COMPANY RESEARCH AND ANALYSIS REPORT

KLab Inc.

3656

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Index

Summary

Results for FY12/19 show lower profit on lower revenue. Higher revenue projected in FY12/20 from the strong-performing title, Love Live! School Idol Festival ALL STARS ("School STARS") and 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 the four main titles: 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"). 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 is 35%.

Notably, in the past few years, KLab has been able to adapt its operations and marketing, including overseas initiatives, 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 advanced KLab into a new phase. Moreover, the Company will work to diversify its income model from FY12/20 by taking steps such as entering the casual game market and pushing further ahead with the support model for co-developing Japanese IPs* into games for overseas markets.

* IP stands for intellectual property. In this report, IP shall refer more broadly to content that contains intellectual property.

2. FY12/19 results

Looking at FY12/19 results, the Company reported lower profit on lower revenue, with ¥31,109mn in revenue (-4.8% YoY) and ¥1,673mn in operating income (-66.5%). Compared with the initial guidance (the Company uses a range format), revenue was slightly below the lower limit of the forecast range, while operating (and ordinary) incomes both finished within the forecast range. Revenue dropped primarily owing to shrinkage over time (natural decline) in existing titles such as Captain Tsubasa, as the boost in demand from the 2018 World Cup ran its course. However, this decrease in revenue was largely in line with expectations. Therefore, the main reasons for revenue falling slightly below the lower range of the initial guidance were sluggish growth in YU☆YU☆HAKUSHO 100% Maji Battle ("Maji Battle"), which was released in the previous fiscal year, and in the new title, Magatsu Wahrheit ("Magatsu"), which was released on April 23. Meanwhile, Love Live! School Idol Festival ALL STARS ("School STARS"), which was released on September 26, appears to be making a positive start. (The title contributed positively to 4Q business results.) On the profit front, the cost of sales ratio deteriorated sharply, due mainly to an increase in depreciation costs associated with the release of a new title, in addition to the impact of a drop in revenue from existing titles, which make large contributions to profit. As a result, the operating margin decreased to 5.4% (compared with 15.3% in FY12/18).

3. FY12/20 forecasts

With regard to full-year guidance for FY12/20 (the Company uses a range format), the Company is forecasting revenue in the range of ¥35,000mn (+12.5% YoY) to ¥40,000mn (+28.6%), and operating income in the range of ¥1,000 million (-40.3%) to ¥3,000 million (+79.3%). The Company is forecasting higher revenue, based on plans to release two new game titles and provide additional language support for current game titles, in addition to the full-year contribution of School STARS to revenue. The range for the coming fiscal year's guidance reflects the revenue life cycle for current titles (natural decline), as well as hit conditions for new titles and current titles released in other languages. Turning to expenses, the Company expects operational costs to increase due to new game releases, and labor and recruitment-related costs to rise due to plans for an increase in personnel, but the upper limit of the forecast range indicates positive growth in profit. In addition, revenue from the entry into casual games is not being factored into the guidance, but the related development and other costs are being factored into the guidance. The Company also plans to review the cost structure going forward.

4. Growth strategy

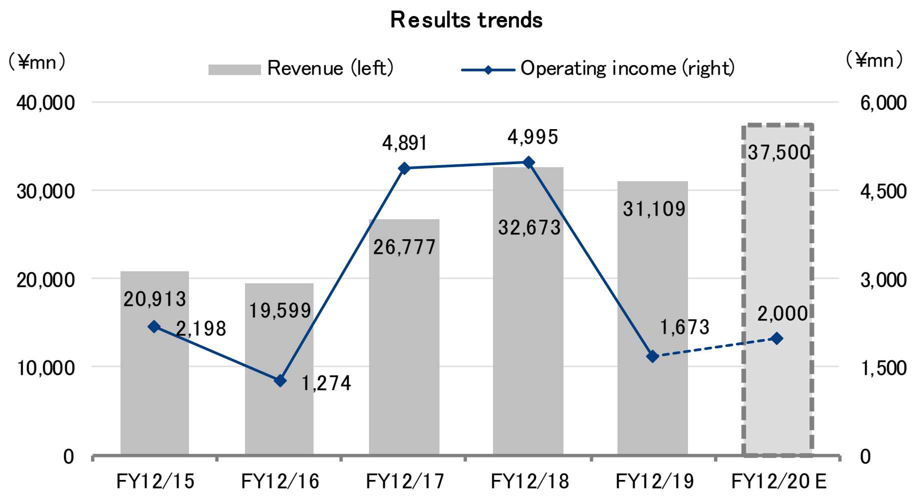
The Company is pursuing business policies of "long-term stable game operations" and "profit expansion driven by a higher rate of hit games" with medium-term goals of sustaining a growth trajectory led by Game business and establishing the KLab brand through provision of strong value globally. In particular, KLab intends to make further progress with the "3 PILLARS" (*partially revised) it has advanced to date —1) Universal IPs (acquiring popular IPs, including those overseas), 2) Global Growth (strengthening global initiatives), and 3) Original Creations (creating its own IPs).

