Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2020-05-05
Event Description: Q1 2020 Earnings Call

Market Cap: 52801.3672906
Current PX: 68.5299987793
YTD Change($): 9.1099987793
YTD Change(%): 15.332

Bloomberg Estimates - EPS
Current Quarter: 0.383
Current Year: 2.471
Bloomberg Estimates - Sales
Current Quarter: 1322.846
Current Year: 6787.8

Q1 2020 Earnings Call

Company Participants

- Christopher Hickey, Senior Vice President of Investor Relations
- Bobby Kotick, Chief Executive Officer
- Daniel Alegre, President and Chief Operating Officer
- Dennis Durkin, Chief Financial Officer and President of Emerging Businesses
- J. Allen Brack, President
- Humam Sakhnini, President
- Rob Kostich, President of Activision

Other Participants

- Mario Lu, Analyst
- Garik Johnson, Analyst
- Ryan Gee, Analyst
- Doug Creutz, Analyst
- Kunaal Malde, Analyst
- Eric Handler, Analyst
- David Karnovsky, Analyst
- Alex Giaimo, Analyst
- Brian Nowak, Analyst

Presentation

Operator

Good afternoon and welcome to the Activision Blizzard First Quarter 2020 Earnings Conference Call. All participants will be in a listen-only mode. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please also note, today's event is being recorded.

At this time, I'd like to turn the conference call over to Chris Hickey, Senior Vice President of Investor Relations. Sir, please go ahead.

Christopher Hickey, Senior Vice President of Investor Relations

Good afternoon and thank you for joining us today for Activision Blizzard's first quarter 2020 conference call. With us are Bobby Kotick, CEO, Daniel Lakeway, President and COO and Dennis Durkin Company's CFO and President of Emerging Businesses. And for Q&A, Rob Kostich, President of Activision; J Allen Brack, President of Blizzard and Humam Sakhnini, President of King will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the impact of the COVID-19 pandemic, the risk factors discussed in our SEC filings, including our 2019 Annual Report on Form 10-K and our first quarter 2020 10-Q, which will be filed shortly and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, May 5th, 2020.

We will present both GAAP and non-GAAP financial measures during the call. We provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions including legal fees, costs, expenses and accruals, expenses related to debt financings and refinancings, restructuring and related charges, the associated tax benefits of these excluded items and significant discrete tax-related items, including amounts related to changes in tax laws, amounts related to the potential or final resolution of tax positions and other unusual or unique tax-related items and activities.

These non-GAAP measures are not intended to be considered in isolation from as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also an earnings presentation which you can access with the webcast and which will be posted to the website following the call.

And now, I'd like to introduce our CEO Bobby Kotick.

Bobby Kotick, Chief Executive Officer

Thank you, Chris. And thank you for joining us today. Let me first convey our sympathies to those who have suffered during this difficult time. While very few of our own team members have contracted COVID-19, a number of our employees have been impacted by the illness and the passing of family members. Our thoughts and prayers are with them and everyone else affected by the pandemic.

Honestly, I've been awestruck during the last two months by the strength of our employees and their families, managing through unprecedented challenges from healthcare to childcare. Our teams around the world have shown ingenuity and incredible resilience. And even faced with so many difficulties, our employees still ensure that the joy, the social connection and the unexpected benefits of gaming as a way to keep our 400 million players around the world connected and engaged and safely at home has continued without interruption.

Our employees and their families have shown incredible empathy for those affected by the pandemic in their communities and across the world. They have organized meal deliveries, care for the elderly, even the use of their own 3D printers to create high quality facial protection for their colleagues. Our teams have shown unwavering support for the first responders, nurses, doctors and medical professionals, working tirelessly in unimaginable conditions.

Our Corporate Social Responsibility initiatives have been expanded to support programs to provide healthcare professionals with a variety of resources, including faster, more effective testing and the use of tools like convalescent blood transfusion as a possible method of immunization. We've also increased our direct support for military families by millions of dollars. Through our team's dedication and incredibly hard work under very difficult circumstances, we delivered results significantly above our outlook for the first quarter. And this momentum will likely continue for the second quarter.

I've conducted almost a 100 earnings calls and none was under a backdrop of so much uncertainty for the future. Our mission to connect and engage the world through epic entertainment has never been more meaningful than it is today. At a time when so many forms of social interactions and entertainment experiences have been shutdown, we're providing entertainment with positive impact for hundreds of millions of people through our games.

Our content and connecting members of our communities around the world is critically important. Our development and commercial teams quickly adapted to this new work environment. And as of now, we're on track to deliver compelling new content, including the World of Warcraft Shadowlands expansion and the next premium Call of Duty release, both of which are planned for the second half of the year.

Our esports organization has quickly pivoted to remote production and continues to deliver live esports for both the Call of Duty League and the Overwatch League, a direct result of the hard work and flexibility of our team owners and our sponsors.

In the face of unprecedented circumstances, our extraordinary teams also delivered extremely strong first quarter financial results. We significantly exceeded our outlook for both revenue and earnings per share. We reached new highs for first quarter net bookings across each of mobile, console and PC. And we exited the quarter with accelerating engagement and momentum across the business as people around the world turn to our content for entertainment and connection.

Performance in the quarter was led by Call of Duty, which is achieving tremendous scale and momentum across platforms, geographies and business models. Following industry leading launches for Call of Duty Mobile and Modern Warfare in the fourth quarter of 2019, the franchise raised the bar even higher with the launch of Warzone in March.

With a free-to-play business model and cross platform play, Warzone expanded Modern Warfare's reach, engagement and player investment. Warzone to date has brought in over 60 million players since its launch. The exceptional results for Call of Duty reflect our team's remarkable execution as they innovate and take on new commercial challenges to grow and better serve our community. Their success demonstrates that free-to-play experiences across mobile, console and PC not only extend the reach of our franchise, but can also lead to strong in-game monetization and sales of premium content.

Call of Duty's success highlights the great potential across our portfolio as we continue to focus on extending our fully owned intellectual property to new platforms, new geographies and new business models. Blizzard also reported strong growth in the first quarter, led by World of Warcraft. After doubling in the second half of 2019, the WoW active community grew further in Q1. Blizzard is seeing strong increases in engagement across our franchises as people around the world stay home, adding to business momentum as our game teams execute against the strongest pipeline of content in Blizzard's history.

At King, Candy Crush was again the top grossing gaming franchise across U.S. app stores, with engagement increasing sharply towards the end of the quarter. To enable our community to play even more as a part of the stay at home initiatives, in late March, King offered unlimited free lives across many of their titles, resulting in the number of game rounds played in a single day shattering all prior records.

Momentum continued to increase in April with strong year-over-year growth in reach engagements and player investment. As we build on our strong first quarter results and our continuing momentum, I'm excited to introduce our new President and Chief Operating Officer, Daniel Alegre.

From his long tenure at Google, Daniel brings deep experience building direct digital relationships with consumers, fostering strategic relationships with key industry partners and driving rapid growth internationally and in early stage businesses. His expertise and commitment to excellence and

Execution will be his focus. I'd also like to thank Coddy Johnson for his extraordinary contributions to the continued success of the company during his 12-year tenure and for being a truly, truly valued friend.

Of course, our strong business performance wouldn't be possible without the efforts of our dedicated, talented and truly empathic teams around the world. We're so grateful for the work we're doing under extremely challenging circumstances. We're also appreciative of the continued support of our shareholders, partners and players and we wish you and your families health and safety through what remains a difficult time.

And now Daniel will review the highlights of our operations with you.

Daniel Alegre, President and Chief Operating Officer

Thank you, Bobby. I'm glad to be with you all for my first earnings call as COO and really proud to be part of a company so deeply connected to its mission during this really challenging time. I want to start by first expressing my deepest sympathies to all those affected by this health crisis and expressing thanks on behalf of the entire company to all those on the frontlines of the battle against the COVID pandemic. I would also like to thank our employees for their commitment to our players and to each other, particularly under such a unique and difficult environment we are currently living in. But before I discuss our recent operational highlights, I'd like to share with you my focus and priorities, they are simple execution, execution and execution. We have great franchises and we will get back to what we are known for, superb execution.

As Bobby said, the health and safety of our employees and their families remains our priority. I'd like to expand on the measures we are taking to keep our employees and their families safe and address our expectations for our development pipeline for the remainder of the year. All our offices had moved to work-from-home environments by mid-March and we are fortunate to have had very few cases of COVID-19 across the company.

And we are ensuring our employees and their family members are receiving the best possible care and we're covering all costs of testing and treatment for affected employees and their families. We have increased access to telehealth resources and contracted private doctors and medical support in regions where employees live and work. We have had additional services to our already best in class health benefits and ensured that employees have access to the mental and physical wellbeing and support they need well at help. And we are continuing to find other ways to support our employees and their families, including services to help families balance work and home life.

Now turning to development, the digital nature of our content means our creative talent can continue to work on our product pipeline from home. Although the shift to remote working does add complexity and challenges in some areas of the game development process including creative collaboration, motion capture, voiceover work, localization and quality assurance. We are implementing mitigation measures to each -- and to address each of these areas.

Importantly, based on the work to date, we still expect to deliver a robust slate of content over the remainder of the year. This includes the next premium release of Call of Duty. Two titles based on library IP from Activision. The World of Warcraft: Shadowlands expansion, regional testing for new mobile titles and ongoing mob -- live operations across our key franchises.

Regardless of location, our teams remain focused on executing against our four strategic growth pillars as Bobby has laid out. First, delivering a strong consistent cadence of major new content releases. Second, driving live operations with ongoing in-game content, services, features and events. Third, expanding King's industry leading mobile success and extending our acclaimed console and PC franchises to mobile. And finally, building new engagement models around our franchises, including advertising, esports and consumer products.

Now more than ever, players new and existing are looking for connection through epic entertainment and our mission is to make that available to them in whatever form they find most convenient. Now turning to our first quarter results, we significantly exceeded our outlook, driven primarily by over performance for Call of Duty: Modern Warfare throughout the quarter, including a highly successful start for our new free to play Call of Duty: Warzone. We also continued -- saw continued momentum for World of Warcraft and better than expected results for other key franchises in the second half of March, as populations sheltering at home in many of our key regions turn to our content for entertainment and social connection.

These trends have continued so far in the second quarter with business performance accelerating further in April. Now starting with Activision, MAUs more than doubled over the prior year, reaching a 102 million as Call of Duty delivered remarkable growth across multiple vectors. As we've discussed on prior calls, we made significant changes with the launch of Call of Duty: Modern Warfare, to enhance the player experience, expand the community and deepen engagement.

We added cross platform play, introduced a new in-game content system and removed the season pass to keep our players closer together. Modern Warfare entered the year with a strong momentum, achieving substantial year-over-year growth and engagement, premium game sales and in-game net bookings in both January and February.

And the launch of Warzone on console and PC on March 10th, really took the franchise to new highs. Warzone is a massive free-to-play experience where upto a 150 players compete in a range of modes on a vast map featuring crossplay and in-game system, entirely integrated with the Modern Warfare Battle Pass. Warzone adds yet more compelling content for our Modern Warfare community and also enables an entirely new set of players around the world to experience Call of Duty for free. This response has been incredible, Warzone has brought in more than 60 million players since the launch, including many on the PC platform and in countries beyond Call of Duty's traditional regions.

