To Our Shareholders

President and Representative Director
Yoichi Wada

I am proud to present the annual report of SQUARE ENIX for fiscal 2004, ended March 31, 2005.

Fiscal 2004 was the Company's second year of business since we were formed through the merger of SQUARE CO., LTD., and ENIX CORPORATION. Consolidated net sales increased 16.9%, to ¥73,864 million; operating income rose 36.3%, to ¥26,438 million; recurring income jumped 41.9%, to ¥25,901 million; and net income climbed 35.8%, to ¥14,932 million. These results all represented record highs for the Company.

Our operating income margin of 35.8% and return on equity (ROE) of 14.5% are among the highest in the industry.

I am pleased to report that all of our operations are proceeding smoothly and according to plan.

As a gesture of appreciation to our shareholders, we added a commemorative dividend of ¥30 to our common dividend, making the total dividend for the period ¥60—double that of fiscal 2003.

Creative & Innovative

Video Game Industry Awaits the Release of Next-Generation Game Consoles

Looking at results by segment, Games (Offline) revenue—our largest segment—rose 10.4% in fiscal 2004, Games (Online) grew 55.2%, Mobile Phone Content jumped 63.2% and Publication increased 12.3%. We achieved revenue and income growth in all business segments, resulting in a more diverse and well-balanced business portfolio.

Total shareholders' equity at the end of the period totaled ¥108,933 million, and with no interest-bearing debt we were able to achieve an equity ratio of 82.7%. This indicates our sound financial position.

Nevertheless, we must not be complacent with our current position. These figures only show that we have built up our strength as planned for the coming challenges. Having completed phase 1, we now need to move on to phase 2. Within the next year or two, Sony Computer Entertainment Inc., Nintendo Co., Ltd., and Microsoft Corporation will release next-generation game consoles. This is a transitional period that occurs roughly every five years, in which downward pressure on prices, an increase in the number of choices for customers to purchase, and intensifying competition with alternate services and products combine to form a difficult market environment.

We have been preparing for this transitional period and are set to launch our strongest-ever lineup of titles. We are also increasing our sales efforts by securing SQUARE ENIX-dedicated shelf space in retail stores to cope with the market leveling off. We also grew revenue outside of packaged game software, further improving our ability to create a stable profit base.

We have also laid down the foundations to become a leader in this next generation of games consoles. At Electronic Entertainment Expo (E3), the world's largest video game trade show, held in Los Angeles in May 2005, Sony Computer Entertainment, Nintendo and Microsoft introduced SQUARE ENIX as one of the most important game software companies. Our presence in the video game industry has without a doubt become world class.

And yet, this is still not enough. The impact of current changes in the industrial structure reaches beyond the video game industry. These are fundamental changes, of the kind that come along only once every few decades, and impact all industries.

The emergence of next-generation game consoles is merely a part of this.

Network is the Game.
Everything plays Games.

The Impact of Ubiquitous Networking

When I say "changes of the industrial structure," I mean the fundamental changes that ubiquitous networking will bring.

The chart below shows the performances of various terminals. (To simplify, we used the clock speed of CPUs as a proxy to the performance of the terminal). This represents the supply curve.

The vertical axis uses a logarithmic scale, so you can really see how much progress had been made over the past decade or so. Also, it is clear that game consoles have been leading the performance of terminals since the late 1990s, especially when taking market penetration into account. This leadership gave the video game industry the leverage to make advances in entertainment.

The more important point, however, is what is happening to the customers' demand curve.

All new game consoles, including portable ones, are now equipped with networking connectivity. Personal computers (PCs), personal data assistants (PDAs) and even car navigation systems can now connect to the Internet. The various terminals that have evolved independently now have common functions as network terminals.

The processing power of each terminal may already be "good enough" since they offer new value to customers by becoming a new window to the Internet.
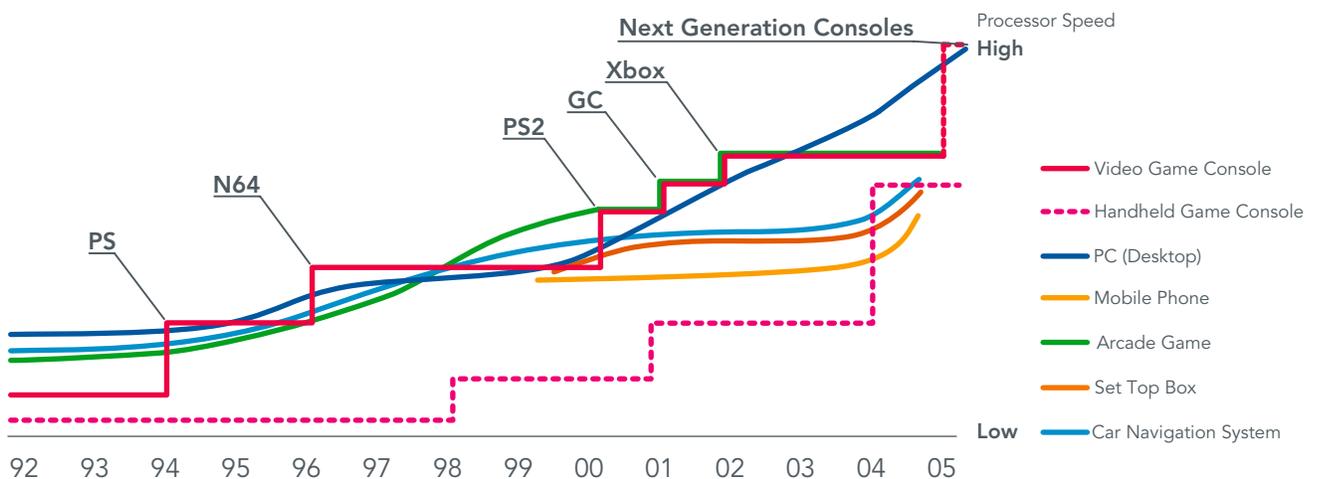
In other words, the customers' demand curve is not rising as much as the terminal capability supply curve, and it may not rise any further.

