

KLab Inc.

3656

Tokyo Stock Exchange First Section

28-Jun.-2018

FISCO Ltd. Analyst

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FISCO Ltd.

<http://www.fisco.co.jp>

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Summary

Rapid growth continues in Q1 FY12/18; overseas sales log strong gains with help from hit game Captain Tsubasa

1. Company profile

KLab Inc. <3656> plans and develops mobile online games (mainly for smartphones) in keeping with its vision of “Creating a world of excitement.” Major, established game titles include Love Live! School Idol Festival and Bleach: Brave Souls. Two new titles released last year, Captain Tsubasa: Dream Team (hereafter, “Captain Tsubasa”) and Utano☆Princesama Shining Live (hereafter, “Shining Live”), have also been strong sellers. KLab’s forte is creating and managing games based on characters from popular Japanese manga (comics) and anime (animation). KLab is also active overseas and, with the recent rapid expansion on this front, overseas sales ratio currently account for more 30% of total sales. The majority of KLab’s revenues come from its top-four game titles. This gives it a fairly well-balanced and stable earnings structure in an industry where most companies depend heavily on just one or two hit titles.

In recent years the smartphone game market as a whole has stagnated and sales and earnings growth at game makers has lagged as new title introductions fared poorly, forcing changes in plans and delaying releases in some cases. KLab, however, was able to adapt its operations and marketing and find success in selling existing titles while at the same time working to bring down fixed costs and make more costs variable. And this, together with successful launches of new titles last year, appears to have put KLab firmly back on the growth track.

2. FY12/18 Q1 results outlook

For Q1 FY12/18, KLab reported strong growth in sales and earnings, with sales hitting ¥7,927mn (+51.0%) and operating profit ¥1,345mn (+43.8%). While this was down QoQ from the record-high results in Q4 FY12/17, it was still very respectable as sales of all four of the Company’s major titles remained at elevated levels. Overseas sales were especially strong, rising 138.9% YoY and 64.0% QoQ on the back of the release of the global version of Captain Tsubasa. On the earnings front, the operating profit margin was down slightly owing to a temporary jump in PR & promotions costs, but operating profit still logged impressive gains thanks to the strong top-line growth.

3. FY12/18 results outlook

The Company made no change to its initial forecast for FY12/18, which is presented in range-based method (*see note below). KLab is still forecasting full-year sales of ¥33,500mn (+25.1% YoY) to ¥38,500mn (+43.8%) and operating profit of ¥3,750mn (-23.3%) to ¥6,250mn (+27.8%). The upper-end of the forecast range points to strong growth in both sales and operating profit. The forecast reflects the Company’s plans to roll out between four and six new titles coupled with expectations of a natural decline in sales of existing titles as they move to the next stage of their sales lifecycle.

| * KLab began using range-based method for full-year earnings forecasts from FY12/17. |

For our part, we at Fisco think there is a good chance that sales and earnings will finish within the range the Company projected. We based this view on the strong starts of recently launched titles Captain Tsubasa and Shining Live, and our expectation that the full-year contributions from these two titles (including sales overseas) will be sufficient to offset any underperformance on the part of the new titles that are slated for release this year.

Summary

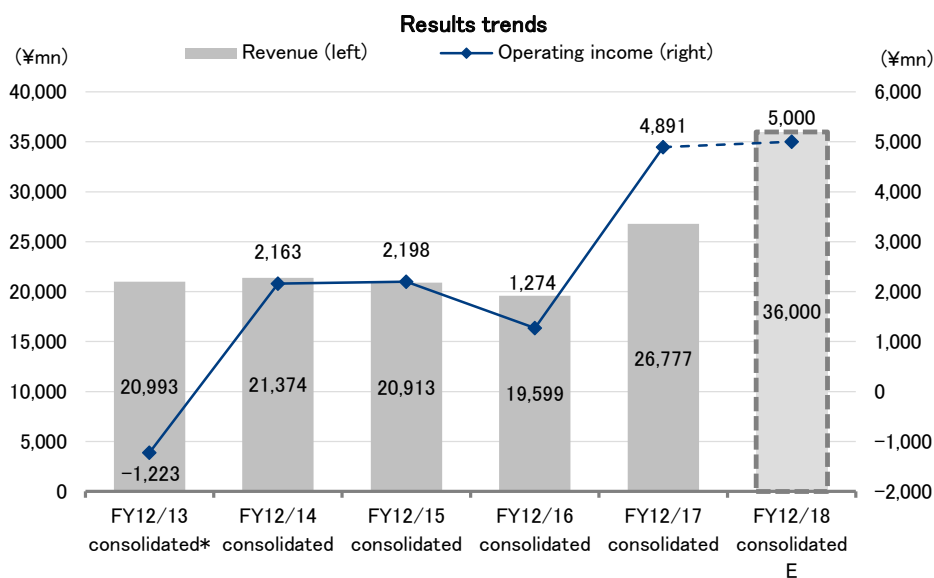
4. Growth strategy

Several years back, the punishing ups and downs in the smartphone games market convinced KLab that it should move away from its heavy dependence on in-house developed games by increasing the number of game titles it published that are made by outside developers. Along with this, KLab also started to move into areas outside the game business, the aim being to create a three-legged base for sales and earnings. However, following the successful launch of new titles and the strong sales of existing titles seen last year, worries about the risks stemming from high levels of volatility in the game business faded and KLab decided to steer a new course and devote more resources to its rapidly rowing game business with the aim of expanding sales and earnings further still. The three key themes in the Company’s growth strategy in its game business are now 1) Japanese IPs (Form the bedrock of revenue and growth with Japanese content), 2) Global Growth (Maximize the amount of revenue per title via international releases), and 3) Original Creations (Create hit titles with KLab-original IPs,aim for further growth).

