer base and the permeation of the network environment will cause both business models and content design to transform fundamentally. From now on, only those who are able to create true innovation in response to this new marketplace will be leaders.

The era of physical media such as DVDs selling through physical channels of retail stores and marketing methods primarily through mass media is coming to an end. Now, the important point is how to best utilize social media networks as sales channels. Furthermore, revenue models will evolve from one-time, fixed priced sales to a pay-as-you-go billing ("freemium" being one example).

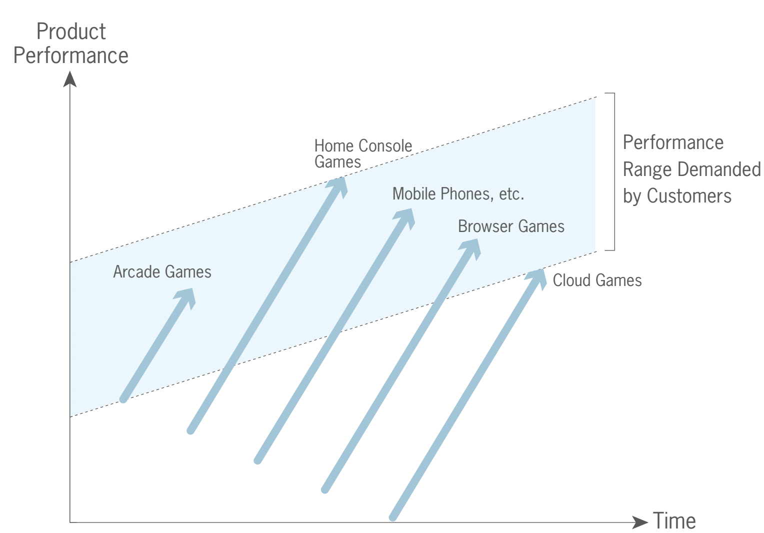
On top of business models changing, content design must also evolve. Values required going forward are fundamentally different from those of the past. In this industry which is not cooling down, but rather, expanding substantially, most game publishers, including us, are struggling to make a leap forward in the midst of such an evolution of values.

Furthermore, what comes next is cloud gaming.

Assuming the availability of a network environment, data storage and processing are performed by servers. When we move to this stage, content and services are managed on the servers, leading to the emergence of a new entertainment market whereby not just games, but many forms of entertainment, are fused together.

Here, I should touch upon a common question. The question is whether or not the browser and cloud are only able to penetrate the market with simple games and full-scale games remain on consoles. I believe that these new platforms are not inferior, but rather, will evolve, whereby the boundary between consoles and other devices will disappear. This is the

Figure 5 **The Innovator's Dilemma**



quintessential innovator's dilemma. Sustaining innovation will be surpassed by disruptive innovation, and the dilemma is that winners in sustaining innovation are unable to comprehend disruptive innovation, or unable to change course, which is precisely what is happening to the game industry (Figure 5). I can even say that cloud gaming will be the most ideal alternative for high-end gaming within 10 years.

The Group's Three Strategic Pillars

1. Globalization

If the gaming industry expands as investment barriers for customers are lowered, geographic expansion is inevitable. Globalization is a basic premise of all companies in the industry. Therefore, our strategy differentiates itself on how we define globalization.

Our group does not think of one global, abstract market. We do not believe it is realistic that every title will sell throughout the entire world, and we do not seek this. Market segments should be identified not by region but by consumer preference, and each piece of content must be pursued on its individual characteristics. It might be the case that certain content designed for Japan's extremely small segment of core users also appeals to French and Chinese students as well. I think our market segmentation approach based on customer preference is more scalable in that deployment is not limited to a specific region.

Having this basic concept, our distribution channels take firm root in each respective region we operate.

Even though there are no national borders for taste, the distribution of content is entirely dependent on local business practices. In fact, even network services are rooted in local cultural differences making them extremely regional in nature.

Furthermore, our Group's recruiting bases that cover the world give us a very significant competitive strength.

In addition to considering talent from various regions, we also consider factors such as personnel systems, taxes, and foreign exchange, to construct the optimal human resource portfolio.

We are also focusing on entering emerging markets. We have almost completed our foundations in Japan, North America and Europe, and established a foothold in China. Going forward, we will be actively expanding into more territories.

2. Becoming "Network Centric"

As I have mentioned, we have to transform both our business model and our content design. The two critical points are embracing the continuous relationships with customers and having pricing determined by customers according to their level of satisfaction. We need to pursue these not only with emerging new genres, but also as we implement network aspects into our traditional packaged software titles as well.

Furthermore, under a common infrastructure, we gain the ability to become network, and even platform operators. Ultimately, however, we must transform ourselves into a community platform operator.

3. Strengthening Own-IPs

As our business domain is entertainment, the ultimate bond between our customers and us is content brands. This will remain unchanged regardless of infrastructure and business models utilized. We will put all our efforts toward creating 10+ compelling IPs comparable to FINAL FANTASY.

Furthermore, with the network as the centerpiece of business operations, the amount of flexibility held when converting a particular title into various content or services becomes critical. How a creator might want to alter a title later in its life-cycle is unpredictable in the development stage. However, the current copyright system defines the rights of copyright holders regarding changes allowed. Thus, without our own-IPs, we would face fundamental obstacles in our business expansion. Therefore, we are focused on holding our own-IPs.

After a year which may have given you concern, we are determined to achieve our established targets and look forward to your continuing loyal support.

Yoichi Wada
President and Representative Director
SQUARE ENIX HOLDINGS CO., LTD.