* The Company has revised "Japanese IPs," one of the 3 PILLARS, to "Universal IPs" (Details are provided later in this report.)

We at FISCO recognize that KLab holds significant advantages as an enterprise that can be expected to achieve sustainable growth based on factors such as its overseas initiatives and profit taking among the remaining players (including utilization of external resources) amid uncertain prospects for the smartphone game market in Japan. We are also taking note of the Company's direction of maximizing income per title through measures to enhance IP (content) value and develop media mix initiatives, as well as measures to diversify the income model by entering the casual game market and further promoting the game co-development support model. We believe that these measures will serve as rational strategies that are likely to curtail development risk and deliver resounding success. For a company such as KLab, we believe the key to success lies in whether the Company will be able to continue creating new value in its own way by harnessing its know-how in converting popular IPs into games and rolling them out globally and by leveraging its unique marketing capabilities.

Key Points

- Results for FY12/19 showed lower profit on lower revenue, but operating and ordinary income finished within the initially forecast range
- While the new title, "Magatsu" posted sluggish growth, "School STARS" made a positive start (contributing positively to 4Q business results)
- Guidance for FY12/20 calls for dramatically higher profits on higher revenue at the upper limit of the forecast range, mainly based on a full-year contribution from "School STARS," while a decrease in profits based on higher costs is envisioned at the lower limit of the forecast range.
- Going forward, the Company intends to continue working to acquire popular IPs, including those overseas; strengthen global initiatives; and create in-house IPs. Trends in the casual game market will also be a key focus as the Company enters the market in FY12/20.



Note: Forecast figures represent mid-point of Company's range forecast value in FY12/20
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 IPs

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") which were released in 2017. These four titles give it a well-balanced earnings structure in an industry where most companies depend heavily on specific hit titles and can be said as a highly stable income structure. Recently, the new title Love Live! School Idol Festival ALL STARS ("School STARS") has made a positive start.

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 Game 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 casts and promotes 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, and trading card games. School-Fes, 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 exceeded 25 million people, and the number of players worldwide surpassed 45 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 it has been downloaded worldwide more than 44 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.

(3) Captain Tsubasa: Dream Team

Captain Tsubasa is a soccer match simulation game that KLab began distributing online on June 13, 2017. 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 release, beating even the Company's expectations. In addition to being based on a well-known IP 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) Utano☆Princesama Shining Live

Utano☆Princesama Shining Live began streaming on August 28, 2017. Since the release of the first version of this game series in 2010, it has proven to be a popular IP with characters that have grown with the help of a media mix strategy. Looking at its track record so far, this game series has recorded substantial sales of 100 game titles in 12 different genres, and has been the basis for four seasons of an animated TV series. It is also popular among buyers of animated series on hard disks (DVD/BD). In the music media, 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. 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. It appears that the series is seeking to make a steady contribution to business results through a strategy focused on lifetime value with an emphasis on the core fan base.

(5) Love Live! School Idol Festival ALL STARS

In September 2019, Love Live! School Idol Festival ALL STARS was released as a rhythm action role playing game (RPG) to add even more energy and excitement to the Love Live! series. Based on its popularity, the new title recorded 1mn downloads in the first four days after its release. With the number of users topping 3mn in less than one month, the title has posted brisk sales since its release. Solid sales of goods to mark the release of the new title contributed positively to business results for 4Q FY12/19. This title has elements of an RPG. Players strategically progress through live performances, and are heavily involved in nurturing and forming teams of school idols in the run-up to these events. Various features have been added to the game, such as team formation across different groups and original costumes unique to the game. School STARS won the award for excellence in the Google Play Best of 2019 Users' Choice for the Game Category. If a player ID is linked to School-Fes, special gifts are awarded mutually to both game accounts. The global version was jointly developed by Bushiroad Inc. <7803> and SUNRISE INC. and was released in February 2020. The global version supports English, traditional Chinese, Thai, and Korean.

Main titles

Source: The Company's website

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, its growth model is driven by acquiring players by creating hit titles and improving 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 sales decrease (natural decline) occurs year by year. Therefore, the most important issue for the Company is how to cover this natural decline 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 based on popular 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 IPs, 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 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, which had served the market since November 2015. KLab Games Station +Plus had 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. Additionally, the Thai language version started broadcasting in October 2019 and the Cantonese language version started broadcasting in December 2019. The number of channel registrants exceeded 26,000. Furthermore, it is scheduled to add distribution for traditional Chinese speaking regions in the future.

