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, 2018 (“1H FY2018/3”).

Today’s presenters are:
Yosuke Matsuda,
President and Representative Director
and
Kazuharu Watanabe,
Chief Financial Officer

First, Mr. Watanabe will give an overview of the Company’s financial results for 1H FY2018/3, and then Mr. Matsuda will discuss the progress made by each of the Company’s business segments.

Good afternoon. I’m Kazuharu Watanabe. I will be presenting an overview of the Company’s financial results for 1H FY2018/3.
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 also 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 Nov 8, 2017. 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 Nov 8, 2017.

In 1H FY2018/3, the Company booked net sales of ¥132.0 billion (+24.2% YoY), operating income of ¥25.8 billion (+132.3%), recurring income of ¥26.6 billion (+217.7%), and net income attributable to parent company shareholders (“net income”) of ¥17.5 billion (+218.7%).

Overall, both sales and income rose YoY.

I will next break our results down by segment.

The Digital Entertainment segment achieved growth in both sales and income. The top contributor in the HD Games sub-segment was the launch of “DRAGON QUEST XI: Echoes of an Elusive Age.” The sub-segment saw both sales and income grow on the back of brisk repeat sales, especially in the form of downloads of catalog titles. The MMO sub-segment also achieved growth in both sales and income thanks to the release of an expansion pack for “FINAL FANTASY XIV” and the increase that drove in paying subscriber numbers. Both sales and income were likewise up at the Games for Smart Devices/PC Browsers sub-segment, where existing titles continued to perform well.

At the Amusement segment, arcade operations remained solid, but both sales and income declined because we launched even fewer new amusement machines than we had the year before.

At the Publication segment, both sales and income rose on solid comic book sales.
Sales and income also both rose at the Merchandising segment thanks to brisk sales of character merchandise, including the figures bundled with the “FINAL FANTASY XIV” expansion packs.

This concludes my overview of our 1H FY2018/3 results.

I am Yosuke Matsuda. I will be discussing the progress we made in each business segment.

I will start with the HD Games sub-segment of the Digital Entertainment segment. The top contributor to earnings here was “DRAGON QUEST XI: Echoes of an Elusive Age,” which has generated great feedback from our customers and is also earnings high marks for its contents. Sales of the remastered “FINAL FANTASY XII: THE ZODIAC AGE” have also been brisk.

Repeat sales were also strong, with cumulative sales of “Nier:Automata” topping 2 million units since its launch in February and the overseas titles “RISE OF THE TOMB RAIDER” and “JUST CAUSE 3” achieving sales growth continuously from previous fiscal year via downloads. We have many overseas titles slated for launch in FY2019/3 and beyond, and we expect for them to generate repeat sales over the long term.
At the present time, disk sales account for a greater percentage of our sales than do digital downloads. Our customers tend to purchase a higher percentage of new titles on disk and a higher percentage of catalog titles via digital download. We will be working to promote digital sales going forward in order to extend the life cycles of our products.

As one part of that endeavor, we have engaged in a major update of our sales website, so we look for digital downloads to account for a greater percentage of sales going forward. Moreover, by making an app version of our sales website, we hope to optimize convenience and the pathway to purchases.

I turn next to the MMO sub-segment, where 1H saw the release of the “STORMBLOOD” expansion pack for “FINAL FANTASY XIV.” This release drove a sharp uptick in subscriber numbers and brought us to the highest paying subscriber count we have had in the four years since launch.

We intend to release an expansion pack for “DRAGON QUEST X” in 2H, and look for it to help us maintain and add to our subscriber base.
At the Games for Smart Devices/PC Browsers sub-segment, existing titles are performing well. In particular, titles such as “FINAL FANTASY BRAVE EXVIUS” have also done well overseas and contributed significantly to earnings.

On the other hand, our earnings on some new titles have been less than what we had planned. The beta testing we’ve been engaged in since FY2017/3 has improved issues we had in previous launches, such as insufficient content offerings and bugs. We see our next challenge to be increasing the percentage of titles that are hits by ensuring the appeal of the games themselves.

Next, I turn to the Amusement segment, where arcade operations are solid. We will be working to bolster earnings by expanding our high-performing arcades, with one example being the refurbishment of the Taito Station in Mizonokuchi. That arcade re-opened in October and will serve as a major flagship location for us.

Our new title “DENSHA DE GO!” has been off to a good start since its November launch.

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I look next at the Publication segment, where sales have been solid.

Digital sales exceeded 20% of total sales in 1H FY2018/3 due in large part to our comics distribution app “MANGA UP!” Our weighting of digital sales has risen significantly in the two quarters the app has been available. We intend to increase the percentage of digital sales going forward by making more titles available on the app.

Next is the Merchandising segment. We have held a variety of events in FY2017/3 and FY2018/3 to commemorate the 30th anniversaries of DRAGON QUEST and FINAL FANTASY. As a result, sales of character merchandise have also been brisk.

FY2017/3 also saw the opening of our first Square Enix Cafe. Before FY2018/3 is out, we plan to open a Square Enix Cafe in Shanghai, which will make for our third location.

We plan an interim dividend of ¥10. We will determine our year-end dividend based on our policy of a consolidated payout ratio of 30%.
Given current challenges in the gaming market environment, we would like to reserve any decision regarding adjustments to our FY2018/3 guidance until we have seen the results of the initiatives we have planned for the year-end holiday season and for the New Year.

