

Conversation: An Analyst's Perspective on Capcom's Strategy for Growth



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Topic **How to Recover from Disadvantages in the Mobile Business?**

Capcom promotes a growth strategy based on Single Content Multiple Usage, but presently the Mobile business is being harshly evaluated by the stock market. How should the Mobile business be positioned within this strategy? How will Capcom attempt to recover from this situation?

President and Chief Operating Officer Haruhiro Tsujimoto responds to the incisive queries of securities analyst Haruka Mori.

Mobile Strategy Summary

Tsujimoto The purpose of this year's dialogue is to deepen readers' understanding of Capcom from a variety of perspectives through the opinions of a third party. At the same time, some are of the opinion that the materials we publish lack transparency, but as with the objective evaluations we receive in typical analysts reports, I hope you will provide us with your frank opinions.

Mori Yes, of course. As with analysts you have had discussions with in the past years, our mission as analysts is to offer fair and balanced evaluations that provide management with actionable feedback. Sugar-coating evaluations does not benefit either side, so I will speak frankly. To begin with, your mobile strategy has been harshly evaluated by the stock market. How do you perceive this situation at present?

Tsujimoto In the Mobile business, we established the Beeline brand in the United States. Although it had a strong start, we spread our strengths too thin in an attempt to expand user segment, resulting in sluggish

growth. Going forward, we will attempt to rectify this by returning to the source of the Beeline brand's strength, the women's casual user segment.

At the same time, app development for the domestic Mobile business did not go well from the start. We restructured this business, which resulted in the recognition of special losses. Identifying the development structure as the cause, we realized that, rather than relying on consumer development methods, we needed a management approach integrating development and marketing similar to the PC Online business.



Mori Yes, but shouldn't you put more emphasis on speed in rapidly growing markets?

Tsujimoto Of course you are right, however, without expertise, the probability of hit titles will be low no matter how many we create. Last year, we created a number of new titles, but because we lacked expertise none of them performed well. We also failed to gain user trust. The mobile business is positioned as the centerpiece of our growth strategy, so rather than giving up, we will analyze these issues and once again take on new challenges.

Mobile and PC Online Businesses —The Keys to Growth

Mori In terms of growth, while there is no problem regarding Capcom's amassing of expertise, the reality is that your response was delayed compared to competitor firms. Rather than relying purely on in-house development, shouldn't you seek short-term results through aggressive business alliances and personnel exchanges with Internet companies possessing management expertise?

Tsujimoto While alliances and collaborations with external entities offer possibilities, such wholesale delegation does not augment Capcom's expertise. Even in consumer games, we are fast approaching the age of free-to-play (F2P) games. When this occurs, we can make use of online management expertise accumulated in the Mobile business in the Consumer business as a long-term strength. Of course, it is also necessary to obtain results in the short-term, so we are already restructuring PC Online and other divisions with abundant management business experience. As a result, in the fiscal year ending March 31, 2015, although we forecast a decline in sales, we expect to significantly improve profits.

To Further Enhance Capcom's Strengths

Mori Although Capcom, established 31 years ago, is a veteran home video games publisher, there is some doubt as to whether you are able to adjust flexibly to the dramatic changes in the market in recent years. Going forward, do you think you will be able to enhance your competitive advantage?

Tsujimoto The mobile market has a peculiar business model, but if we can combine it with Capcom's strength of development capabilities for creating original content, I think we should have a sufficient chance to succeed. Some time ago, when game consoles advanced from 2D to 3D, Capcom went to painstaking lengths involving trial and error to create popular title "Resident Evil". Our biggest competitive advantages are our developers, who tenaciously persevere in the face of any adversity, and senior management, who have complete trust in the clear policies indicated by developers. Going forward, no matter what kind of new technologies or business models may arise, we are confident we have the spirit and capabilities to overcome any challenge.

Mori I'd like to hear about your strategy for Asia and China, which the stock market is intensely focused on. Starting with the PC Online business, there seems to be a huge potential for development particularly in China. What are your thoughts?

Tsujimoto In the Asia region, which has a large-scale PC online games market, we are attempting to quickly establish brands and create an earnings foundation. Particularly in China, the world's largest market,

we are releasing titles such as "Monster Hunter Online" that make use of core series. However, these titles are not developed in-house, but in collaboration with local companies such as Tencent Holdings Limited. We determined that presently, it will be most effective to forge alliances with powerful local companies to acquire management expertise conforming to user preferences, which differ significantly from those in Japan.

Mori In the rapidly expanding China mobile market, the need for high-quality content and powerful IPs is on the rise, providing plenty of chances for Japanese game companies.

Tsujimoto As with the PC Online business, the environment differs significantly from that in Japan, so we outsource app games developed by Capcom in Japan to local companies in China for localization and management. To establish this process flow, it is first important that the title is a success in Japan. Unlike other game companies, Capcom has a variety of businesses generating steady earnings. If mobile games succeed, this success is linked to all other businesses, making us extremely unique among the world's content makers. We will continue to move forward with dogged determination.