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.

d) Overseas business development capabilities

Overseas business development capabilities are an advantage too. In FY12/19, the Company generated overseas revenue of more than ¥10bn for the second straight year, following a rapid expansion in revenue to over tenfold in the five years through to FY12/18. As the domestic smartphone game market matures, we at FISCO believe that the ability to deploy games in overseas markets with substantial room for growth could be KLab's biggest strength. For Brave Souls, the global version continues to post higher revenue than the Japanese version, due in part to the success of efforts to provide multilingual support. Additionally, Captain Tsubasa, which saw the release of a global version in December 2017, grew much faster than expected and has driven earnings growth in the past few years, despite showing some signs of settling down recently. We believe that the sources of the Company's overseas business development capabilities include an ability to deliver Japanese IPs that are also highly popular in overseas markets, multilingual support and advertising operation skills (ad creation tailored to specific regions and languages and suitable distribution by specific targets), the ability to foster a community of fans (online video streaming 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.

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.

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. In these and other ways, the Company has also taken steps to develop Non-Game Businesses. That said, the Company has recently shifted to a course of specializing in the strong-performing Game Business, and has restructured its Non-Game Businesses*.

* 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. The decision was made to dissolve KLab Global Pet in December 2019.

To bring in younger executives, the Company appointed Hidekatsu Morita as Representative Director & CEO at the Board of Directors meeting after the Annual Shareholders Meeting 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

Results for FY12/19 show lower profit on lower revenue. Positive start by the new title, Love Live! School Idol Festival ALL STARS "School STARS"

1. FY12/19 results

The Company reported FY12/19 results with lower profit on lower revenue at ¥31,109mn in revenue (-4.8% YoY), ¥1,673mn in operating income (-66.5%), ¥1,625mn in ordinary income (-67.5%), and ¥383mn in net income attributable to parent shareholders (-85.1%). Compared with the initial guidance (the Company uses a range format), revenue was slightly below the lower limit of the forecast range, while operating (and ordinary) incomes both finished within the forecast range.

Revenue dropped primarily owing to shrinkage over time (natural decline) in existing titles such as School-Fes as well as Captain Tsubasa, as the boost in demand from the 2018 World Cup ran its course. However, this decrease in revenue was largely in line with expectations. Therefore, the main reasons for revenue falling slightly below the lower range of the initial guidance were sluggish growth in "Maji Battle*," which was released in the previous fiscal year, and the new title Magatsu Wahrheit ("Magatsu"), which was released on April 23. Meanwhile, School STARS, which was released on September 26, appears to be making a positive start. (The title contributed positively to 4Q business results.)

* YU☆YU☆HAKUSHO 100% Maji Battle was released in August 2018.

In addition, overseas revenue decreased year on year owing to the natural decline of revenue from Captain Tsubasa. Nonetheless, overseas revenue remained at a high level (at more than ¥10.0bn) primarily due to the strong-performing title, Brave Souls and multilingual support for BLEACH (simplified Chinese language version, traditional Chinese language version, Southeast Asian version, Korean version).

On the profit front, the cost of sales ratio deteriorated sharply, increasing to 77.4% (from 67.7% in FY12/18). This deterioration was due mainly to increases in labor costs, and outsourcing and subcontracting costs, and depreciation costs associated with the release of new titles, in addition to the impact of a drop in revenue from existing titles, which make large contributions to profit. Meanwhile, selling, general and administrative expenses decreased mainly due to a reduction in PR & promotions costs. Even so, operating income decreased drastically as lower revenue pushed down profit and cost of sales increased. The operating margin also decreased to 5.4% (compared with 15.3% in FY12/18). Profit attributable to owners of parent decreased significantly because of the recording of an impairment loss on software assets (¥1,300mn) related to Magatsu in connection with sluggish growth for this title.

With regard to financial position, equity capital rose 7.0% from end-FY12/18 to ¥15,463mn, owing to the accumulation of internal reserves. Meanwhile, total assets amounted to ¥23,669mn, an increase of 23.0% from end-FY12/18. This increase mainly reflected increases in cash and deposits and accounts receivable because of the sale of certain cross-shareholdings and borrowing of long-term debt, along with an increase in revenue. As a result, the equity ratio decreased to 65.3% (vs. 75.1% at end-FY12/18).