We are seeing the free-to-play experience driving strong incremental sales on the premium Modern Warfare title, adding to its sales momentum entering the year and rising demand from stay at home conditions. Modern Warfare's sell-through in Q1 was the highest ever for a call Call of Duty title outside of the launch quarter. Life-to-date, Modern Warfare has sold through more units and has more players than any prior Call of Duty title, at this point after its release.

Warzone also contributed to a further acceleration in Modern Warfare's in-game net bookings, which more than doubled year-over-year versus the prior game in Q1, even with the removal of the season pass. And this momentum has only strengthened, the third season of in-game content launched in April and is Call of Duty's best performing to date, for both engagement and player investment.

With the new free-to-play experience contributing to massively expanded audience, unprecedented momentum in premium game sales and robust in-game growth, we expect Modern Warfare's net bookings this year to be the highest for a Call of Duty game in the year after launch.

And looking ahead, the next premium release for Call of Duty already looks great and remains on track for release later this year. On the mobile platform, the Call of Duty Mobile team continued to build on last October's breakout launch with new content, features and events aimed at optimizing engagement, retention and player investment. The team started to deliver an accelerated cadence of content in March, launching new seasonal events every four weeks, twice as frequently as previously. The combination of increasingly compelling content and events and stay at home dynamics drove the growth in reach and engagement in March. And player investment has followed with April's Season 5, delivering the highest monthly in-game net bookings since Season 1. With deep engagement, substantial content in the pipeline and opportunities to further refine the in-game system, we expect Call of Duty Mobile to be an increasing contributor over time.

Q1 also saw the launch of the inaugural season of the professional Call of Duty League. Originally planned in a local city-based homestand format, we quickly pivoted all matches to online play and remote production for the remainder of the regular season, to keep our players and fans safe while still delivering premium esports content toward mobile audience.

With the Call of Duty demonstrating the power of our franchise model across platforms, geographies and business model and premium content on track for the fall, we really couldn't be more excited about the growth trajectory for 2020 and beyond. Now turning to Blizzard. MAUs were 32 million in Q1 with each of Blizzard's key franchises experiencing a month-on-month increase in reach, in March. Word of Warcraft continued its strong momentum in the quarter as the team continued to deliver more content between expansions than ever before, having doubled its active community in the second half of last year, the number of players on monthly or longer-term subscription plans increased further in Q1.

Reach and engagement were particularly strong as regions introduced shelter at home measures through the quarter, with momentum increasing further in April. The community continues to engaged deeply in Classic, a recreation of our original WoW from 15 years ago, which has delivered substantial content drops in recent months and has much more to come later in the year. Reach and engagement also increased for Modern WoW, which again received a major content drop in Q1.

And this increased activity drove accelerating pre-sales of Shadowlands, the next expansion for Modern WoW, which is slated for the second half of the year. Hearthstone continued to deliver improved engagement trends in the first quarter, driven by the launch of the new battlegrounds auto battler mode in November and strong execution in live operations.

Overwatch also experienced a meaningful increase in engagement in March, as its latest seasonal event coincided with stay at home effects and fans continue to engage with the franchise through the Overwatch League which successfully moved to online play and remote production during the quarter.

And finally, Diablo Immortal is shaping up very well. We remain on track to begin regional testing for the game in the middle of the year. At King, MAUs were 273 million, increasing 10% from the fourth quarter.

MAUs grew month-on-month in January and February and then accelerated further in March as shelter at home conditions came into effect. King's key franchises -- franchise Candy Crush grew MAUs year-over-year in each month of the quarter with double-digit growth in March. And within the Candy franchise, the community played more rounds of games in any quarter since the 2016 acquisition.

Now in terms of player investment, Candy Crush Saga remained the top grossing title across U.S. app stores and the wider Candy franchise was once again number one. We previously discussed King's initiatives to bring back lapsed payers and attract new payers into the ecosystem, positioning the business for stronger growth over the medium and long-term. And as expected, these initiatives dampened in-game net bookings again in Q1. But they contributed to ongoing improvement in payer trends, in January and February. The four payers numbers -- payer numbers stepped up further in both March and April. And with strengthening engagement in payer trends, we've seen King's in-game net bookings grow by low double-digit percentage year-over-year in April.

While we saw improving trends in King's, in-game business, which represents a significant majority of the segment's net bookings. The advertising business slowed towards the end of the quarter. Advertising grew over 75% year-over-year for the first quarter, then moderated a bit in April against the backdrop of a sudden decline in demand across the digital advertising sector, albeit still growing over 20% year-on-year in April.

While we assume the environment will remain challenging, we do expect growth for the full year as we roll out more ads to more players, enhance our infrastructure to deliver the highest value adds to each player and broaden both our base of advertisers and demand partners.

I'd also note that the combination of King's strong in-game trends in the current situation in the ad market is creating more opportunities for the business to cost effectively bring players into the network, expanding its audience and further boosting its MAU trajectory, the same is true across our other business units.

So in summary, we entered the year with strong momentum in some of our biggest franchises, which only increased further through the quarter. Our employees are showing remarkable dedication as they take on the responsibility of delivering the highest quality content to our expanded communities. And I couldn't be more excited to be part of this great and dedicated global team. I'm focused on executing on our priorities as we deliver against a substantial opportunity to extend our largest IP across new platforms, geographies and business models and work on the strongest pipeline in our company's history.

I will now hand over the call to Dennis to discuss our Q1 financial results and outlook. Dennis?

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Thanks, Daniel. Today, I will review our Q1 2020 results as well as our outlook for 2020 and the second quarter. But before I start, I'd just like to echo Daniel and Bobby's sentiments about the unique environment we are in and share my sincerest sympathies to those who have been affected directly by it as well as my thanks and gratitude to all our teams and employees who have so seamlessly transitioned into this new work environment we find ourselves in.

Our digitally native business model, both on the production and the distribution side of our business makes us well positioned to deliver world-class content and experiences for our players. Our teams take our mission and our responsibility to deliver fun and social engagement to our players in this tough time very seriously. They really didn't miss a beat during all this transition and you can see the strong results of those efforts in our Q1 results and increased full-year guidance.

Our first quarter revenue and earnings were well ahead of our prior outlook, primarily driven by our investment in creative and commercial initiatives for Call of Duty, delivering better than expected results throughout the quarter.

In addition, World of Warcraft continued to over-deliver and other key franchises and catalog sales also exceeded our outlook, benefiting from stronger demand towards the end of the quarter as consumers sheltered at home in many of our key regions. To review the quarter, I will start with our segment results.

Activision revenue was a $519 million, growing 64% year-over-year. Growth was driven by Call of Duty, Modern Warfare and Warzone in-game revenues, strong game sales of Premium Modern Warfare and the addition of Call of Duty mobile. Operating income was a $184 million, with an operating margin of 35%, 12 percentage points higher year-over-year. Blizzard revenue was $452 million, increasing 31% year-over-year, reflecting strong growth for World of Warcraft and the release of Warcraft III: Reforged in the quarter. Operating income was a $197 million. Blizzard's operating margin was 44%, significantly higher year-over-year, primarily due to strong revenue growth. King's revenue of $498 million was roughly flat sequentially and lower year-over-year, driven primarily by King's actions to prioritize mobile payer engagement in the quarter.

The ads business grew over 75% year-over-year. Operating income was a $156 million, with an operating margin of 31%, lower than a year ago due to lower revenues and higher operating expenses as King made disciplined investments in expanding its player network. Across our segments, in-game net bookings grew 20% year-over-year to $956 million.

Now let's turn to our overall consolidated results. Unless otherwise indicated, I will be referencing non-GAAP figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated Q1 GAAP revenues of $1.79 billion, a $148 million above our February guidance. This includes the net recognition of deferrals of $266 million. Net bookings of $1.52 billion were $247 million above our February outlook. We incurred GAAP only restructuring and related charges of $23 million. And we generated Q1 GAAP EPS of $0.65 and Q1 non-GAAP EPS of $0.76, which was $0.10 above guidance. These figures include the net recognition of deferrals of $0.18.

In terms of cash flow, the increasingly digital, recurring and cash generative nature of our business remains one of our fundamental strengths. This powers a strong balance sheet, which continues to be an important strategic asset for the company, especially now. In Q1, we delivered operating cash flow of a $148 million, lower year-over-year despite higher operating income due to cash payments for tax settlements and working capital timing. Our cash and investments at the end of March were approximately $6 billion. And we ended the quarter with a net cash position of approximately $3.3 billion. And as previously announced, this week, we will pay an annual dividend of $0.41 per share, 11% higher year-over-year.

Now let's turn to our outlook for Q2 and the full year. In Q2, Activision plans to deliver two seasons of in-game content for Modern Warfare and Warzone versus one season in the first quarter. Season three is already launched very successfully in April. Activision also released Call of Duty: Modern Warfare 2 Remastered on PC and Xbox One following the PS4 release in late Q1. And they plan to continue delivering new features, events and seasons for Call of Duty mobile.

In April, Blizzard launched its latest Hearthstone expansion, Ashes of Outland and through the quarter will continue to support other key franchises with in-game content and King will continue to deliver innovative features, events and live ops across its portfolio.

Turning to the second half of the year. Our planned slate includes a new Call of Duty premium title, two releases based on our extensive library of IP from Activision and Blizzard's Shadowlands expansion for World of Warcraft. We will also continue to deliver in-game experiences for our other key franchises across our portfolio. And we continue to expect to begin regional play testing for Diablo Immortal and certain other mobile titles, although, as discussed last quarter, we don't include any material revenue from these new mobile titles in our guidance.

Before I discuss the specifics of our outlook, I'll provide some context. The full extent of the impact of the pandemic on our financial results will depend on numerous evolving factors that are -- we are not able to fully predict at this time.

While we have seen a positive impact on demand, there are also risks related to global economic weakness, rising unemployment, pressures on retail channel, pricing and other factors where we have limited visibility currently. We have tried to be prudent in our guidance to account for these effects. And we believe there is a potential for over-performance if these risks do not materialize.

Now, the addition of the Warzone free-to-play experience has further increased the reach, engagement and player investment in Call of Duty, building on an existing strength for Modern Warfare and creating a strong foundation for future financial performance. As discussed, we are also seeing increased demand for our other franchises as interest in gaming grows. The current environment creates the potential for a structural opportunity to bring more players into our communities who we can then engage and retain for the long-term and to accelerate the continuing shift towards digital sales in our business. We have attempted to be conservative in our assumptions around the impact of these trends beyond the second quarter, but the backdrop does create greater potential for operating over-performance later this year.

Since we provided our initial guidance in February, the strengthening dollar has resulted in an additional FX headwind to full year net bookings of approximately a $100 million. And a combination of FX and lower interest income from declining interest rates represent in aggregate, approximately $0.08 of headwind to our full-year GAAP and non-GAAP EPS versus our prior outlook.

Overall though, with strong momentum across the business, we are raising our outlook for net bookings revenue and EPS for the year and in the case of EPS, we are raising by an amount greater than our first quarter over performance, despite the FX and interest rate headwinds I just described.

