

KLab Inc.

3656

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Summary

Provider of mobile online games from popular IP like Love Live! Aiming to accelerate growth by releasing new titles

KLab Inc. <3656> (hereafter, also “the Company”) focuses on the planning and development of mobile games, mainly for smartphones, toward realizing its vision of “Creating a world of excitement.” It also operates a non-game business with the aims of expanding sales and reducing volatility. The main titles include Love Live! School Idol Festival (hereafter, School Festival) and Bleach Brave Souls (hereafter, Bleach). The Company’s strength is in creating games from popular Japanese manga and animation and then managing these games, and it is also actively developing its business overseas. Approximately 16% of revenue is from overseas sales, which has tripled in the last 3 years. Also, the majority of the revenue is provided by the top four titles, but it can be said to have a comparatively balanced lineup within an industry where the reliance on specific hit titles tends to be high. In the last few years, there has been a sense of stagnation in the smartphone games market as a whole, and in this situation, the Company’s results have been sluggish due to the poor performance of new titles and the postponement of releases following a change in policy. However, to a certain extent it has achieved results, as in addition to the ongoing development of 11 pipeline titles that include popular IP, it is currently strengthening its management and marketing capabilities. As the Company is making progress in reducing fixed costs and switching to variable costs, it can be said to have established a system for returning to a growth trajectory.

1. Recent results trends

In the FY12/16 results, revenue decreased 6.3% year on year (YoY) to ¥19,599mn and operating income fell 42.0% to ¥1,274mn, for declines in revenue and profits and a net loss. Revenue declined due to the poor performance of titles released in 2015 and the postponement of the release of new titles, following a change in policy. The sluggish performance of the event business that was launched in 2015 also adversely affected the results. In terms of profits, while the aim was to lower SG&A expenses, including by reducing personnel costs and closing an overseas center, operating income declined due to a significant rise in the cost of sales ratio (an extraordinary factor caused by the event business) and as profits were kept down by the decline in revenue. Moreover, the reasons for the net loss included the recording of a foreign exchange loss following the appreciation of the yen, an impairment loss due to the poor performance of the titles, and a loss on the liquidation of a subsidiary.

2. New titles are expected to be hits

From FY12/17, the Company has adopted the presentation of full-year earnings forecasts using a range-based method, and it is forecasting revenue in the range of ¥17,500mn to ¥22,500mn and operating income of ¥600mn to ¥2,900mn. Should it reach the upper limits of these ranges, it would achieve new record highs for both revenue and operating income. A prerequisite of these forecasts is that the new titles (it plans to release from 2 to 5 titles) contribute to the results. Also, the assumptions when setting the ranges reflect the sales lifecycles of the existing titles (natural decreases) and the extent to which new titles are hits. At FISCO, we think that it is very possible that the Company will achieve the upper limits of the ranges for the full fiscal year earnings forecasts. This is because it made a strong start in Q1 (high rates of progress) and that among the titles scheduled for release, we consider that it is fairly certain that the popular titles of Captain Tsubasa and Uta no Prince-sama ♪ will be released and that it is also very likely that they will be hits.

Summary

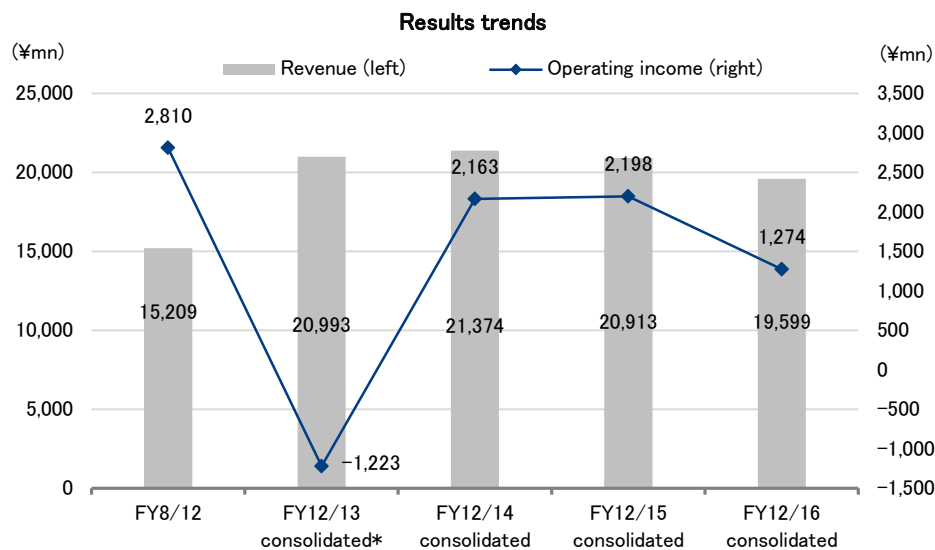
3. Achieving both business stability and growth through a diversified business portfolio

The Company's direction for its medium-term growth strategy is to increase the number of game titles through external development and publishing for the Game Business that has so far been focused on in-house development, and also, by advancing the non-game business, to achieve a state of balance for the three businesses. In the context of the rapid changes to the environment surrounding smartphone games, its strategy can be said to be accelerating growth through diversifying its business portfolio and building a flexible profit structure (turning fixed costs into variable costs), thereby converting to a structure that enables stable profit management.