After the Conversation

Although I was strongly aware that Capcom's core business is still console games, I discovered that mobile contents play an unexpectedly central role in Capcom's future growth strategy. However, in the Mobile business, it is not a simple task to speed up and pull ahead of other companies in the industry. I can evaluate Capcom over the medium-term based on how it uses its strength of originality and accumulates internal expertise, but more time is needed before Capcom can fully establish its Mobile business, which needs to make proactive use of successful domestic company expertise and move forward with well-balanced operations. Investors are aware of the upsides involved with the Tencent alliance, but to be reevaluated Capcom needs to demonstrate results in the short-term, such as a hit title in the Mobile business in the next year. (Mori)

Haruka Mori (Profile)

Joined JP Morgan Securities Japan Co., Ltd., in April 2013 covering the gaming and Internet sector.

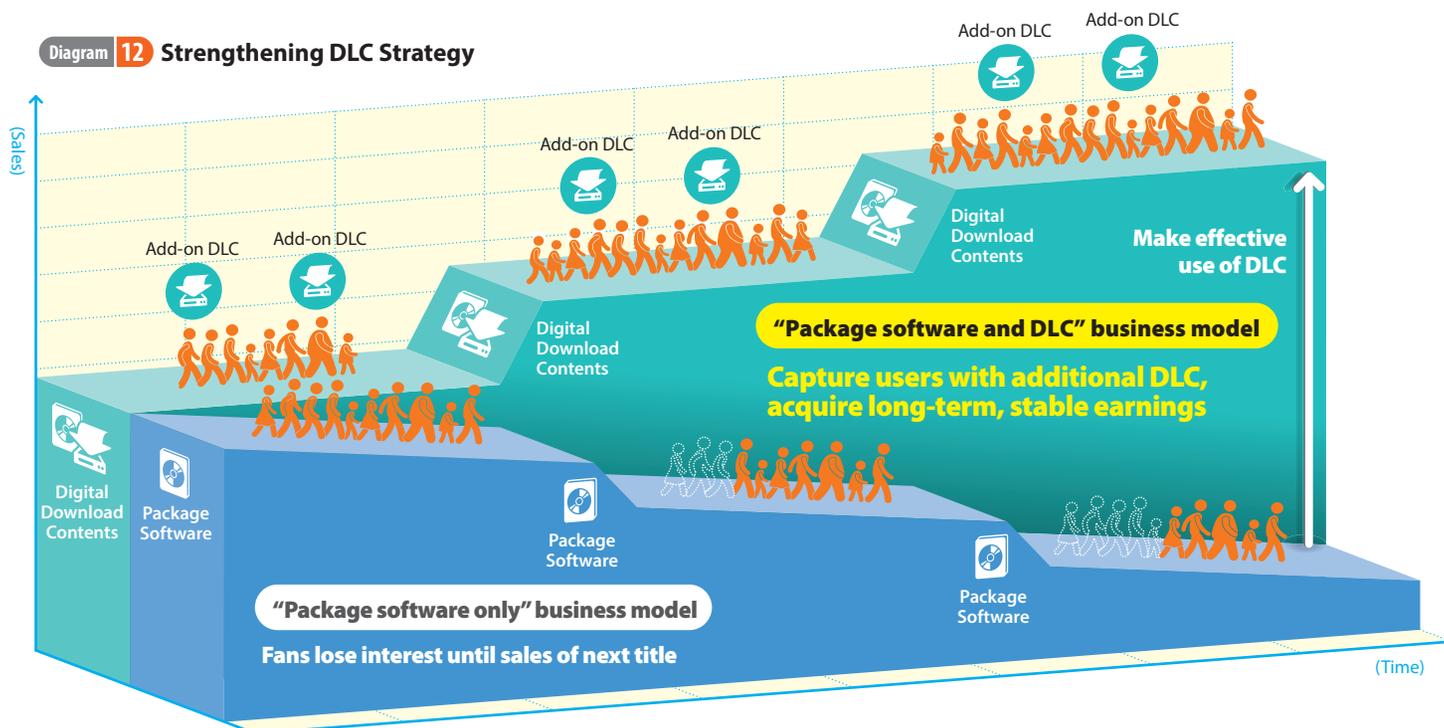
Previously worked for Goldman Sachs Japan Co., Ltd. and Barclays Securities Japan Limited.

Covered the gaming sector since 2010.

Graduated from Sophia University Faculty of Law.

Improving the Consumer Business

Diagram 12 Strengthening DLC Strategy



Creating a High Revenue Structure with 20% Operating Margins

Here, I'd like to explain "improving the Consumer business", the first of our growth strategies for achieving our medium-term business goals. As I touched upon in the CEO Message (see page 19, Q1-2), the consumer market is currently undergoing major changes due to digital download contents (DLC) market expansion and market oligopoly by top titles. Previous fiscal year (ended March 31, 2013), our late response to DLC and other problems adversely affected earnings, but our swift execution of improvement measures (1st stage) has enabled us to significantly improve sales, operating income and operating margins this fiscal year (ended March 31, 2014).

In the consumer market, we are concerned about diminishing profitability from investors due to a rise in development expenses and increased competition with overseas makers resulting from the arrival of next-generation consoles. However, this is still a major market expected to represent about one-third of the overall game market in 2018. Possessing a large amount of popular content, Capcom positions this as a core business able to ensure an operating margin of 20% or higher by improving highly profitable DLC operating margins.