While the outlook for the smartphone game market remains clouded by uncertainty, we at Fisco believe that KLab’s expansion into overseas markets together with the benefits it has accrued by being one of the survivors in the industry (including its ability to utilize the resources of outside companies) will help support growth at KLab in the years ahead, and will be keeping an especially close eye on developments on these fronts. We must also give high marks to KLab for its capable and stabile management, and its current emphasis on top-line growth over risk hedging as illustrated by its concentration of resources on its game business and the divestment of its non-game businesses. For a company such as KLab, its growth prospects would seem to depend in large part on the exercise of its skills at developing Japanese IP and utilizing its in-house marketing capabilities to create new value.

Key Points

- Underpinned by four major game titles, sales and earnings remain at elevated levels in Q1 FY12/18
- Launch of Captain Tsubasa provides major boost, drives overseas sales to new record high
- Expanded overseas sales and launch of new game titles expected to drive strong growth in sales and earnings in FY12/18
- Plans call for acquiring popular IP, expansion of overseas publishing, and creation of in-house IP



* FY12/13 was an irregular fiscal period of 16 months due to a change to the fiscal period.

Note: Forecast figures represent mid-point of Company's range forecast value

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

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■ Company profile

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

1. Business description

KLab plans and develops mobile online games (mainly for smartphones) in keeping with its vision of “Creating a world of excitement.” Major, established game titles include Love Live! School Idol Festival (hereafter, School-Fes”) and Bleach: Brave Souls (hereafter, Brave Souls”). However, two new titles released last year, Captain Tsubasa: Dream Team (hereafter, “Captain Tsubasa”) and Utano☆Princesama Shining Live (hereafter, “Shining Live”), have also been strong sellers.

KLab's forte is creating and operating online games base on popular characters from Japanese manga and animation. The majority of its revenues come from its top-four game titles, which gives KLab a fairly well-balanced and stable earnings structure in an industry where most companies depend heavily on just one or two hit titles.

KLab has two main business segment, its mainstay Games business, which accounts for the vast majority of sales, and its Other Business, which includes a legacy large-scale, high-load compliant infrastructure service that it has been engaged in since its founding (*see note below).

* The Ramen Arena business, established in 2016, was sold off as KLab changed direction and returned its focus to its game business.

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 June 2017, the number of domestic players worldwide exceeded 21 million people, and in September 2017, the number of players worldwide surpassed 40 million people.

(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.

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(3) Captain Tsubasa: Dream Team

Captain Tsubasa is a soccer match simulation game that KLab began distributing online last year. Pre-release registration numbers attracted a lot of attention and the Japanese version of the new game topped the 2mn download mark only three weeks after its June 13 release, beating even the Company's expectations. In addition to being based on a well-known character that has a large fan base around the world, Captain Tsubasa is rated highly in terms of its features (including its emphasis on training, the thrill of competitive match-up games, creation of a "dream team" of soccer players from around the world, and premium extras), and we believe this too has contributed to its popularity and sales. KLab released the global version of the game on December 5, 2017 and within two weeks of its release it had racked up more than 2mn downloads. Downloads have continued to grow apace since then and, as of May 2018, Captain Tsubasa has logged more than 10mn downloads worldwide (*see note below).

* According to the ranking of the best-selling games by country and region compiled by the App Store, Captain Tsubasa ranked No. 1 in online game downloads in Bahrain, Hong Kong, the UAE, and Macau, and was among in the top-ranked games in soccer-loving countries in Europe and South America, including Italy, France, Spain, and Argentina.

(4) Utano☆Princesama Shining Live

Another new title released last year is Shining Live, released on August 28, 2017. This is an extension of the popular Utano☆Princesama started in 2010 and whose characters have grown in popularity with the help of a media mix strategy. This game series has been the basis for four seasons of an animated TV series, and is popular among buyers of animated series on hard disks (DVD/BD). In the music arena, songs from this title series have been ranked No. 1 in the music rankings from well-known ranking companies and spinoff CDs from the animated series are perpetually ranked among the top sellers. With most of the fans consisting of wildly enthusiastic young women, tickets for live events sell out almost immediately and fans pack even well-known event centers. In other words, a media mix distribution strategy has successfully pushed up the IP value of this title. Although the latest title did not stay long in the top-ten game sales rankings, it has maintained a consistently high ranking and, thanks to KLab's focus on lifetime value, has consistently generated solid sales and earnings. The Mainland Chinese version and global version of this title were released on January 24, 2018, and by the end of March the online game had racked up more than 3mn downloads worldwide.

Images: Major game titles

Upper left: School-Fes; Upper right: Bleach: Brave Souls; Lower left: Captain Tsubasa; Lower right: Shining Live



Source: The Company's website

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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.

