Yoichi Wada
President and Representative Director

I am grateful to our shareholders for the opportunity to present the Company's annual report for the fiscal year ended March 31, 2012.

On a consolidated basis, net sales for the fiscal year ended March 31, 2012 totaled ¥127,896 million (an increase of 2.1% from the prior fiscal year), operating income totaled ¥10,713 million (an increase of 46.2%), recurring income totaled ¥10,297 million (an increase of 91.0%) and net income totaled ¥6,060 million (compared to a net loss of ¥12,043 million in the prior fiscal year).

The Company's operating income ratio was 8.4% and return on equity (ROE) stood at 4.5%.

We set dividends applicable to the fiscal year ended March 31, 2012 at ¥30 per share (a consolidated payout ratio of 57.0%).

In our dividend policy, we are mindful of the balance between being performance-based and providing stable returns. In being performance-based, we aim for a payout ratio of 30%. At the same time, we advocate stable returns. Hence, we paid out dividends of ¥30 per share in the fiscal year ended March 31, 2011, despite a net loss. We will pay dividends this fiscal year as in previous years, and if we back calculate from the actual payout ratio, earnings per share should be higher than ¥100.

We achieved a genuine recovery from the last fiscal year to this fiscal year, but I realize that we have only completed half of our objective.

Summary of Individual Business Segments

I'll now review results by individual business segments.

Please take a look at the change in our operating income by segments (Figure 1).

Compared to the prior fiscal year, the following segments saw an increase: Digital Entertainment (¥1,319 million), Amusement (¥374 million) and Merchandising (¥62 million). Publication had a decrease in profit of ¥629 million. We saw an improvement in Eliminations or Unallocated cost of ¥2,262 million, which is a result of the reassessment of assets from the last fiscal year.

The Digital Entertainment segment increased in profits, but the structure of the business has changed more than the numbers. I will elaborate on this point later.

Sales in the Amusement segment are flat but generated more profits. The arcade business is getting out of its slump, and we see the fruit of ongoing efforts to reduce fixed costs. That said, profit contributions by arcade game machines were limited this fiscal year whereas next fiscal year will see the release of major, new arcade titles. While many operators have withdrawn from this segment, we can expect to enjoy the profit of the remaining player since the contraction of the market is limited. Although this could hardly be described as a fast-growing sector, I will ensure that it brings stable profit contributions alongside its primary entertainment objective: producing live experiences that cannot be recreated at home.

The Publication segment peaked in the fiscal year ended March 31, 2010, and profits have steadily decreased since then. We saw huge success with “FULLMETAL ALCHEMIST,” followed by hit titles every year such as “Black Butler” and “SOUL EATER.” In this fiscal year we were able to produce quality, popular titles on a regular basis, such as “Inu Boku Secret Service.” However, an increase in the number of serial publications and a focus on the production of animated series created a rise in fixed costs, which leads to this segment’s downtrend in profit margins. That said, a more fundamental issue of profitability within this segment is not rising expenses, but rather revenue opportunities being limited to the domestic comics market. Once we establish capabilities to produce a string of hits, I am confident we can overcome the status quo by entering overseas markets and online businesses, though this will take some time.

Changes in the Undercurrent of the Digital Entertainment Business

The Digital Entertainment business is a broad segment that covers all types of devices and all genres of games. We group this segment broadly because it is impossible to find appropriate classifications in this time of transition for the industry. In other words, even if we create some classifications for this segment, those classifications may rapidly change, and we cannot guarantee the consistency of a segment within our reporting. However, I would like to show you a breakdown of the segment in more detail to promote understanding of our business performance. Therefore, I will divide this segment into three categories for convenience’s sake (Figure 2): MMO games (Massively Multiplayer Online games), SN games (Social