We will promote additional improvement measures on the back of our 1st stage achievements to create a high revenue structure with 20% operating margins.

To this end, we will (1) strengthen DLC, (2) accumulate expertise and improve product quality by transitioning outsourced work to in-house production and (3) revise our title lineup to create a portfolio of titles enabling sustainable growth over the medium- to long-term.

Measure 1 Strengthening DLC to Improve Profitability and Lock in Users

In terms of strengthening DLC (Diagram 12), we will continue previous fiscal year's expansion of DLC sales, improving the ratio of DLC sales of 18%. (Diagram 13) The merits of increasing the ratio of DLC are (1) the reduced manufacturing costs and inventory risks of DLC distribution and (2) locking in users to establish stable long-term addition revenues through ongoing DLC distribution. This is one countermeasure aimed at concerns over rising development costs and increased volatility (which dictate hit titles) in the consumer business, as pointed out by investors.

We are already seeing the effect of previous fiscal year's promotion of improvement measures, particularly with respect to the focus on full title DLC as mentioned in (1). Compared to previous fiscal year, DLC sales have increased 87% and the ratio of DLC has grown seven percentage points.

Going forward, strengthening (2) in addition to (1), we will increase the DLC ratio to 31% in the consumer market. Specifically, we will (1) sell major title "Monster Hunter 4 Ultimate" in package and full-game digital content formats, expanding full-game digital content sales through Steam and (2) strategically release add-on DLC after launching major titles, such as "Street Fighter", to lengthen the lifetime of each game.

Measure 2 Improving Product Quality and Accumulating Expertise Through Transition to In-House Game Creation

We will "improve product quality and accumulate expertise through the transition to in-house game creation" through a structure focused

Diagram 13 DLC Sales Ratio (Capcom and Market Average Comparison)

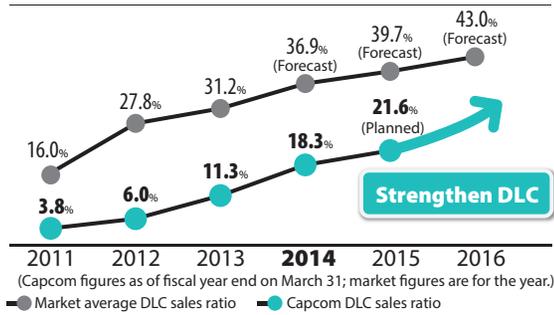
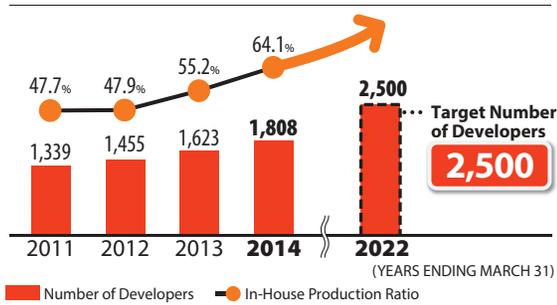


Diagram 14 Number of Developers and In-House Production Ratio

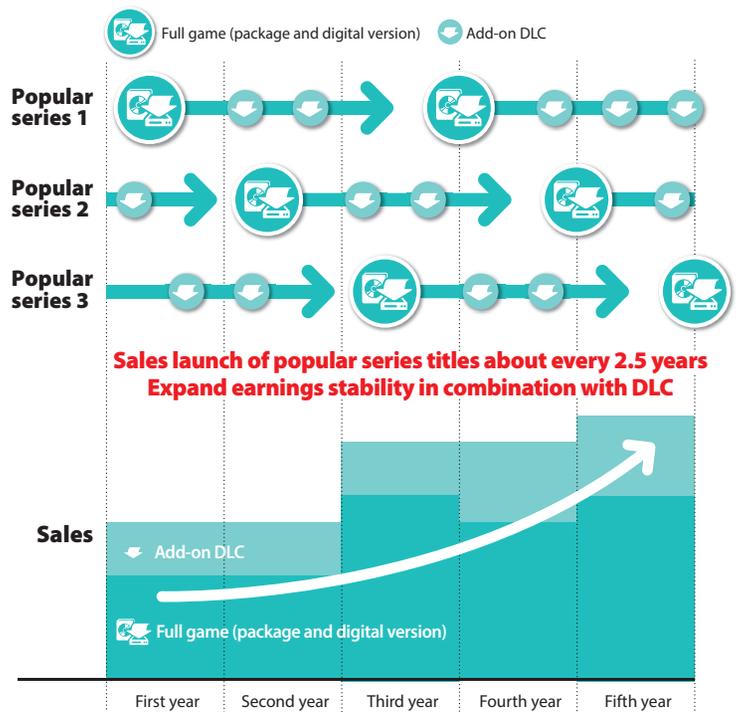


on in-house development and a shift away from our aggressive use of overseas game developers, which began in the fiscal year ended March 31, 2010. The reason for this shift is because major technological innovations in the market led to our inability to sell titles appropriately conforming to market needs due to the time required to change specifications and other agreements with overseas development companies, as well as an increased number of development companies that could not keep up with this technology.