Now let me get into specifics. For Q2 on a GAAP basis, we now expect revenues of $1.69 billion, including the net recognition of deferrals of $15 million. We expect net bookings of $1.68 billion. Product cost, game operations and distribution expenses of 19% and operating expenses including software amortization of 48% and a GAAP-only restructuring charge of approximately $20 million. We expect the tax rate of 21%, GAAP and non-GAAP share count of $776 million and EPS of $0.54.

For Q2 on a non-GAAP basis, we now expect product cost, game operations and distribution expenses of 19% and operating expenses including software amortization of 43%, We expect a tax rate of 19% and non-GAAP EPS of $0.64 including net deferrals of $0.01. On a GAAP basis for 2020, we now expect revenues of $6.8 billion, including net deferrals of a $100 million. We now expect net bookings of $6.9 billion for the year. Product costs, game operations and distribution expenses of 19%, operating expenses, including software amortization of 48% and a GAAP-only restructuring charge of approximately $50 million.

We now expect a GAAP tax rate of 20%. GAAP and non-GAAP share count for $778 million, and GAAP EPS of in $2.22. For 2020 on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 20% and operating expenses including software amortization of 42%. We expect a tax rate of 19% and non-GAAP EPS of $2.62, including the net recognition of deferrals of $0.02.

So in closing, our business has accelerating momentum from the dual tailwinds of strong execution in our largest franchises following last year's investments and increased development capacity and expanded reach and engagement as people turn to our interactive content as they shelter at home. We are humbled that so many people are turning to our content for solace, joy and connection in this challenging time and we'll continue to stay focused on delivering the high quality experiences that they have come to expect from us.

Now Bobby, Daniel and our business leaders Rob, Humam and J and I are happy to answer your questions. Operator?

Questions And Answers

Operator

Ladies and gentlemen, at this time we'll begin the question-and-answer session. (Operator Instructions) And our first question today comes from Mario Lu from Barclays. Please go ahead with your question.

Mario Lu, Analyst

Great. Thanks for taking the question. Amazing quarter and I hope everyone and their family is safe. So I know it's hard to parse out due to the increased engagement from COVID and social distancing but can you provide any color in terms of how accretive Call of Duty: Warzone has been to Modern Warfare unit sales, and what should we expect that success to have on the new Call of Duty 2020 premium title sales later this year? Thank you.

Bobby Kotick, Chief Executive Officer

Hi, Mario. This is Rob. Thanks for the question and also for your note upfront. I think the short answer to the question is that Warzone has definitely been accretive to the franchise. And it's become, and it is a really important part of the overall franchise ecosystem that we're creating and I think it's worth just talking about that a bit. Since the last few calls, we've been discussing bringing our community together through a number of player-focused initiatives and that started with crossplay's where all the friends can just get together, no matter what platform you're on, it was about the free content to our community at the same time and was about kind of the new deterministic content system we put in the game and of course in the backdrop here you have Modern Warfare, which has been just a fantastic game that gets better over time.

And then what we really did is amplified all of this with the launch of Warzone, our massive scale Battle Royale experience. And when you look at Warzone, it was definitely built to provide endless fun on its own and to stand on its own as a great game, but Warzone and Modern Warfare are also obviously connected in many ways, including through share progression systems, game systems and content offerings and what we're seeing right now in Warzone is a large number of players choosing the upgrade to the premium Modern Warfare game and experience everything that the Modern Warfare universe has to offer.

And so far, the number of upgrades to premium that we're seeing are definitely above our initial expectations and that's really great to see. And also across this universe, the Modern Warfare universe from an engagement perspective, we're also seeing franchise highs now in daily average unique players, peak concurrent players and overall player investment as been indicated on the call so far. So regarding the future of Warzone, we know how much the community is loving it. I mean how much they're enjoying the experience so far, so we're going to continue to invest in this significantly in terms of content, events, new modes, new ways to play and really it's just a ton more in the future.

And to follow up on the last part of your question, I think what I'd say is, yes, we believe it has the potential to positively impact future premium games as well and so we're excited about that opportunity. And before I jump off, I would also just like to thank all our Activision publishing, development teams and all our employees for keeping all of our critical projects on track. This shift to work-from-home has been a massive logistical exercise across the organization and the teams have done just an outstanding job and I just wanted to close this question by a big thank you to them, but again Mario. Thanks for the question. Appreciate it.

Mario Lu, Analyst

Great. Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks Mario. Operator, do we have the next question please.

Operator

Our next question comes from Garik Johnson from BMO Capital Markets. Please go ahead with your question.

Garik Johnson, Analyst

Thank you. Good afternoon. Hey. So you guys think increased engagement with video game owing to the stay-home-trend and COVID-19 will be sustainable, do you see a swing perhaps back either direction once we return back to normal?

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Hey, Garik, it's Dennis. Thanks. That's obviously a super important question and really applicable. Clearly, it's obviously a scenario, we'd all love to see which is life returning to back to normal as soon as possible, but the reality is that we really don't know what that new normal will look like once that comes to pass. It does seem like that there is a likelihood that even once shelter at home ends that there may be, it may be a fair amount of time before people are really returning to normal as we know it.

So we do think that there is potentially an acceleration to the structural change that we've seen in consumer entertainment, consumption patterns that we've already been seeing in gaming and that trend could persist for the long-term, which would obviously benefit social yet socially distant categories like gaming. We've already seen this with the younger generation of consumers where gaming is more an integrated part of their social entertainment fabric and times like these will make that activity, we believe, even more mainstream. We're obviously trying to lean into this and welcome as many players into our ecosystem as possible and bring more gamers into our communities and give them a compelling experience that hopefully turns them into long-term fans.

We don't really have any great data points right now on what happens to consumption when people return from shelter at home. But we have seen in Asia that the strong momentum continues even as they started the transition back. So we hope that's a sign of the similar opportunity we may have in other parts of the world, as they start to return to normal as well. So generally speaking, we think there is a pretty big opportunity here to see and then acceleration in the long-term structural shift that we've already seen from the existing heightened engagement, but as usual we're always trying to be prudent how we model that because we know there are still so many unknowns at this time.

Garik Johnson, Analyst

Great, thank you very much.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, can we have the next question please?

Operator

Our next question comes from Ryan Gee from Bank of America. Please go ahead with your question.

Ryan Gee, Analyst

Hey, good afternoon. Thanks for the question. Fantastic quarter you guys, I was hoping you can provide a little more color on the subscriber trends for a while during the period. And specifically, how you see the opportunity to sustain this larger base, post Classic as you move towards the Shadowlands expansion? Thanks.

J. Allen Brack, President

Hi, this is J, thank you for the question. Before I answer I would take a step back and just say we're really thankful that our games are able to play a part in helping bring people together during what's really an unprecedented and challenging time for us all. In the World of Warcraft is a very -- it's been fortunate to be had it engineered as a very social experience and that is true today as the day we launched.

Over time we listen to feedback from the community and the game has evolved, to what we now we call the modern game, which has really expanded the breadth and the depth of gameplay as well as making it easier to find friends, group-up, make progress or play alone, all within the social environment.

At the same time, we've seen a lot of good work and good returning -- experienced players are turning to the Classic WoW experience. So today we think about, World of Warcraft as a single community under one subscription where players can enjoy both WoW Classic and Modern WoW and they really show steady stream of content to both.

In a variety of different experiences that has been a strength of the game and it's been good to see players resonate, resonate with players as they see a lot of what they're looking for in the Warcraft. We've seen particularly strong engagement with Classic in the East and the momentum has continued in those regions even as they have stared to come back to work. And we saw Western subscribers grow in March, driven by players returning to Modern WoW primarily. And this has contributed to strong pre-sales for Shadowland. The momentum we saw in March across both zones continues with the active community growing faster than it ever has and of outside of expansion launch period.

On the development side, our teams have done a really good job in shifting to work from home. We're able to welcome select players into the closed offer for Shadowlands last month and thanks to the hard work of the team, Shadowlands is on track to launch in Q4 of this year.

And lastly, before I hand off the call, I'll hand off to the next question, I really want to thank all the Blizzard employees during this difficult time. It's been really amazing to kind of see everyone come together in a positive way. Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Right. Operator, can we have the next question please.

Operator

Our next question comes from Doug Creutz from Cowen. Please go ahead with your question.

Doug Creutz, Analyst

Hey, thank you. You talked a bit about the pressure on the outside at King as the economy slows down. I was wondering if you could maybe go into a little more detail there, what are you seeing in terms of your CPMs? And then along with that, is there any offset on your user acquisition side because presumably you're acquiring users through a lot of the same channels -- that similar channels to your advertising? Thanks.

Humam Sakhnini, President

Hey Doug, this is Humam. Thanks so much for the question. So we exited 2019 as you heard, with strong momentum in the ads business and that's continued in Q1, where we saw in the quarter that we delivered over 75% year-on-year growth. And as you mentioned in the question, we saw a deceleration towards the end of March within the broader advertising ecosystem. But the business did grow 20% year-on-year in April or over 20% in April.

So let me answer your question by talking a little bit of what we're doing is going forward. I think about the things that we are already doing and would love to continue and that's about rolling out more ads to more players, broadening our advertiser base and working with more partners as we continue to build our tech infrastructure. But now we're actually increasing some focus areas that we see as kind of in short and medium-term will provide opportunities. So we're going to the brand advertisers and doubling down on the relationships in those sectors that aren't experiencing slowdowns and they are experiencing actually sustained demand for their products, so the team is quite active there.

We're also starting to leverage quite a bit of advertiser interest in very differentiated products, like the sponsorship product that we have, which was new to our ecosystem and seeing some really nice advertiser interest and that really amplifies the value proposition of the King network in this environment. And then, we are rolling out a new technology in our games and that's become the focus. That allows us to really optimize our demand and get the higher CPMs for the ads that we are showing. And that's been a focus in this quarter and continues to be for the year. So if you add that, plus you look at our network, which is truly global and international, what we're doing is we're looking at it as a pretty diversified set of opportunities. So when regions are starting to experience some recovery before others, we focus our efforts there as the opportunity may sit geographically in some places at a certain point in time.

So with all of that, my expectation is that the advertising business does deliver growth this year. On your point on acquisition cost, that's a (technical difficulty) so what we're seeing is, while we see it some advertisers are back and they're smart and seeing an opportunity to bring new players more efficiently than ever for our ad network. And when you couple that with a very different approach ads to reach for us for the medium and long-term.

So when we do that, of course that reinforces kind of both in-app side of the house of the game business and the advertising number as we continue to invest in the network. So again, kind of to echo a lot of what my colleagues have said and before I hand it back to the operator, I just want to, thank all the King's team and employees across King who have really harnessed the beat as we have experienced something quite remarkable and going to work-form-home pretty quickly. And so, a big thanks from me for the team and the incredible work that they are doing.

Doug Creutz, Analyst

Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, can we have the next question please.

Operator

Our next question comes from Kunaal Malde from Atlantic Equities. Please go ahead with your question.

Kunaal Malde, Analyst

Hi, thanks for taking the question.There's clearly a very strong momentum in the business right now. But given the broader economic pressures from COVID-19, how are you thinking about the potential risks to consumer spending trends over the next few quarters?

