To Our Shareholders

I am grateful to our shareholders for the opportunity to present the Company's annual report for the fiscal year ended March 31, 2008.

In the fiscal year under review, on a consolidated basis, net sales declined 9.8% to ¥147,516 million. Operating income decreased 17.0% to ¥21,520 million, and recurring income declined 28.1% to ¥18,864 million. Net income amounted to ¥9,196 million, a 20.9% decrease compared with the previous fiscal year. As a result, the recurring income margin was 12.8%, and return on equity (ROE) stood at 6.7%.

The Company's dividend policy is to maintain an optimal balance between performance-linked payouts and stable returns to shareholders. In line with this policy, we have set dividends for the fiscal year ended March 31, 2008 at ¥30 per share, resulting in a consolidated payout ratio of 36.7%.

We were unable to surpass the recurring income we achieved in the previous fiscal year.

Five years have now passed since the merger that led to the formation of SQUARE ENIX. After reviewing the progress made during this period, we intend to refine and reaffirm our strategies for the future.

Fiscal year ended March 31, 2008: Earnings Remain within Current Range

In April 2003, Square Co., Ltd., and Enix Corporation carried out a merger in order to be better prepared for the coming industry reorganization. Since its formation, the Company has successfully raised recurring income from its previous range of ¥5–¥18 billion to a new range of ¥15–¥27 billion (see Figure 1 on page 05). The synergies created between Square and Enix have acted to bolster the earning potential of the merged Company, and have built a foundation to take us to the next stage of growth.

We have embarked on an array of initiatives to further increase the Company's earning potential to ¥50 billion; however, we were unfortunately not able to make significant headway towards this target in the fiscal year ended March 31, 2008.

Results of the Company's First Five Years: Nearly All Business Segments on a Growth Track

To shape a basic business structure, management should first focus on sales growth, while following with a focus on earnings enhancement. To verify the effectiveness of our growth strategies, it is worthwhile to look at the compound annual growth rate (CAGR) of sales for each business segment. The Games (Offline) segment generated sales of ¥45.7 billion in the fiscal year ended March 31, 2003 (simple total of the corresponding segment sales of the pre-merged companies), while in the fiscal year ended March 31, 2008, the corresponding figure was ¥41.6 billion. With a CAGR of -1.9%, we can see that this segment has fallen back to its starting point. This alludes to issues that must be addressed in both product development and marketing, which I will discuss later. Meanwhile, all of our other business segments have exhibited robust growth over this five-year period. The Games (Online) segment has achieved a 23.8% CAGR, with sales moving from ¥4.2 billion to ¥12.1 billion. The segment has also built a good balance among the three key regions of Japan, North America, and Europe, while exhibiting an extremely strong operating income margin of 48.6% in the fiscal year ended March 31, 2008. In a very short time this segment has become one of our core businesses. At present, the segment's reliance on our flagship massively multiplayer online role-playing game (MMORPG) is considerable; however, we see progress in our nurturing of different types of products and services, including casual online games. We are also starting to experiment with a range of new earnings models, such as per-item-based charging. These developments have enabled continuous growth in the Games (Online) segment.

In the Mobile Phone Content segment, we have expanded sales from ¥1.7 billion to ¥6.6 billion, a CAGR of 31.1%. Not only has the segment grown greatly, but it has achieved a high operating income margin of 26.7% in the fiscal year under review. However, a key issue for the Mobile Phone Content segment is its over-dependence on the Japanese market. In developing overseas markets, we will not rely excessively on independent ventures, but work with strong partners in each region to accelerate business development.

In the Publication segment, sales recorded a CAGR of 11.7%, moving from ¥6.4 billion to ¥11.2 billion over the five-year period. The operating income ratio stood at 32.5% in the fiscal year ended March 31, 2008. This rate of sales growth and profit margin are both exceptional when viewed within Japan's publishing industry.

Our cross-media strategy involving magazines, anime, and comics is producing effective results. However, our unrivaled strength lies in the harmonious teamwork between authors and our editorial staff, as well as our business stance emphasizing early-stage investment in prospective talent and content. Thanks to these strengths, we have produced a constant stream of hit titles each year in this unpredictable business, leading to a very healthy pattern of business development.

The Others segment comprises the sum of our merchandising business and the arcade game machine business of SQUARE ENIX (excluding TAITO). Sales have risen from ¥4.2 billion to ¥9.0 billion over five years, resulting in a CAGR of 16.4%, while exhibiting a robust operating income margin of 36.9% in the fiscal year ended March 31, 2008. The merchandising business has provided steady growth, and we have also made a sound start in the development of overseas businesses, so we anticipate significant progress in the near future. In the fiscal year under review, arcade game machines, including "DRAGON QUEST Monster Battleroad," made a significant contribution to sales. By bringing TAITO into the Group, we have been able to utilize SQUARE ENIX's renowned game development capabilities to bolster the arcade game business, thus reaping valuable synergies.