For Capcom, given the current drastic changes in the marketplace, such as the arrival of next-generation consoles and the expansion of the DLC market, shifting our development structure to an in-house focus will improve quality because we can learn all about new technologies associated with next-generation consoles while accumulating expertise on the strategic deployment of additional content. Already, we are seeing benefits from previous fiscal year's improvement measures, with in-house development growing nine percentage points, from 55% previous fiscal year to 64% in the year under review. **Diagram 14**

Also, there is concern over worsening profitability associated with staff allocation and rising personnel costs. In response, Capcom thinks it possible to (1) hire 100 development employees, mainly new graduates, every fiscal year, growing to a structure of 2,500 people by fiscal 2021, (2) strengthen development personnel allocation management with a 52-week map and improve operating rates and (3) keep costs (of sales) down and reduce overseas outsourcing expenses. As a result of these measures, we forecast a cost to sales ratio of 64%, an improvement of 6.7 percentage points.

Diagram 15 Long-Term Portfolio Strategy



Measure 3 Revising Title Lineup to Stabilize Earnings

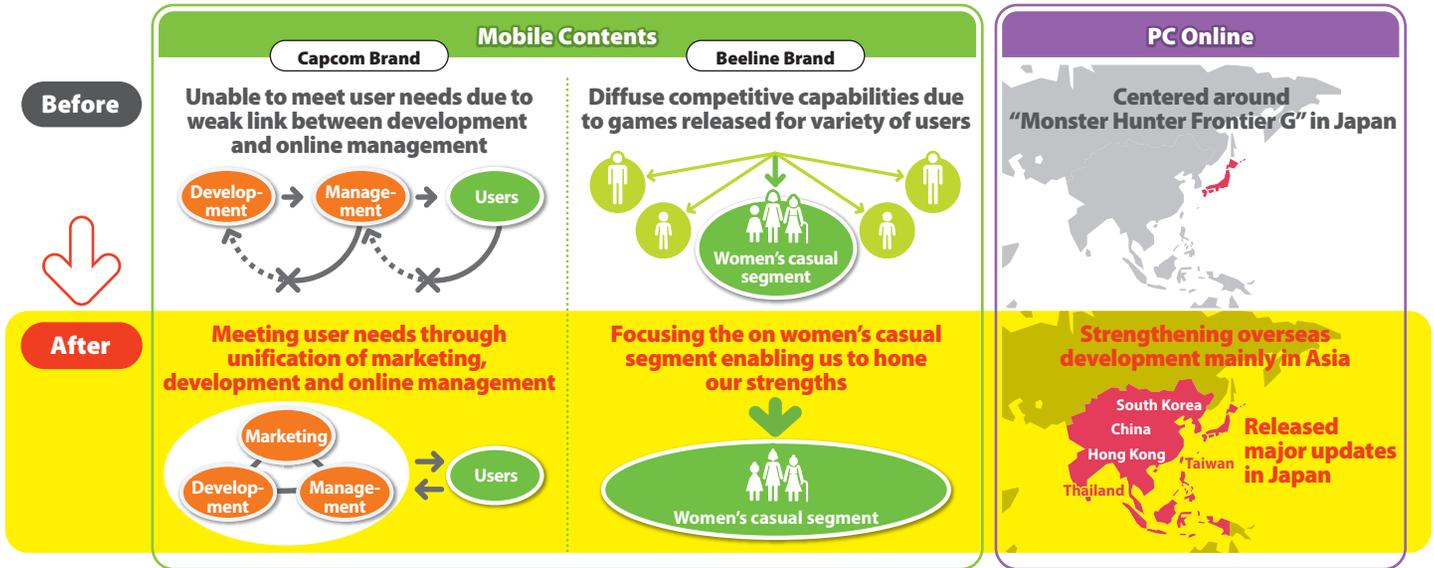
In terms of "revising our title lineup to stabilize earnings," we will (1) advance a multiplatform response focused on current and next-generation consoles and (2) launch a popular Capcom series title about every 2.5 years. **Diagram 15**

The reasons for this are, with regard to (1), to maximize earnings with sales launch of one popular title for both consoles; as the popularity on current consoles peaks, the adoption of next-generation consoles will rise. In terms of (2), three to four years are required to develop a major title, and if we only have a small number of hit titles, it will be difficult to launch a series every year, which will adversely affect earnings. Accordingly, it is important we either stabilize earnings by creating a large number of popular titles, or shorten the time required to launch new titles. Capcom possesses a large number of major titles, including "Resident Evil" and "Street Fighter", so we are able to proceed with both (1) and (2) to pursue stable earnings and growth, increasing the number of titles launched each year to maximize earnings.

With these three overlapping growth strategies and thorough management of our medium-term strategy maps (60-month and 52-week maps) we will flexibly respond to rapid changes in the market, creating popular titles for various consoles sold in about 2.5 year cycle. Furthermore, during times between launches, we will continuously offer new item and scenario downloads to attract users and solidify our fan base in an attempt to attain revenue from the sale of additional items and improve profitability.