The remaining issue is communication infrastructure.

The chart on page 5 shows the home broadband penetration rate in Japan. Japan now has one of the best Internet infrastructures in the world, overcoming its slow start in the 1990s.

Communication is borderless, and communication environments in all countries are synergizing and advancing irreversibly. In the near future, I believe communication infrastructures will not be an issue in most countries.

Progress of Terminals —Taking CPU Power as an Example—

Processor Speed

Next Generation Consoles

Xbox

GC

PS2

N64

PS

High

- —— Video Game Console
- ---- Handheld Game Console
- —— PC (Desktop)
- —— Mobile Phone
- —— Arcade Game
- —— Set Top Box
- —— Car Navigation System

Low

92 93 94 95 96 97 98 99 00 01 02 03 04 05

Created by SQUARE ENIX from various sources

Structural Changes Mean a Power Shift to Customers

Prophets never tell us exactly when future events will take place. Business people are often overeager to act in fear that the future will suddenly becomes the present. If they acted too early one time, the next time they are overcautious and miss out on opportunities.
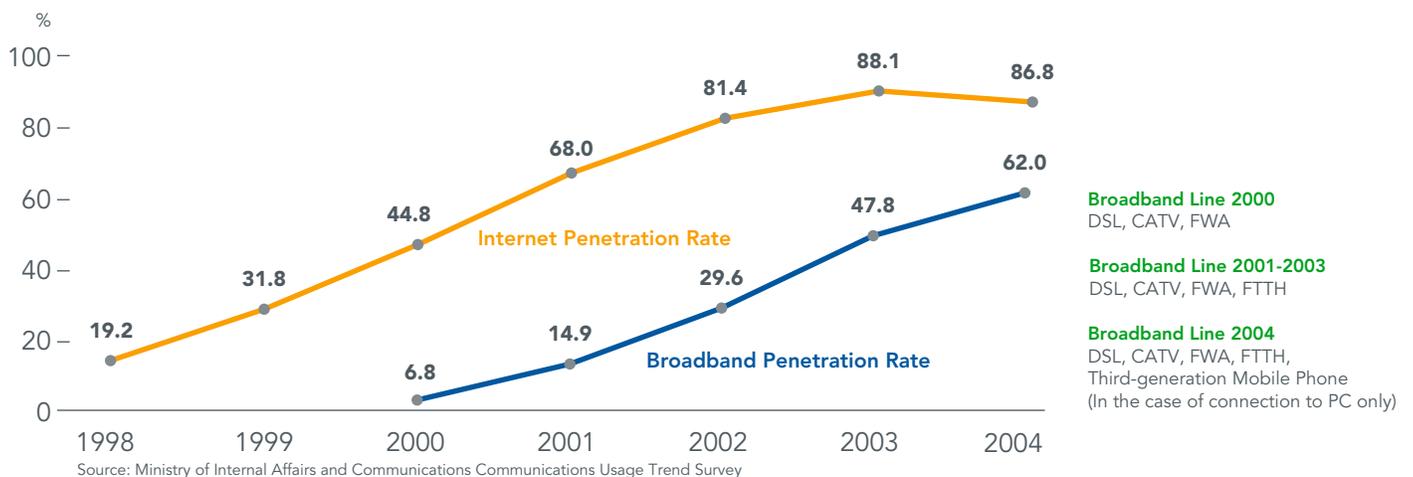
We have been bombarded with clichés, such as "consumer-owned" and "customer-centric," that herald a shift in power toward the customer. This time, however, it is different. The clichés are finally becoming a reality, and a true power shift is under way.

I firmly believe the most important quality that management can possess is insight into the timing and details of structural changes. The next two to three years will usher in structural changes not only to industry but to the entire social system. All my managerial strategies are based on this perspective toward these coming years.

Content is information. That is why these upcoming structural changes will directly affect our industry as well as the surrounding industries. When the processing power of terminals and communication bandwidth become more than "good enough," customers will have the same capability as content providers to broadcast content. In other words, customers will inevitably become suppliers of content, and content providers need to provide support for such customers to broadcast their own content while remaining content suppliers themselves.