I also note that we intend to explore a variety of approaches for securing the development resources we will need to achieve the sales target of ¥300-400 billion set forth under our medium-term management plan.
SQUARE ENIX HOLDINGS CO., LTD.
2Q FY2018/3 Financial Results Briefing Session Q&A

Date/Time: November 8, 2017 (Wed); 5:30-6:30pm (JST)
On behalf of the Company: Yosuke Matsuda, President and Representative Director

Q&A

Q: Why is the balance of your content production account larger now than it was at the end of FY2017/3 even though “DRAGON QUEST XI” has already been released?
A: Development efforts for major titles are underway at both our overseas and domestic studios. We will be making announcements about the release dates of those titles between the end of FY2018/3 and E3.

Q: Did you book any impairment losses on the content production account at the end of 1H FY2018/3?
A: We did book impairment losses, primarily on smart device titles. We needed to write down the value of titles that have produced a weak response and that do not look promising in terms of their earnings contribution.

Q: You mentioned that you’d be launching major overseas titles in FY2019/3. Given that you will need to amortize considerable development costs in the first year of the titles’ releases, should we expect that they will not contribute to earnings in a major way until at least FY2020/3?
A: While there will be amortization costs, we believe the titles will be of such a quality that we will be able to generate ample profits in the fiscal year of their release. That said, competition is fierce in the Western markets, so we continue to face uncertainty related to the competition the titles might face.

Q: How are you feeling about your potential for reaching the operating income target under your medium-term management plan?
A: We have built a pipeline of major titles, so we are currently exploring how to market and run those so as to maximize their potential. For starters, we definitely want to achieve operating income of ¥40 billion.

Q: What do you think of the platform Steam for downloading PC games?
A: Steam has many users, but our games tend to get lost amongst the many titles it offers. As such, we think it’s important to guide users from our sales website to Steam.
Q: Have your efforts to increase digital sales resulted in any changes to your approach to game development?
A: Now when we are developing the main titles, we in parallel also plan and develop things like post-launch updates and add-on services.

Q: “Left Alive” was introduced in September. What will it cost to develop, and what is the positioning of the title?
A: We want to make it into a AAA brand, but that does not mean that we intend to devote massive development costs to it. Content-wise, the game will be satisfying in a hardcore way, and that’s how we want to market it to players.

Q: You set a target development lead time of around three years for your games, especially your overseas titles. How is that going?
A: I believe you will be able to tell how long our development lead times are based on the launch dates we will be announcing for our games going forward. I will say that we are facing less risk of having to engage in re-work thanks to the precision with which we are approaching our designs in the initial phase of each development project. I believe that the development efforts for the new titles we will be launching starting in FY2019/3 are proceeding in line with our plans.

Q: Do you foresee any changes in the percentage of the smart device game development you do in-house vs. via outsourcing going forward?
A: We have no plans of intentionally changing those percentages. From the perspective of development management, there is no major difference between working in-house vs. with outsourcing. I think the more important question is what to do about a shortage of development resources.

Q: Where do you intend to prioritize allocation of your development resources going forward?
A: We base our development resource allocations on the unique attributes of each platform. In particular, Nintendo Switch makes it easier for us to leverage our back catalog of assets and expertise, so we want to be proactive in creating new IP and rebooting past titles for that platform.

Q: Approximately what percentage of the HD Games sub-segment’s business do you think will be accounted for by digital downloads over the medium to longer term?
A: Digital downloads already account for around 50% of business in the Western markets. Given that the gaming market is shifting further to digital sales, I believe it will reach approximately 70-80%.
Q: What do you think about the current state of your smart device game business and where it is headed?
A: We now have an organization in place that should prevent us from repeating the same mistakes. Once you’ve improved upon quality issues, it all comes down to how fun the contents you produce are, so our next challenge will be to increase the success rate of our titles.

Q: “DRAGON QUEST RIVALS” has been performing well recently, but how do you expect smart device game earnings to trend going forward?
A: It’s true that “DRAGON QUEST RIVALS” is off to a good start, but there are some titles slated for release in the remainder of FY2018/3 that we are going to have to revisit. As such, some uncertainty surrounds our earnings outlook. I would like to reserve any judgment on that until we’ve seen what kind of start the new titles get off to.

Q: What do you think of Nintendo Switch, and how are you approaching development efforts for it?
A: Nintendo Switch is seeing rapid uptake, and we welcome the arrival of such a platform. We intend to be proactive in our development efforts given that it’s a platform that is well suited to the mid-sized titles at which we excel.

Q: How are you going to secure development resources going forward?
A: We want to be proactive in recruiting talented resources regardless of whether they are new grads or mid-career hires. What is key is that our company, brand, and titles be attractive to creators. Our 30th anniversary events and Square Enix Cafes have been part of our efforts to enhance our brand value.

Q: What has led to the increased intensity of competition in the gaming environment?
A: Players have become extremely discerning about game quality. Providing new experiences is also important, and to that end, we would like to make proactive efforts in the mobile AR space.

Q: What is your policy on technological initiatives for AI?
A: We have used AI in some of our games up until now, but we are now researching a variety of potential applications including applying AI or automation to our development processes.