Online Business Reforms

Diagram 16 Online Business Reforms



Structural Reform of Growth Engine Online Business

Now, let's explain the second growth strategy for achieving medium-term business goals, "Online business innovation". Diagram 16

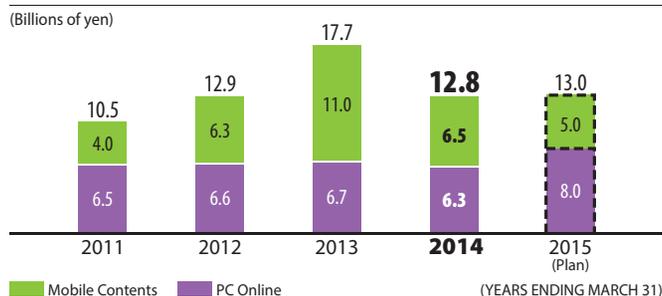
In terms of online business measures, Capcom is (1) strengthening marketing and monetization, (2) revising title lineups and (3) promoting PC Online business overseas development.

We are fighting an uphill battle in the high growth rate online market, and aware that some investors are concerned about Capcom's growth Strategy.

However, we think it is possible to once again reach operating margins of 30% over the medium-term because (1) we maintained operating margins of 30% or higher in the online business for the three years ended March 31, 2013 and (2) at the end of this fiscal year (March 31, 2014), we reviewed measures and carried out organizational improvements based on analysis of the cause of unachieved goals and issues that arose this fiscal year.

For more detailed information, please see "Verification! Stage 2" on pages 23-24.

Diagram 17 Capcom Online Sales



Next fiscal year (ending March 31, 2015), although we do not expect a sufficient recovery in net sales, we do expect to improve cost efficiency and increase operating margins 10% or more through the following measures. Diagram 17

Measure 1 Strengthening Marketing and Monetization (Capcom Brand)

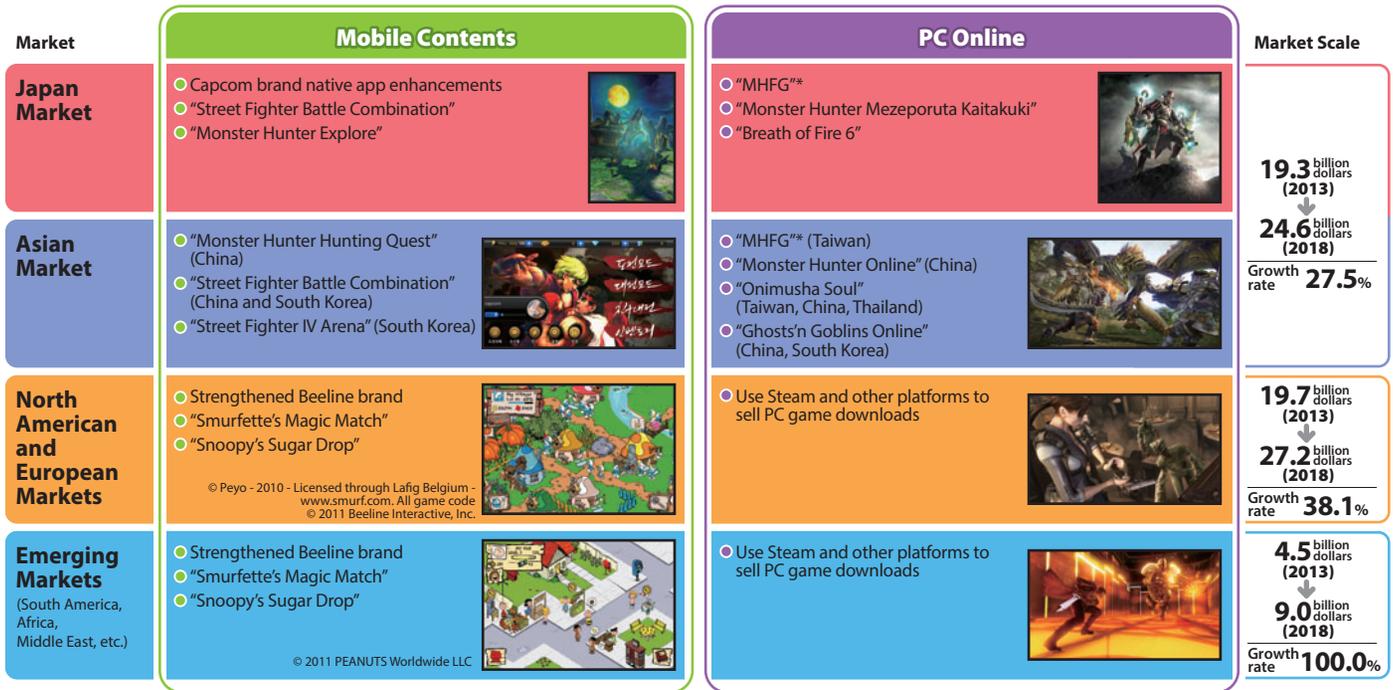
To succeed in the Mobile business, it is important to maintain (1) popular content that can be differentiated from a sea of competition and has low barriers to entry and (2) operational expertise developed by analyzing user movements after a game has been distributed, then providing feedback to development.