In a situation in which the future of the smartphones games market feels uncertain, at FISCO we think that the Company's growth will be supported by its overseas business development and by it benefiting from the profits of the remaining players (including by utilizing external resources), and we will be focusing on the developments in these areas. Also, we think that its strategy of advancing the non-game business toward expanding its business and stabilizing its profit structure is rational. The key to success is likely to be whether the Company can utilize its expertise in developing IP in Japan and its independent marketing capabilities to create new value that is unique to it.

Key Points

- A mobile online games company specializing in the creation of hit titles from popular IP
- Strengths include its unique marketing capabilities and overseas business development capabilities
- Revenue and profits declined in FY12/16, mainly due to the postponement of new titles
- Is aiming to expand results in FY12/17 by releasing new titles
- Its policy is to realize both stability and growth from external development and publishing, and to expand the non-game business, while maintaining a balance



*FY12/13 was an irregular fiscal period of 16 months due to a change to the fiscal period.
 Source: Prepared by FISCO from the Company's financial results

■ Company profile

A mobile online games company specializing in the creation of hit titles from popular IP

1. Business description

KLab focuses on the planning and development of mobile games, mainly for smartphones, toward realizing its vision of “Creating a world of excitement.” It also operates a non-game business with the aims of expanding sales and reducing volatility. Its main titles include School Festival, Bleach, Celestial Craft Fleet (hereafter, Celestial Craft), and Tales of Asteria (hereafter, Asteria). The Company’s strength is in creating games of popular Japanese manga and animation and then managing these games, and it is also actively developing its business overseas. The majority of the revenue is provided by the top four titles, but it can be said to have a comparatively balanced lineup within an industry where the reliance on specific hit titles tends to be high.

The business segments are classified into the mainstay Game Business and also Other Businesses, which includes large-scale, high-load compliant infrastructure services that it has provided since its establishment, and the event business* that was consolidated from FY12/16. However, practically all of the revenue is provided by the Game Business and in addition, Other Businesses recorded a segment loss due to the impact of the poor performance of the event business.

* It announced in March 2017 that it was withdrawing from this business

The Company has five consolidated subsidiaries (of which, four are overseas subsidiaries), and one equity method affiliate. The four overseas subsidiaries are KLab Global Pte. Ltd. (Singapore subsidiary), KLab America, Inc. (U.S. subsidiary)*1, KLab Cyscorpions, Inc. (Philippines subsidiary)*2, and KLab China Inc. (Chinese subsidiary). Its subsidiary in Japan is KLab Entertainment Inc., which manages the event business, and equity method affiliates are KLab Venture Partners Co., Ltd., which is a joint venture with SBI Investment Co., Ltd. that invests in venture companies, and KLab Ventures Inc.

*1 Following changes to its global strategy, as of May 2017, it closed the games development studio function.

*2 Following changes to its global strategy, it liquidated this subsidiary in April 2017.

An overview of the main titles is as follows.

(1) Love Live! School Idol Festival

Love Live! is a media-mix project that sells imaginary female high school students as school idols, and it is a popular series that is being developed not only for releases of TV anime and music CDs with animation PV (DVD), but also for various other media, including Internet radio, live events, magazines, trading card games. Love Live! School Idol Festival, which is the game created based on the Love Live! IP, is a rhythm, action, and adventure game that the Company jointly developed with Bushiroad Inc., and launched in April 2013. It has sold strongly, including rising to fifth in the top-sales ranking of the App Store within Japan in just one day from its release. Subsequently also, it has continued to contribute to results as a long-running hit title, and in September 2016, the number of players worldwide exceeded 30 million people, and in March 2017, the number of domestic players surpassed 20 million people.

Company profile

(2) Bleach Brave Souls

This is an exciting 3D action game launched in July 2015. The popular BLEACH is a sword-battle-action comic serialized in Weekly Shonen Jump, a well-known manga magazine for young people in Japan published by Shueisha Inc. In addition to a TV anime, a theatrical version has also been released. The game is extremely popular not just in Japan, but around the world also, and by March 2017 it had been downloaded worldwide more than 20 million times.

(3) Celestial Craft Fleet

This is aerial-fleet action-battle game launched in February 2014. It is an original title that combines 3D action and training simulation elements and has simple operations, and it is set in a fantasy world where continents float in the sky. Players conduct exciting aerial battles with their original battleships that are manned by beautiful girl sailors.

(4) Tales of Asteria (delivered by BANDAI NAMCO Entertainment)

This is role playing game (RPG) launched in April 2014 from a joint development with BANDAI NAMCO Entertainment Inc. The characters in the “Tales of” series released by BANDAI NAMCO Entertainment all appear in this RPG created for smartphones.

The main titles; School Festival (left) Bleach (right)



Source: The Company's website

Improvements in player acquisition and the in-game purchase rates are the driving forces behind the growth in results

2. Corporate characteristics

(1) The growth model

The Company's main source of revenue is in-game purchases of items by the games' players. In other words, its growth model is to acquire players by creating hit titles and then to improve the in-game purchase rates. Also, the lifecycle of its mobile online game hit titles can be expected to be comparatively long, although this depends on their management, but it is unavoidable that a (natural) sales decrease occurs year by year. Therefore, the most important issue for the Company is how to cover this natural decrease in hit titles with new titles, and it can be said that the key to growth is accumulating titles in the development pipeline (the number of releases of new titles) and improving the hit rate.

