

KLab Inc.

3656

Tokyo Stock Exchange First Section

21-Oct.-2019

FISCO Ltd. Analyst

Ikuo Shibata



FISCO Ltd.

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

■ Index

■ Summary	01
1. Company profile	01
2. FY12/19 1H results	01
3. FY12/19 forecast	01
4. Growth strategy	02
■ Company profile	03
1. Business description	03
2. Corporate characteristics	05
3. History	06
■ Results trends	07
1. FY12/19 1H results	07
2. Quarterly results trends	09
3. Other topics	10
■ Outlook	10
1. FY12/19 results forecasts	10
2. Development pipeline	12
■ Past results trend	12
■ Growth strategy	15
1. Business policy	15
2. Future direction (three pillars)	15
■ Returns to shareholders	16

Summary

1H results on track within expectations, but lowered the FY12/19 revenue target even with smooth ramp-up of new titles

1. Company profile

KLab <3656> plans and develops mobile online games with emphasis on smartphone apps. It is a well-balanced company, generating a majority of overall revenue from four titles – mainstay Love Live! School Idol Festival (“School-Fes”), BLEACH Brave Souls (“Brave Souls”), Captain Tsubasa: Dream Team (“Captain Tsubasa”), and Utano☆Princesama Shining Live. This is a highly stable income structure in an industry with heavy reliance on single hit titles. The Company possesses strength in conversion of popular Japanese manga and animation into games and operating these titles. It is also actively promoting overseas business. The overseas revenue ratio was 35% in FY12/18.

In the past, 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 appears to have put KLab on the new growth track.

2. FY12/19 1H results

In FY12/19 1H results, the Company reported ¥14,812mn in revenue (-7.3% YoY) and ¥1,304mn in operating income (-49.7%), on track with the full-year outlook (it uses a range format). Revenue dropped on shrinkage over time (natural decline) in Captain Tsubasa, including non-recurrence of the 2018 FIFA World Cup Tournament Russia effect, and School-Fes businesses. Overseas revenue, however, remained healthy on continued growth in Brave Souls business. In 2Q, both domestic and overseas businesses recovered and new title Magastu Wahrheit (“Magastu”) released in April 2019 ramped up smoothly. These trends supported revenue roughly in line with guidance. Operating income declined sharply on a substantially higher unit cost ratio with increases in labor costs, outsourcing and business consignment costs, and depreciation costs. These cost factors, however, were generally within the outlook.

3. FY12/19 forecast

The Company lowered guidance from the period-start level (only for revenue) in FY12/19 (range format). Updated FY12/19 targets are ¥31,000mn (-5.1% YoY) to ¥37,000mn (+13.2%) in revenue and ¥1,000mn (-80.0%) to ¥4,500mn (-9.9%) in operating income. It reduced the revenue outlook because of revised targets for Yu☆Yu☆HAKUSHO 100% Maji Battle (“Maji Battle”) released in August 2018 and new title Magastu. It retained the profit outlook, meanwhile, on lower variable costs related to game operations with adjustment of the revenue plan and optimization of companywide costs. This outlook projects higher margin than initially. The Company plans to release two new titles in 2H, one of which has already been released. In costs, it expects higher advertising and promotional costs and operating costs the new titles and increased labor costs and hiring-related costs due to adding personnel. It thus guides for declines in operating and ordinary incomes (across the entire range).