Although Capcom has a wide variety of popular content such as "Resident Evil", our Osaka mobile division, which was responsible for native app development in Japan this fiscal year, had insufficient operational expertise as it is staffed by consumer game developers, resulting in the distribution of titles that struggled from an earnings perspective.

In response, the Tokyo mobile division, which is very experienced in the Capcom brand PC online and browser operations business, absorbed the Osaka division to integrate the development structure of native apps. As a result, we will be able to make efficient use of operational expertise and human resources, create teams where marketing staff are positioned above development staff and promote the management and development of titles based on user needs.

Next fiscal year, we plan to launch native app games using core brands, including "Monster Hunter Explore", using a new organizational structure incorporating operational expertise resulting from structural reforms. We will also make use of our powerful

Diagram 18 **Capcom Online Strategy (Matrix)**



* MHFG: "Monster Hunter Frontier G"

content and operational expertise to develop the Asia market where the adoption of smartphones continues to accelerate. We will expand our mobile business in Taiwan, South Korea, Hong Kong, and in particular, China, where growth remains robust.

Measure 2 **Revising the Title Lineup (Beeline Brand)**

Turning to the Beeline brand, being too conscious of high growth prospects in the content market and high key performance indicators (KPI) in the Japan market led to our allocating resources to the release of titles outside our traditional strengths in the men's segment, resulting in no new hits this fiscal year.

In response, from next fiscal year, we will go back to Beeline's traditional strengths in the women's casual segment. We aim to create a hit in our area of strength by returning to what made "Smurfs' Village" a success, namely (1) the development of a title making use of globally popular content and (2) a management style with integrated development and marketing that can turn on a dime. At our development bases in North America, Europe and Japan, we will develop games that incorporate characteristics from each of these regions while attempting to acquire users in developing regions where home game consoles have not yet been adopted. The title lineup will include "Smurfette's Magic Match" and "Snoopy's Sugar Drop".

Measure 3 **Promoting PC Online Business Overseas Development**

Recognizing the need to quickly establish our brand in the large Asia market and create a foundation for earnings, we began full-fledged

promotion of PC online overseas development this fiscal year. Specifically, we distributed browser game "Onimusha Soul" to Taiwan in April 2013, where it reached number one in the popularity rankings. We also upgraded the development lines at our subsidiaries in South Korea and Taiwan.

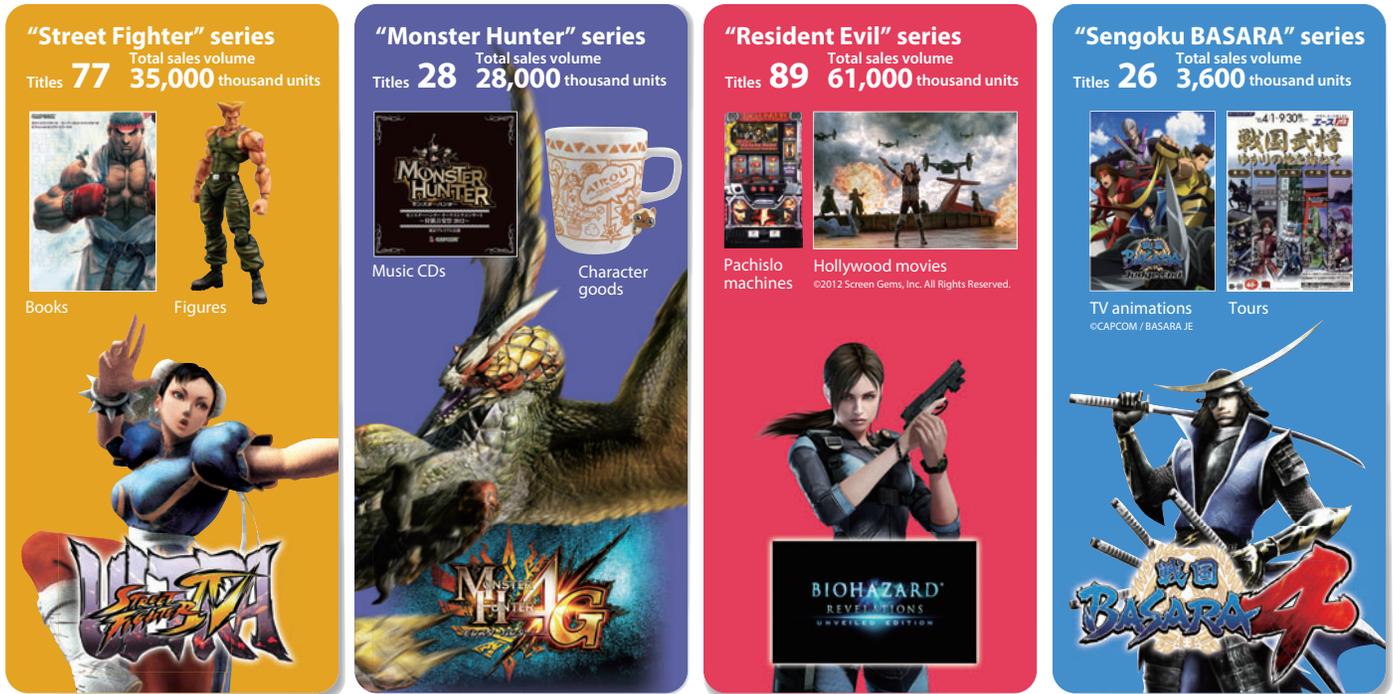
Next fiscal year, in China, the world's biggest online game market, we will begin beta testing of "Monster Hunter Online" in collaboration with Tencent Holdings Limited. We will also begin distributing "Onimusha Soul" to China and Thailand. The reason we are collaborating with Tencent and other local companies is to avoid country risk in Asia while gaining management expertise. We decided that alliances with local, well-established management companies were the most appropriate way forward.