FY12/19 results

(¥mn)

	FY12/18		FY12/19		Change		FY12/19		
	Results	% of total	Results	% of total		Change rate	'Guidance (11/7)	% of total	Achievement rate
Revenue	32,673		31,109		-1,563	-4.8%	31,500		98.8%
Game Business	32,371	99.1%	30,744	98.8%	-1,626	-5.0%	-	-	-
Other	302	0.9%	365	1.2%	62	20.8%	-	-	-
Cost of sales	22,124	67.7%	24,079	77.4%	1,954	8.8%	-	-	-
Gross profit	10,549	32.3%	7,030	22.6%	3,518	-33.4%	-	-	-
Game Business	10,441	32.3%	6,972	22.7%	-3,469	-33.2%	-	-	-
Other	107	35.4%	58	16.0%	-48	-45.5%	-	-	-
SG&A expenses	5,553	17.0%	5,356	17.2%	-196	-3.5%	-	-	-
Operating income	4,995	15.3%	1,673	5.4%	3,321	-66.5%	1,750	5.6%	95.6%
Ordinary income	4,997	15.3%	1,625	5.2%	-3,372	-67.5%	1,600	5.1%	101.6%
Profit attributable to owners of parent	2,570	7.9%	383	1.2%	-2,186	-85.1%	1,200	3.8%	32.0%
Breakdown of cost of sales									
Labor costs	3,337		3,899		562	16.8%			
Subcontracting /outsourcing expense	4,598		4,730		132	2.9%			
Royalties / commissions	15,724		14,964		-760	-4.8%			
Breakdown of SG&A expenses									
Salary allowance, etc.	1,013		1,146		133	13.1%			
PR & promotions costs	2,593		2,354		-239	-9.2%			
Other	1,942		1,851		-91	-4.7%			

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

Financial standing at the end of December 2019 (summary)

(¥mn)

	As of the end of December 2018 Results	As of the end of December 2019 Results	Change	Change rate
Total assets	19,245	23,669	4,424	23.0%
Shareholders' equity	14,450	15,463	1,013	7.0%
Equity ratio	75.1%	65.3%	-9.8pt	-

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

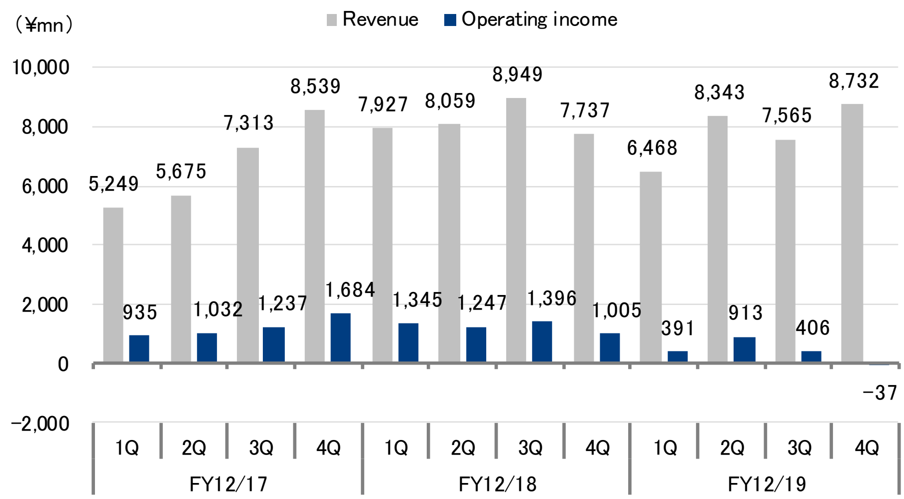
2. Quarterly results trends

Looking at quarterly revenue trends, the Company delivered large increases in 3-4Q FY12/17 and sustained strong levels in FY12/18 due to the domestic and global releases of Captain Tsubasa. It even set an all-time high revenue (quarterly basis) in 3Q FY12/18. In FY12/19, 1Q saw a temporary decline in revenue mainly because of seasonal factors, but the Company generated revenue of more than ¥8.0bn in 2Q and 4Q due primarily to a comeback by existing titles and contributions from new titles. We can say that the Company has delivered consistently high levels of revenue performance. Notably, growth in 4Q (when the Company recorded its second highest-ever revenue) was attributable to a positive start by the new title, School STARS, which is expected to continue contributing positively to revenue performance in FY12/20.

In overseas revenue quarterly trends, 3Q FY12/18 moved above ¥3bn led by faster growth in Captain Tsubasa global revenue than expected. In FY12/19, although Captain Tsubasa revenue settled down, revenue was firm as a whole, mainly because of healthy growth in Brave Souls and multilingual support for BLEACH (simplified Chinese language version, traditional Chinese language version, Southeast Asian version, Korean version).

