To Our Shareholders

Yosuke Matsuda

President and Representative Director

Oct. 2001	Senior Vice President, SQUARE CO., LTD. (currently SQUARE ENIX HOLDINGS CO., LTD.)
Apr. 2003	Senior Vice President and General Manager, Accounting and Finance Division
Jun. 2004	Director, Accounting and Finance
Mar. 2013	Senior Executive Managing Director and Representative Director
Jun. 2013	President and Representative Director (incumbent)

(Significant Positions Concurrently Held)
President and Representative Director, SQUARE ENIX CO., LTD.
Director, SQUARE ENIX OF EUROPE HOLDINGS LTD.
(the Group's intermediate holding company in Europe)
President and Director, SQUARE ENIX OF AMERICA HOLDINGS, INC.
(the Group's intermediate holding company in North America)

I would like to express my sincere appreciation for all the understanding and support you kindly extend to the Square Enix group (“Group”). I was appointed to the position of President and Representative Director at the Annual Shareholders’ Meeting and the Board of Directors’ Meeting held on June 25, 2013. I will draw on my previous experience and do my utmost to guide the Group under the new management structure toward significant business growth. I look forward to your continued support.

The fiscal year ended March 31, 2013 was a very difficult year for the Group. On a consolidated basis, net sales totaled ¥147,981 million (an increase of 15.7% from the prior fiscal year), operating loss amounted to ¥6,081 million (operating income of ¥10,713 million in the prior fiscal year), recurring loss amounted to ¥4,378 million (recurring income of ¥10,297 million in the prior fiscal year), and net loss amounted to ¥13,714 million (net income of ¥6,060 million in the prior fiscal year). The Group posted an operating loss for the first time since the merger between ENIX CORPORATION and SQUARE CO., LTD. into SQUARE ENIX CO., LTD.

The business environment is undergoing major changes, notably, the evolution of consumer game consoles into the next generation, considerable growth in new game genres such as social gaming, and the rapid spread of smart devices including smartphones and tablets. While we exerted managerial efforts in the major business segments of Digital Entertainment, Amusement, Publication, and Merchandising under the changing environment, sluggish performance of the Digital Entertainment segment, most noticeably in the HD (High-Definition) games category, and slow sales of new arcade game machines in the Amusement segment led to the consolidated operating loss.

The Amusement segment consists of the operation of amusement facilities and the development and distribution of arcade game machines. In the arcade game machine business, “Chosoku Henkei GYROZETTER” (Super High-Speed Transforming GYROZETTER), a new machine launched in the first half of the fiscal year under review, ended up with a disappointing result, far below the original plan. The GYROZETTER business attained some progress in creating new intellectual property (“IP”), but failed to become a big hit as a whole, with the number of shipments substantially below the target.

On the other hand, the operation of amusement facilities produced favorable results throughout the fiscal year under review, and in particular, achieved, in the second half, comparable store sales of 103% on a year-on-year basis. In the fiscal year under review, sluggish sales of arcade game machines had a negative impact on segment performance, but the entire Group’s arcade game machine development capabilities grew considerably, which produced strong IPs such as “LORD OF VERMILION” and “GUNSLINGER STRATOS.” In the context of live, non-virtual entertainments, the development of games for amusement facilities as well as the operation of amusement facilities are areas where we can expect deep-rooted demand going forward, and will thus continue to represent vital parts of our business portfolio.

In and after the next fiscal year ending March 31, 2015, amusement facility operations will be adversely affected by the upcoming increase in the consumption tax. However, we shall overcome the negative impact by further efficiency in operations and our strong IP portfolio, and strive to achieve a solid recovery in this business.

The Publication segment made steady progress with net sales of ¥11,086 million and operating income of ¥2,484 million. The segment is taking effective control of the business process from creation of new titles to enhancement of comic book sales through deployment of TV animation series to generate steady business expansion. In addition, our web-based new media called “GANGAN ONLINE” is accelerating on full scale development of new IPs such as “Watashi ga Motenai no wa Dou Kangaete mo Omaera ga Warui!” (It’s obviously you guys’ fault I’m not popular!) and “Gekkan Shojo Nozaki-kun” (Monthly girl’s comic magazine “Nozaki-kun”), and thus “GANGAN ONLINE” is increasing its presence as an additional medium alongside magazines for highlighting new titles. The emergence of electronic books is making a major change in the paper media-oriented publication industry. The Group is taking a responsive approach to the new tide of the industry, and will strive to capture new opportunities precisely for further business expansion.