Summary

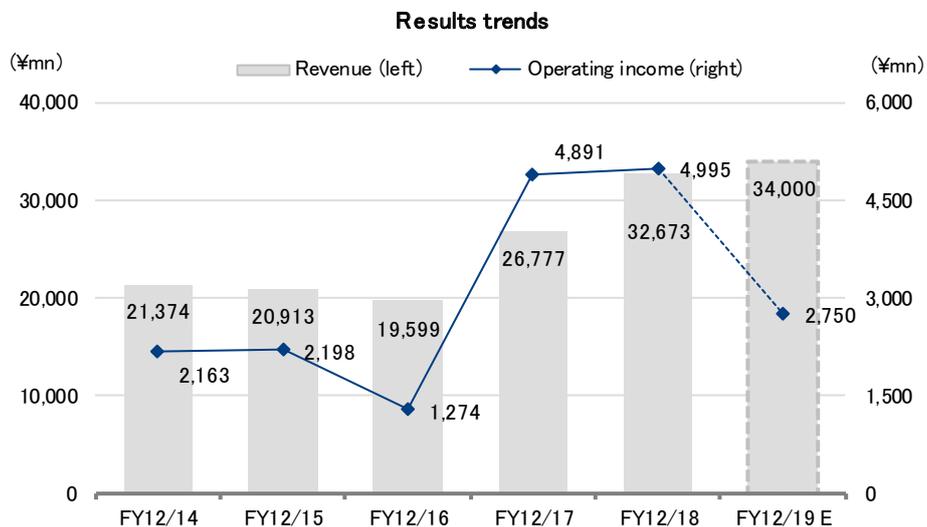
4. Growth strategy

The Company is pursuing business policies of “long-term stable game operations” and “profit expansion driven by a higher rate of hit games” with medium-term goals of sustaining a growth trajectory led by games business and establishing the KLab brand through provision of strong value globally. In particular, it intends to make further progress with the “three pillars” presented in December 2017 – 1) Japanese IPs (acquiring potent IPs), 2) Global Growth (strengthening global initiatives), and 3) Original Creations (creating its own IPs).

We think overseas initiatives and acquisition of survivor benefits (including utilization of external resources) offer excellent growth opportunities to the Company amid uncertainty about prospects in the smartphone game market. We are also focusing on measures to enhance content value and utilize media mix and the direction of maximizing income per title by delivering games to platforms and devices currently not covered by distributions as rational strategies likely to provide success. For a company such as KLab, we believe the key to success to creating new value will be developing games based on Japanese IPs and utilizing its expertise and marketing capabilities to expand distribution around the world.

Key Points

- Making progress on track with full-year guidance (range format) despite revenue and profit declines in FY12/19 1H
- Smoothly ramping up new title Magatsu based on proprietary IPs and plans to release two new titles in 2H (one of which has already been released)
- Lowered FY12/19 revenue guidance due to revising targets for Magatsu and Maji Battle (released in FY12/18)
- Plans call for acquiring popular IPs, strengthening global initiatives, and creation of in-house IPs



Note: Forecast figures represent mid-point of Company's range forecast value
 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 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 (“School-Fes”), BLEACH: Brave Souls (“Brave Souls”), Captain Tsubasa: Dream Team (“Captain Tsubasa”) and Utano☆Princesama Shining Live (“Shining Live”) and the four titles give it a well-balanced earnings structure in an industry where most companies depend heavily on specific hit titles. The Company released new title Magatsu Wahrheit that uses a proprietary IP on April 23.

The Company possesses strength in conversion of popular Japanese manga and animation into games and operating these titles. It is also actively promoting overseas business.

The business segments for KLab are 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.

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.<7803>, 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 2019, the number of domestic players worldwide exceeded 25 million people, and the number of players worldwide surpassed 45 million people. During FY12/19, the Company has already released the new title Love Live! School Idol Festival ALL STARS (“School STARS”).

(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 May 2019 it had been downloaded worldwide more than 40 million times. It posted all-time high revenue in FY12/18, the third anniversary. We think the ability to sustain growth even after some time has passed since the release offers evidence of the Company’s operational prowess.

KLab Inc.

21-Oct.-2019

3656 Tokyo Stock Exchange First Section

<https://www.klab.com/jp/english/>

Company profile

(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 substantial premium extras) and its effective promotions, 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. With the FIFA World Cup Russia held in 2018, downloads have continued to grow since then and, as of August 2019, Captain Tsubasa has logged more than 20mn downloads worldwide.

(4) Magatsu Wahrheit

This is a completely original mobile online RPG that started distribution on April 23, 2019. While the Company has not delivered hits with its own IP for a while, this is a key title that involved talented creators from outside the company and used popular voice actors for character voices and creates a unique atmosphere. The title was already known and had a fan base prior to the release thanks to the Company’s various promotional activities early on. It surpassed 1mn downloads in just six days after starting service and has been generating revenue at a pace on track with the plan. The Company intends to continuously enhance this title as it has done with other major titles.

Main titles

Upper left: School-Fes; Upper right: BLEACH Brave Souls

Lower left: Captain Tsubasa; Lower right: Magatsu



Source: The Company’s website

We encourage readers to review our complete legal statement on “Disclaimer” page.

KLab Inc. | 21-Oct.-2019

 3656 Tokyo Stock Exchange First Section | <https://www.klab.com/jp/english/>

Company profile

2. Corporate characteristics

(1) The growth model

The Company's main source of revenue is in-app purchases of items by the games' players. In other words, in general, 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. The Company, meanwhile, excels in long-term operational skills and overseas initiatives and is taking steps to maximize income (lifetime value) per title by broadening business to game-related areas (multi-device and media mix activities). We think it is important to focus on advances in the growth model that differs from other game firms.