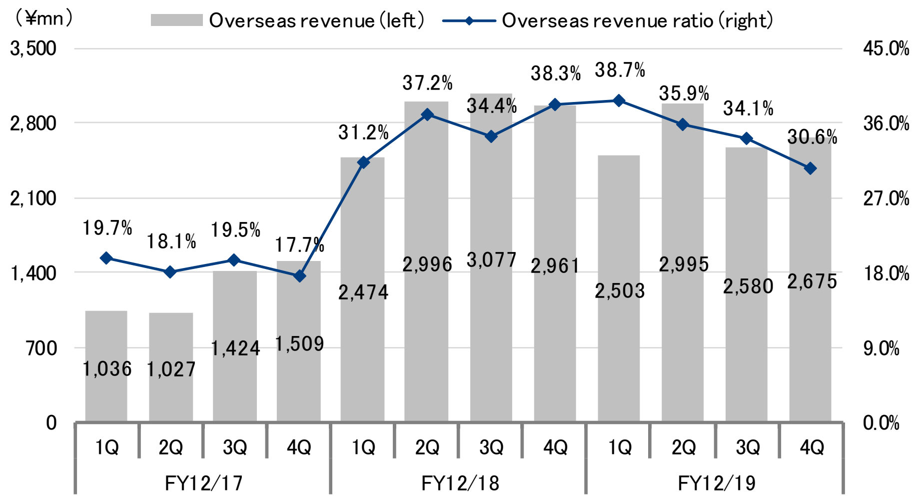
In earnings, operating income stayed at a high level in FY12/18 with support from revenue expansion. In FY12/19, however, operating income remained at a lower level than in the previous year due to increases in labor costs and personnel expenses and the start of depreciation costs for software assets related to a new title (development costs). Moreover, an operating loss was posted in 4Q, due to factors such as increased costs for the initial promotion of School STARS.

Quarterly trends in revenue and operating income



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

Quarterly trends in overseas revenue and overseas revenue ratio



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

3. Main activities

(1) Release of new titles

In FY12/19, the Company released two new titles, specifically Magatsu (proprietary IP) on April 23 and School STARS (third party IP) on September 26. Magatsu, the former title based on a proprietary IP, made a positive start, but experienced sluggish growth thereafter. In contrast, School STARS, the latter title based on a popular IP, surpassed 3 million users in less than three weeks after the start of streaming. School STARS also won the award for excellence in the Google Play Best of 2019 Users' Choice for the Game Category. The Company had planned to release another title, Tales of Crestoria (third party IP), but it decided to postpone the release to FY12/20 because of a change in development plans. The Company has successively rolled out multilingual versions of the existing title BLEACH in Southeast Asia and Korea. Additionally, it released an official version of Captain Tsubasa for mainland China. These titles have helped to maintain the level of overseas revenue and maximize income per title.

(2) Media mix projects for proprietary IPs

Lapis Re:LiGHTs (media mix project with KADOKAWA <9468>) is a joint development with China-based Shengqu Games (formerly, Shanda Games), scheduled for release in Japan and mainland China. Following a CD debut project (first independent live event) that began in August 2019, the 1st album went on sale on February 5, 2020. The release event for Odaiba was held on February 9, 2019. Further release events are scheduled to be held in Yokohama and Akihabara. There is also a TV anime planned for Lapis Re: LiGHTs that is scheduled to broadcast within 2020. The Company seems to have received a favorable response to Lapis Re: LiGHTs ahead of the release of the game title. One major pillar of the Company's strategy is to build a core fan community and diversify income sources through media mix projects for proprietary IPs. The Lapis Re: LiGHTs project will also draw attention because it will serve as a test of the Company's strategy going forward.

(3) Executed a global licensing agreement for Kumamon (deploy the game co-development support model)

The game co-development support model refers to the process of obtaining licenses for games from Japanese IP holders seeking to expand overseas revenue, and then developing games jointly with overseas developers and deploying those games in overseas markets. The Company already has a track record with this model in the BLEACH series in partnership with the Chinese company Kunlun. It plans to push ahead with this model even further. As part of these efforts, the Company executed a global licensing agreement with Kumamoto prefecture and ADK Emotions Inc. for game development based on Kumamon in February 2020. Kumamon is highly recognized worldwide, especially in China, Thailand and other parts of Asia. A new game is scheduled to be developed based on Kumamon.