(2) The Company's competitive advantages

a) Its ability to create hit titles from popular IP

KLab's strength lies in creating and managing games base on popular characters from Japanese manga and animation. This strength is the product of its long track record of major hit games like School-Fes and Captain Tsubasa that feature a wide variety of popular characters, and expertise that goes all the way from acquiring popular IP, to planning and developing games, to operational management and marketing after the games have been released. The growing popularity of Japan's pop culture (otaku culture), not just in Asia but also the Europe, the US, and the rest of world, has also worked to KLab's advantage when marketing its games overseas. KLab's track record and experience of turning popular Japanese character IP into games and its network has also created a favorable environment in which to foster its own proprietary 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*. 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.

* The domestic market is served by KLab Games Station (Japan), which did more than 100 broadcasts during December 2017. The global market is served by KLab Games Station (Global), which broadcasts in English and French. Together, these broadcasts cultivate a fan base for KLab games both inside and outside Japan.

c) Operational management capabilities

As mentioned previously, most mobile online games have a sales lifecycle and their popularity naturally declines as the years pass. On top of this, there is also the problem of fickle users quickly switching to new games. In the case of KLab, however, recent results show revenues from existing titles are actually increasing over time—a good sign that post-release operational management of games has also become one of its strengths. This tells us that KLab has learned the secrets of how to make best use of the unique appeal of popular characters licensed for its games, and also expertly time live events and the release of spinoff goods to keep the game's fan base intact and not only continue playing but spend more money as well.

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Company profile

d) Overseas business development capabilities

Another one of KLab's strengths is its overseas business development capability. Overseas sales have more than quadrupled over the past three fiscal years to just under ¥5.0bn in FY12/17 and currently account for roughly 30% of total sales ratio (as of Q1 FY12/18). In particular, the foreign language versions of Bleach: Brave Souls are proving a great success (a French-language version has come out) and sales of the global version of the game continue to exceed those of the Japanese version. The global version of Captain Tsubasa has been received warmly since its release in December 2017 and is a major force underpinning growth in sales and earnings at this time. In addition to natural draw of popular Japanese IP in overseas markets, KLab is also tailoring its overseas marketing activities to fit each local market; in addition to online video distribution, this includes participating in live events in the US and Europe. KLab also started its own in-house management of Web advertising distribution and is accumulating expertise in this field as well.

Since its inception, KLab has provided various IT-related technology in the form of services; its entry into the social game business was the impetus 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 (now USEN-NEXT HOLDINGS Co., Ltd.<9418>), 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 August 2015, it established a subsidiary (KLab Entertainment) to manage an event business, then in October that year established another subsidiary (KLab Venture Partners) to run its venture capital business. The following year, in August 2016, KLab established another subsidiary (KLab Food & Culture Inc.) to develop an overseas business for Japanese food and culture. Also in July 2017, acquired a mobile on-line game's research and overseas consulting company, Spicemart Inc. as a wholly owned subsidiary. After working to develop these non-game businesses for several years, KLab changed its strategic direction again and, having enjoyed the recent success of its game business, is now focusing on games and winding down its non-game businesses (*see note below).

* Along with the change in its international strategy, KLab completed the pullout from its subsidiary in the Philippines in April 2017. The change in its business direction also led to the decision to wind down KLab Entertainment and sell off KLab Food & Culture.

Company profile

Following the annual shareholders meeting in March 2018, KLab's board of directors promoted Yousuke Igarashi to the position of Representative Director. With Tetsuya Sanada the Representative Director, Chairman of the Board, President and CEO, and Yousuke Igarashi the Representative Director, Executive Vice President and COO, KLab now has two representative directors.

Results trends

Strong sales and earnings continue in Q1 FY12/18; Captain Tsubasa driving strong growth in sales overseas

1. FY12/18 Q1 results

For Q1 FY12/18, KLab reported strong growth in both sales and earnings with sales of ¥7,929mn (+51.0% YoY), operating profit of ¥1,345mn (+43.8%), ordinary income of ¥1,229mn (+16.4%), and profit attributable to owners of parent of ¥805mn (+16.9%).

The sharp jump in sales reflects the launch of two new titles last year, Captain Tsubasa (which started online distribution in June 2017) and Shining Live (launched in August 2017). Overseas sales of ¥2,475mn were up 138.9% YoY and, having topped the ¥2.0bn mark, also set a new record high for quarterly sales. The Company attributed much of the growth in overseas sales to Captain Tsubasa, whose global version was launched in December 2017.

On the earnings front, the Company saw a modest increase in its CoGS ratio, which rose to 66.4% (versus 66.0% in the same quarter last year) due to increased spending on outside contractors and outsourcing. At the SG&A expense level, a temporary jump in PR & promotions costs * pushed the SG&A expense ratio up to 16.7% (versus 16.2% in the same quarter last year). Together, this brought the operating profit margin down to 17.0% (versus 17.8% in the same quarter last year), though operating profit still finished up sharply thanks the strong top-line growth. The comparatively modest growth in ordinary income and net profit reflects losses on foreign currency-denominated receivables resulting from the appreciation of the year during the period, as foreign currency conversion resulted in a loss of ¥159mn versus a gain of ¥101mn in the same quarter last year.