Figure 1 **Operating Income by Business Segment**

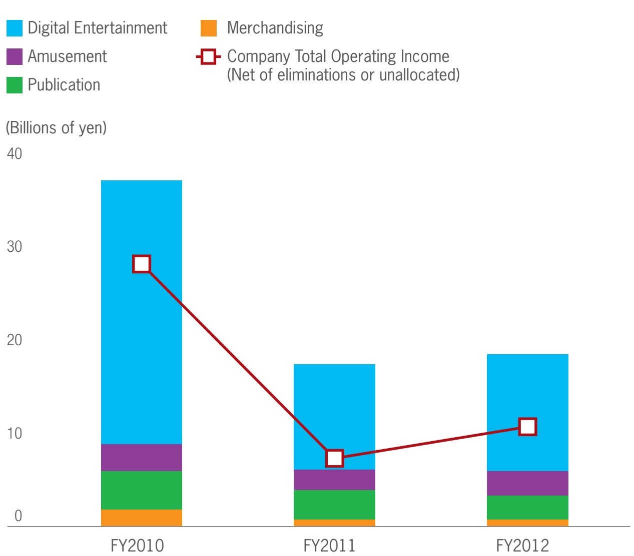
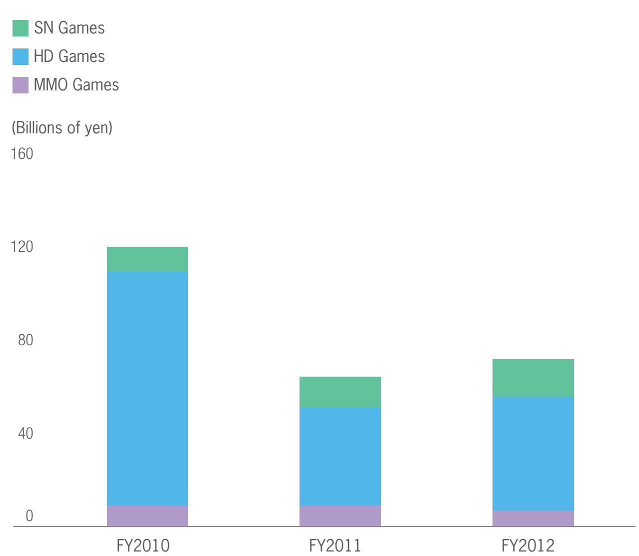


Figure 2 **Net Sales of Digital Entertainment Segment**



Networking and mobile games), and HD games (High-Definition games). These categories are how we organize internally rather than classifications about markets or business models.

I have long expected MMO games to provide a stable source of profit.

"FINAL FANTASY XI" has been continuing services for ten years since its launch, and even if we consider all the server, operational staffing, and maintenance costs in addition to the development costs, the accumulated operating profit generated by the title is close to ¥40 billion. As a single title, "FINAL FANTASY XI" has had the highest level of contribution to our profits. If successful, MMO is a genre where we can achieve very high profitability. Also, the MMO game market itself has been growing at a regular pace (Figure 3). At the same time, development of MMOs is challenging, requiring large initial investments and deployment of sizable support teams. MMOs have an extremely high barrier to entry. Thus, our strategy is to win the fierce battle among a small number of competitors, creating a supporting rock for the Company's profit.