(2) The Company's competitive advantages

a) Its ability to create hit titles from popular IPs

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 IPs, 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 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 IPs into games and its network has also created a favorable environment in which to foster its own proprietary IPs.

b) Unique 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 +Plus (Japan), which is the renewed version of KLab Game Station served since November 2015. KLab Games Station +Plus broadcasted more than 50 times as of August 2019 since its start in August 2018. The global market is served by KLab Games Station (Global), which broadcasts in English, French and Arabic. 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 the titles are actually increasing over time—a good sign that post-release operational management of games has also become one of its strengths. One example is Brave Souls. The domestic version ranked third, its highest level, in the iOS country and regional top sales ranking in July 2019 at the fourth anniversary of the release. 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.

We encourage readers to review our complete legal statement on "Disclaimer" page.

Company profile

d) Overseas business development capabilities

Overseas capabilities are an advantage too. The Company reached ¥11,508mn in overseas revenue in FY12/18 following a rapid expansion to over tenfold in the past five years. We think the ability to deploy games in overseas markets with substantial room for growth could be the Company's biggest strength considering domestic smart-phone game market maturation. For Brave Souls, the Company succeeded with provision of a multi-lingual version (French release), and global revenue consistently exceeds the Japanese version. Additionally, Captain Tsubasa, which released a global version in December 2017, grew much faster than expected and led earnings growth in the past few years. We think sources of the Company's overseas deployment strength include an ability to deliver Japanese IP that is highly popular in overseas markets too, multi-lingual support and advertising operation skills (ad creation tailored to specific regions and languages and suitable distribution by specific targets), fan community cultivation (online video distribution for overseas audiences and exhibits and participation in real-world events held in the US and Europe), and App Store/Google Play features*.

* App Store/Google Play are download services operated by Apple <AAPL> and Google. Positioning on their feature pages (introduction as a recommended app) has a powerful advertising effect. Brave Souls and Captain Tsubasa realized effective (and efficient) promotion via App Store/Google Play features.

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, the company name was changed to KLab Inc., and 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.

Company profile

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, has recently shifted its focus on games and to wind 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 in March 2017 to wind down KLab Entertainment and sell off KLab Food & Culture.

To bring in younger executives, the Company appointed Hidekatsu Morita as Representative Director & CEO at the Board of Directors meeting after the regular shareholder general assembly held in March 2019. It also shifted Tetsuya Sanada from Representative Director, Chairman & President to Director & Chairman and Yosuke Igarashi from Representative Director & Vice President (COO) to Representative Director & Vice Chairman. These changes moved the company to executive control under Mr. Igarashi and Mr. Morita as representative directors.

Results trends

1H results in line with expectations despite lower revenue and profits New title Magatsu Wahrheit contributed for 69 days

1. FY12/19 1H results

The Company reported FY12/19 1H results with lower revenue and profits at ¥14,812mn in revenue (-7.3% YoY), ¥1,304mn in operating income (-49.7%), ¥1,204mn in ordinary income (-53.6%), and ¥799mn in net income attributable to parent shareholders (-53.4%). Nevertheless, these levels showed healthy progress toward FY12/19 guidance (range format).

Revenue dropped on shrinkage over time (natural decline) in Captain Tsubasa, including further non-recurrence of the 2018 FIFA World Cup Tournament Russia effect, and School-Fes businesses. With School-Fes, the recently released School STARS, a new title for the same popular IP, appears to have affected activity. Overseas revenue, however, remained healthy on continued growth in Brave Souls business and releases of Southeast Asia version BLEACH (March 2019) and Korea version BLEACH (May 2019). In 2Q, both domestic and overseas businesses recovered and new title Magatsu Wahrheit ("Magatsu") released on April 23, 2019 contributed for 69 days.

KLab Inc. | 21-Oct.-2019
 3656 Tokyo Stock Exchange First Section | <https://www.klab.com/jp/english/>

Results trends

Earnings faced a substantially higher unit cost ratio at 73.8% (vs. 66.5% a year earlier) with increases in labor costs*, outsourcing and business consignment costs, and depreciation costs related to new title Magatsu's release. Even though the Company lowered SG&A expenses with cutbacks in advertising and promotional costs and other areas, operating income dropped sharply on downward impact from weaker revenue and higher unit costs. Operating margin slipped to 8.8% (vs. 16.2% a year earlier). Nevertheless, costs were generally within outlook scope.

* Group employees (regular employees) rose to 632 people (+69 people YoY, +35 people vs. end-FY12/18) with games business at 477 people (+43 people YoY, +22 people) and marketing and business development at 48 people (+13 people YoY, +10 people). The Company appears to have assigned many new university graduates who entered in April to the games business.

In financial standing, while capital climbed 7.8% from end-FY12/18 to ¥15,579mn on additions to retained profit, the capital ratio dropped to 69.4% (vs. 75.1% at end-FY12/18) because of a large rise in gross assets to ¥22,440mn (+16.6%) on increases in sales receivables and intangible fixed assets related to game development.