* The added spending reflects the cost of operating a large exhibition at the AnimeJapan 2018 trade show in March.

In terms of the Company's financial position, total assets of ¥17,632mn, a decline of 5.2% versus the end of previous fiscal year. The decline reflects a drop in cash and deposits resulting largely from the payment of dividends and corporate taxes. Non-current assets increased during the period as the Company booked costs related to software in progress under a suspense account, and also booked the costs to create animated videos for Lapis Re:LiGHTs (*see note below). On the liability and equity side, growing internal reserves led to a 3.7% rise in net assets to ¥13,015mn, boosting the equity ratio to 73.8% versus 67.4% at the end of previous fiscal year.

* Lapis Re:LiGHTs is a game title based on IP that was created by KLab but is being developed externally as part of a media mix project.

Results trends

FY12/18 Q1 results

(¥mn)

	FY12/17 Q1		FY12/18 Q1		Change	
	Results	% of total	Results	% of total	Change	Change rate
Revenue	5,249		7,927		2,677	51.0%
Game Business	5,234	99.7%	7,866	99.2%	2,631	50.3%
Other Businesses	15	0.3%	60	0.8%	45	306.1%
Cost of sales	3,465	66.0%	5,259	66.4%	1,793	51.8%
Gross profit	1,783	34.0%	2,667	33.6%	883	49.5%
Game Business	5,437	103.9%	9,503	120.8%	4,066	74.8%
Other Businesses	-244	-1626.7%	62	103.3%	306	-125.4%
SG&A expenses	847	16.2%	1,321	16.7%	474	55.9%
Operating income	935	17.8%	1,345	17.0%	409	43.8%
Ordinary income	1,055	20.1%	1,229	15.5%	173	16.4%
Profit attributable to owners of parent	689	13.1%	805	10.2%	116	16.9%
Breakdown of cost of sales						
Labor costs	638		765		127	19.9%
Subcontracting/outsourcing expense	380		945		565	148.7%
Royalties / commissions	2,636		3,784		1,148	43.6%
Other	-188		-235		-47	-
Breakdown of SG&A expenses						
Salary allowance, etc.	213		230		17	8.0%
PR & promotions costs	257		622		365	142.0%
Other	376		469		93	24.7%

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

2. Trends in quarterly results and sales of main game titles

Looking at results trends on a quarterly basis, we find Q1 FY12/18 sales down 7.2% QoQ and operating profit down 20.2% versus the record-high levels set in Q4 FY12/17, but still high and very respectable in absolute terms. As mentioned previously, overseas sales were especially strong, surging 64.0% QoQ on the back of sales of the global version of Captain Tsubasa.

Explaining the QoQ decline in sales of Love Live! School Idol Festival, the Japanese version of Captain Tsubasa, and Shining Live, the Company said the drop in sales of School-Fes reflected difficult comparisons with Q4, when sales jumped sharply in response to a promotional campaign and TV broadcasts of animated series based on the game. The drop in sales of the Japanese version of Captain Tsubasa was also attributed to elevated levels of sales in Q4, when the players in the game started wearing the official uniform of Japan's national team. In both cases, the Company said the QoQ drop in sales was in line with expectations. In the case of Shining Live, however, the Company said that despite the release of both the global version and Mainland Chinese version of the game that overall sales were a bit slower than expected. In contrast, Bleach: Brave Souls saw sales of the Japanese version and the global version rise QoQ in response to the release of the characters from the Thousand-Year Blood War Arc of the manga and a worldwide promotional campaign to get global downloads over the 30mn mark.