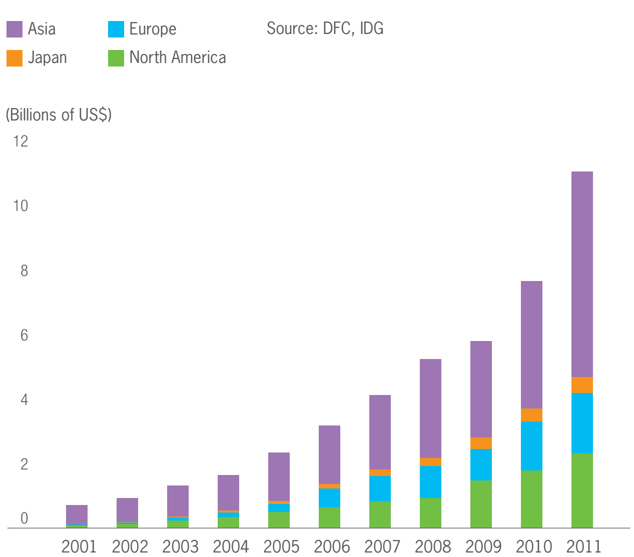
To raise our chances for success, we adopted tactics that concentrated our efforts on our most powerful IPs, FINAL FANTASY and DRAGON QUEST, and we did not pursue other MMO projects before the success of these two titles was ensured. More concretely, "FINAL FANTASY XI" was to be continued for as long as possible; "FINAL FANTASY XIV" was to be launched in 2010 in Japan, North America, and Europe, and then in China from 2011; and "DRAGON QUEST X," a DRAGON QUEST MMO, was planned for launch in 2012 in Japan. However, we stumbled at the launch of "FINAL FANTASY XIV." Not only was the FINAL FANTASY brand damaged, but the Company's profit planning was undermined, and deployment of development staff was also affected. This was a challenging time for the Company, but I stood fast that we should not change our original plan. In order to revive the FINAL FANTASY brand and to regain trust in the MMO market, we chose not to shut down "FINAL FANTASY XIV." We are treading the thorny path of continuously improving the existing service while simultaneously working to renovate the game fundamentally. Due to the initial stumble, most players had left the game during the first six months, but more than a year later, in early 2012, we began charging for the game, and we realized that the game had regained more trust from our players than we had expected. The number of players has increased since we began charging. We have successfully brought the game back on track. "FINAL FANTASY XIV" is eyeing a full comeback with the release of its fundamentally revamped version between 2012 and 2013. I am confident that the title will be one of the main profit generators for us. Furthermore, the development of "DRAGON QUEST X" is proceeding smoothly toward its 2012 launch.

While taking two years longer than we originally planned, this fiscal year we finally completed the work of correcting the path of our business in the MMO category. I believe that we have been able to demonstrate our strong commitment to the brand, as well as the ability to take action in order to overcome difficulties. By the fiscal year ending March 31, 2013, these MMO games will provide more revenues and in the fiscal year ending March 31, 2014, further contribute to our profit.

SN games refer to those with designs that allow customers to have fun by connecting with each other, in other words, those developed with social elements at their base. At this point, we provide such games for feature phones, smartphones, and browsers. Non-social games provided on these platforms are also included in this category. This is because these games are developed by the same teams. While MMO games are supporting the Company as the rock providing stable source of income, the SN game teams' mission is to increase the upside of our income as much as possible.

This area is a frontier for both the expansion of the user

Figure 3 **MMO Game Market Size**



base and the evolution of the business model. In order to create solid ground in such an uncertain area we need to accumulate a dense amount of experience in a short period of time. I believe that we should not place big bets in a specific area or consolidate operations merely for the sake of better efficiency. We have intentionally broken up the organization into about ten teams. This method aims to shorten the cycle of "trial and error," while accumulating a variety of experiences at fast-pace across our group companies by having small teams run side by side.

This fiscal year we saw a lot of progress. "SENGOKU IXA," a browser game launched in the prior fiscal year, has achieved over ¥3 billion in profits and has become one of the pillar products of the Company. In addition, "FINAL FANTASY BRIGADE," a feature phone and smartphone game launched earlier this calendar year had one million registered users within one month of launch, and by March had surpassed two million. "FINAL FANTASY BRIGADE" is already one of the pillar titles of the fiscal year ending March 31, 2013. We are planning to expand the service area into Asia, North America, and Europe, where we can expect further growth. Incidentally, the above-mentioned games have F2P (Free To Play) business models. After experiencing several successes, our ability to analyze KPIs (Key Performance Indicators) related to such games has been improving. When a company has several successful cases such as the above, often they look to double down on scale and efficiency by organizational consolidation. However, I feel that there is rich knowledge to be gained, and we should continue to be aggressive in accumulating as much experience as possible. When a project is a success, I urge the team to spin-out and form its own group, rather than merging the teams.

The above examples are projects from Japan, but this fiscal year we were able to kick-off business in this area in the North America and Europe. Both regions have titles that are aiming for launch in the fiscal year ending March 31, 2013. For example, our European subsidiary developed "Gameglobe," an innovative title that lets users create games themselves, share them with their friends and play together. Not only that, but "Gameglobe" is technologically advanced in that it is a console-quality product that works in a browser. The title was highly regarded at the E3 game show in 2012.