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Thanks for the question. Obviously we're in kind of uncharted waters and there's not really any precedent for what's going on right now in the economy, which definitely makes us cautious and careful maybe more so than normal. Relatively speaking, however, we do feel pretty good about the value proposition of our content even in tough times. There is not great past precedence obviously for where we are. But you can look at least back to the past two market dislocations in 2001 and 2008 for at least some directional indication of how gaming has performed in challenging economic times. And what we've seen is that consumer recreational spending in the U.S. for example was fairly resilient during those downturns. And if you hone in a little more specifically on entertainment, the global gaming industry, gaming industry fared extremely well and actually grew low to mid single-digits in these time periods, whereas broader consumer recreational spending declined low single-digits. And that, we think that's driven by the low cost per hour of gaming, which makes it a great value versus other forms of entertainment.

And so, if you compare that to the situation we're in now, where other forms of location-based entertainment like going to movies, concerts, sporting events, whatever those may be and they may not be available for some time to for consumers for some period of time. This may also drive some share shift to gaming from those other categories.

And thankfully in contrast to other forms of media, we're very fortunate that the digital nature of our business enables us to not only to distribute content remotely but to produce it remotely, so obviously an advantage for us to keep our content fresh.

Another point is in those past recessions in 2001 and 2008, gaming has come a long way since then. Obviously, it's much more social and more connected and more mainstream. And our business is much more diversified too across platforms, geographies, types of games, which is helpful when times get challenging.

On the flip side, there obviously are more free ways for players to play games than there have been. So there could be more engagement with slightly weaker monetization. But in the long-term, we kind of view that as an opportunity as well because that usually normalizes itself. So I'd say, there's puts and takes across the spectrum, but which is why with all this uncertainty in the economy, we try to reflect these risks as we think about forecasting the business. But the strong momentum we are seeing gives us obviously confidence in raising our outlook even with this challenging backdrop.

Kunaal Malde, Analyst

Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Thank you. Operator, can we have the next question please.

Operator

Our next question comes from Eric Handler from MKM Partners. Please go ahead with your question.

Eric Handler, Analyst

Thank you very much for the question and glad everyone is healthy. A follow-up on Call of Duty. I wondered if you could talk a little bit how the funnel of players has widened for Call of Duty, with the release now of mobile and Warzone? And along those lines, how much overlap is there for players between the three games and what does that mean for overall spending basically what I I am trying to get at is, is the spending for per player additive when they play multiple games?

Rob Kostich, President of Activision

Hey Eric, it's Rob. Thanks. I'll take the question. I think it's important to probably first just step back and think about what our goal has been through all of this and the goal has been pretty simple one. And what we wanted to do is provide players around the world a real fun, high quality. And I think importantly, an authentic Call of Duty experience regardless of what platform you play on, where you happen to live or what business model really motivates you to play and that's exactly what we've delivered across mobile, across console and across PC and if you look at some of the metrics over the last six months, if you see in Q4, and both in Q1, we've crossed over a $100 million MAUs and dramatically increasing our player base and a lot of that's been driven by Mobile and Warzone of course, as is ongoing success of Modern Warfare driving that.

But through Mobile and Warzone, we're definitely reaching new audiences and new geographies in ways that we just haven't before. And as I look at Call of Duty, right now it's more global today than at any point in time in its history in terms of audience profile and that's pretty exciting for us to see. So a little bit on your question on engagement and for us, when it comes to engagement what we've seen really time and time again is that engagement just tends to drive engagement.

And so for us exposure on what platform is driving engagement across other platform and other experiences, so we actually like to see that crossover a lot. And in terms of the investment part of your question, that also is looking additive to us across this ecosystem as well. In the previous question, I talked about Warzone and how we're seeing that as being accretive to the franchise overall and with respect to CoD mobile then specifically when you take a look at it, we're seeing really great momentum there, it was referenced earlier that Season 5, just concluded, and it's our best performing season in terms of engagement and in game performance since the first season and Season 6, just launched on May 1st and so that's off to a really strong start as well.

So for me when I look at it, I see the positive trends on mobile as a platform are coming at a time, we're having record engagement and record performance across console and PC and to me that's a pretty clear indication that what we're seeing on Call of Duty Mobile is delivering incremental results for the franchise as well, so the ecosystem, the way we're looking at right now seems to be working incredibly well.

And in terms of Mobile, in terms of our strategy, it remains a critical part of our overall plans going forward and a key investment area for us. And just speaking of the ecosystem, I probably just close by, obviously a very exciting time for everyone on the franchise right now and our teams are hyper focused and passionately focused, most importantly, on delivering great new content and seasons and games to our growing community around the world that we're seeing right now. And I guess I would just close by saying, we couldn't be more thankful for the incredible and growing community that we're seeing out there around the world for their trust and support and we look forward to everything that's to come in the future. So thanks for the question.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks Eric. Can we have the next question, please?

Operator

Our next question comes from Alexia Quadrani from JP Morgan. Please go ahead with your question.

David Karnovsky, Analyst

Hi, this is David Karnovsky on for Alexia. Thanks so much for taking the question. Can you just expand a little bit on what impact you're seeing to your pipeline both near and long-term from having developers work at home? Thanks.

Daniel Alegre, President and Chief Operating Officer

Sure, and this is, this is Daniel. Thanks. Thanks for the question. Look the vast majority of our developers, they moved to remote work by mid-March, as I mentioned in my opening remarks. And really just credit to all those involved, it was such a huge undertaking, multi-functional teams across facilities, IT, HR security operations and other groups really rallied together to make it all happen and we're really fortunate to be in a truly digital business where the majority of our content creation really can be performed across any location.

So the vast majority of our developers, they took their computers home, plugged into secure access and just kept creating. So in some cases, we've had to move high-end computing and graphic rigs to our developers homes as well, but we were able to do that relatively quickly. So, our development teams working on everything from design to art to engineering to production, really had most of what they needed to keep working.

That being said, it's not easy and there are aspects of building our games that are more challenging via remote work, like collaborative design, in-person user research, motion capture, voiceover and QA. So we've really had to find some creative solutions to work through these, like for record voiceovers we did that remotely. We've also enabled new secure access systems for some of the functions where large groups are engaging. But so far, and based on what we can see and with true ingenuity and creativity from the teams, we're managing through this as best as we can and what's really important is we just need to continue to provide our communities with the innovative content and features that they love and that they want to keep playing. So that's why I said in my prepared remarks that we're currently still on track to deliver our key content in the second half of this year and my primary focus is to ensure that we continue to execute on these top priorities.

Bobby Kotick, Chief Executive Officer

And I would just add, I think that our teams are doing an extraordinary job right now on continuing to stay focused, work hard, deliver great content, but it is a challenging process. We still have a lot of uncertainty for the future and I think that it's hard to know a year from now or two years from now, what the impacts of all of this will be on our development processes, on the way we go to market, on the economics of selling games. So there more to come as we have more clarity over the next few months, but we remain focused on execution of our strategy and I think that our teams are doing a truly extraordinary job of accomplishing that.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, can we have the next question please.

Operator

Our next question comes from Alex Giaimo from Jefferies. Please go ahead with your question.

Alex Giaimo, Analyst

Great, thanks for taking the question. I was hoping to get a bit more color on the Hearthstone franchise, maybe if some of the recent updates you've rolled out, have been well received. And if you're seeing any notable change within the competitive landscape? Thank you, guys.

J. Allen Brack, President

Thank you for the question. This is J and I want to take those in reverse order. So when we think about competition, Blizzard is full of gamers and we're always excited when new games release. We think new titles are good for the players, they bring fresh ideas and that's really something that everything -- or that's something everyone benefits from. The industry is big enough for lots of different teams to be successful.

And we found that if we are focused on gameplay first and if we continue to listen to our community feedback, experience player evolves and so I'm really proud on the Hearthstone team and what they've accomplished, especially recently. Under the leadership with an expanded development team, they have delivered larger content update for players and has really maintained a high quality bar that we set for ourselves.

We rolled out the first major new game mode which was Battlegrounds in November, we've talked about and we've seen it bring players back and continue to drive renewed engaged in the game. And then last month, we launched the latest expansion, which was Ashes of Outland and that's in the first game that we've launched which we were on a working from home environment.

And that expansion into these two games. First new class, so the first new class had never been added to the game since we launched the Demon Hunter and broader out-- brought about really some of the biggest fundamental changes that the game has seen to date. The sentiment around the new features and new content is very positive and as a result of the steady updates in the game, we saw increased engagement in Q1 versus Q4, we had further updates in April.

The Hearthstone team is looking to build on that momentum with a really good headway of contents later to come this year. And then one of the things we've learned is that battlegrounds has proven that new modes can drive meaningful engagement and so the team is thinking about that as part of their future planning going forward.

Alex Giaimo, Analyst

Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, operator. We have time for one last question.

Operator

Our final question today comes from Brian Nowak from Morgan Stanley. Please go ahead with your question.

Brian Nowak, Analyst

Thanks for taking my question. Hey guys, good to hear your voices. I just had one on King, the user number was really strong I think you added over 20 million, like 24 million users quarter-over-quarter. Maybe talk to us how you think about some of the key strategies you have to sort of develop and roll out, to really retain those new players. And then how do you think about converting those new players into payers over time?

Humam Sakhnini, President

Hey, Brian. It's Humam. Thanks for the question. So let me first step back and set the context of what we're seeing here in Q1, you heard us talk about it, which is in the past few quarters, we've been focusing on growing that audience of players and also payers. And so in Q3 and Q4 last year we grew the Candy player base. And then in Q3 we started introducing initiatives that are aimed at broadening the payer reach across the network, which started improving the payer conversion mechanics in the second half of last year, so back then when we did that. You heard me talk about that there would be a trade-off in the near-term bookings but we thought that's the right thing to do for the business for the long-term health of our business.

So we've seen that through the introduction of the right content and timely offers, contextually placed more players start coming into the ecosystem and more payers start coming into the ecosystem. So, in Q1 we went further with that approach both on content and on offer management and we started bring --broadening our reach of the player investment initiatives. So we started building on top of that momentum in Candy and we started expanding to all of our network in Q1.

And so as that player base started growing steadily in the quarter, we started seeing kind of that momentum build and in March, we saw even further acceleration. And then on the payer conversion we started seeing some really encouraging results in Q1 and in fact kind of in Q1 we saw the stronger sequential improvement in payers that we've seen in many years.

So the trends have really kind of started looking very favorable and that's improved in April. So I'm really pleased with how the ecosystem has been building up, not just in Q1, but all the things that we've been doing from a content perspective and from a player engagement mechanics perspective in the past few quarters to get to here.

So when I look ahead, you'll expect us to continue to do this, you'll expect content from us, you'll continue to expect more ways that we optimize offerings for different players to kind of go after those broader motivations. And the good news here is that you won't see the drag on Q2 bookings that we would have otherwise expected because of this really strong engagement that we're seeing. And then we add on top of that, that we can grow this network now more efficiently. As I just answered before.

So I think the combination of all of those really kind of tend to the network and then where we continue to keep the players active is really about what the King team does incredibly well, which is innovating the content pipeline and the features within what's happening in the game to keep these players engaged and continue to kind of drive towards players and payer numbers increasing over time.