Outlook

The outlook calls for substantial revenue growth in FY12/20 at both the upper/lower limits of the forecast range. Meanwhile, costs are estimated conservatively in the profit guidance (lower limit)

1. FY12/20 results forecasts

The Company is forecasting FY12/20 targets (range format) of ¥35,000mn (+12.5% YoY) to ¥40,000mn (+28.6%) in revenue, ¥1,000mn (-40.3%) to ¥3,000mn (+79.3%) in operating income, ¥1,000mn (-38.5%) to ¥3,000mn (+84.6%) in ordinary income, and ¥750mn (+95.4%) to ¥2,100mn (+447.1%) in net income attributable to parent shareholders.

The Company is forecasting higher revenue, based on plans to release two new game titles and provide additional language support for current game titles, in addition to the full-year contribution of School STARS to revenue. The range for the coming fiscal year's forecasts reflects the revenue life cycle for current titles (natural decline), as well as hit conditions for new titles and current titles released in other languages. In other words, the upper limit of the range is for the case where new titles perform strongly and there is only small attrition in existing titles, while the lower limit of the range is for the case where new titles are sluggish and there is a large attrition in existing titles. The Company plans to enter the casual game market in FY12/20 (details are provided later in this report). The revenue contribution from casual games is not included in the guidance, while the related costs are factored into the guidance.

Turning to expenses, the Company expects operational costs (labor costs, outsourcing and subcontracting costs, depreciation costs) to increase due to new game releases, and labor and recruitment-related costs to rise due to plans for an increase in personnel. Meanwhile PR and promotion costs will remain mostly the same as in FY12/19. Fixed costs are also estimated at constant levels. Therefore, we believe that the forecast range for operating and ordinary incomes have been set so as to largely correspond to the forecast range for revenue. In addition, the Company has plans to review the cost structure, but this has not been factored into the guidance. (Details are provided later in this report.)

We believe that revenue can finish at the very least within the forecast range given that a full-year revenue contribution (nine months' additional revenue) is expected from School STARS, which has made a positive start. That said, a certain amount of natural decline in existing titles is unavoidable. Therefore, the main point to watch will be how closely revenue will approach the upper limit of the forecast range through new titles and multilingual support for current game titles. Additionally, the lower limit of the range for profit guidance has been set assuming a conservative estimate of cost factors. For this reason, we have concluded that profits are highly likely to end up within the forecast range. As explained earlier, we are also focusing on the possibility that two factors (entry into the casual game market and review of the cost structure), which have not been factored into the guidance, may provide upside support and help the Company to outperform the guidance.

FY12/20 results forecasts

(¥mn)

	FY12/19		FY12/20		Change	
	Results	% of total	Initial forecast	% of total		Change rate
Revenue						
Upper limit	31,109		40,000		8,890	28.6%
Lower limit	35,000		3,890	12.5%		
Operating income						
Upper limit	1,673	5.4%	3,000	7.5%	1,326	79.3%
Lower limit	1,000	2.9%	-673	-40.3%		
Ordinary income						
Upper limit	1,625	5.2%	3,000	7.5%	1,374	84.6%
Lower limit	1,000	2.9%	-625	-38.5%		
Profit attributable to owners of parent						
Upper limit	383	1.2%	2,100	5.3%	1,716	447.1%
Lower limit	750	2.1%	366	95.4%		

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

2.Main initiatives in FY12/20

(1) Entry into the casual game market

The Company has announced plans to enter the casual game market in FY12/20. The background for entering the casual game market is as follows: (1) The scale of video advertising is expanding globally. As a result, the media value of casual games has risen and the market has grown rapidly; (2) Casual games are simple and intuitive to play, targeting users around the world. These are fields where the Company can leverage its strengths in global marketing; and (3) Since these games can be developed in a short period of time and at a low budget, it can be expected to supplement earnings during the period of development for major titles. It looks like the Company's strategy is to put many projects into play at the same time, and to explore and identify which one of those projects will become a hit title. There are two different models* for casual games: hyper casual and operation-based casual. The Company seems likely to pursue the well-balanced development of both models.

* The hyper casual model is notable for enabling players to progress through a game effectively by viewing video ads shown during pauses in the game. It has a revenue model based only on advertising revenue. On the other hand, the operation-based casual model has a revenue model that includes the generation of revenue from billings through some operation aspects, such as gacha rewards (in-game purchases of items).

(2) Advancing the "Game co-development support model" for co-developing Japanese IPs into games for overseas markets

The Company will further advance the "game co-development support model," including the BLEACH series, which was co-developed with the Chinese company Kunlun (the game business brand is GameArk). This model provides several major advantages. In this area, the Company can leverage its key strengths, such as relationships with domestic IP holders it has built over time, and insights into overseas expansion. In addition, the Company can develop projects without being constrained by the capacity of its internal resources, which has the merit of controlling the development risk. In FY12/20, the Company seems to have plans to develop two to four projects based on this model.