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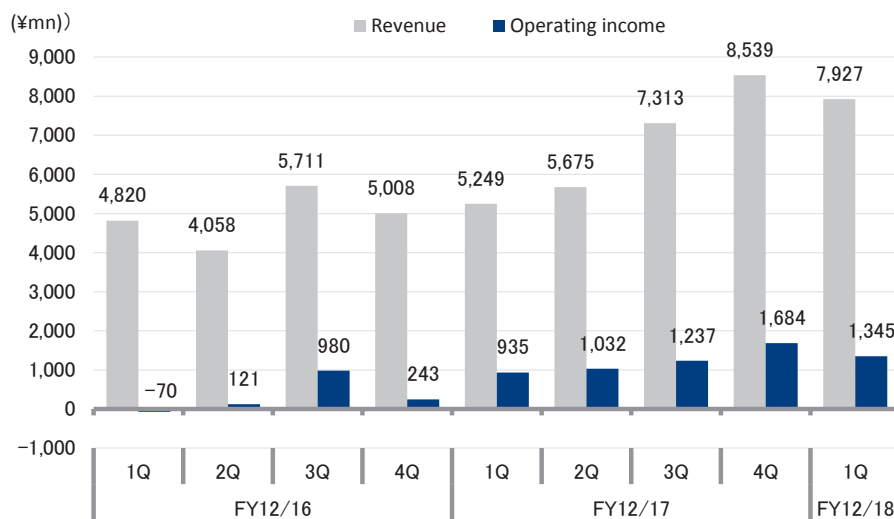
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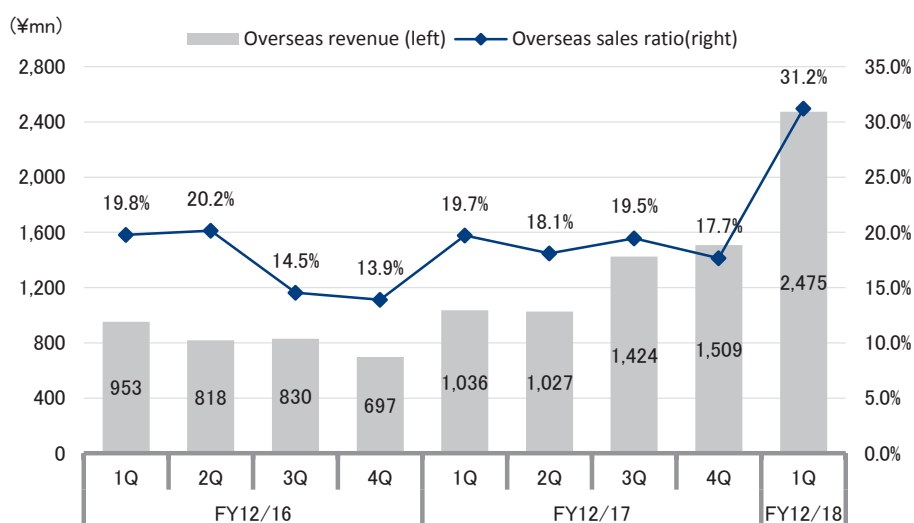
On the earnings front, labor and personnel costs, outsourcing costs, and spending on subcontractors rose along with the increase in sales but the operating profit margin remaining safely ensconced in the 17–19% range. The increase in outsourcing and use of outside contractors is a good indication that KLab is starting to make greater use of external resources. At the same time, however, the increase in labor and personnel costs reflects the Company's decision in Q3 FY12/17 to start increasing internal staffing levels, bringing the employee headcount for the group up to 524 at the end of March 2018 (versus 497 at the end of March 2017). As finding good people is one of the biggest challenges across the entire smartphone game industry right now, KLab says it would like to increase staffing levels a little more to help it push forward with the three key elements of its growth strategy. (For further details, see discussion under Growth Strategy later in this report).

Quarterly trends in sales and operating profit



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

Quarterly trends in overseas sales and overseas sales ratio



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

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Results trends

3. Results of other activities

On March 28, 2018, KLab entered into a capital and business partnership agreement with AXEL MARK, INC. <3624>, which is also involved in planning and developing games for smartphones. With this partnership KLab aims to make use of AXEL MARK's game development resources to help strengthen its own game pipeline. By combining the expertise of both companies to the fullest extent and working together to develop new games, KLab is looking to expand its game lineup with high-quality, innovative, and engaging games (*see note below). To seal the agreement KLab acquired 204,900 shares of AXEL MARK's common stock (at a cost of ¥349mn) through a third party allocation. This gives KLab a 4.46% stake in AXEL MARK and makes it AXEL MARK's second-largest shareholder.

* KLab is currently working with AXEL GameStudio Inc., a wholly owned subsidiary of AXEL MARK, to co-develop the game YU☆YU☆HAKUSHO 100% Maji Battle.

Results outlook

Company sees strong growth in sales and earnings continuing in FY12/18

1. FY12/18 results forecasts

The Company made no changes to its initial forecast for FY12/18, which is presented in the range-based method (*see note below). KLab is still forecasting full-year sales of ¥33,500mn (+25.1% YoY) to ¥38,500mn (+43.8%), operating profit of ¥3,750mn (-23.3%) to ¥6,250mn (+27.8%), ordinary income of ¥3,650mn (-24.8%) to ¥6,150mn (+26.7%), and profit attributable to owners of parent of ¥2,350mn (-24.8%) to ¥4,200mn (+34.3%). The upper-end of the forecast range points to strong growth in both sales and earnings.

* KLab began used a range-based method for full-year results starting in FY12/17. Explaining the change, the reason why the Company applied full-year earnings forecasts is that sales and earnings can vary greatly depending on how many and to what extent new game titles were hits, and that the quarterly forecasts it had been using through FY12/16 did not give investors enough information to properly gauge its enterprise value from a long-term standpoint.

The Company's sales forecast reflects plans to roll out between four and six new titles. The range given for sales also reflects expectations that sales of existing titles will naturally decline as they move into the next stage of their sales lifecycle, and the uncertainty regarding how many and the extent to which new titles (and overseas sales of existing titles) will be hits. In short, the upper end of the forecast range assumes sales of the new titles are good while the lower end of the forecast range assumes that sales of the new titles are not so good or, alternatively, that the deterioration in sales of existing titles is much larger than expected.

On the expense side, the Company is forecasting increased spending on PR & promotions costs (including promotional events and trade show exhibitions) as part of its plan to aggressively support new game introductions, an increase in ongoing operational costs following the release of the new titles (labor, subcontracting/outsourcing expense, depreciation), an increase in labor and other personnel-related expenditures as a result of the increase in staffing levels, and aggressive investment spending to support further business expansion in FY12/19 and subsequent years. Given these spending plans, we believe that sales near the upper end of the forecast range would easily cover the increase in costs but, if sales finished near the lower end of the range, that earnings would indeed come down under the weight of the added costs.