Its strengths are its independent marketing capabilities and overseas business development capabilities

(2) The Company's competitive advantages

a) Its ability to create hit titles from popular IP

The Company's strength is in creating games from popular Japanese IP, such as manga and animation, and then managing these games. Starting with its main titles of School Festival and Bleach, it has a track record of creating games for a number of popular IP, and it has accumulated expertise in acquiring leading IP, planning and developing games that leverage each IP's strengths, and then in managing and marketing these games after they have been released. This supports the Company's strengths. In particular, Japan's pop culture (otaku culture) has been increasing in popularity around the world, including in Asia, Europe, and the United States, and this has become a major advantage for the Company for its overseas business development. It is also utilizing its track record and experience of turning popular IP into games, and the network it has acquired from this, to develop its own IP.

b) Independent marketing capabilities

In addition to developing efficient advertising and promotions activities from accurate KPI analysis and effects measurements, the Company is conducting effective marketing to capture a core player base (fostering a fan community) through its implementation of measures that are unique to it, such as for online video distribution* and real events. Moreover, these points-of-contact with grassroots players (networks) provide it with considerable support in terms of offering hints for the planning and development of new titles and title management after their releases, which is an asset that its competitors cannot easily imitate.

| * By KLab Games Station (Japan) domestically and KLab Games Station (Global) for overseas |

c) Overseas business development capabilities

Another of the Company's strengths is its overseas business development capabilities. Currently, approximately 16% of revenue is provided by its overseas business, which has tripled in the last 3 years. In particular, the foreign language versions of Bleach are proving a great success (a French version has been launched) and sales of the global versions exceed those of the Japanese version (FY12/16 results). Overseas also, in addition to developing very popular Japanese IP, the Company is developing its business against the backdrop that, starting with online video distribution for the overseas market, it conducts marketing activities tailored to each local market, including exhibiting and participating in real events in Europe and the United States. It has also launched in-house management of Web advertising distribution and it is working to accumulate expertise in these fields.

Since its foundation, it has provided various IT related technologies in the form of services

Entry into the social game business was the trigger for growth

3. History

The Company's origins can be traced back to the launch of K Laboratory in January 2000 as the R&D division of CYBIRD Co., Ltd. In August 2000, K Laboratory Inc. was established as a subsidiary of CYBIRD. It worked on the development of programs for mobile phones and other projects, and achieved results including releasing the world's first Java application to run on a mobile phone. Since its foundation, it has offered various IT related technologies in the form of services, including large-scale, high-load compliant infrastructure services. In November 2004, when the company name was changed to KLab Inc., it became a consolidated subsidiary of USEN CORPORATION <4842>, and then in February 2007, the Company's shares were transferred to SBI Holdings, Inc. <8473> and to others.

A turning point for the Company was in 2009 when it decided to focus on social games and released the hit title Koi-shite Kyaba-jyo. Subsequently in September 2011, it listed on the Tokyo Stock Exchange (TSE) Mothers market, against the backdrop of the growth of its Game Business.

After that, the Company's business foundation continued to expand, centered on the Game Business. It also actively developed an overseas business and established a series of overseas subsidiaries, in Singapore in February 2012, in the United States and the Philippines in April of the same year, and in China in November of the same year. In May 2012, its listing was transferred to the TSE First Section.

In November 2013, the Company sold the SI business division and license business division in order to concentrate its management resources into the Game Business. Meanwhile, in August 2015 it established a subsidiary (KLab Entertainment) to conduct an event business and related operations. Then in October of the same year, it established a subsidiary (KLab Venture Partners) to conduct a venture capital business, and in August 2016, it established a subsidiary (KLab Food&Culture Inc.) to develop an overseas business for Japanese food and culture. In such ways, it has been working to advance non-game businesses for the future.

Business results

Achieved record high revenue in FY12/14 from the hit School Festival

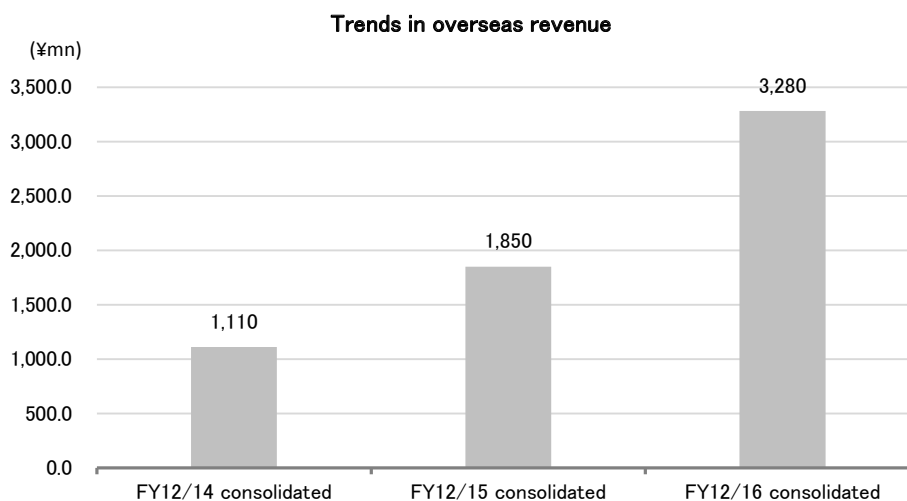
1. Past results trend

Looking back on the results in the past 5 years, while the Company achieved record high revenue in FY12/14 as a result of School Festival becoming a hit, subsequently, revenue trended downward. This is because in addition to the poor performance of titles released in 2015, in FY12/16 it postponed the releases of new titles following a change in policy, so it was unable to cover for the natural decrease in existing titles, such as School Festival. On the other hand, overseas revenue increased greatly from the contributions of School Festival and Bleach.