So that's kind of I think, what you're seeing now. But it's kind of the combination of those things that we've been building over the past few quarters.

Christopher Hickey, Senior Vice President of Investor Relations

All right.

Brian Nowak, Analyst

Great. Thank you.

Christopher Hickey, Senior Vice President of Investor Relations

Thank you. Yeah. Thanks, Brian. Thank you, Humam. Thanks everyone for joining us today. We greatly appreciate your interest and participation and look forward to speaking with many of you throughout the quarter. Please do stay safe and we'll hopefully see all in game. Thank you.

Operator

Ladies and gentlemen, that does conclude today's conference call. We do thank you for joining. You may now disconnect your lines.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2020-02-06
Event Description: Q4 2019 Earnings Call

Market Cap: 46295.3518182
Current PX: 60.26
YTD Change($): 0.84
YTD Change(%): 1.414

Bloomberg Estimates - EPS
Current Quarter: 0.373
Current Year: 2.476
Bloomberg Estimates - Sales
Current Quarter: 1325.053
Current Year: 6864.207

Q4 2019 Earnings Call

Company Participants

- Christopher Hickey, Senior Vice President of Investor Relations
- Robert Kotick, Chief Executive Officer
- Collister Coddy Johnson, President and Chief Operating Officer
- Dennis Durkin, Chief Financial Officer and President of Emerging Businesses
- Rob Kostich, President of Publishing
- Humam Sakhnini, President of King Digital Entertainment
- Allen Brack, President and Chief Executive Officer of Blizzard Entertainment, Inc.

Other Participants

- Mario Lu, Analyst
- Benjy Scurlock, Analyst
- Anthony Duplisea, Analyst
- Ben Charland, Analyst
- Michael Ng, Analyst
- Colin Sebastian, Analyst
- Eric Sheridan, Analyst
- Michael Olson, Analyst
- Michael Hickey, Analyst

Presentation

Operator

Good day, and welcome to the Activision Blizzard Q4 2019 Earnings Conference Call. At this time, I would like to turn the conference over to Chris Hickey, Senior Vice President of Investor Relations. Please go ahead, sir.

Christopher Hickey, Senior Vice President of Investor Relations

Good afternoon, and thank you for joining us today for Activision Blizzard's Fourth Quarter 2019 Conference Call. With us are Bobby Kotick, CEO; Coddy Johnson, COO and President; and Dennis Durkin, Company's CFO and President of Emerging Businesses. And for Q&A, Rob Kostich, President of Activision; Jay Allen Brack, President of Blizzard Entertainment; and Humam Sakhnini, President of King, will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings including our 2018 annual report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, February 6, 2020.

We will present both GAAP and non-GAAP financial measures during this call. We will provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation; the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses and accruals; expenses related to debt financings and refinancings; restructuring and related charges; the associated tax benefits of these excluded items; and significant discrete tax related items, including amounts related to changes in tax laws, amounts related to the potential or final resolution of tax positions, and other unusual or unique tax-related items and activities.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also an earnings presentation, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert Kotick, Chief Executive Officer

Thank you, Chris, and thank you all for joining us today. Our fourth quarter results exceeded our prior outlook for both revenues and earnings per share. As we continue to transform the company, we've remained focused on the delivery of epic entertainment that connects and engages the world. We believe we can do this with greater speed and efficiency while maintaining our long-standing commitment to quality and excellence and providing superior returns to our shareholders.

We ended the year with over 400 million monthly active users, strong year-over-year engagement, and significant potential in monetization. We're in the privileged position of having a direct digital connection with hundreds of millions of players to whom we deliver some of the world's best professionally produced content. And we have the ability to provide our audiences with a variety of ways to enjoy our content with monetization through subscriptions, premium digital purchases, digital native advertising and a variety of other player investment mechanisms.

Each of our large brand franchises as well as our new potential franchises have greater opportunities than ever before. Using Call of Duty as an example, with the introduction of Call of Duty Mobile, we grew our player base from 40 million to 100 million players in less than a year, and we expect significant growth in the Call of Duty franchise in 2020 as compared to 2019 as a result of this and from other unannounced Call of Duty initiatives. Mobile, in fact, is now our leading platform.

The business model for Call of Duty Mobile is free-to-play, which enables the rapid development of a large community of players, with the option to purchase digital items and services as well as our ability to generate advertising revenues. Franchises like Call of Duty offer advertisers a very difficult to reach target, and today, the ad load is extremely low as we're experimenting with the best advertising solutions for our players and our advertising partners.

We successfully developed great games for mobile. Our franchises have the power to attract far bigger audiences than previously. We're hard at work on high-quality mobile games for all of our most important franchises.

And with respect to esports, two weeks ago, we debuted the Call of Duty League with 12 city-based teams. Working closely with our experienced team owners and globally recognized sponsors, we're thrilled to celebrate our players and inspire our community with professional Call of Duty esports. And with our new strategic broadcast relationship with YouTube, over 200 million game reviewers now have access to our world-class esports content for both Call of Duty League and Overwatch League.

Across console, PC, mobile and touch points like esports, the momentum for Call of Duty could not be stronger, and this success illustrates the larger opportunities we have across our diverse and large wholly-owned library of titles dating back to our founding 40 years ago. Having our franchises on all platforms in all geographies with a constant flow of content, and leveraging the additional touch points we have available to us like esports and advertising, continues to be our focus.

Another great example of our franchise transformation is what happened with Warcraft. We doubled the size of the active World of Warcraft community in the second half of 2019 by adding classic to the WoW subscription offering. The remarkable growth of the WoW community represents an important proof point of the value and potential of our established franchise, and it has energized our development team as we develop new content for all of our key franchises. These franchises form the basis for large, engaged communities of players and spectators, with whom we take our responsibility to deliver high-quality content very seriously.

Prioritization of opportunity and access to more talent are our challenges, but we are meeting these challenges with improved execution, and we expect to grow audiences, engagement and monetization and provide superior shareholder returns as we have for the last 30 years.

As a final note, we wanted to acknowledge the tragedy of Kobe Bryant's untimely death. Kobe was a longtime friend of the company, starring masterfully in commercials for Guitar Hero and Call of Duty. He was a tireless supporter of our veteran employment initiatives and always made himself available for all of our veterans events and activities. He will be greatly missed by all of us, and our thoughts and prayers are with his family.

And now Coddy will review the highlights of our operations with you.

Collister Coddy Johnson, President and Chief Operating Officer

Thanks, Bobby. Strong execution in 2019 on our strategy enabled Activision Blizzard to exceed our fourth quarter outlook and enter 2020 with momentum. That momentum was created by the increased investment and focus on the creative and commercial resources of our biggest franchises and allowed us to accelerate progress against our four key growth pillars.

In our first growth pillar, driving a consistent cadence of major new content to grow our reach, our expanded Call of Duty development team launched a very successful Modern Warfare, with unit sell through in Q4 increasing by a double-digit percentage versus the prior year across console and PC combined. And the team followed up with great execution on our second growth pillar, live operations for in-game content, services, features and events to drive engagement and recurring revenues.

Modern Warfare's first season of follow-on content rolled out our new, more engaging in-game system, which drove both engagement and net bookings up significantly year-over-year. Similarly, the World of Warcraft team followed up on the remarkable Q3 launch of WoW Classic with substantial content updates that kept the community engaged and the subscriber base well above pre-Classic levels.

In Hearthstone, we've seen increased engagement upon the launch of Blizzard's latest expansion and the rollout of the new Battlegrounds games mode in Q4.

As for our third pillar, extending our acclaimed console and PC franchises to mobile, the October launch of Call of Duty Mobile, one of the most successful in industry history, driving Activision publishing to record monthly active users. It also highlighted the opportunity for our other large franchises to reach hundreds of millions of new players once they expand on the mobile.

And, finally, as we build and enhance engagement models for our franchises, our advertising business again grew rapidly, and further strengthened our leadership in esports. We expect to build on this momentum in 2020, with each of these pillars driving net bookings growth for the company this year.

I'll now provide more detail on our Q4 results and recent developments across our franchises. Starting with Activision, Q4 was a fantastic quarter. Monthly active users tripled in Q3 to reach 128 million. Call of Duty continued its leadership on console, with Modern Warfare driving year-on-year sell-through growth and generating more upfront console sales than any other franchise worldwide, a feat the franchise has now accomplished for 10 of the last 11 years. Modern Warfare also saw strong growth in full game downloads, with console and digital mix at almost 50%. And we ended Q4 with the retail channel at its tightest level in many years, positioning us well for ongoing catalog sales in 2020.

The franchise also expanded its audience on PC, with Q4 PC sell-through on Battle.net growing 50% year-over-year. This growing cross-platform Call of Duty Community received in early December the largest free content offering in franchise history, alongside a new system for player investment. And as a result, Q4 in-game net bookings grew by double-digit percentage year-over-year despite a later launch of the in-game system and despite the removal of Season Pass.

We have a second season of Modern Warfare follow-on content launches next week, and the team has more great experiences and surprises in store, both for that season and throughout 2020, which we expect to drive strong in-game net bookings growth year-over-year. And, of course, the Call of Duty franchise saw a breakout success in Q4 with the launch of Call of Duty Mobile. The game has received widespread acclaim.

And with over $150 million installs, has brought a huge number of new players into the franchise and given existing players a new way to experience Call of Duty. Engagement is strong, which the teams from Activision and Tencent Games Timi Studios intends to sustain for the long-term with a substantial pipeline of features, events and content benefiting from over 15 years of Call of Duty releases. The title outperformed our net bookings expectations in Q4, ranking in the top 15 grossing games in US app stores. And the third season is already well underway and tracking well.

So across console, PC, mobile and esports, the Call of Duty franchise has never been better positioned for growth, and there's more to come, including entirely new experiences within the Modern Warfare universe. And then, of course, in Q4 of this year, a new premium Call of Duty release, which is already generating excitement in our play tests.

Finally, across the Activision portfolio, we are honored to see the team's focus on high-quality, world-class content recognized by the industry at the 2019 Game Awards. Call of Duty Mobile won Mobile Game of the Year. Crash Team Racing won Best Game in the Sports and/or Racing category. And FromSoftware's Sekiro: Shadows Die Twice, won Game of the Year.

Turning to Blizzard. Monthly active users were 32 million in the fourth quarter. World of Warcraft monthly active users were higher sequentially, reflecting the sustained engagement of players following the August launch of WoW Classic, Blizzard's recreation of the original WoW from 15 years ago. As you may remember, in Q3, WoW added more monthly or longer-term subscription plans than in any prior quarter in franchise history. That momentum continued into Q4.

Then Blizzard's sustained engagement with robust slate of content for both modern and Classic WoW and exited the year with an active community more than twice the size of its Q2 ending level. A strong cadence of content will continue in 2020 with a great series of in-game releases for Classic and a strong Shadowlands expansion coming from modern WoW in the second half of the year. Shadowlands will have new regions to explore, new ways to customize characters and a revamped leveling system to onboard new players.