FY12/19 1H results

	FY12/18 1H		FY12/19 1H		Change	
	Results	% of total	Results	% of total	Change	Change rate
Revenue	15,986		14,812		-1,174	-7.3%
Game Business	15,851	99.2%	14,605	98.6%	-1,246	-7.9%
Other	134	0.8%	206	1.4%	72	53.7%
Cost of sales	10,624	66.5%	10,933	73.8%	309	2.9%
Gross profit	5,361	33.5%	3,878	26.2%	-1,483	-27.7%
Game Business	5,320	33.6%	3,803	26.0%	-1,517	-28.5%
Other	40	29.9%	75	36.4%	35	87.5%
SG&A expenses	2,768	17.3%	2,574	17.4%	-194	-7.0%
Operating income	2,593	16.2%	1,304	8.8%	-1,289	-49.7%
Ordinary income	2,593	16.2%	1,204	8.1%	-1,389	-53.6%
Profit attributable to owners of parent	1,713	10.7%	799	5.4%	-914	-53.4%
Breakdown of cost of sales						
Labor costs	1,580		1,910		330	20.9%
Subcontracting /outsourcing expense	2,033		2,291		258	12.7%
Royalties / commissions	7,612		7,080		-532	-7.0%
Other	995		1,459		464	46.6%
Other account transfer	-1,601		-1,811		-210	
Breakdown of SG&A expenses						
Salary allowance, etc.	489		569		80	16.4%
PR & promotions costs	1,289		1,061		-228	-17.7%
Other	988		941		-47	-4.8%

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

Financial standing at the end of June 2019 (summary)

	As of the end of December 2018 Results	As of the end of June 2019 Results	Change	
			Change	Change rate
Total assets	19,245	22,440	3,195	16.6%
Shareholders' equity	14,450	15,579	1,129	7.8%
Equity ratio	75.1%	69.4%	-5.7%	-

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

Results trends

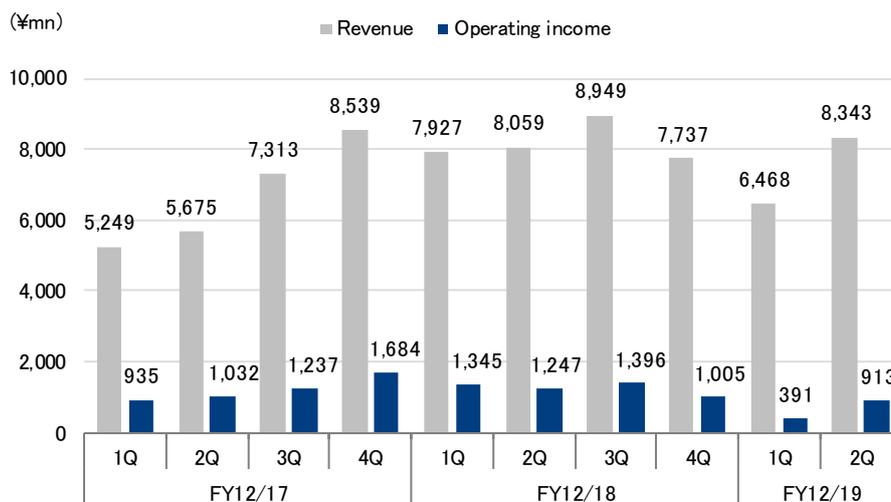
2. Quarterly results trends

Looking at quarterly revenue trends, the Company delivered large increases in 3-4Q FY12/17 and sustained strong levels in FY12/18 thanks to Captain Tsubasa domestic (June 2017) and global (December 2017) releases. It even set all-time high revenue (quarterly basis) in 3Q FY12/18. In FY12/19, while revenue temporarily eased in 1Q due to seasonal factors and other impacts, it returned to the ¥8bn level in 2Q on rebounds by existing titles and contributions from new title Magatsu, as explained above.

In overseas revenue quarterly trends, 3Q FY12/18 moved above ¥3bn led by upside in Captain Tsubasa global revenue. In FY12/19, the Company secured roughly ¥3bn in 2Q revenue, despite decline in Captain Tsubasa revenue, because of healthy growth in Brave Souls business and releases of Southeast Asia version BLEACH and Korea version BLEACH.