In terms of profits, the Company recorded an operating loss in FY12/13, which was due to the growth in fixed costs following its establishment of a series of overseas centers, and also because the number of releases was less than planned due to development delays, the poor performance of new titles, and the increase in outsourcing costs in order to recover from the development delays. However, since FY12/14, it has made progress in reducing costs and SG&A expenses and improving its profit structure (lowering the break-even point) by withdrawing from low-profit and unprofitable projects. Alongside this, the Company has reduced personnel numbers through focusing on development resources, as well as turning fixed costs into variable costs. One of the reasons for the deterioration in the costs of sales ratio in FY12/16 was the impact of the event business (an extraordinary factor).

Financially, at the end of FY12/14 the equity ratio rose to 70.8% following a capital increase from a third-party allocation* and subsequently it has trended at above 70%. The current ratio at the end of FY12/16 was also at the high level of 263.9% and there are no concerns about the stability of the Company's financial base.

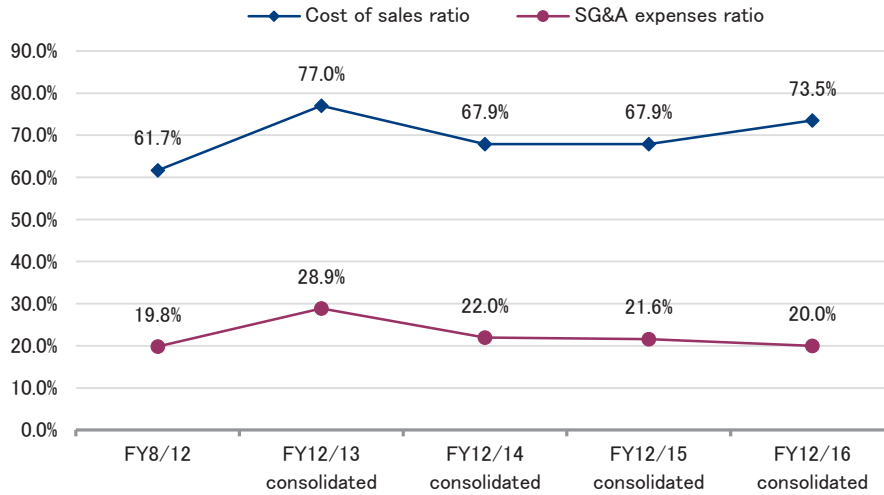
* In addition to a capital and business alliance with Qihoo 360 Technology Co. Ltd., which operates a distribution platform for China's largest distribution application for smartphones, it involved the issue of new shares and share acquisition rights to the London branch of the Deutsche Bank by a third party allocation (targeted issue program).



Source: Prepared by FISCO from the Company's results briefing materials

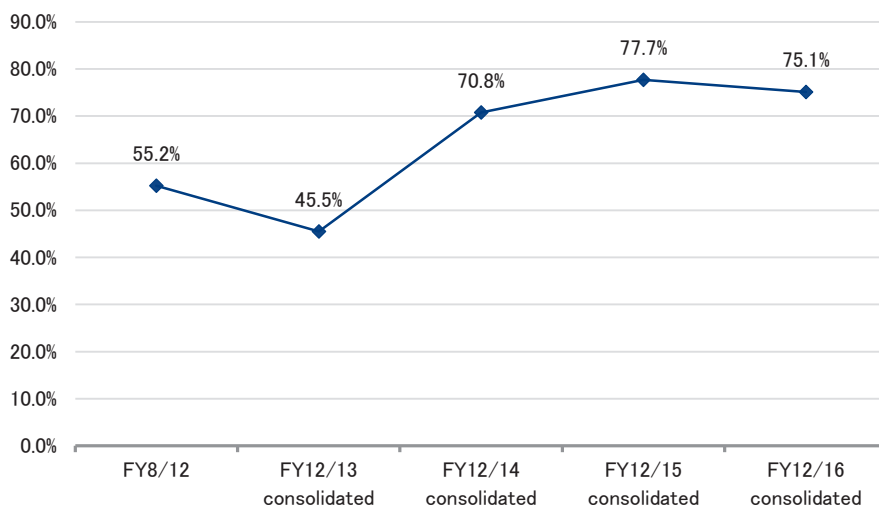
Business results

Trends in the cost of sales ratio and the SG&A expenses ratio



Source: Prepared by FISCO from the Company's financial results

Trend in the equity ratio



Source: Prepared by FISCO from the Company's financial results

Revenue declined in FY12/16 for the second consecutive fiscal year due to the poor performance of titles released in 2015 and the postponement of new titles

2. FY12/16 results

In the FY12/16 results, revenue decreased 6.3% YoY to ¥19,599mn, operating income fell 42.0% to ¥1,274mn, ordinary income declined 56.7% to ¥830mn, and the net loss attributable to owners of parent was ¥814mn (compared to net profit of ¥700mn in the previous fiscal year) for declines in revenue and profits and a final loss.