Hearthstone, the competitive environment remains intense, but we did see sustained improvement engagements following the release of the Descent of Dragon expansion and the new Battlegrounds auto battler mode in Q4. Q4 net bookings were lower year-over-year, but grew sequentially, and the Hearthstone team continues to iterate quickly. They launched a new game store in December and will release a number of new content and engagement model enhancements in 2020.

Q4 also saw the launch of Overwatch on Nintendo Switch, further expanding a community that has now surpassed 50 million players since the 2016 launch. And next weekend, the Overwatch League returns with 20 teams from around the world competing in the home stand format for the first time. Blizzard's teams as you know, are working on their broadest pipeline in its history, including Overwatch 2 and Diablo IV on PC and console. And Diablo Immortal, a mobile game developed in partnership with NetEase, continues to make good progress and will move into the testing phase with its first regional tests planned for the middle of the year.

Turning to King. Monthly active users were 249 million, increasing 2 million from the third quarter. On a year-over-year basis, we saw declines in web and smaller mobile titles. But importantly, Candy mobile reach was little changed and benefited from growth in King's largest title, Candy Crush Saga. In the second half of 2019, King introduced new initiatives to grow payer conversion, targeting lapsed payers as well as converting new payers into the ecosystem, and these initiatives led to encouraging payer engagement trends in the last two quarters.

While these initiatives dampened in-game net bookings in Q4 and will continue to do so in Q1, we believe a broader and more engaged payer base positions the franchise for growth over the medium and long term. And even with these actions, Candy Crush Saga remained the top grossing title in the US app stores, and the wider Candy franchise was once again number one.

King's advertising business grew net bookings over 80% year-over-year, with strong growth in ad-enabled users, volume and pricing. Both direct and indirect sales grew sharply. For the full year, ad net bookings exceeded $150 million, with the business set for robust growth again in 2020. Throughout this year, King will continue to optimize the economy within Candy, launching ongoing features, services and events to drive player engagement and investment. And having previously narrowed its pipeline focused on the highest potential projects, King is investing in several promising new titles, including content based on Activision's beloved catalog IP. Regional testing of some of these new titles will begin in 2020.

So in conclusion, our strategy to focus on our growth pillars and invest in creative and commercial resources and initiatives of our biggest franchises is delivering results. In 2020, we will continue that focus with the releases and pipeline initiatives highlighted today to further expand our reach, engagement and player investment, and to extend our largest IP across new platforms, geographies and business models. We plan to reach more players on the platforms in more regions than ever before.

To do so, we'll also further increase investment in our technology capabilities, technology platforms and data analytics. We'll fund these investments with an ongoing focus on efficiency and organizational optimization to leverage our scale across the business. And we know that some of our investments won't bear fruit until next year or later, but we're confident in our growth trajectory this year and our growth plan, and we enter 2020 with momentum.

I'll now hand the call over to Dennis to discuss our Q4 and full year financial results and outlook. Dennis?

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Thanks, Coddy. Today, I will review our Q4 2019 results as well as our outlook for 2020 and the first quarter. Q4 GAAP and non-GAAP EPS were ahead of our prior outlook, reflecting better-than-expected results for Call of Duty and World of Warcraft and a lower tax rate. To review the quarter, I'll start with our Q4 segment results.

Activision revenue was $1.43 billion, led by Call of Duty growth in both upfront and in-game revenues on console and PC and the addition of Call of Duty Mobile. Operating income was $696 million with an operating margin of 49%. As expected, Call of Duty Mobile was not a material contributor to operating income in Q4 despite a great launch as we invested to build our player base and position the title for long-term success.

Blizzard's revenue was $595 million, lower year-over-year as growth for World of Warcraft and Overwatch was offset by a decline for Hearthstone and Diablo. Operating income was $260 million, with the revenue decline more than offset by lower costs. Blizzard's operating margin was 44%, significantly higher year-over-year due to mix and lower costs.

King revenue of $503 million was flat sequentially and lower year-over-year, driven primarily by King's actions to prioritize mobile payer engagement in the quarter as well as year-over-year decline in web titles. The ads business grew more than 80% year-over-year.

Operating income was $197 million, with an operating margin of 39%, 1 point higher year-over-year, driven by high incremental margins from advertising. Across our segments, in-game net bookings were $1.1 billion.

Now let's turn to our consolidated results. Unless otherwise indicated, I will be referencing non-GAAP figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated Q4 GAAP revenues of $2.0 billion, $174 million above our November guidance. This includes the net deferrals of $722 million. Net bookings of $2.7 billion were $62 million above our November outlook. We incurred GAAP-only restructuring and related charges of $30 million, and we generated Q4 GAAP EPS of $0.68 and Q4 non-GAAP EPS of $0.62, which was $0.19 above guidance. These figures include the net deferrals of $0.61.

For the year, we generated GAAP revenues of $6.5 billion. This includes the net recognition of deferrals of $101 million. Net bookings were $6.4 billion. We incurred GAAP-only restructuring and related charges of $137 million, and generated GAAP EPS of $1.95 and non-GAAP EPS of $2.31. These figures include the net recognition of deferrals of $0.06.

From a cash flow perspective, our business delivered Q4 operating cash flow of $918 million. Annual operating cash flow was $1.8 billion, higher year-over-year due to lower working capital and cash taxes. Our cash and investments at the end of December was approximately $5.9 billion, and we ended the year with a net cash position of approximately $3.2 billion.

Turning to capital allocation. We entered 2020 with a strong balance sheet and significant flexibility. As always, we continue to take a disciplined and balanced approach to capital allocation. And with this in mind, our Board has authorized an 11% increase in our annual dividend to $0.41 per share payable in May. As we look back over the last year, we are pleased with the company's operating discipline, commercial execution and content delivery during a period where we refocused the business and increased investment in key franchises to position us for future growth.

Now, let's look forward to our outlook for 2020. First, regarding our slate and plans for each business unit.

Activision enters the year with strong momentum for Call of Duty across upfront sales, in-game, mobile and esports. Along with a tight retail channel that should benefit catalog sales, this positions us for strong growth in the franchise, particularly in the first half of the year. In Q4, we plan to launch the next premium release of Call of Duty. We can't wait to unveil what our teams have been working on, and we feel great about the content. Although, as is customary, we are prudently assuming lower sell-in for Q4 versus Modern Warfare this past year.

Turning to Blizzard, which just last week released Warcraft III: Reforged. Blizzard will build on World of Warcraft momentum with ongoing content for classic and the Shadowlands expansion in the second half of the year. The Hearthstone and Overwatch teams will support their communities with ongoing content and services that drive engagement and player investment. And as Coddy mentioned, Diablo Immortal is planned to enter a regional testing towards the middle of the year, though we don't have any material revenue from that title in our guidance.

King will continue to release content, features, services and events across its portfolio, with an ongoing focus on optimizing reach, engagement and player investment for Candy. And the advertising business is set to deliver another year of strong net bookings growth. At the same time, King will continue to invest in several promising new titles in its pipeline. And although we expect regional play testing for certain titles, similar to Diablo Immortal, our outlook does not include material revenue from these titles.

In addition, our business units will continue to tap into our portfolio of beloved IP to bring several remastered and reimagined experiences to our players in 2020, which we will announce closer to launch. Bringing all this together, our outlook reflects 5% year-over-year growth in net bookings. We expect Activision to experience the strongest net bookings growth amongst our segments, both in dollar terms and on a percentage basis.

We expect solid net bookings growth from Blizzard for the year, and our outlook reflects a flattish performance at King, with year-over-year trends improving in the second half of the year. From a margin perspective, our outlook reflects GAAP and non-GAAP operating margin increasing year-over-year.

Now, let's turn to the numbers. On a GAAP basis for 2020, we expect revenues of $6.45 billion, including net deferrals of $275 million. We expect net bookings of $6.73 billion; product costs, game operations and distribution expenses of

22%; operating expenses, including software amortization of 50%; and a GAAP-only restructuring charge of approximately $50 million.

We expect a GAAP -- a tax rate of 19%, GAAP and non-GAAP share count of $778 million and GAAP EPS of $1.85. For 2020, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 23%; operating expenses, including software amortization of 44%. We expect a tax rate of 19% and non-GAAP EPS of $2.22, including net deferrals of $0.13.

Now, let's turn to our Q1 outlook. On a GAAP basis for Q1, we expect revenues of $1.64 billion, including the net recognition of deferrals of $365 million. We expect net bookings of $1.28 billion; product costs, game operations and distribution expenses of 21%; operating expenses including software amortization of 48%; and a GAAP-only restructuring charge of approximately $35 million.

We expect a tax rate of 17%, GAAP and non-GAAP share count of 775 million, and GAAP EPS of $0.55. For Q1, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 21%, and operating expenses, including software amortization, of 41%. We expect a tax rate of 17% and non-GAAP EPS of $0.66, which includes the net recognition of deferrals of $0.31.

In closing, in 2019, we have come a long way in refocusing the business on our biggest franchises and opportunities. The momentum for World of Warcraft, Call of Duty and our new engagement models highlights the growth potential for our broader portfolio of durable, fully owned franchises when we apply our top creative talent and commercial talent against our biggest opportunities. We are encouraged by our 2019 results. And as we return to growth in 2020, the opportunity set for our business across platforms, geographies and business models, has never been greater.

Going forward, we will maintain our operating discipline and focus as we execute against a great content lineup this year and a pipeline that includes Overwatch 2, Diablo IV, Diablo Immortal and multiple unannounced initiatives, including several mobile titles. We remain confident that ongoing execution against our plan will position us to deliver growth to our shareholders over the long term.

Now, I welcome our business leaders, Jay, Humam and Rob, as they join us for the Q&A portion of the call. Operator?

Questions And Answers

Operator

Thank you. (Operator Instructions) We'll take our first question from Mario Lu with Barclays.

Mario Lu, Analyst

Hi. Thanks for taking the questions. A couple on Call of Duty Modern Warfare. How has not having the Season Pass affected the user behavior thus far compared to years past? And secondly, any color you can provide regarding its impact on in-game revenue growth and what we can expect in 2020? Thanks.

Rob Kostich, President of Publishing

Mario, it's Rob. Thanks for the question. I think before I touch on Season Pass specifically, it's important that we kind of step back for a second and look at some of the macro changes that we made, and Season Pass was one of them. Our intent was just to create a better overall experience for our player community, and we think we've done that.

The first big thing we did was bring in cross play and cross progression, enabling friends to play together no matter what platform they're on. In the case of Modern Warfare, it's just great to see players come back together after so many years of experiencing the franchise in the past.

Now with Season Pass, it kind of played a similar role, right? So instead of certain portion of the audience having certain content, we're focused now on free content for the entire community to drive engagement with the overall community. And I'd say the last big change that we made was really focusing on the new Battle Pass and item shop system in the game, giving players kind of more transparency to the content they are after and obviously focusing more on cosmetic content.

And I suppose the best way to judge all of it is just what's the player behavior and what's the community saying. And when you look at engagement and you look at daily average unique, our engagement is up significantly year-over-year, and that's really great for us to see so many people enjoying and playing this fantastic game.

And then on the player investment side, I'd say fans certainly seem to be appreciating the new system quite a bit. We mentioned kind of the growth year-on-year. But one other thing I might add is that we're also seeing increased attach rates in-game to the new system, which I think is a very, very positive sign for us.