(3) Review the cost structure

As stated earlier, the Company plans to review the cost structure in earnest and convert to a leaner business structure. Specifically, the Company has identified the following items as its main priorities: (1) Review common costs such as outsourcing, production, and customer support in order to revise order volume and unit price; (2) Focus on establishing a common infrastructure that can be used across projects and reduce the number of processes per project; (3) Advertising expenses (PR and promotion costs) are estimated to decrease as a percentage of sales due to more emphasis on return on investment; (4) Projects whose profitability has declined will be switched over to labor-minimized operation and where necessary also consider transferring, selling, or withdrawing; (5) Aim to increase productivity by optimizing the number of employees; (6) Restructuring of groups and organizations for optimized strategic execution; and (7) Optimize all other cost items.

3. Development pipeline

As of the end of December 2019, the Company had five titles in the development pipeline (titles in development), comprising two new titles, multilingual versions of two existing titles and one title based on the game co-development support model. The two new titles in the pipeline are Tales of Crestoria, whose release was postponed from the previous fiscal year, and Lapis Re:LiGHTs. Multilingual versions are planned for two existing titles: School STARS and Magatsu. With regard to the game co-development support model, the Company will develop a casual game based on the aforementioned Kumamon character.

Although they are not indicated in the development pipeline, the Company is advancing four other projects (not including global versions, titles based on the game co-development support model, and minors casual games). It appears that these projects include popular IPs that are now in the final stage of negotiations.

Past results trend

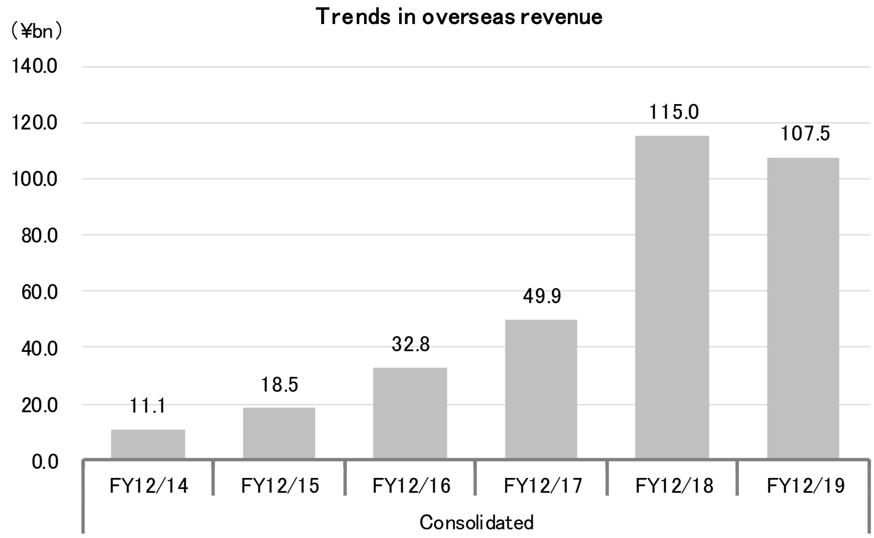
Results have steadily increased since FY12/17

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. In FY12/19, while the Company posted lower profit on lower revenue, we can say that the Company has maintained a high level of business performance, including overseas revenue.

Overseas revenue had already expanded at a steady 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 in the Game business and the Company successfully transformed itself into a "firm capable of generating income globally."

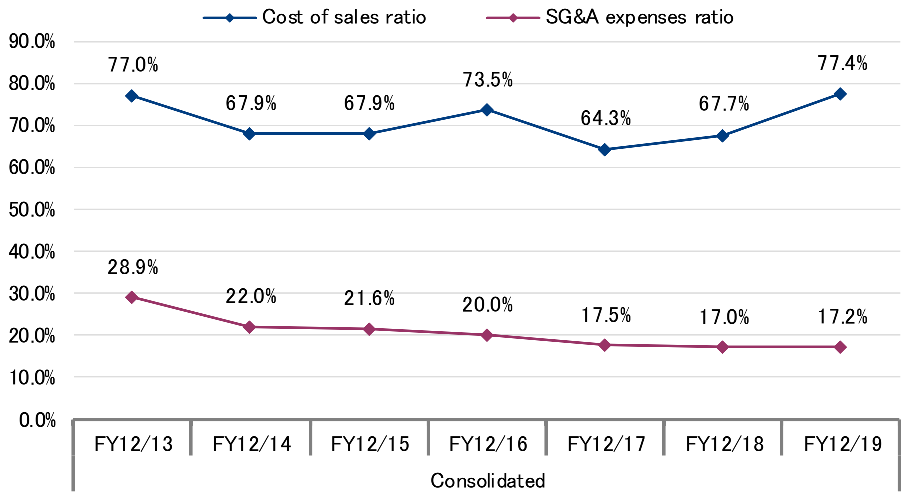
In terms of profits, the Company recorded an operating loss in FY12/13, which was due to the growth in fixed costs following its establishment of a series of overseas centers, and also because the number of releases was less than planned due to development delays, the poor performance of new titles, 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 third party IPs, and expanding personnel costs, as explained above, the Company has been sustaining profit improvement with revenue growth and cost controls. That said, the deterioration in the cost of sales ratio in FY12/19 reflected factors such as the rise in development costs related to new titles (the increase in depreciation costs), as explained earlier.