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Results outlook

For our part, we at Fisco think there is a good chance that sales and earnings will finish within the range the Company has projected. We base this view on the strong sales of Captain Tsubasa and Shining Live will become full-year contributions including overseas sales and will be enough to offset poor performance on the part of any of the new titles that are slated for release this year, as well as our belief that there is little chance of a sharp drop in sales of any of the Company's existing major titles. In short, we believe the lower end of the forecast range is conservative. In the case of Captain Tsubasa in particular, we note that the licensed characters are extremely popular in soccer-loving countries in Europe, South America, and even the Middle East, and that sales in 2018 are likely to get a favorable tailwind from the FIFA World Cup Russia championship matches that are scheduled during June 2018. A further boost to sales will come from the fact that the game is already available in six languages other than Japanese, including English, French, German, Italian, Spanish, and Chinese traditional characters, and will soon be made available in Arabic and Brazilian-Portuguese. Sales may also benefit from the broadcasts of a related animated series that started on April 2, 2018.

FY12/18 results forecasts

	FY12/17		FY12/18		Change	
	Results	% of total	Forecast	% of total	Change	Change rate
(¥mn)						
Revenue						
Upper limit	26,777		38,500		11,723	43.8%
Lower limit			33,500		6,723	25.1%
Operating income						
Upper limit	4,891	18.3%	6,250	16.2%	1,358	27.8%
Lower limit			3,750	11.2%	-1,141	-23.3%
Ordinary income						
Upper limit	4,853	18.1%	6,150	16.0%	1,296	26.7%
Lower limit			3,650	10.9%	-1,203	-24.8%
Profit attributable to owners of parent						
Upper limit	3,127	11.7%	4,200	10.9%	1,072	34.3%
Lower limit			2,350	7.0%	-777	-24.8%

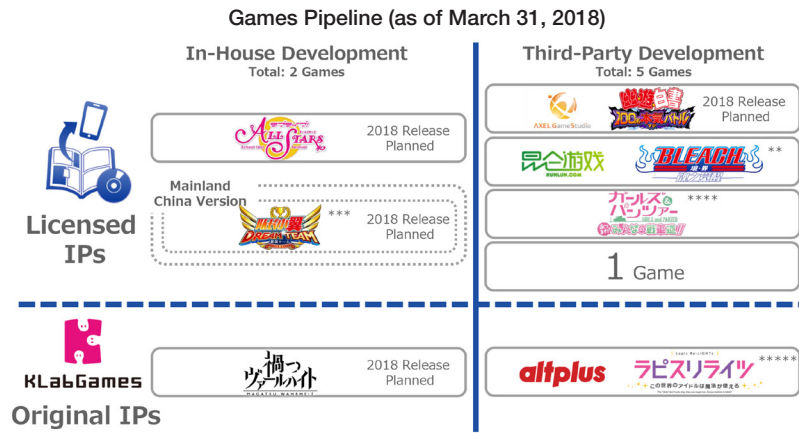
Source: Prepared by FISCO from the Company's financial results

2. Pipeline conditions

As of the end of March 2018, KLab's game pipeline had a total of seven titles (including titles under development and pilot development. Two are in-house games (one based on licensed IP and one on in-house IP) and five are being development by outside companies (four based on licensed IP and one based on in-house IP). One of these, Girls und PANZER: Tanks for Everyone! (*see note below), began preregistration on March 18, 2018. The extent to which these game titles are hits is likely to be roughly the same as the titles KLab has developed this far based on IP from other companies; however, the impact on earnings from the games KLab has subcontracted to outside developers will be smaller than the titles that it has developed in-house.

* Development overseen by KLab, published by BANDAI NAMCO Entertainment Inc.

Results outlook



* The above represents the number of games currently in the prototype phase or later. This does NOT represent a commitment to release a certain number of games.
 All games only count as one game each, no matter how many language releases are planned for that particular game.
 New language releases of existing titles do NOT count towards the number of titles in the upcoming games pipeline.
 ** To be published by Beijing Kunlun Lexiang Network Technology Co., Limited (Kunlun Games). *** To be published by Beijing Geos Interactive Entertainment Co., Ltd. (GAEA).
 **** To be published by BANDAI NAMCO Entertainment Inc. Previously appeared written as "1 Game" in the Fourth Quarter and FY2017 Financial Results presentation released on February 13, 2018.
 ***** The official title of Project PARALLEL was unveiled on March 24, 2018 at AnimeJapan 2018.

Source: The Company's results briefing materials

Assuming the release of titles based on IP from other companies is not delayed, KLab's game pipeline appears likely to make a decent contribution to sales and earnings. With regard to games based on in-house IP, we note that KLab has not had a hit game title based on its own IP for a while. Still, even we at Fisco see a lot of potential on this front as KLab's internal IP creation and media mix marketing strategy promises to be a key to growth for its game business and the further expansion of its revenue base. We are also expecting good results from the games currently under development that are based on KLab's in-house IP but whose development work is being done in collaboration with talented outside game creators.