And, for us, this all signals to a really healthy ecosystem within Modern Warfare, one that we think we can build on and create momentum with our community. It's really on us from now to really build great content, which we intend to do for the long haul on this game. A great pipeline of content is coming, starting with season two next week, and we have some surprises in store beyond that.

So I'd say, overall, what we expect is a healthier Call of Duty in 2020 versus the previous year, and we look forward to sharing more in the future. But thanks for the question.

Mario Lu, Analyst

Okay. Thank you.

Collister Coddy Johnson, President and Chief Operating Officer

Thanks, Mario.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, next question please.

Operator

We'll take our next question from Benjy Scurlock with the Arete Research.

Benjy Scurlock, Analyst

Hi. Thanks for taking my question. Just one on King. So when do you expect to see engagement and monetization stabilize and the King segment start to reaccelerate? Thanks.

Humam Sakhnini, President of King Digital Entertainment

Thanks for the question. This is Humam. So overall growth is impacted by some of our smaller titles and the web platform. We also had a number of initiatives more recently in the driving payer conversion and bringing back lapsed payers, and that presented a near-term trade-off, but it's the right thing to do for the medium term and beyond. And we'll continue to see some of those trade-offs in Q1.

But with all that said, when I look forward, I see a number of growth areas with King. First and foremost, is Candy. Candy continues to be an incredibly durable franchise, and we see growth just through the slate of new features, all the services we're releasing, and the in-game events that we hold. More recently, we're also thinking quite a bit about our social features. We've seen that really work in different panels and in different genres. And when I think about how that could be in Candy and the size of Candy, that could be a big unlock for us.

Another thing that's really I look to for growth is our advertising business. So as you heard, that's really coming along really nicely. And we built a really large and high-margin business, and I see growth there. And then additionally, I see growth in our pipeline. We reset our pipeline recently, and we're starting to see some really good results in our prototypes, and we will start doing some regional testing on some of those this year. So when I put all that together, I look to the medium term and beyond, and I think we have some really good growth opportunities here.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Benjy. Operator, can we have the next question, please?

Operator

Thank you. Our next question comes from Matthew Thornton with SunTrust.

Anthony Duplisea, Analyst

Hey, this is Anthony on for Matt. Thanks for taking the question. Do you have any color on how successful World of Warcraft has been in 4Q and into 2020 in retaining users from the Classic mode launch? And then relatedly, also on Warcraft, there's been some negative press on Warcraft III Reforged lately. Can you tell us what you're doing to address that? Thanks.

Allen Brack, President and Chief Executive Officer of Blizzard Entertainment, Inc.

Hi. This is Jay. I'll talk about the World of Warcraft question first. So as a reminder, when we designed the model for World of Warcraft Classic, it was important that players have a single existing subscription to support both games. And we think about the WoW community as supporting both even though Classic and Modern are very distinct experiences. And we're committed to kind of continuing to support both of those experiences over the long term.

Given the content updates for Modern WoW and the cadence that we have for Classic, we exited our year with the subscriber base that was double what it was at the end of Q2. And we also see players remaining engaged in both versions of the game. We launched Visions of N'zoth, which is a content patch for Modern WoW in January.

Engagement with Classic has been particularly strong in the east, and we see very high levels of player retention there. And our next update for Classic is going to be Phase 3, which is Blackwing Lair. It's one of my favorites. And we're planning on launching that on February 13.

Concerning Warcraft III: Reforged, honestly, it's been a bit of a hard week. Our community has come to expect really amazing things from us, and we've heard from them that we did not achieve that bar. But we stand behind our games and have consistently shown that not only do we support them, but we continue to build on them even after launch, and we're committed to doing that here as well. And so we're going to continue to update the game, and we'll continue to update the community with our plans going forward.

Operator

We'll take our next question from Ben Charland [ph] with Bank of America.

Ben Charland, Analyst

You now have about $3 billion of net cash on the balance sheet. You've got the annual dividend, have done some buybacks in the past, some acquisitions. Maybe just an update on the thoughts around capital allocation and uses of cash against the opportunities ahead.

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Yes. No, thanks for the question. Obviously, we do view a strong balance sheet as a really important strategic asset for the company. And having that gives us considerable flexibility to invest in the business, do buybacks and return capital or pursue M&A when we see attractive opportunities. And our track record probably somewhat speaks for itself as you look at that over a long period of time.

We borrowed, I'd say, very fortuitously to finance our Vivendi transaction and our King transaction and then subsequently paid down that debt. So we paid down more than $4 billion since we financed those transactions and actually have climbed our way up the investment grade ratings grid. And then we've returned, over the last decade, more than -- I guess, around $10 billion of capital back to our shareholders, about $8 billion through share repurchases.

And we still do have our $1.5 billion authorization, and then about $2 billion over that time period in dividends, which has increased double digits, I'd say, probably on average over the course of that period. And again, this year with the $0.41 dividend, which we announced today.

M&A is always something we keep our eye on. And as we have our radar detectors up and we always look at lot of things, but we -- I'd like to think we're pretty disciplined about our process. We do have a pretty rigorous process, and we try to look for a few criteria of things when we are considering it. We're always trying to find great franchises or technology that could add to our portfolio and make our business and our franchise portfolio stronger. We'd like to see a track record of profitability or path to profitability, a strong leadership team that's aligned around growing the business.

And then, lastly, and this one's been more challenging is finding things in -- at a valuation that makes sense. So it's not easy to find all those things, and so you have to be very disciplined and patient as you think about those inorganic opportunities.

So that gives you a little bit of an overview in terms of how we've approached it. I think our past track record and philosophy on this is probably the best indicator of how we think about it and how we'll allocate capital in the future.

Operator

Thank you. Our next question comes from Michael Ng with Goldman Sachs.

Michael Ng, Analyst

Hey. Thanks for the question. Could you just give us an update on Diablo Immortal and discuss how that informs your go-forward mobile strategy for Blizzard? Thanks.

Allen Brack, President and Chief Executive Officer of Blizzard Entertainment, Inc.

Absolutely. So as you know, we've been working closely with NetEase on the development of the game, and our goal is to deliver an authentic and deep Diablo experience for mobile. We did show an updated version of the game at BlizzCon last year, and we saw a lot of excitement. We've also begun doing internal play tests or additional internal play tests since that time. And the results are encouraging. We're getting ready to move to the next phase of development with some regional alpha testing later this year. Player feedback is invaluable. And as we continue to work on building the game, we'll be looking to that feedback to make sure that we're making really a great Diablo experience.

When we think about -- when I think about mobile overall for Blizzard, we have our roots in PC gaming. And we're going to continue to be deeply committed to the PC. But we do think there are opportunities for additional experiences and in different ways for players to engage on different kinds of devices. And we see mobile as also a way to attract players that we don't currently reach on PC and console. So we think the mobile opportunity for Blizzard overall is very substantial. And Diablo Immortal will be our first release as a mobile-first game, and we continue to work on multiple mobile initiatives across Blizzard in addition to the PC and console games.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Mike. Operator, can we have the next question, please.

Operator

Our next question comes from Colin Sebastian with Baird.

Colin Sebastian, Analyst

Thanks. Digging down a little bit more into your relationship with Google, wondering what the key factors behind the decision to partner with GCP and then as well with YouTube Gaming, are there -- as well there, considerations or implications embedded that could increase your level of support for Stadia? Thank you.

Collister Coddy Johnson, President and Chief Operating Officer

Sure. Hey, this is Coddy, I'll take that. I mean, I'd say, first, as Bobby mentioned earlier today on an interview, we've had a long-standing relationship with Google. It's been great. We are thrilled to formalize that into a deeper partnership over multiple years. And as you said, there's really two big pieces to it. The first is on sort of the global IT infrastructure. And then the second is on what really is just a fantastic content platform in YouTube.

On the first piece, what we have the opportunity to do now is have a more efficient and better delivery of the back-end services and infrastructure handled by a partner where that is their great expertise. And what it allows us to do is it frees up our resources and developers and mind share to focus on what we do best, which is making the content and getting it out into the hands of our players at a faster cadence. That is a great balance of trade for us, and we feel really good about the depth of that partnership and how it will carry us going forward.

On the content side, on YouTube, there's 200 million game reviewers on YouTube, and it's just a tremendous opportunity to bring our platform to new audiences there. We think not only just in a way that players can experience it today, but with new modes and formats. And also, YouTube is a great on-demand viewing platform, and we think viewers might be increasingly interested in viewing our content that way. There are other pieces to this deal where there's real value, we think, in terms of how we utilize their platforms and how they help us build more reach and engagement in our ecosystem. Not in this deal, and you mentioned it, is Stadia.

There's cloud game streaming experiences that are directly to the consumer. We continue to watch with interest and we'll make appropriate assessments as we go forward to figure out our own next steps there. But I think what it points to is just as a last thought, a broader point, which is over the last two years, we've been talking about these large technology players that are coming to our space at scale.

What we've said is we see this tremendous opportunity as a content provider, to take advantage of where we sit in the space, and this Google deal is an example. It drives a large amount of value for us as we go forward. And we think we're only even better positioned for other partnerships as we take next steps.

Colin Sebastian, Analyst

Thanks.

Operator

Thank you. Our next question comes from Eric Sheridan with UBS.

Eric Sheridan, Analyst

Thank you so much for taking the question. Can you provide us an update on how Call of Duty Mobile is trending in terms of engagement, retention of users, how we should be thinking about future content as a driver of monetization for that property going forward? And second part, any key learnings that we should be aware of as you're learning to develop mobile games at that sort of scale, and how it might be applied to other parts of the portfolio. Thanks so much for the call.

Rob Kostich, President of Publishing

Eric, it's Rob. Thanks for the question. Let me start with the last part of your question on the key learnings, and I apologize for being a little redundant on this. But I think a key theme throughout our call is that I think what we learned more than anything else is that the market is certainly ready for our franchises on mobile.

When we make a great game and kind of stay true to the core tenets of what made the franchise great in the first place, and we execute on that, now we can reach just millions and millions of people around the globe that may have never experienced our franchise before. And that's just -- that's very exciting for us as an organization because that obviously is true not just for just Call of Duty but also for the many great franchises that we have in the organization.

If I were to turn back and talk about Call of Duty Mobile a little bit, in terms of engagement and retention, like you asked, look, I'd say it's still in the early days, but we've seen a number of encouraging signs. Obviously, the installs at the beginning, which we reported on, have been fantastic. But also in terms of our daily engagement, are looking at our DAUs, Mobile hit levels that were multiples higher than any other title in franchise history. So that engagement base is really, really exciting for us to work from.

Now for us, the content now becomes on the content pipeline to sustain and build on that. In mobile, we have a game and a platform essentially that we want to build on for a really long time to come. So we're hyper-focused on our content pipeline, our monthly, weekly and daily events as they come into the game, to make sure we drive the best possible experience for our player community there.

We're in the middle of season three right now, and that's tracking really well. And I think what you're going to see is we're learning a lot real time, and the learnings are great. And you'll see us adjusting our content and continuing to make the best possible experience we can for our fans as we move forward in the future. So I'd say, right now, we're off to really a nice start and -- that I'm excited about, and we'll be reporting on our progress as we head into the future.