On the domestic front, we will distribute a major update to "Monster Hunter Frontier G" for PC and four types of console, and we plan to release new titles including "Breath of Fire 6". We are aiming for net sales of 8 billion yen (up 27.0% from the current year) next fiscal year.

The Online business is considered the core of Capcom's growth strategy. Having quickly made decisions in response to the cause of unachieved goals and issues that arose this fiscal year, the benefits of which won't become apparent until next fiscal year or after, we expect to achieve business growth that exceeds market growth. **Diagram 18** We can also make use of online management expertise in the Consumer business to increase the DLC ratio, creating greater synergies through the sharing of Digital Content business information and know-how to achieve our medium-term business goals.

Expanding Single Content Multiple Usage Development

Diagram 19 Making Use of Multiple Popular Contents



Generating Earnings Through the Development of 100% Capcom-Owned Content in a Variety of Regions and Media

This section will explain the “expansion of Single Content Multiple Usage” in terms of the aforementioned three growth strategies formulated to achieve the medium-term business goals.

A “home video game” is an artistic media product that consists of highly creative, multi-faceted elements such as images, storyline, a worldview, music and interactive gameplay. This is exactly why each of these constituent elements can be individually developed into an attractive product through different facets of media.

Therefore, we can expect the following four effects by developing each of these elements into different business fields: (1) creating new profit opportunities other than the consumer business; (2) creating heightened excitement through increased exposure by simultaneous multiple-field development (promotional effects); (3) absorbing customers obtained from other business segments as home video game users; and (4) reducing profit fluctuations through business portfolio creation (risk hedge).

We own scores of intellectual properties based on popular content. We are now creating a business model to enjoy multiple profits by promoting Single Content Multiple Usage strategy in several applications. **Diagram 19**

While other companies in our industry are rolling out similar strategies,

Capcom’s competitive advantages are (1) more 100% owned content than any other company, able to be developed in a variety of ways using our strength in creating original content and (2) an ability to maximize earnings, compared to companies that only operate in Japan, due to the global development of content popular around the world. **Diagram 20**

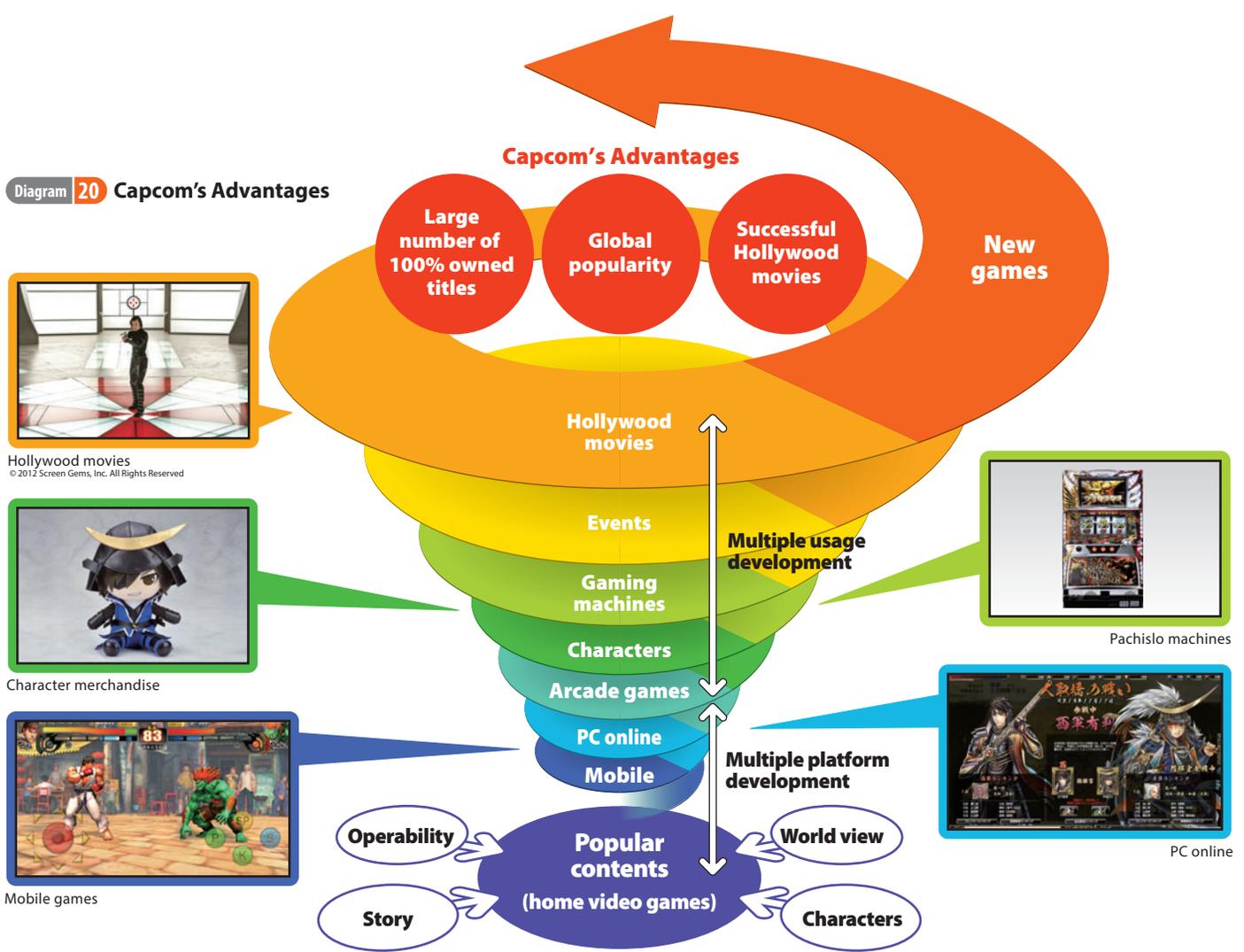
In particular, we are putting more effort into movies based on Capcom content, which is expected to have a significant promotional effect on the sale of consumer games. Other domestic game makers are undertaking similar efforts, but comparing the number of titles made into movies and box office revenues, it is clear that Capcom leads the industry in this regard.