The Merchandising segment showed steady performance, posting net sales of ¥3,264 million and operating income of ¥667 million. In the fiscal year under review, we launched a collector’s box and held special concerts to commemorate the 25th anniversary of the FINAL FANTASY series, which received favorable reception from our fans. We also opened an official merchandise store, ARTNIA, at our new headquarters, following our relocation, and crowds of people have come to enjoy shopping at the store. On top of the merchandising of character goods and CDs, the ARTNIA store is contributing to further elevation of our brand value.

Now let me discuss the Digital Entertainment segment. This segment is divided broadly into three categories; HD games, MMO (Massively-Multiplayer Online) games, and social gaming and others (“SG”) for internal management purposes. While HD games turned in disappointing results, MMO games are highlighted by two major titles; “DRAGON QUEST X: Mezameshi Itsutsu no Shuzoku Online” (Rise of the Five Tribes Online) (“DQX”) and “FINAL FANTASY XIV: A REALM REBORN” (“FFXIV”). DQX has been operating steadily since its launch of service in August 2012. The development of FFXIV, another major pillar in this category, has been smoothly progressing toward the goal of its August 2013 launch.

In the SG category, existing titles are continuously contributing to the profit of this segment. “Kaku-San-Sei Million Arthur” (Diffusible Million Arthur), an SG title released in April 2012, has been successful not only in the domestic market, but also in Korea, where the game has become an instant hit since its launch in December 2012. In this manner, new titles are expanding satisfactorily. In the fiscal year under review, the SG category’s net sales amounted to ¥22,686 million, which resulted in significant growth in net sales and operating income from the previous fiscal year ended March 2012. We expect further expansion of the SG category as a key growth area.

In the HD games category, we delivered three major titles in the fiscal year under review, primarily in Europe and North America. These titles—“SLEEPING DOGS,” “Hitman: Absolution,” and “TOMB RAIDER”—failed to reach their respective targets, and resulted in financially unsatisfactory consequences, whereas the HD business in Japan remained strong through sales of the Nintendo 3DS version of “DRAGON QUEST VII: Eden no Senshitachi” (Warriors of Eden) and others.

These three titles, which were developed for consumer game consoles, were critically-acclaimed through media coverage, and therefore, I believe, were successful from a game development perspective. However, we were exposed to increasingly severe competition with a number of blockbuster titles from major publishers, and experienced great difficulties in price control of these titles from a marketing perspective. We had to expend considerable incentive programs offered to retailers such as price protection, back-end rebates, and promotional cooperation costs, which generated a certain level of shipment quantity but with lower margins than expected. As a result, provision for sales returns increased considerably year on year, reaching ¥3,927 million, and was a major factor in the deterioration of profits.

We do not recognize this situation as a temporary phenomenon that can be dealt with merely by restrengthening the distribution system, but as a structural problem in the HD business. That is to say, the financial results posted in the fiscal year under review reflect an intrinsic problem within the HD game business model that has come to the surface.

The basic business model of the HD games category is to distribute disc media on which a game is recorded. Many games for consumer game consoles are still provided on discs, whereas download distribution using no record media is becoming the mainstream for PC games and additional content available after a title is released. In the case of the disc-based distribution model, sales are determined by multiplying the unit price by the number of discs sold. An increase in shipments or unit price will naturally drive sales higher. However, supplying games to distribution channels has become much more difficult in the video game market due to an increase in the number of titles, in particular, blockbuster titles competing with each other. As retailers become more selective about titles to purchase, game publishers have to deal with more expenses associated with pricing policy, such as back-end rebates, advertising, and price protection, in order to expand the number of units shipped. As a result, street prices are substantially declining, which leads to a situation where profits remain sluggish even though the number of units shipped increases.

This business model is also having a critical impact on game development. Under the model of selling packaged games, the timing by which we may offer a game to customers is limited to the release of the product. Profit opportunities are almost non-existent during the game development phase. Although we are making on-site efforts to streamline our game development processes through the use of utility game engines and other approaches, HD games development requires increasingly longer time periods as the performance of game consoles improves.

From a financial point of view, investment in game development is being capitalized on the balance sheet over a significant time frame, and investment recovery risk increases. In other words, the investment turnover is low. In consequence, the financial results of the fiscal year under review were very unsatisfactory, being compounded by the sizable drop in street prices at the point of sale. I believe the problem is not a one-time event but a structural issue within the HD games category.