There has been a sense of stagnation in the smartphone games market as a whole, and in this situation, revenue fell due to the poor performance of new titles* and the postponement of releases, mainly due to a change in policy. In addition, the sluggish performance of the event business that was launched in 2015 also adversely affected the results. The postponement of the releases of new titles was based on the Company reflecting on the poor performances of the titles released in 2015 and deciding to change its policy and to only release titles after refining them to an even higher level of completion. Revenue from existing titles has trended steadily, as it has worked to strengthen its management and marketing capabilities, and this can be viewed as having kept the extent of the decline in revenue to a minimum.

| * Puzzle Wonderland and Age of Empires: World Domination |

In terms of profits also, although the Company worked to keep down SG&A expenses, including by reducing personnel costs and closing an overseas center, it recorded an operating loss because of the downward pressure placed on profits by the significant rise in the cost of sales ratio (67.9% → 73.5%) and the decline in revenue. The cost of sales ratio rose because of the increase in outsourcing costs, including for funding for joint development projects and costs related to the event business. The impact of costs relating to the event business (an extraordinary factor) seems to have been particularly great. The Company recorded a foreign exchange loss (¥388mn)*¹ within non-operating expenses following the appreciation of the yen. It also recorded extraordinary losses, of an impairment loss (¥757mn)*² from the poor performing titles, a loss on the liquidation of a subsidiary (¥252mn)*³, and a loss on the valuation of investment securities (¥131mn), and consequentially it recorded a net loss compared to the profit in the previous fiscal year.

*¹ It was generated due to a revaluation of foreign-currency deposits and held for the settlement of foreign-currency transactions, and not for costs for cash expenditures (to be used unchanged as foreign currency).

*² The entire amount of the impairment loss was recorded for the Puzzle Wonderland and Age of Empires: World Domination titles.

*³ From the decision to withdraw from an offshore development center (the Philippines subsidiary).

Financially, total assets declined to ¥12,133mn (down 4.0% on the end of the previous fiscal year) due to the sale of investment securities and the recording of an impairment loss from the poor performing titles (software account), while shareholders' equity also declined to ¥9,110mn from the recording of a net loss (down 7.2% on the end of the previous fiscal year). As a result, the equity ratio fell, although only slightly, to 75.1% (77.7% at the end of the previous fiscal year).

Business results

Business results

(¥mn)

	FY12/15 Results		FY12/16 Results		Change	
		% of total		% of total		Change rate
Revenue	20,913		19,599		-1,313	-6.3%
Game Business	20,868	99.8%	19,283	98.4%	-1,584	-7.6%
Other Businesses	44	0.2%	315	1.6%	271	612.8%
Cost of sales	14,199	67.9%	14,407	73.5%	208	1.5%
Gross profit	6,713	31.9%	5,192	26.5%	-1,521	-22.7%
Game Business	6,702	32.1%	5,437	28.2%	-1,265	-18.9%
Other Businesses	11	25.0%	-244	-	-256	-
SG&A expenses	4,515	21.4%	3,917	19.9%	-598	-13.2%
Operating income	2,198	10.4%	1,274	6.5%	-923	-42.0%
Ordinary income	1,919	9.1%	830	4.2%	-1,089	-56.7%
Profit attributable to owners of parent	700	3.3%	-814	-	-1,514	-
Breakdown of cost of sales						
Labor costs	2,781		2,630		-151	-5.4%
Outsourcing costs	813		1,430		617	75.9%
Royalties / commissions	10,567		9,830		-737	-7.0%
Other	31		511		480	-
Breakdown of SG&A expenses						
Salary allowance, etc.	1,181		1,081		-100	-8.5%
PR & promotions costs	1,733		1,344		-389	-22.4%
Other	1,597		1,487		-110	-6.9%
Total assets	12,633		12,133		-499	-4.0%
Shareholders' equity	9,819		9,110		-709	-7.2%
Equity ratio	77.7%		75.1%		-2.6pt	-

Source: Prepared by FISCO from the Company's financial results

Results of activities

Is making steady progress in the development pipeline toward the release of new titles