The Amusement segment is comprised of all the former TAITO Group businesses to date. As TAITO was integrated into the Group in September 2005, it falls outside the calculations covering our business portfolio at the time SQUARE ENIX was formed. Consequently the whole of sales in this segment, ¥69.1 billion in the fiscal year ended March 31, 2008, contribute to growth in sales of the Group. Substantial improvement in profits by the Amusement segment is of particular note. In the fiscal year ended March 31, 2006, the initial year in which TAITO joined the Group, the segment recorded an operating loss of ¥0.7 billion (before amortization of goodwill). However, by the

fiscal year ended March 31, 2007, we had turned this around, achieving an operating income of ¥1.0 billion (ditto). In the fiscal year under review, operating income reached ¥4.4 billion (ditto). Seizing on this momentum, we plan to expand this segment to a level of ¥10 billion.

As can be seen from this summary, over the past five years all businesses outside of Games (Offline) have performed to a respectable level, although there are still a number of outstanding issues to be dealt with. Next, I will take a closer look at the challenges we are facing in the Games (Offline) segment and outline some of the key strategies we have formulated to deal with these issues.

Challenges in the Games (Offline) Business

The game software we create is primarily centered on role-playing games (RPGs), and one of the features of our products is our unrelenting pursuit of the highest possible quality standards. This quality-focused culture is something in which we take great pride, and we intend to maintain this approach. Contrarily, if this focus on quality becomes too extreme, it can turn into a form of stubbornness, which can sometimes lead to situations where an organization becomes unable to respond appropriately to changes in its operating environment. Our track record shows that we have created works of unrivaled quality by specializing in the development of games for the leading game console of the time, thus enabling us to fully capitalize on the capabilities of that particular platform. Furthermore, to efficiently develop major RPG titles, we were the first in the industry to adopt a development system based on functional labor division. However, the success of this approach eventually became the yoke around our necks.

Diversity is the keyword describing the current business environment. First and foremost, we have to deliver our games on multiple platforms and in various languages. Furthermore, we have to cater to consumer tastes that are becoming increasingly diverse. Our previous experience with focusing on a single console has slowed our progress constructing a multi-platform strategy. In addition, our game development system has become too segmented to allow us to maintain a comprehensive view of a project while preserving organization mobility. Such factors have hindered our progress toward development in multiple languages and genre diversification.

In “FINAL FANTASY XI,” we have achieved multi-platform, simultaneous worldwide release almost every year for the past four years, proving that there are no significant problems in terms of technical capabilities. As I have explained, the issues are primarily related to culture rather than capabilities. Failure to fully recognize the importance of this problem is something for which I take personal responsibility, and am committed to remedying.

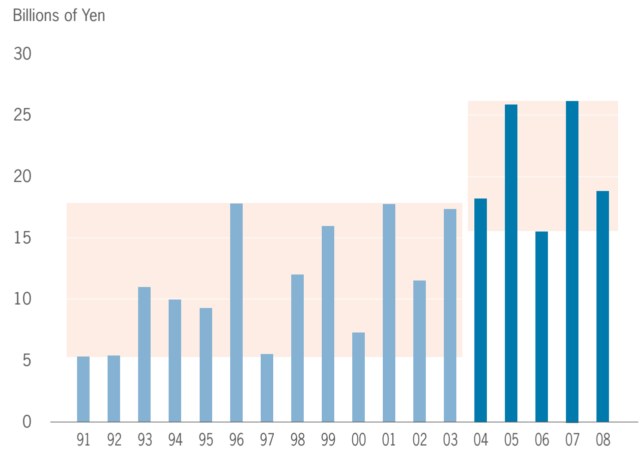
We are substantially revamping our formerly pursued management policy, and from the fiscal year ended March 31, 2008, embarked on a thorough transformation of strategies. Accompanying this was the implementation of the reorganization of several game development lines. This led to losses during the fiscal year under review totaling ¥4.8 billion, comprising a ¥3.0 billion valuation loss within cost of sales and a ¥1.8 billion loss on write-offs of content production accounts within non-operating expenses.

My honest opinion is that this transformation process will continue until the fiscal period ending March 31, 2009, to be fully effective, but I am confident we are making solid progress. I believe we can successfully regain our position as one of the world’s preeminent game developers.

There are also issues apart from those related to internal game development. Although we are a publisher, until now we have not sold titles developed by other companies. While we have a strong sales force Japan, our sales and marketing organizations in North America and Europe have not been fully equipped for this task. Consequently, we have not been able to embark on a truly global publishing strategy. Although belated, we have recently completed a reinforcement of our organization, allowing us to begin the publishing of other companies’ titles.