How to address the issue is a major task for the executive team. As noted above, the HD games category faces the structural issues of an inflexible earnings model and long-term, large-scale development resulting in a low rate of investment turnover. These two factors are closely interconnected. First, we have to create earnings opportunities even before a product is released in order to raise investment turnover of a long-term, large-scale development project. Titles of large-scale development are our flagship

titles, showcasing our technologies. We will never lower the flag of such titles. In fact, they are strong brands and therefore have the potential of diverse content exploitation. It is possible to establish a business model that delivers content in various formats to customers even before the launch of a game. Through implementation of such a development process, we will promote approaches to raise investment turnover by accelerating earnings opportunities and reducing financial risks. These approaches should not be discussed in the context of financial consequences. A lack of earnings opportunities over a long period of time means, essentially, having no contact with customers during the same period. In these days, it is becoming crucial to strengthen customer relations. Re-examining our approach to long-term, large-scale development is also a step toward building a better customer relationship.

Next, let me comment on the earnings model. In the online game area, including games for mobile devices, flexible pricing models represented by free-to-play ("F2P") have become mainstream. Sales units of F2P-based games are not physical discs, but rather are in-game items or virtual currency. Therefore, the F2P model is flexible in that earnings are adjustable according to players' demand without any restriction on distribution of game products. My aim here is not to discuss the dichotomy between F2P and the fixed pricing model, but I would like to put emphasis on the major transformation of the game-playing environment in these days and big changes in consumer preferences regarding games. Devices for playing games are undergoing a rapid evolution and customer requirements for game experiences are becoming diversified accordingly. Consequently, the time has come for us game makers to take more flexible approaches in offering games and to devise various earnings models conforming to customers' game-playing environments, moving away from the limited outlet of disc-based distribution of games. In this current of change, it is extremely important for the HD games category to enable transition from a disc-based earnings model to a more flexible one. This will define the future way we pursue HD games development.

The evolution of devices, particularly smartphones and tablets, is progressing at an amazing pace. Consumer game consoles are becoming smarter as well. It is too soon to predict if all of these devices will ultimately converge or diverge, but regardless of the direction taken, we still have to have the capability of supplying games to any platform. On top of all that, the market has even more choices: new game machines called microconsoles, as well as the upcoming commercial launch of cloud gaming services. The market for our HD games has considerably expanded from the days when games could only be played on conventional PCs and consumer game consoles. That is to say, consumers can now enjoy playing HD games on various devices and in various environments. This is an enormous paradigm shift. Under the conventional disc distribution business model, development and sales were separated as different functions, with total optimization achieved through partial optimization in each function. Since games were provided on discs, we set a price of a game upon a unit-basis, we concentrated our development efforts on the completion of a gold master, and we were able to maximize profits through maximization of the number of discs shipped and unit prices. However, the spread of smart devices has now enabled multi-device, multi-environment experiences of HD games. Once distributed exclusively on discs, HD games are now available through other media. We must shift away from the traditional divided structure in favor of a unified system that aligns earnings models with game development.

This is a new challenge for us—a big one that requires a new skill set. If we can resolve the challenge successfully, we will open the door to new business opportunities. We are the company developing games and delivering them to customers. No matter how devices evolve or how the game environment changes, we still have to have the capabilities of delivering games to our customers. The environment supporting high-end games is definitely expanding, and this fact convinces me of the advent of a new age when we can fully demonstrate all the game development capabilities we have accumulated to date. The big difference from the past practice is the earnings model. A priority in the fiscal year ending March 31, 2014 is to build a firm business structure as quickly as possible to address changes in the earnings model while providing customers with excellent game experiences that make us stand out from the others.

Let me wrap up with one more major theme—the issue of locality. Marketing AAA titles on a global basis was one of our strategic initiatives. I, however, have to admit that titles appealing to a global audience are very limited, with a few exceptions. In addition, it is exceedingly difficult to achieve worldwide prominence for a new IP. Customer preferences vary from region to region, and other factors such as lifestyle, income status, and infrastructure are vastly different throughout the world. Therefore, developing a game on the assumption of world-wide distribution involves tremendous challenges. Consequently, we will prioritize a product portfolio for the future that attaches importance to consumer preferences in each region we serve. We will utilize our global network to propel our global business with a product lineup that emphasizes regional tastes. Of course, we will always pursue an opportunity to expand a hit title's service territory beyond its original region. We, however, will start with global business development by fine-tuning each product portfolio to customers in the targeted region. We will also be watching markets that present considerable growth potential, particularly the India and Asia region, the Middle East, and Latin America. We aim to establish a solid business base in these markets, and start generating a profit as soon as possible thereafter. This is another major business objective for the fiscal year ending March 31, 2014.

Our poor performance in the fiscal year under review undoubtedly caused shareholders considerable concern. It is our mission, as the new executive team, to reverse this situation, and to return the Group to a profitable position at the earliest possible date.

The business environment for the game industry is in the midst of intense and extensive changes not yet seen. However, we see this as an enormous opportunity for growth. I would appreciate your continued great support.

Yosuke Matsuda
President and Representative Director