Results in past years

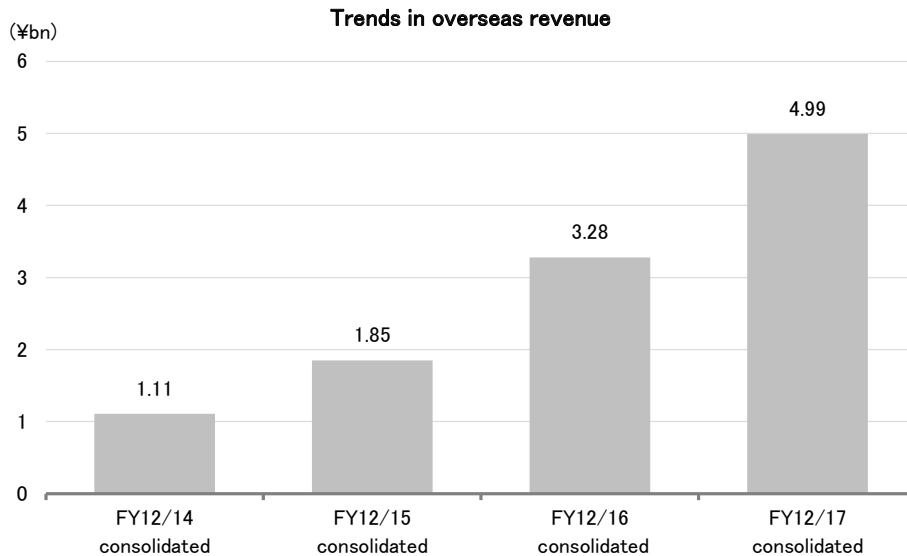
Looking back at results in past years, we note the sales peak in FY12/14 coincided with the release of hit game School-Fes and the sales turned down from there and continued falling through FY12/16. In addition to poor performance of titles released during 2015, delays in the release of new titles stemming from the change in KLab's strategic direction in FY12/16 meant that sales from new titles were not enough to offset the natural decline in the sales of existing game titles (including School-Fes). Sales turned around in FY12/17, however, and now with sales making great gains on the back of rising sales from existing titles and new titles, KLab has entered a new growth era and is also making plans to stabilize its revenue base.

Overseas sales grew steadily in past years as titles like School-Fes and Bleach: Brave Souls were rolled out internationally. Going forward, overseas sales can count on an additional boost from recently released titles like Captain Tsubasa and Shining Live.

Results in past years

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). In FY12/17, the improvement made to the Company's earnings structure along with strong top-line growth led to a sharp increase in earnings and high profitability.

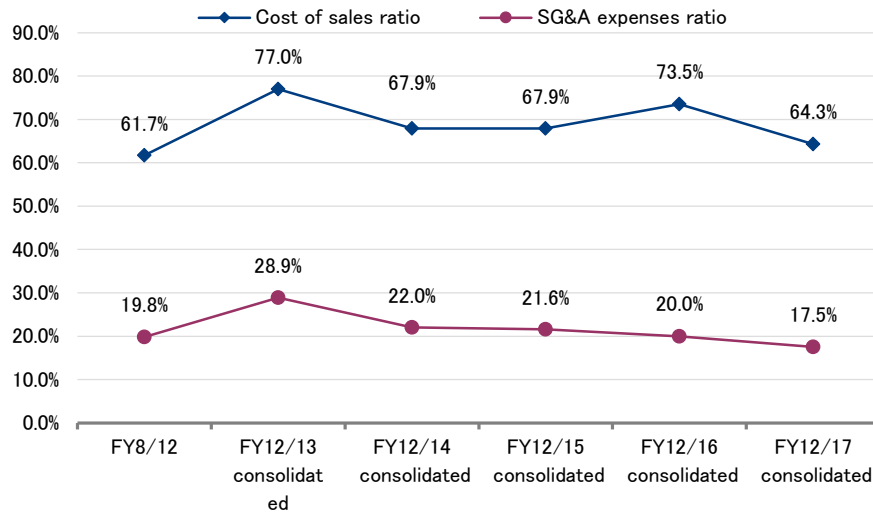
In terms of its financial position, at the end of FY12/14 KLab got its equity ratio up to 70.8% with help from an influx of new capital via a third party allocation. Since that time the equity ratio has generally stayed above 70%.