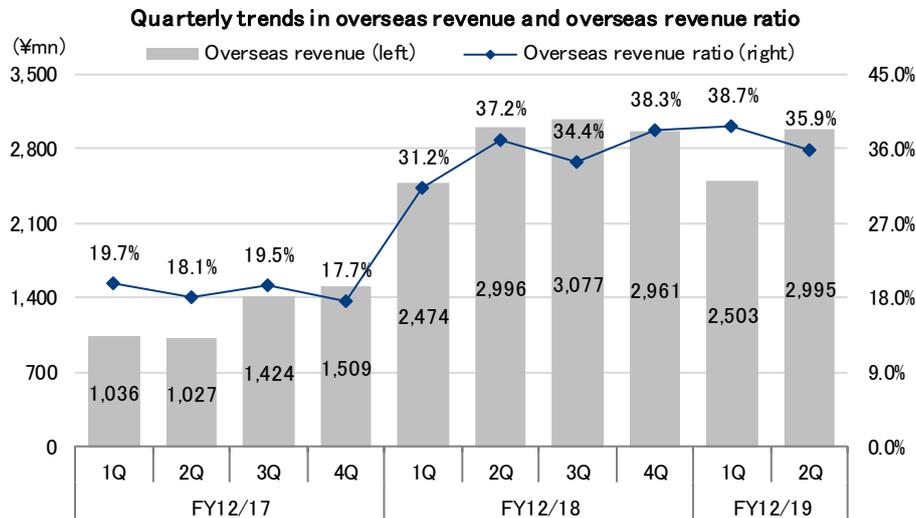
In earnings, operating margin stayed at a high level in FY12/18 with support from revenue expansion. In FY12/19, however, operating margin has remained at a lower level than in the previous year due to increases in labor costs and personnel expenses and the start of Magatsu depreciation costs.

Quarterly trends in revenue and operating income



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

Results trends



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

3. Other topics

The Company has outlined a key strategy of broadening business to game-related areas, including game multi-device and multi-platform deployment and IP usage in non-game applications, as an initiative with longer-term prospects. It is actively promoting alliance efforts to realize these goals. On August 7, 2019, the Company invested in ActEvolve Inc., which plans, develops, and operates VR live platform VARK and positions the deal as part of these activities.

Additionally, it announced an investment in Ichikara Inc., which operates Japan's largest virtual live performer group Nijisanji, on August 29, 2019. We think the Company is steadily creating new business opportunities with its quick alliance initiatives.

■ Outlook

Lowered FY12/19 revenue guidance (profit targets unchanged)

1. FY12/19 results forecasts

The Company lowered revenue in FY12/19 guidance (range format). Updated FY12/19 targets are ¥31,000mn (-5.1% YoY) to ¥37,000mn (+13.2%) in revenue, ¥1,000mn (-80.0%) to ¥4,500mn (-9.9%) in operating income, ¥1,000mn (-80.0%) to ¥4,500mn (-10.0%) in ordinary income, and ¥700mn (-72.8%) to ¥3,100mn (+20.6%) in net income attributable to parent shareholders.

Outlook

The Company reduced the revenue outlook due to revised targets for Yu☆Yu☆HAKUSHO 100% Maji Battle (“Maji Battle”) released in August 2018 and new title Magatsu. For Maji Battle, the Company suspended development of the global version, which had been planned, because domestic revenue was lower than expected. For Magatsu, despite ramping up faster than expected as explained above, the Company identified improvement points to cultivate even more business and intends to focus on these future-oriented changes. It retained the profit outlook, meanwhile, on lower variable costs related to game operations with adjustment of the revenue plan and optimization of companywide costs. This outlook projects higher margin than initially.

The Company plans to release two new titles in 2H, one of which has already been released. When setting the guidance range, it factors in existing title revenue lifecycles and the extent of hit success with new titles (including overseas rollout of existing titles). In other words, the top end of the range assumes upbeat results in new and existing titles, while the bottom end envisions weakness in new and existing titles.

In costs, it expects higher advertising and promotional costs for robust promotion of new titles, additional operating costs related to new title releases (labor costs, outsourcing/work consignment costs, and depreciation costs), and increases in labor costs and hiring-related costs due to adding personnel. The Company plans to actively invest in business initiatives from FY12/19 as well. It keeps fixed costs at constant levels. These assumptions work out to declines in operating and ordinary incomes (across the entire range).

We think the Company is sufficiently capable of at least attaining the bottom end of guidance ranges due to healthy momentum in existing titles and the prospect of some level of contribution from new titles. A key point hence is how much the Company can add to results with the Magatsu title released in 1H and two new titles scheduled for release in 2H, one of which has already been released. In profits, we expect results within the range since bottom-end values use conservative cost assumptions. We advise emphasis on 1) efforts to maximize income (lifetime value) per title, the Company’s biggest strength, and 2) title cultivation as a new growth driver from FY12/20. In particular, Magatsu enhancements and ramp-up of School STARS, a new title based on the popular IP, are opportunities.