(Figure 1)

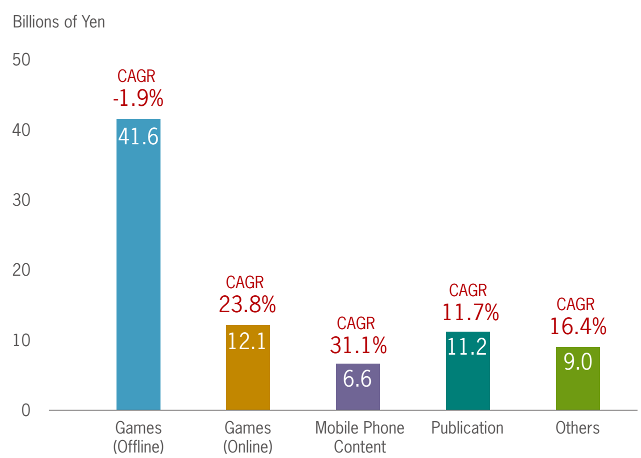
Consolidated Recurring Income



2008 = Fiscal year ended March 31, 2008
Until 2003, figures shown are the simple sum of the two premerger companies’ results. For 1991–1993, results for the former Square Co., Ltd., are on a non-consolidated basis. For 1991 and 1996–2001, results for the former Enix Corporation are on a non-consolidated basis.

(Figure 2)

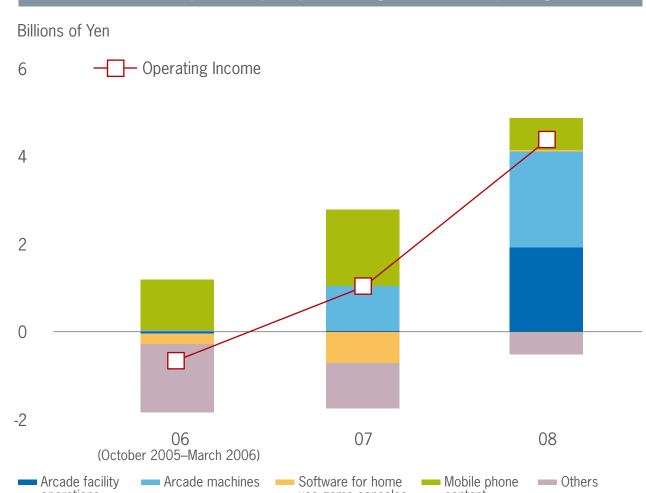
Net Sales by Business Segment and CAGR



Compound Annual Growth Rate (CAGR)= CAGR of net sales over the period from the fiscal year ended March 31, 2003 (the simple sum of premerger companies’ results immediately prior to merger) to fiscal year ended March 31, 2008

(Figure 3)

Amusement (TAITO): Operating Income by Segment



TAITO Corporation was made a consolidated subsidiary at the end of September 2005.
Figures shown are prior to deduction of amortization of goodwill. 2008 = Fiscal year ended March 31, 2008

Despite there being no particularly high barriers to entry, we have no track record in this field. However, I view this as an opportunity to enhance the performance of the entire Company, and fully believe we are capable and seasoned enough to successfully launch this venture.

With regard to game development projects with external studios, we have heretofore only pursued this strategy within Japan. Hereafter, we intend to add game development functions to our North American and European operations, and aggressively commission overseas development projects where deemed appropriate.

Evolutional Stages of the Video Game Industry

In my view, evolution of the video game industry can be perceived as moving through three distinct stages, and I believe that execution of the optimal business strategy at each stage is the core task for management.

Stage I: The era of hardware manufacturers

(Industry Conception to the early-2000s)

The appearance of game consoles led to the birth of a completely new form of entertainment—video games. At the time, since there was no general-purpose hardware with interactive graphics capabilities available for consumers, video games could only be played on specialized game consoles. Video game console makers produced and marketed consoles, while also developing and selling their own software. To enhance network externalities, console makers also sourced game software from third-party developers, with a large proportion of these third-party games being fed through the console maker's own distribution network. Hence it would be fair to call this industry ecosystem based on a completely vertically integrated business model "the video game console industry."

Since hardware during this phase was not yet able to satisfy user expectations, enhancing console functional capabilities was the number one priority. All console makers worked vigorously to bolster the processing capacity of their game consoles, while failing to adopt differentiation strategies such as the incorporation of unique attributes. This is illustrated by the fact that competition among console makers often focused on central processing unit (CPU) performance, such as was displayed in the "32-bit war," and it is my view that competition during that phase was unidirectional. The vertically integrated business model inevitably resulted in a winner-take-all scenario in the console market where competitive parameters remained very limited.