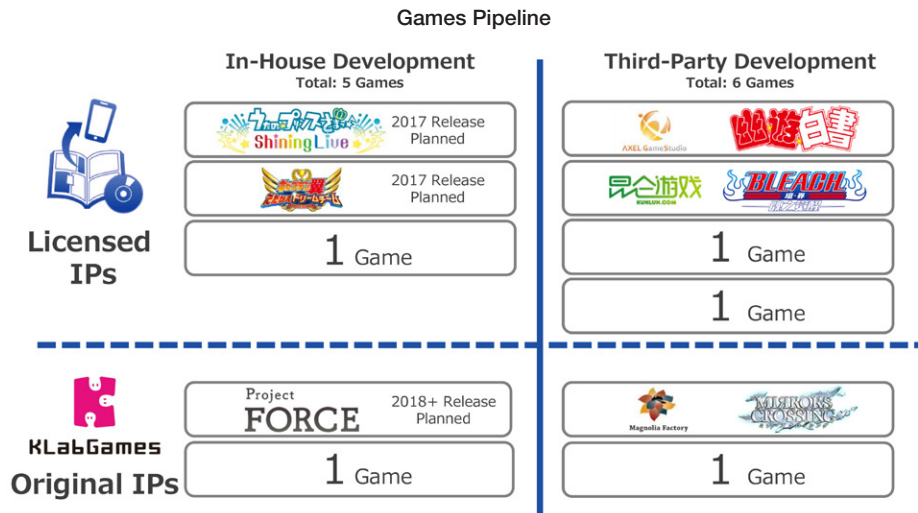
1. Review of the development policy

The Company reviewed its development policy based on factors such as the situation up to the present time and changes to the external environment. It decided 1) not to adopt poor performing IP from Europe and the United States and to focus mainly on highly popular Japanese IP even for its overseas market (changed to a system of developing games utilizing Japanese IP in Japan, and then releasing them overseas), and 2) to shift from in-house development to promoting external development and publishing. In accordance with this, it decided to withdraw from an overseas development center (the Philippines subsidiary). In addition, it has started to review its system for the division of labor internationally and to reorganize its overseas centers, including closing the studio function of its U.S. subsidiary. Also, by promoting external development and publishing, it plans to change game development-related costs from fixed costs to variables costs, which it expects to bring about cost reductions, risk hedging, and improved hit rates in the future.

Results of activities

2. Pipeline conditions

As previously explained, the releases of new titles in FY12/16 were postponed, and currently the Company is progressing the development of a total of 11 titles (development of both actual game titles and pilot titles), and it can be evaluated as steadily accumulating pipeline titles toward their release as new titles. Among them, 5 are being developed in-house and 6 by external development and publishing. Also, a total of 6 titles, including Captain Tsubasa and Uta no Prince-sama♪ are the IP of other companies.



Source: The Company's results briefing materials

3. Evolving its management and marketing capabilities

In the absence of new titles in FY12/16, the Company worked to maintain its existing titles, and as a result, it was able to refine its management and marketing capabilities. Specifically, it increased the efficiency of player acquisition from effective advertising, and also improved the in-game purchase rates through utilizing monetization techniques. It also worked to strengthen other various measures, including to improve the retention rates of players and to foster fan communities. As a result, titles released two or more years ago still achieved record high sales on a monthly basis, from which we can see that the Company's management and marketing capabilities have evolved to a new stage.

4. Promoting the non-game business

The Company also actively worked to strengthen the non-game business. It planned to hold the Classic Rock Awards (at the Ryōgoku Kokugikan in Tokyo), the rock world's most authoritative awards, held in Japan for the first time. In addition, it established a subsidiary (KLab Food&Culture) with the aim of exporting Japanese culture (particularly Japanese food culture) to the world, and it also started development of Ramen Arena, a food theme park, and opened the first store in Shanghai, China, in December 2016. Although the Classic Rock Awards ended up performing poorly, the Ramen Arena has made a steady start. The Company has also formed an investment fund and started investing in promising startups.

To summarize from the above the financial results and the results of activities in FY12/16, while revenue declined for the second consecutive fiscal year, the Company constructed a framework for growth in the future (including accumulating pipeline titles, reviewing the development policy and system, strengthening the profit structure, and enhancing the management and marketing capabilities). On these points, we can evaluate the Company as having achieved a certain level of success.

Growth strategy

Aiming to diversify its business portfolio through external development and publishing, and promoting the non-game business toward realizing both stability and growth

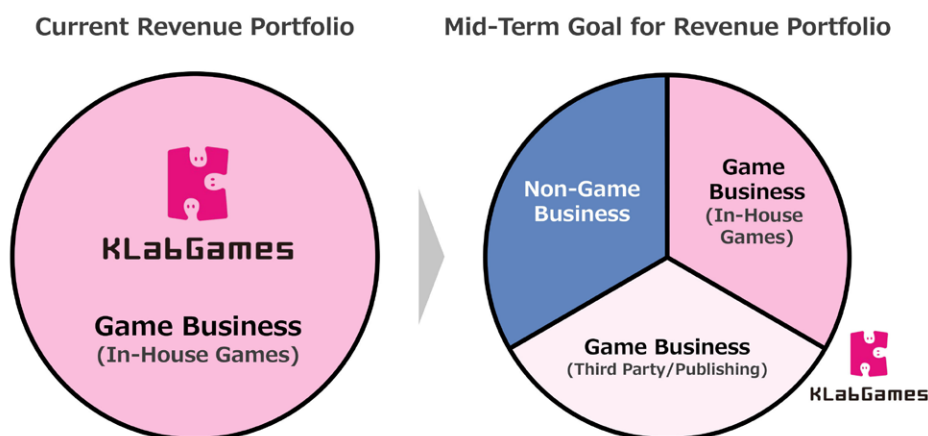
1. Medium-term direction

The Company's direction for its medium-term growth strategy is to increase the number of game titles through external development and publishing for the Game Business, which so far has been focused on in-house development, based on the review of the development policy in FY12/16. At the same time, it aims to advance the non-game business to achieve a state of balance for the three businesses. In the context of the rapid changes to the environment surrounding smartphone games, its strategy can be said to be accelerating growth through diversifying its business portfolio and building a flexible profit structure (turning fixed costs into variable costs), while also converting to a structure that enables stable profit management.

In particular, the following 5 effects can be expected from the promotion of external development and publishing; 1) a reduction of fixed costs and converting personnel costs to variable costs, 2) the appointment of excellent external creative staff, 3) the diversification of soaring development costs and risks, 4) an increase in the number of titles being developed simultaneously and a shortening of the development period, and 5) expanding and contracting the development pipeline and responding flexibly to the conditions for the acquisition of IP.