FY12/19 results forecasts

	FY12/18		FY12/19				Change	
	Results	% of total	Initial forecast	% of total	Revised forecast	% of total	Revised forecast	Change rate
(¥mn)								
Revenue								
Upper limit	32,673		40,000		37,000		4,327	13.2%
Lower limit	32,000		31,000		-1,673	-5.1%		
Operating income								
Upper limit	4,995	15.3%	4,500	11.3%	4,500	12.2%	-495	-9.9%
Lower limit	1,000	3.1%	1,000	3.2%	-3,995	-80.0%		
Ordinary income								
Upper limit	4,997	15.3%	4,500	11.3%	4,500	12.2%	-497	-10.0%
Lower limit	1,000	3.1%	1,000	3.2%	-3,997	-80.0%		
Net profit								
Upper limit	2,570	7.9%	3,100	7.8%	3,100	8.4%	530	20.6%
Lower limit	700	2.2%	700	2.3%	-1,870	-72.8%		

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

Outlook

2. Development pipeline

In FY12/19 1H, the Company released Magatsu as a new title (in-house with proprietary IP) and rolled out multilingual versions of existing title BLEACH in Southeast Asia and Korea, as explained above. Additionally, it released an official version of Captain Tsubasa for mainland China on June 28. The Company disclosed three pipeline titles (currently developing the main version or prototype) at the end of June 2019. In FY12/19 2H, it intends to release two of these titles – School STARS (in-house with other company IP, which has already been released) and Tales of Crestoria (external with other company IP). We think it is reasonable to expect a certain amount of hit potential for School STARS because it uses the same popular IP as existing hit title School-Fes and is designed to collaborate with School-Fes that has over 45mn users.

Lapis Re:LiGHTs (media mix project with KADOKAWA <9468>), the third title, is a joint development with China-based Shengqu Games (formerly, Shanda Games) and aims to release the product in Japan and mainland China. Promotional activities to raise awareness have already started, including unit promotion video and music video releases and official broadcast program launches. The first independent event took place on August 18. With applications for advanced ticket sales exceeding expectations, the project team added an extra show on the same night. These activities have steadily built a foundation for the title. The Company is also preparing to release a global version of Magatsu, the new title launched in 1H.

While not disclosed in the development pipeline, the Company is moving forward with multiple other projects too, including important IP currently in the final stage of negotiations. There is even a possibility of a detailed announcement during FY12/19. We think it is necessary to closely monitor trends.

Past results trend

Posted all-time high results in FY12/18

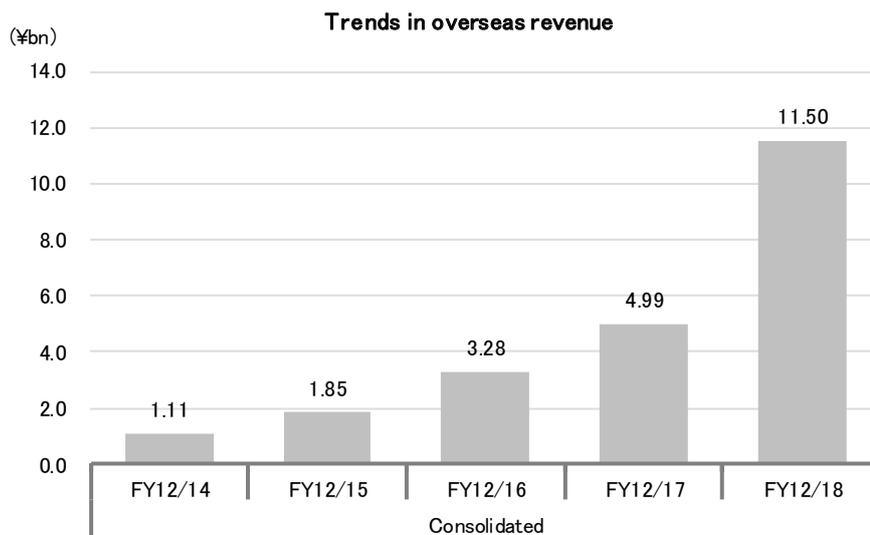
Looking back at results in past years, we note the sales peak in FY12/14 coincided with the release of hit game School-Fes and the sales turned down from there and continued falling through FY12/16. In addition to poor performance of titles released during 2015, delays in the release of new titles stemming 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. The company posted all-time high revenue and operating and ordinary incomes in FY12/18.

Overseas sales had already expanded at a healthy pace led by School-Fes and Brave Souls, but grew significantly in FY12/18 on gains by Captain Tsubasa to more than twice the previous year and an advance of over tenfold in five years. As a result, overseas revenue (annual) is currently about 35% of total revenue and the Company successfully transformed itself into a “firm capable of generating income globally.”