Consequently, for third-party game software developers, the most efficient strategy was to supply software only for the most successful console manufacturer and to depend on the manufacturer for marketing and all other operations beyond game development. The main strategic choice for game software developers was whether to adopt a high risk–high return strategy by completely relying on the dominant console maker, or alternatively, a moderate risk–moderate return strategy by retaining room for discretion.

The former Square excessively adapted to the prevailing environment. A corporate culture resistant to changes was created by a lack of self-awareness of the fact that its success was built on an extremely rare set of market circumstances and depended on a very unusual strategy. This is the ultimate reason why the reforms we are currently working on are taking a long period to implement.

Stage II: The era of publishers

(Mid-2000s to early-2010s)

Around 2000, the popularity of video games spread through most of the world and the following trends emerged:

- Variation in the timing of product permeation as well as varying regional trends at the time games became popular led to the formation of diverse user preferences among these regions. These can be thought of as "geological layers" within the game world.
- Since hardware performance capabilities in most consoles had generally reached the level expected by users, makers could finally focus on differentiation strategies related to other product attributes.
- Games could now be enjoyed on platforms other than specialized game consoles, including generic PCs and mobile phones.
- Since a broad array of devices became network capable, a completely vertically integrated business model based on hardware alone began to lose its viability.

The era dominated by hardware manufacturers was already drawing to a close as the environment that gave rise to a dominant console platform no longer prevailed. In the meantime, however, the game-playing population continued to expand briskly, and computer games became recognized globally as an important entertainment genre. This marked the beginning of the "video game industry" as it is perceived today.

Software developers were no longer able to rely on the ecosystem provided by a single platform manufacturer. Survival now depended on the software developer's own ability to exert influence on markets stretching around the globe.

From a game development perspective, to reach the largest audience possible, creating games in a multi-platform, multi-lingual format is now an essential element for competing in this era. From a marketing perspective, software developers need to build their own robust global distribution network.

I have already covered how we lagged in the first half of this era, as well as how we recovered lost ground. However, we are now entering the second half of this stage of the industry's development.

At this point, we must not only successfully make the transformation outlined above, but also execute a strategy in which network factors are given even more importance. Fortunately, at present within the game industry a clear verdict has yet to emerge. In this light, we see this juncture a valuable opportunity for SQUARE ENIX.

Stage III: The era of media and content market convergence

(From the mid-2010s)

In this era, the media and content industries will converge, dissolving the boundaries between such industries as movies, music, and games, as well as making the borders between countries obsolete. Right now, in addition to maximizing current earnings by adapting to the environment of Stage II, we must strive to fully prepare for Stage III of the industry's development.

Competition in Stage III will not be limited to the Video Game Industry

I see three material change drivers leading the industry towards Stage III. The first of these is the evolution of telecommunication technology. It is now becoming feasible to sustain the transfer of large volumes of data at speeds and scales that were previously unattainable. This means that digital content is no longer tied to physical media, and that the boundaries separating various types of content—primarily owing to physical differences between media and distribution channels—are disappearing.

The second change driver is the evolution of hardware. High-performance, multi-functional devices make it possible to process any type of content on any digital format.

The third driver is the emergence of a "network culture." The first two drivers help free content from physical limitations, while the third driver fuses content through communication and cooperation among users. Communities will emerge through the unifying force of user preferences alone, rather than content categories utilized in the past.

We do not yet clearly know what kind of industry ecosystem will emerge in this new era. What is clear though, is that massive-scale competition will affect the entire media and content industries. In such a scenario, our competitors will cease to be limited to other video game companies. If we are complacent, we may end up at the bottom rung of the industry providing only a very limited number of functions.

To become a major player in such an era, it will be vital to achieve at least top-five status within the video game industry. I also believe the following capabilities will be essential.

The first essential capability is internally-developed intellectual property. If markets converge, even if a company holds rights in a particular medium there is no way to respond to the new market paradigm. Second, it will be essential to build direct links with customer communities. No matter what kind of era emerges, there will be enduring value in customer communities united by customer preferences. Third, the Company must develop new types of human resources. In the new era, relationships will not be built in accordance with the old hierarchical structure but with a new network-oriented structure.

It is extremely difficult to maintain continuous growth of a business enterprise through changes of the times.

While working to maintain and enhance current earnings, we must not delay these preparations for the next stage of the industry's development. To maximize revenues and profits, it is necessary to design the overall organization of the Company. However, there is always the chance that this design may not work in the next era. Changing times can be said to resemble phase transitions in physics. Until we reach the critical point, we do not notice the changes. However, during this time, change is steadily taking place, and then one day, all of a sudden, everything changes completely.

I believe that continuous growth is the key mission for management.

We are absolutely committed to achieving our long-term missions. In these endeavors, I look forward to your ongoing support.

July 2008

Yoichi Wada

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