The Company is also focusing on supporting its revenue from the non-game business and creating a growth engine for the future. It is utilizing its development capabilities and IP procurement capabilities for the development and management of non-game smartphone apps and also to develop a media business. In addition, it is looking widely toward the application of technologies with future potential, like VR, AI, IoT, EdTech, and Fintech.

Medium-Term Business Formation Conception



Source: The Company's results briefing materials

Its policy is to focus on actively launching new titles and global business development in order to return to a growth trajectory

2. Policies for activities in the current fiscal year

(1) Actively launch new titles and stably manage existing titles

As previously explained, the Company is currently developing a total of 11 titles, either for the development of the game itself or the development of a pilot, and it plans to launch between 2 to 5 of these development titles as new titles in this fiscal year. It is also aiming to launch around the same number of new titles in FY12/18. In other words, even as the market has matured and some companies are withdrawing from it, its strategy can be said to capture profits from the remaining players through aggressively going on the offensive. Conversely, its policy is also to diversify the costs of development, including through utilizing external development and publishing, and to hedge risks. So it is maintaining a balance between offense and defense.

For existing titles, the Company makes a clear distinction between “future main titles we will continue to support” and “titles marked for closure.” For the “main titles,” it intends to maintain and improve revenue by further developing the management and marketing methods that were successful in FY12/16, while for the “closure titles,” it will either close them, transfer their management, or sell them.

(2) A contents strategy centered on IP

The Company continues to develop its business based on its strength of releasing titles that utilize IP. In particular, it will not adopt IP from Europe and the United States that are performing poorly, and instead it will aim to acquire Japanese IP (especially IP with a passionate, highly loyal fan base). It is also working in-house to develop new player experiences and to open-up new logics for games (however, it intends to improve the hit rates by narrowing down the number of titles and concentrating development resources by repeatedly conducting reviews at the pilot-development stage). Further, regarding original titles it develops on its own, the Company is not simply releasing games, it is developing them as its own IP or shared IP through cooperating with various companies in related industries, including animation and manga, light novels, and music. In other words, its strategy for its own IP is to target synergy effects and the diversification (strengthening) of monetization through multifaceted media development, while continuing to take the lead in the game development.

(3) Further promoting external development and publishing

Having acquired external development partners since 2015, the Company plans to release the titles it is currently developing sequentially from FY12/17 onward. Due to the soaring costs of development, it has become difficult for small-scale businesses to release games independently. Seizing this opportunity, the Company is further strengthening its relationships with external development partners by providing them with technologies, management expertise, and funds.

(4) Global strategy

For the overseas market also, the Company is aiming to expand overseas revenue by developing highly popular Japanese IP. Moreover, it is developing games especially for China and Asia. Particularly in China, which is a huge market, while on the one hand Japanese animation and other IP are very popular, on the other hand the logic of Japanese games tends not to translate very well, and it is difficult for Japanese games to become hits in this market. Therefore, it plans to jointly develop games using Japanese IP with Chinese companies. It is also continuing to release versions of titles in various languages and to strengthen marketing that is tailored to each specific location.

Growth strategy

(5) Converting the structure from fixed costs to variable costs

The number of (full-time) employees planned for the current fiscal year is 450 people in Japan (up 3 people on the end of the previous fiscal year) and 40 people overseas (down 145 people) for a total of 490 employees (down 142 people). So a major decrease in employee numbers is expected, which will be mainly from its closure of an overseas development center. Its policy is also to keep down the increase in employee numbers by utilizing outsourcing for titles that are being developed in-house (however, it will consider increasing employees for new titles that are performing well).

■ Results outlook

Aiming for business expansion through releasing new titles

1. FY12/17 results forecasts

From FY12/17, the Company has adopted the presentation of full-year earnings forecasts using the range-based method, and it is forecasting revenue in the range of ¥17,500mn (down 10.7% YoY) to ¥22,500mn (up 14.8%), operating income of ¥600mn (down 52.9%) to ¥2,900mn (up 127.5%), ordinary income of ¥450mn (down 45.8%) to ¥2,750mn (up 231.1%), and profit attributable to owners of parent of ¥160mn to ¥1,750mn (compared to a loss of ¥814mn in the previous fiscal year). Should it reach the upper limits of these ranges, it would achieve new record highs for both revenue and operating income.

The reason why the Company changed to the presentation of full-year earnings forecasts using the range-based method include that its results fluctuate significantly from the extent to which a new title is a hit, and also that it felt that the presentation of earnings forecasts for the next quarter, which it adopted in FY12/16, did not provide investors with sufficient information to judge its corporate value from a long-term perspective.

A prerequisite of the revenue forecasts is that the new titles (it plans to release from 2 to 5 titles) contribute to the results. Also, the assumptions when setting the ranges reflect the sales lifecycles of the existing titles (natural decreases) and the extents to which new titles are hits. In other words, the ranges' upper limits assume the new titles will be hits and will sell well, while their lower limits assume they will not be hits and will sell poorly.

In terms of costs, game development-related outsourcing costs, and also depreciation costs from the increase in the number of new titles scheduled for release, are both expected to rise.