This strategy will allow us to leverage the success of our consumer business with the aim of maximizing profits and achieving success in other businesses (Mobile Contents, Pachinko & Pachislo, Arcade Games, Movies, Publishing, Character Goods, etc.).

Measure 1 Using Popular Content for Events, Stage Productions, Comics and Animation

This fiscal year (ended March 31, 2014), we maximized profits by promoting the multiple usage development of content from popular series. In the “Monster Hunter” series, we held “Monster Hunter Festa ‘13” in five cities across Japan timed to coincide with the launch of home video game “Monster Hunter 4”, as well as “Monster Hunter the Real 2014”, an event in collaboration with Universal Studios Japan (USJ). In addition, we collaborated with the Shibu Onsen Ryokan

Diagram 20 **Capcom's Advantages**



Association in Nagano Prefecture to hold the “Monster Hunter x Shibu hot springs resort in Nagano prefecture” tourist event. Synergy with the game resulted in the participation of 13,000 users.

In the “Sengoku BASARA” series, we collaborated with the Takurazuka Revue to present “Sengoku BASARA”. We also presented the “Sengoku BASARA 3 Utage 2” stage production and held “Sengoku BASARA Busyo Festival 2013” as well as fan appreciation event “BASARA Festival 2014”, an annual affair. Additionally, we collaborated with the Japan Travel Bureau (JTB) to offer a bus excursion, the “Sengoku BASARA Date Bus Tour”, all part of our effort to effectively promote consumer game “Sengoku BASARA 4”.

As for “Ace Attorney”, in conjunction with the release of “Phoenix Wright: Ace Attorney –Dual Destinies” we attracted users by presenting stage production “Ace Attorney –Gyakuten no Spotlight” and experience-based detective game “Ace Attorney in Joypolis” and “Phoenix Wright: Ace Attorney Dual Destinies x Keikyu Corporation” in collaboration with the Keikyu Railway Corporation.

We conducted a new project for kids involving large-scale cross media development timed to coincide with the release of “Gaist Crusher”. We attempted to establish this new brand with serial stories in Saikyo Jump and V Jump comics, animation programs broadcast on television and the sale of music CDs and “Gaimetal” toys linked to the game.

In commemoration of our 30th anniversary, we also held the “Capcom summer festival in Huis Ten Bosch” in Nagasaki Prefecture,

which drew more than 25,000 fans.

Measure 2 Attempting to Increase Brand Value Even More by Appealing to a Wide Customer Segment

Multiple usage development next fiscal year (ending March 31, 2015), will attempt to further improve Capcom brand value and profitability by appealing to a wide customer segment through the ongoing development of titles including “Monster Hunter”, “Sengoku BASARA” and “Street Fighter” in a variety of media formats.

Specifically, with regard to the “Monster Hunter” series, we will hold “Monster Hunter the Real 2014” at USJ and continue hosting tourism events at Shibu hot springs resort in Nagano prefecture. To commemorate this series’ 10th anniversary, we plan to hold a “10th Anniversary Monster Hunter Exhibition” and “Monster Hunter 10th Anniversary Orchestra Concert –Shuryo Ongakusai 2014–” in addition to a diverse array of activities timed to coincide with the release of “Monster Hunter 4 Ultimate”. We also plan to promote “Sengoku BASARA” with stage productions “Sengoku BASARA 3 –Toga Kuruwashikizuna–” and “Sengoku BASARA 4”, as well as the broadcast of animated television program “Sengoku BASARA –Judge End–”.

These collaborations with other industries function as the linchpin of game content horizontal development. By appealing to a wider customer segment than ever before, we anticipate further increases to our brand value.