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



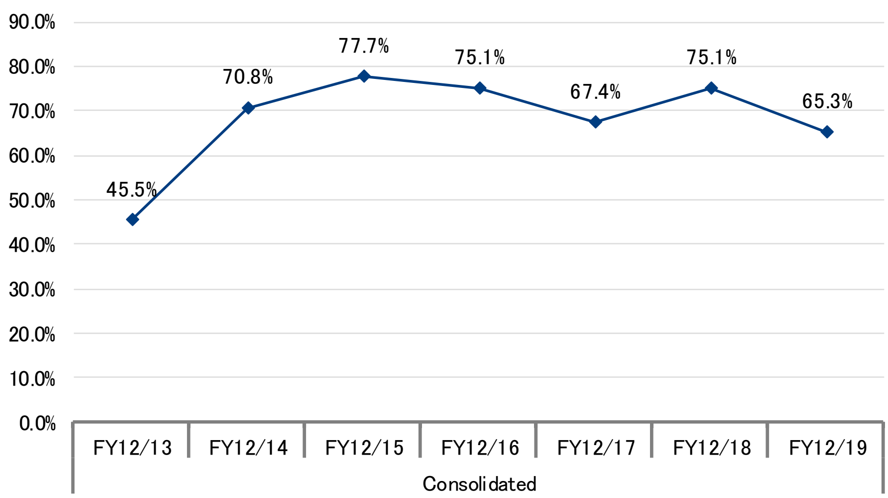
Source: Prepared by FISCO from the Company's results briefing materials

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

Growth strategy

1. Business policy

The Company is pursuing two 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 the Game business and establishing the KLab brand through provision of strong value globally. In particular, it intends to make further progress with the 3 PILLARS (partially changed) presented in FY12/17.

2. Future direction (3 PILLARS)

The Company is advancing the 3 PILLARS in order to drive further growth in the Game business. It has revised "Japanese IPs," one of the 3 PILLARS, to "Universal IPs." In other words, the Company intends to actively acquire IPs that it can produce (i.e., IPs within its scope of expertise)—IPs that are popular not only in Japan but worldwide. The background to this seems to be that the Company has strong confidence in and has received favorable responses to its operational expertise and marketing capabilities in overseas business expansion. The 3 PILLARS and the basic policies are listed below.

(1) Universal IPs (acquiring popular IPs, including those from overseas)

- Build a stable earnings platform and drive growth based on IPs with a global fan base
- Strengthen relationships with IP holders and encourage the conversion of IPs into games
- Invest in anime and other ventures to develop more works

(2) Global Growth (strengthening global initiatives)

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

(3) Original creations (create own IPs)

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

We at FISCO recognize that KLab holds significant advantages as an enterprise that can be expected to achieve sustainable growth based on factors such as its overseas initiatives and acquisition of survivor benefits (including utilization of external resources) amid uncertain prospects for the smartphone game market. We are also taking note of the Company's direction of maximizing income per title through measures to enhance IP (content) value and develop media mix initiatives (create income opportunities from areas other than games, such as goods and licensing), and to deliver games to platforms and devices currently not covered by distribution, as well as measures to diversify the income model by entering the casual game market and further promoting the game co-development support model. We believe that these measures will serve as rational strategies that are likely to curtail development risk and deliver resounding success. For a company such as KLab, we believe the key to success lies in whether the Company will be able to continue creating new value in its own way by harnessing its knowhow in converting popular IPs into games and rolling them out globally and by leveraging its 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 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.

That said, the Company once again did not pay dividends in FY12/19, nor did it conduct any share buybacks during the fiscal year. It does not have any plans to pay dividends in FY12/20 at this point.

We at FISCO also think it is strategically important to secure dynamic investment leeway as much as possible in light of the KLab'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 recognize the Company's approach as rational.

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.

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