In addition, we intend to advance aggressively into Central and South America, Asia, and Eastern Europe markets.

HD games is a coined phrase that mainly refers to console games. This fiscal year we released "DEUS EX: HUMAN REVOLUTION" and "FINAL FANTASY XIII-2" in Japan, North America, and Europe, and saw them perform well. "DEUS EX" in particular was meaningful in that it not only contributed to our income but also made a debut as one of our major IPs.

This area is reportedly declining, but I question such views. It is true that the business framework is no longer working. However, I believe that high-definition content will continue to evolve.

The following three points summarize the traditional business framework in the high-definition area: 1) Distribution: selling packaged products at retail stores, 2) Major devices: game consoles, and 3) Revenue recognition: one-time only disc sales. Conversely, we can solve the problem with HD games by reforming each of the above components. With regard to distribution, we are already seeing evolution occur, even before the other elements. Not only e-commerce, but download sales have become common, and major game titles are frequently equipped with PDLCs (Premium Downloadable Content). While we'll likely see the ratio between the conventional model and the new one reverse going forward, the inevitable transformation has already taken place. That said, with regard to the devices, there is still a clear line drawn between game consoles and any other device. It is wrong to expect that similar game experiences are achievable on any type of device. We should, however, delineate between which style of gameplay is appropriate for the right device depending on the way in which that device intersects with our lives. If such delineations are drawn accurately, the user base for games will expand further. Lastly, the revenue recognition model has fallen behind the most among these three points. For online services connected to game consoles, the console manufacturers are the publishers. Unless these manufacturers change their policy and implement necessary features, nothing will change. The business model change has begun partially with PDLC, but even the subscription model is rarely accepted, and manufacturers are still not open to the F2P model. I feel that one of the fundamental causes of the declining trend of the game console market is the delay in implementing new business models. This is regretful. However, if we take another perspective, all it takes is for manufacturers to change their ways of thinking, and change could happen overnight. I am eagerly awaiting this change in policy.

Our strategy in this area is: 1) Modifying our game design on the premise of change in business models, 2) Focusing on, and nurturing 10 strong IPs, since keeping a continuous relationship with consumers is important, and 3) Not compromising on quality. In order to achieve 1), we are actively applying our knowledge from MMO and SN games. In addition to regular sessions for sharing information across our organization, we require individual projects to identify issues related to business models. Regarding point 2), I have been long mentioning it as one of the pillars of our strategy. I would like to expound on point 3). The reality is that game development has become so costly and complicated that the whole industry is at a loss. It is understandable why game engines took the industry by storm in the 2000s.

We have two strategic options open to us for game development. One option is to take full advantage of open environments, which allow for indie developers to be able to develop games. However, many resulting products will be casual-style games and it is unclear if we could generate significant profits. Thus, in this scenario, we would seek to minimize fixed costs. In other words, we would downsize to a minimum capacity as a company and devote ourselves to licensing out IPs without having internal development staff. Another option is to exert our efforts to the fullest extent to differentiate ourselves from our competitors. We have chosen the latter path. You may have noticed a similar philosophy expressed earlier in the Amusement and MMO games sections of this message. Given this philosophy, we need to tackle the establishment and evolution of our development environment as a global task. Game engines are of significant relevance. We use both third-party and internally developed engines. We are in the midst of developing the “Luminous Studio” engine, with an eye toward next-generation capabilities. We presented the demo for the first time at the E3 game show in 2012, and the reaction was greater than we had anticipated. We were able to confirm that we are heading in the right direction.

The category I call HD games will eventually cease to be necessary as a classification from both perspectives of business model and devices on which they will run. It is not that the market will shrink. But on the contrary, it means that current console games will transform and further develop. When the above three organizational categories will no longer be necessary and we can propose a new business segment, we will see an end to the industry’s current transition period.

The Transformation to Come

I have repeatedly stated that similar to other media industries, the game business will be enveloped into the upheaval of the ecosystem of the entire content industry. I believe that we are nearing that moment, and I would like to discuss my outlook on the future while touching upon the content industry as a whole.