Past results trend

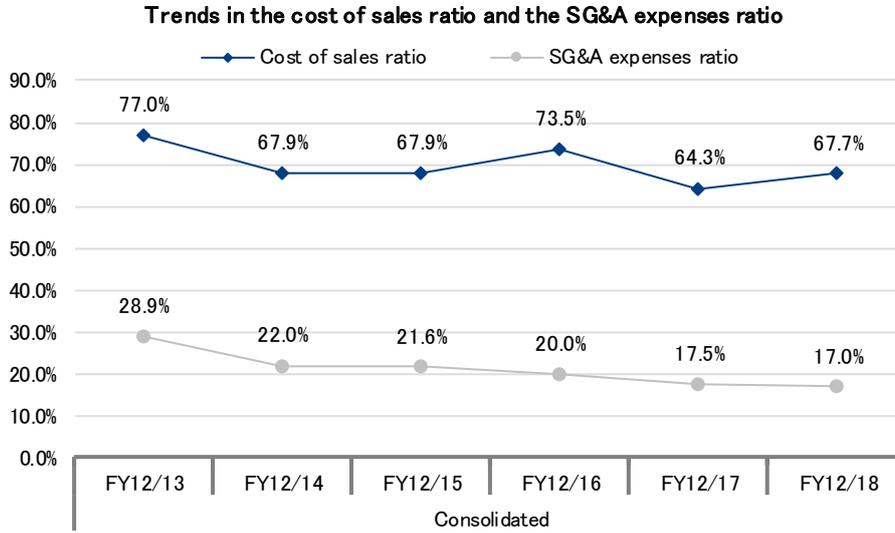
In terms of profits, the Company recorded an operating loss in FY12/13, which was due to the growth in fixed costs following its establishment of a series of overseas centers, and also because the number of releases was less than planned due to development delays, the poor performance of new titles, 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 (however, the personnel plan moved to a phase of adding people from 3Q FY12/17). 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 FY12/18, even though costs climbed because of strategic aims (to achieve business stability and growth potential), such as raising the outsourcing ratio, utilizing other company IPs, and expanding personnel costs, as explained above, the Company has been sustaining profit improvement with revenue growth and cost controls.

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%.

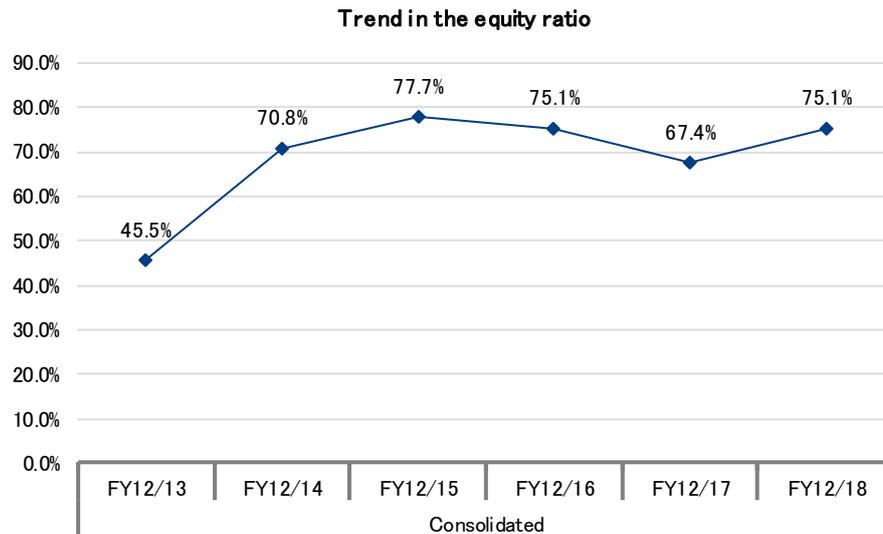


Source: Prepared by FISCO from the Company's results briefing materials

Past results trend



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



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

■ Growth strategy

Moving toward further enhancement of the three pillars to realize further growth in the games business

1. Business policy

The Company is pursuing business policies of “long-term stable game operations” and “profit expansion driven by a higher rate of hit games” with medium-term goals of sustaining a growth trajectory led by games business and establishing the KLab brand through provision of strong value globally. In particular, it intends to make further progress with the “three pillars” presented in FY12/17.

2. Future direction (three pillars)

The three key themes in the Company's growth strategy for its game business are now (1) Japanese IPs (i.e., acquire valuable intellectual property from outside companies), (2) Global growth (strengthening global initiative), and (3) Original creations (create own IPs).

(1) Japanese IPs (i.e, acquire valuable IPs)

- a) Utilize the KLab brand and the proven track record for creating IP hit titles to acquire leading Japanese IPs with long-term growth. KLab will also consider reviving its own titles and as well as past titles from other companies.
- b) Further strengthen its abilities for global releases and make KLab an even more attractive option as a publisher.
- c) Engage in the creation of products through investments in anime, etc.