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

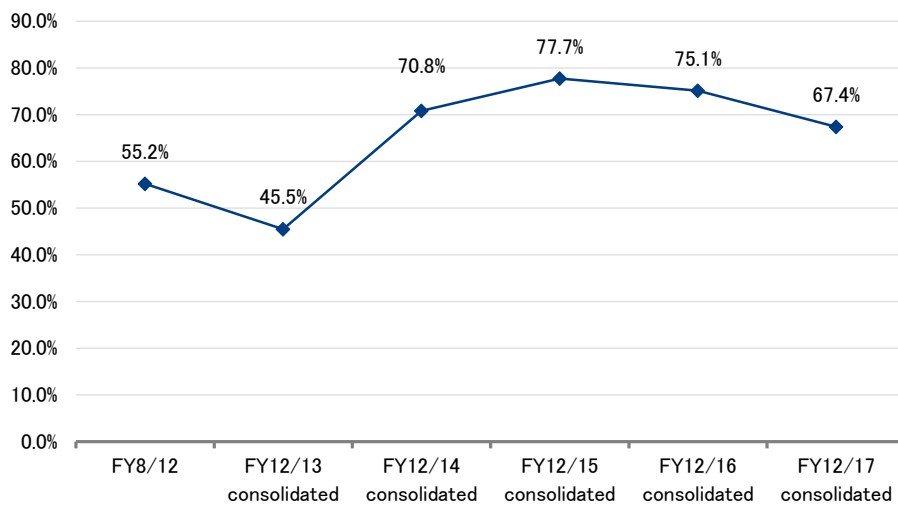
Results in past years

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



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

Trend in the equity ratio



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

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Growth strategy

1. Change of business policy

The punishing ups and downs in the smartphone games market in recent years has convinced KLab to lessen its dependence on in-house developed games by increasing the number of games published that are made by outside developers. It also started moving into areas outside the game business, thereby creating a three-legged base for sales and earnings. However, following the successful launch of new titles last year and growth in revenues from existing titles, management's worries about the risks of a highly volatile game business faded as KLab found that it had achieved a well-balanced and profitable earnings structure that secured revenues from multiple titles and was not overly dependent on one or two titles. This prompted the Company to change its course again and focus more resources to its now-hot game business with the aim of growing sales and earnings further still (*see note below).

* KLab is constantly looking for new business opportunities in peripheral areas that could generate synergies with its mainstay game business.

2. Activities for future

The three key themes in the Company's growth strategy for its game business are now (1) Japanese IPs (Form the bedrock of revenue and growth with Japanese content), (2) Global Growth (Maximize the amount of revenue per title via international releases), and (3) Original Creations (Create hit titles with KLab-original IPs,aim for further growth).

(1) Japanese IPs (Form the bedrock of revenue and growth with Japanese content)

- a) Sustain steady, long-term growth by acquiring popular IP with strong track record
- b) Build up distribution capabilities overseas including China to boost attractiveness as publisher
- c) Strengthen relations with IP owners by investing in anime

(2) Global Growth (Maximize the amount of revenue per title via international releases)

- a) Use overseas distribution to maximize revenues per game title
- b) Enhance publishing operations in Asia, US, and Europe
- c) Strengthen distribution capabilities in China, now the world's largest market, to accelerate growth

(3) Original Creations (Create hit titles with KLab-original IPs,aim for further growth)

- a) Hire talented people who can create original work, increase collaboration with alliance partners and talented external creators
- b) Use animated programming as part of media mix strategy to build core fan base, then follow that with the game. In other words, increase hit rate by first releasing songs, light novels, drama CDs, comics, and animation as part of a comprehensive entertainment media blitz that will test the potential for a creating a hit game.
- c) Put spinoff goods on the market before actually developing the game

Given the uncertain outlook for smartphone game market, we at Fisco see KLab's growth being underpinned by its expansion overseas and the advantages of its position as a survivor (including its access to outside resources), and will continue watching closely how it fares in this regard. We also give high marks to KLab for its stable and strong management and its "focus on sales growth over risk hedging" that has led it to concentrate its resources on its game business and divest its non-game businesses. For a company such as KLab, we believe the key to success to creating new value will be developing games based on Japanese IP and utilizing its expertise and marketing capabilities to expand distribution around the world.

■ Returns to shareholders

Shareholder return policy focused mainly on share buybacks

For a long time KLab did not pay any dividends because it was intent on building up internal reserves to fund further business expansion and reinforce its financial position. That changed in FY12/17, however, when KLab paid a special dividend of ¥9.0 per share at the fiscal year-end in recognition of sales and earnings setting a new record high. However, with respect to returns to shareholders going forward, the company will give more consideration to implementing share buybacks over paying dividends and, at this time, has no plans to pay a dividend in FY12/18. In keeping with this, on March 28, 2018, KLab announced plans to buy a maximum 350,000 shares at a maximum cost of ¥500mn. The Company completed its share buyback program during April, buying back a total of 261,100 shares for a total of ¥499mn on April 23–24.

With regard to management's thinking on returns to shareholders, we note that for a company like KLab that is still at a stage where it needs to be aggressively investing, share buybacks offer much more flexibility than a fixed cash dividend payment both in terms of timing and the size of the commitment. Taking into further consideration the desire of shareholders to see the share price appreciate and the stock's demand/supply balance in the stock market improve, we believe a preference for share buybacks has great merit at this time. With regard to the size of returns to shareholders, share buybacks also allow companies to give more thought to the balance of capital reserves that are held for the purpose of funding new investments to grow the business and those that are held to provide financial stability.

According to the Company's IR spokesperson, shareholders have expressed mixed feelings about its policy on returns to shareholders, with many individual investors saying they prefer to receive dividends and many institutional investors saying they want to see share buybacks and/or aggressive investment spending. For our part, we believe the Company's current stance is reasonable. Indeed, given the many investment opportunities KLab has (both in Japan and overseas) that would support growth in the future, we believe now is the time for KLab to be building up its revenue base by making new business investments that will facilitate internal IP creation and strengthen its multimedia distribution capabilities. We also recognize the strategic importance of maintaining as much flexibility as possible when it comes to capital allocation decisions.

The Company has also implemented a special shareholder rewards program with the aim of encouraging more investors to be medium-to long-term shareholders. Under its rewards program, shareholders receive QUO cards featuring original designs from its popular titles. The number of cards awarded per shareholder varies between one and five, depending on the number of shares held and the length of the holding period.



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