The content business is composed of three functions: Production, Commercialization, and Marketing. Marketing includes promotion, distribution, and monetization. Taking an example of the music sector, composition and performance is the Production, recording and pressing on CDs is the Commercialization, and selling CDs at retail stores is the Marketing. In the game sector, the assets that we develop are programs, and we cannot sell these programs “as is.” Therefore, after Production, the Commercialization process is required. Game console machines, on which game software can run, are manufactured and sold. Then the program is pressed onto DVDs and packaged. This is the Commercialization process, and the console manufacturers fulfill this function. Marketing is selling the packaged discs at retail stores. In any content industry the basic structure is the same.

Since content is intangible, in order to do business, the Commercialization, in other words reproducing the content onto media, is an inevitable process. Marketing methods were determined by the type of media. The content industry has been segmented in accordance with the method of Commercialization, which adds the highest value.

Networking and digitization triggered the first transition of this structure.

The network became the media of content, and without requiring a specialized device for media playback, users could enjoy content, which led to a decline in the Commercialization's value. Moreover, because it is so easy to make copies in the digital environment, content overflowed on the internet. Huge amount of user-generated content such as blogs created a situation where information and content were supplied more than demand could absorb. Now the function that could organize all this information and content grew to be valuable. This new function belonged to the category of the Marketing. The words that symbolize this era's culture are "free" and "share." On the internet, the value of information and content declined dramatically, and it became difficult for those doing business on the Production and the Commercialization to survive. Also, internet service providers, who had been engaged in the Marketing, now had limited opportunities to generate revenue due to self-invited free content issues and at the same time engaged in fierce competitions to keep their customers. As a result, the functions of the content industry became imbalanced, and the industry faced a crisis of its ecosystem. We entered an era of "search engine" this century where a "winner-takes-all" situation was created. Interestingly, the content businesses that survived during this time were those with vertical integration models such as games and Japanese mobile phone services.

However, as Apple emerged, we saw change for the second time.

Every choice they made was opposite of the one from the prior era. Vertical integration models rather than horizontal integration, native applications rather than browser application, premium rather than free. Perhaps the internet users were feeling that while the then-existing environment was convenient and free, it was disordered and unsafe, and they flocked to the iPhone. Apple succeeded in complete customer lock-in. IT companies that were struggling to find a solution saw this success, and they switched over to the vertical integration model, one company after another. The archetype of this vertical integration model was the combination of iPhone, a physical device, and iTunes, an online marketing platform. Google, Amazon, and Microsoft announced their intention to manufacture their own devices, and it seems that even Facebook may join the party. At this moment the main battlefield is tablet PCs. In order to become the ruler of the internet, IT companies are now competing over physical devices, which is a paradox.

For a company like ours that is specialized in the Production function, it is good news since content is now shifting from being free to paid. At the same time, it becomes necessary to support many devices and development work becomes inefficient.

Then, what is to come next?

I believe that two significant innovations, HTML5 and cloud computing, will dramatically transform the ecosystem once again. These two innovations will make it difficult to differentiate devices, and the IT companies that are competing for customers will lose their present weaponry. Apple's vertical integration model will no longer work.

Since games are interactive content that are enjoyed by having consumers get involved in the virtual world, they are not replicable. Unlike other content, the value is placed in the consumer experience rather than code or data itself. Moreover, online elements are now implemented into games, and our relationship with customers has become continuous, rather than one-time upon purchase. Currently the only people standing between the customer and us are those that handle the Marketing functions. The above-mentioned innovations will be what will dissolve those that dominate the Marketing functions. For the first time since the Company was founded, we will be able to connect directly with our consumers.

The strategy that we are now executing is not only to secure the profit for today, but also to prepare for a new era. We wish to run after two hares; expanding the current business and leaping for the next era.

Lastly, I would like to thank our shareholders for your ongoing support.

Yoichi Wada

Yoichi Wada
President and Representative Director
SQUARE ENIX HOLDINGS CO., LTD.