(2) Global Growth (strengthening global initiatives)

- a) Strengthen global initiatives and maximize income per game title.
- b) Bolster marketing activities globally.
- c) Continue to enhance operational capabilities and speed up growth in the world's largest market of China.

(3) Original creations (create own IPs)

- a) Acquire top talent, strengthen KLab's ability to work alongside alliance partners and talented creators from outside the company.
- b) Develop anime and other media mix projects to grow the core fan base.
- c) Globalize own original creations.
- d) Research entertainment that utilizes the latest technology to innovate the business.

We think overseas initiatives and acquisition of survivor benefits (including utilization of external resources) offer excellent growth opportunities to the Company amid uncertainty about prospects in the smartphone game market. Furthermore, in light of risk from the tough industry environment (difficulty delivering new hits, related increase in development costs, etc.), we believe measures to enhance content value and utilize media mix (create income opportunities from areas other than games, such as goods and licensing) and the direction of maximizing income per title by delivering games to platforms and devices currently not covered by distributions are rational strategies likely to provide success in leveraging existing business resources and strengths. In any case, we think the key to success lies in the extent to which the Company is capable of creating new value in its own way by harnessing its knowhow in conversion of Japanese IPs into games and rolling them out globally and unique marketing capabilities.

Returns to shareholders

Shareholder return policy focused mainly on share buybacks Provides QUO cards with original designs from popular titles

With regard to management's thinking on returns to shareholders, it has presented a policy of that gives priority to share buybacks, over dividends. 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.

In FY12/18, while the Company did not pay dividends, in line with initial guidance, it purchased 261,100 of its own shares (¥499mn). It does not have any plan to pay dividends in FY12/19 at this point.

We also think it is strategically important to secure dynamic investment leeway as much as possible in light of the Company's many opportunities to invest in growth, including overseas initiatives, and current stage of needing to reinforce the income foundation with new business investments, such as creating proprietary IPs and multimedia projects, and hence agree with the Company's approach. In financial standing, while capital has risen to ¥15,579mn (69.4% capital ratio), value available for allocation* under the Companies Act is limited. Looking at the financial balance, meanwhile, since assets contain the software provisional account (¥3,406mn) and goodwill (¥713mn) that involve some uncertainty, we cannot say that the Company has built a sufficient financial base to guarantee continuation of healthy dividends and believe that shareholders are likely to benefit more in the future from funds going toward financial base stability and growth investments, rather than modest and intermittent dividends.

* Value available for allocation = Other capital surplus + other profit surplus – treasury stock book value
Calculated using other adjustment items (securities valuation difference, etc.)

The Company has also implemented a special shareholder rewards program with the aim of encouraging more investors to be medium-to long-term shareholders. Since 2018, under the rewards program, shareholders at the end of December each year, receive QUO cards featuring original designs from its popular titles. The number of cards awarded per shareholder varies between two and five, depending on the number of shares held and the length of the holding period.



Disclaimer

FISCO Ltd. ("FISCO") offer stock price and index information for use under the approval of the Tokyo Stock Exchange, the Osaka Stock Exchange and Nikkei Inc.

This report is provided solely for the purpose of offering information, and is not a solicitation of investment nor any other act or action.

FISCO prepared and published this report based on information which it considered reliable; however, FISCO does not warrant the accuracy, completeness, fitness nor reliability of the contents of this report or the said information.

The issuers' securities, currencies, commodities, securities and other financial instruments mentioned in this report may increase or decrease in value or lose their value due to influence from corporate activities, economic policies, world affairs and other factors. This report does not make any promises regarding any future outcomes. If you use this report or any information mentioned herein, regardless of the purpose therefor, such use shall be made based on your judgment and responsibility, and FISCO shall not be liable for any damage incurred by you as a result of such use, irrespective of the reason.

This report has been prepared at the request of the company subject hereto based on the provision of information by such company through telephone interviews and the like. However, the hypotheses, conclusions and all other contents contained herein are based on analysis by FISCO. The contents of this report are as of the time of the preparation hereof, and are subject to change without notice. FISCO is not obligated to update this report.

The intellectual property rights, including the copyrights to the main text hereof, the data and the like, belong to FISCO, and any revision, reprocessing, reproduction, transmission, distribution or the like of this report and any duplicate hereof without the permission of FISCO is strictly prohibited.

FISCO and its affiliated companies, as well as the directors, officers and employees thereof, may currently or in the future trade or hold the financial instruments or the securities of issuers that are mentioned in this report.

Please use the information in this report upon accepting the above points.

■ For inquiry, please contact: ■

FISCO Ltd.

5-11-9 Minami Aoyama, Minato-ku, Tokyo, Japan 107-0062

Phone: 03-5774-2443 (Financial information Dept.)

Email: support@fisco.co.jp