Broadband Penetration Rate for Households in Japan

Broadband Line 2000
DSL, CATV, FWA

Broadband Line 2001-2003
DSL, CATV, FWA, FTTH

Broadband Line 2004
DSL, CATV, FWA, FTTH,
Third-generation Mobile Phone
(In the case of connection to PC only)

Internet Penetration Rate: 19.2 (1998), 31.8 (1999), 44.8 (2000), 68.0 (2001), 81.4 (2002), 88.1 (2003), 86.8 (2004)

Broadband Penetration Rate: 6.8 (2000), 14.9 (2001), 29.6 (2002), 47.8 (2003), 62.0 (2004)

Source: Ministry of Internal Affairs and Communications Communications Usage Trend Survey

Our Vision for a New Era

Some people may wonder how we can make money in such a structural change; others may feel that there will be no profit opportunities because of this intensified competition. We believe the opportunity lies in the structural change itself.

We do not expect end users to spend more money. Customers will spend the same amount, but the money will be distributed differently. In the initial stage of the industry evolution, the value-added lies at the infrastructure layer. As a result, money is distributed heavily to the infrastructure providers. They will reinvest the cash to improve infrastructure. This will eventually lead to commoditization of the infrastructure and the distribution of money will be diminished.

Going forward, we expect more money to be distributed to the software layer rather than the infrastructure layer. Our fundamental strategy is to grasp this shift of value. The two points below sum up our competitive advantages in the marketplace.

1. We are not involved in the infrastructure or hardware sectors.

In what may seem like a contradiction in terms, our strength lies in what we lack. Players already successful in the infrastructure and hardware layers cannot deny their own business domains, and they will end up leaning toward an impractical vertical integration model, which is doomed to fail in the network age. Even if they pursue new businesses without seeking synergies with their existing core businesses, limited returns on investments in new fields are swayed by the oversized core businesses, and this eventually sinks new businesses.

2. We are one of a few players in the position to expand their presence comprehensively across all the areas in the software layer.

In the world where the larger value-added resides in the software layer, it is clear that the company that controls a larger part of the software layer wins. There are several layers in the software layer, including the software platform, application and user service layers. SQUARE ENIX is in the unique position of having advantages in each of these.

In the software platform layer, we have ramped up our development since acquiring UIEvolution, Inc., in 2004. To make all terminals become windows into a virtual space, we need a platform that absorbs the differences of terminals. This idea is embodied in our cross-platform strategy, which enables users to access content from game consoles, PCs and mobile phones anywhere.

In a networked society, content providers and customers will develop content together

Software	Community
Content made by game makers	Content generated by users
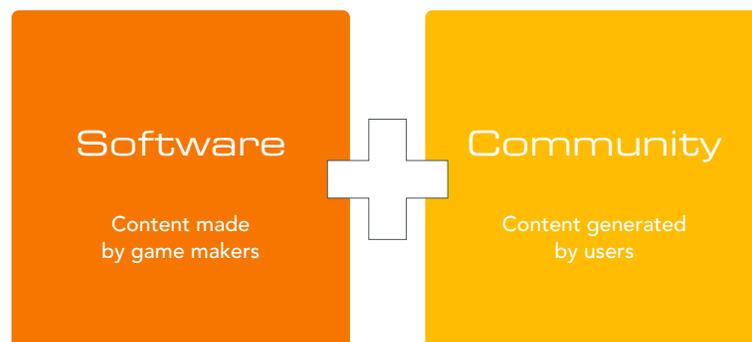
The application layer is where our core capability resides. We have the property rights to a variety of games, *anime* and *manga* enjoyed by fans all over the world, backed by skilled personnel who continue to produce high-caliber content.

In the user service layer, our experience in the operation of online games is a source of competitiveness. The knowledge and skills to operate online games can be acquired only through actual operation, and as such it is very difficult to catch up if you are behind.

We are aware that we also have a weakness, which lies in our corporate culture and how we succeeded in the past. We excelled selling top-quality packaged software. Our emphasis on perfection, however, could have appeared to some as arrogance, particularly when dealing with the supporting role of customers' activities. In this new era, it is important to change our mindset so that our relationship with customers is content, and the quality of content is something we improve over time working with customers.

Grasping the shift of value-added in the industry is critical to be competitive. This is exactly why the most recent merger and acquisition (M&A) and alliance activities are based on economies of scope rather than scale.

M&A and alliance activities that have happened to date have been relatively predictable, but we need to pick up speed to respond to a rising trend toward attempting to ride out structural changes by relying on huge amounts of capital.

The new society will require new values and social codes. We realize the important role lying squarely on our shoulders and continue to uphold our obligations to society.

Fiscal 2004 was a year of building stamina for SQUARE ENIX. Fiscal 2005 and 2006 will see the Company enhance its structure. The merger between SQUARE and ENIX was a significant milestone in the structural change within the game industry. Going forward, I expect more alliances with companies outside of the game industry will happen.

We appreciate your unwavering support.

July 2005

Yoichi Wada

Yoichi Wada
President and Representative Director