Results outlook

FY12/17 results forecasts (range format)

(¥mn)

	FY12/16 Results		FY12/17 Forecast		Change	
		% of total		% of total		Change rate
Revenue						
Upper limit	19,599		22,500		2,901	14.8%
Lower limit			17,500		-2,099	-10.7%
Operating income						
Upper limit	1,274	6.5%	2,900	12.9%	1,625	127.5%
Lower limit			600	3.4%	-674	-52.9%
Ordinary income						
Upper limit	830	4.2%	2,750	12.2%	1,919	231.1%
Lower limit			450	2.6%	-380	-45.8%
Profit attributable to owners of parent						
Upper limit	-814	-	1,750	7.8%	2,564	-
Lower limit			160	0.9%	974	-

Source: Prepared by FISCO from the Company's financial results

FY12/17 made a smooth start in Q1

2. The progress made in FY12/17

In the FY12/17 Q1 results, the Company made a steady start to the fiscal year. Revenue was ¥5,249mn (rate of progress toward achieving the full-year forecast's upper limit, 23.3%), operating income was ¥935mn (rate of progress, 32.3%), ordinary income was ¥1,055mn (rate of progress, 38.4%), and net profit was ¥689mn (rate of progress, 39.4%).

While there were no releases of new titles, among the existing titles, sales grew from the Japanese version of School Festival and the global version of Bleach, and as a result, revenue trended strongly, up 8.9% on the same quarter in the previous fiscal year and up 4.8% on the previous quarter. It is considered that this is from the greater precision of the Company's management and marketing capabilities since the previous fiscal year.

In costs, the cost of sales ratio greatly improved to 66.0% (76.0% in the same period in the previous fiscal year and 76.4% in the previous quarter.) In particular, the improvement from the previous quarter was mainly due to the elimination of costs relating to the event business. The SG&A expenses ratio also improved to 16.1% (25.5% in the same period in the previous fiscal year and 18.8% in the previous quarter), while operating income to revenue rose considerably to 17.8% (an operating loss of ¥70mn in the same period in the previous fiscal year and 4.9% in the previous quarter). The major improvement in the SG&A expenses ratio from the same quarter in the previous fiscal year was due to the significant reduction in PR and promotions costs, and also from the contribution of the lower personnel costs (including due to the closure of the KLab America studio).

Results outlook

Summary of the FY12/17 Q1 results

	FY12/16 Q1		FY12/16 Q4		FY12/17 Q1		YoY	vs FY12/16 Q4
	Results	% of total	Results	% of total	Results	% of total		
Revenue	4,820		5,008		5,249		8.9%	4.8%
Cost of sales	3,663	76.0%	3,821	76.4%	3,465	66.0%	-5.4%	-9.3%
Gross profit	1,156	24.0%	1,187	23.7%	1,783	34.0%	54.2%	50.2%
SG&A expenses	1,227	25.5%	943	18.8%	847	16.1%	-30.9%	-10.1%
Operating income	-70	-	243	4.9%	935	17.8%	-	284.0%
Ordinary profit	-435	-	706	14.1%	1,055	20.1%	-	49.4%
Profit attributable to owners of parent	-413	-	-12	-	689	13.1%	-	-
Breakdown of costs of sales								
Labor costs	694		639		638		-8.1%	-0.1%
Outsourcing costs	251		604		380		51.4%	-37.1%
Royalties / commissions	2,443		2,515		2,636		7.9%	4.8%
Other	274		62		-188		-	-
Breakdown of SG&A expenses								
Salary allowance, etc.	304		249		213		-29.9%	-14.3%
PR & promotions costs	496		290		257		-48.2%	-11.2%
Other	426		403		376		-11.7%	-6.8%

Source: Prepared by FISCO from the Company's financial results

At FISCO, we think it is highly possible that the Company will achieve the upper limits of the full-year earnings forecasts. This is because it made a strong start (high rates of progress) in Q1, despite not releasing any new titles, and also that among the titles scheduled for release in the near future, at least two of them, the popular Captain Tsubasa and Uta no Prince-sama♪, can be expected to become hits to a certain extent. Rather, we consider the points that should be focused on are how many new titles it can release, and to what extent can these new titles contribute to the results.

Also, in the medium to long term and in the context of the sense of uncertainty about the future of the smartphone games market, we think the Company's growth will be supported by its overseas business development and it benefiting from the profits of the remaining players (including by utilizing external resources), and we will be paying attention to developments in these areas. We also consider its strategy of promoting its non-game business toward expanding its business and stabilizing its profit structure to be rational. The key to success is likely to be to what extent the Company can utilize its expertise in developing IP in Japan and its independent marketing capabilities to create new value that is unique to it.

■ Shareholder returns

It has a track record of actively acquiring treasury shares and related measures. If it achieves profits, it may return them to shareholders, including as dividends

The Company does not pay a dividend at the current time, as it is working to build up internal reserves to develop its business for the future and to further strengthen its corporate structure. This is considered to be because in its extremely competitive industry environment, it is still presently in a phase of actively investing in the development pipeline and it is prioritizing the allocation of funds to strengthening its management and marketing capabilities.

On the other hand, the Company acquired its treasury shares on four occasions in 2012 and 2015. Even after it reached the upper limit for the distributable amount as stipulated by the Companies Act and was no longer able to acquire treasury shares, it has implemented “treasury stock price reservation transactions,” which can be expected to have similar effects as the acquisition of treasury shares. An urgent task is stabilizing the profits structure through reforming its business structure (diversifying its business portfolio). Based on its approach in the past on returning profits to shareholders, it is thought the Company may start returning profits to shareholders, including by paying dividends, should revenue in its mainstay Game Business trend favorably, and if the prospect of revenue rising in the future also increases.



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