Operator

Thank you. Our next question comes from Mike Olson with Piper Sandler.

Michael Olson, Analyst

Hey, good afternoon, and thanks for taking the question. You touched on it a bit, but could you update us on anything further related to the status of King advertising? How does it ramp throughout 2019? And what's your thinking on potential for 2020? Thanks.

Humam Sakhnini, President of King Digital Entertainment

Yes. This is Humam again. Thanks for the question. So look, I think advertising has been a real success story for King, as you saw in 2019. We've really built a durable business here, and it's a high-margin one. And the way I think about it is with our scale of monthly, it really allows us to get the benefit of having such a large audience.

As you know, a small fraction of them want space in our in-game economy. So now it's become a needle mover for us. We crossed 150 million in net bookings in 2019. And it's really a testament to a great collaboration between the product teams and the game teams, the advertising team, and really all of them thinking about what's a great player experience and how do we deliver something very differentiated for our advertisers.

And so when I look to 2020 and beyond, I see continued growth. There are many avenues of that growth. First and foremost, we're going to continue to roll out advertising to more and more of our players. And then I think the teams will continue to innovate there. We already, as I said, have an incredibly differentiated product that advertisers are really attaching to, but we can continue to make it better.

A good example of this was in Q4 was some of the -- what we delivered to Sony Pictures on the Jumanji film launch. And there, we not only had our flagship rewarded video product, but we did something truly differentiated in the marketplace, where we put an in-game integration. We put some of the game -- film characters in our game. It was greatly engaging for our players, and it delivered tens of millions of views to Jumanji and it's really moved the needle for them, too. So I think about continuing to move down that journey. And as we do that, we unlock more demand, and we are working very closely with our agencies. While we also continue to build our direct sales team and continue to build kind of the infrastructure around it.

So, all in all, I think kind of that strategy that's been working continues to bear fruit for us. And I think there's plenty of growth ahead of us and some good runway.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Mike. Operator, we have time for one last question.

Operator

Thank you. We'll take our final question from Mike Hickey with Benchmark.

Michael Hickey, Analyst

Hey, guys, congrats on the quarter. Thanks for taking my question. You made a lot of changes, obviously, to Call of Duty this year. You introduced the cross platform, new in-game system. You launched mobile. Obviously, has a huge success in esports. I guess, to what extent can we expect to see similar moves over the rest of your key franchises? Thank you.

Robert Kotick, Chief Executive Officer

Thanks for the question, Mike. It's Bobby. When -- I think one of the things that we found with the launch of Call of Duty Mobile, with games like Hearthstone, our designers and developers have gotten a lot more excited about reaching bigger, broader audiences. And we've seen that across the whole company. And so I think what you're going to continue to see is a commitment to innovation on all of our franchises. And that now includes commitment to innovation with mobile devices. And I think that as long as we can deliver new innovative game play with great user experiences on mobile devices, you'll see more franchises taking advantage of that as a platform.

I think the other thing we've seen is that people want to reach more customers in more countries and especially when you look at some of the things that we're doing in esports. Being able to build these big inclusive communities around the world, and today, our mobile games are played in almost 200 countries. That's been a real catalyst for us to really rethink the way that we're approaching our franchise development.

So you can expect, as Jay pointed out, obviously, as Humam can attest to, and as we've even seen the Activision business with the success of Call of Duty Mobile, mobile is now our largest platform, and you'll continue to see us with not just mobile touch points, but all the other important touch points that we've now added into the business, expanding the reach of our franchises, the engagement of our franchises and the monetization of our franchises.

So we couldn't be more enthusiastic about the prospects that we have going forward. We've talked a little bit about the challenges, which is prioritization of opportunity and making sure that we have the right talent aligned with those opportunities. But those are challenges we managed for a long time. So it's a great question, and I think you can expect that all of our franchises are investing in all of these new opportunities.

Christopher Hickey, Senior Vice President of Investor Relations

All right. Thanks, Bobby. Thanks, everyone, for joining us today. We look forward to speaking with many of you this quarter. And if not, we'll see you on our next earnings call in late April, early May. Thank you.

Operator

Thank you. Ladies and gentlemen, this concludes today's call. We thank you for your attendance and participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2019-11-07
Event Description: Q3 2019 Earnings Call

Market Cap: 41908.5868185
Current PX: 54.55
YTD Change($): 7.98
YTD Change(%): 17.135

Bloomberg Estimates - EPS
Current Quarter: 1.272
Current Year: 2.206
Bloomberg Estimates - Sales
Current Quarter: 2734.4
Current Year: 6377.609

Q3 2019 Earnings Call

Company Participants

- Christopher Hickey, Senior Vice President, Investor Relations
- Bobby Kotick, Chief Executive Officer
- Coddy Johnson, President and Chief Operating Officer
- Dennis Durkin, Chief Financial Officer and President, Emerging Businesses
- Robert Kostich, President of Activision
- J. Allen Brack, President of Blizzard
- Unidentified Speaker
- Humam Sakhnini, President of King

Other Participants

- Michael Ng, Analyst
- Mike Olson, Analyst
- Mario Lu, Analyst
- Ted Counihan, Analyst
- Matthew Harrison, Analyst
- Mike Hickey, Analyst
- Alex Giaimo, Analyst
- Ray Stochel, Analyst
- Robert Berg, Analyst
- Colin Sebastian, Analyst

Presentation

Operator

Good day, and welcome to the Activision Blizzard Q3 2019 Earnings Conference Call.

At this time, I would like to turn the conference over to Chris Hickey, Senior Vice President of Investor Relations. Please go ahead, sir.

Christopher Hickey, Senior Vice President, Investor Relations

Good afternoon, and thank you for joining us today for Activision Blizzard's third quarter 2019 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, COO and President; and Dennis Durkin, Company's CFO and President of Emerging Businesses. And for Q&A, Rob Kostich, President of Activision; J. Allen Brack, President of Blizzard Entertainment; and Humam Sakhnini, President of King, will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the Company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the Company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our

2018 annual report on Form 10-K and those on the slide that is showing. The Company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, November 7, 2019.

We will present both GAAP and non-GAAP financial measures during this call. We'll provide non-GAAP financial measures, which excludes the impact of expenses related to stock-based compensation; the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses and accruals; expenses related to debt financings and refinancings; restructuring and related charges; the associated tax benefits of these excluded items; and significant discrete tax-related items, including amounts related to changes in tax laws, amounts related to the potential or final resolution of tax provisions and other unusual or unique tax-related items and activities. These non-GAAP measures are not intended to be considered in isolation from, as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision.

Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also an earnings presentation, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results.

And now I'd like to introduce our CEO, Bobby Kotick.

Bobby Kotick, Chief Executive Officer

Thank you, Chris and thank you all for joining us today. Our third quarter results exceed our prior outlook for both revenue and earnings per share as we made continued progress on our growth initiatives for 2020 and beyond. For the fourth quarter, we decided to increase investment in consumer marketing and user acquisition, as we inspire to reach more players in more countries on more platforms than ever before. Our recent success with Call of Duty highlights the potential for our portfolio fully-owned intellectual property.

Call of Duty mobile is experiencing one of the industries most successful launches ever. In extending Call of Duty to the largest and fastest growing platform, we've more than tripled the franchises reach with over 100 million downloads in the first month alone. The game reached the top of the install charts in over 150 countries and regions, reflecting Call of Duty's global stature and monetization is of to a strong start with the game entering the top 10 grossing charts in over a 100 countries and regions.

On console and PCs too Modern Warfare is of to an exceptional start and we have more surprises in store, that we think will delight existing and new players in the coming months. We plan this a Call of Duty Fandom to new levels with the launch of the Call of Duty league in late January. So far we have secured 12 fantastic team owners who bring deep operation and entrepreneurial expertise as they prepare for games and cities around the world next year. These ownership groups include some of the biggest aims in professional sports and 10 of them have already success with us on the Overwatch League. In fact the Overwatch League recently completed remarkable second season that saw over 30% growth in US average minute audience. We couldn't be better positioned as we continued to execute on our vision and strategy for armature and professional Esports.

The phenomenal response to World of Warcraft Classic in the quarter also illustrates the vast potential in enduring PO of our fully owned franchises across the company. Celebrating the 15th anniversary of World of Warcraft and the 25th anniversary of the Warcraft franchise World Classic brought millions of players back to the game. And Blizzard has the resources, talent and pipeline to continue delivering great content for World of Warcraft players into 2020 and beyond.

At BlizzCon last week, we gave Blizzard players a preview of some of the superb content in our pipeline. We expect the innovations on display across World of Warcraft, Hearthstone, Overwatch and Diablo to inspire Blizzard players and expand Blizzard communities. And we expect Blizzard to deliver the consistent business growth that we know is possible in an industry with so many opportunities. King continued to lead the way in mobile gaming, Candy Crush was again the number one grossing game on the US mobile app stores in the third quarter, and the team is hard at work on new features and content that we expect to drive further growth for the franchise in coming years.

Our in-game advertising initiatives delivered exceptional results again advertising net bookings within King almost double year-over-year and we're now starting to apply our capabilities in this area to Call of Duty mobile and certain other properties across the Company. I'm of course grateful for the continued focus and extraordinary efforts of our employees around the world. We appreciate the ongoing support of our shareholders and we have deep gratitude for our players and spectators who derive an incredible sense of purpose, meaning and belonging, from being a part of the communities created through our franchises. Our mission to bring the world together through epic entertainment is the driving force behind our ambitions and we remain steadfast in our commitment to this ideal.

Thank you for joining us today and now Coddy will review the highlights of our operations for this quarter.

Coddy Johnson, President and Chief Operating Officer

Thank you, Bobby. Activision Blizzard exceeded our third quarter outlook, driven by better-than-expected performance from Call of Duty, in-game and World of Warcraft, as well as favorable cost timing. And we started Q4 with successful launches for Call of Duty, mobile and Call of Duty, Modern Warfare and achieved important milestones in several other franchises. We plan to build on this momentum and we will invest this quarter to maximize the potential of our franchises in 2020 and beyond. So far this year, we've increased investment and development resources in our key franchises to drive innovation and improved performance across our four strategic growth pillars. We've made clear progress against each.

And our first pillar, delivering a strong consistent cadence of major new content releases the World of Warcraft Classic launch in August drove a record quarterly increase in subscription plans, with the player base remaining elevated in the Q4. Then, last week in BlizzCon was announced the next World of Warcraft expansion and sequels to both Overwatch and Diablo giving fans hands on game play for the next major installments some of our biggest franchises. And two weeks ago, Activision launched Modern Warfare with exceptional early sales.

And our second pillar, which is driving live operations with ongoing in-game content, services, features and events. We saw encouraging results from our increased focus as we continue to invest in growing our capabilities in this area. The expanded development team on World of Warcraft has sustained strong engagement within world classic into Q4 as delivered the first in a wave of substantial content updates. Black Ops 4 reach and in-game performance continue to benefit from our focus on delivering more compelling in-game experiences. And we saw a positive community response to our plans for Modern Warfare's in-game system.

Our third pillar is to build on King's leadership position and extend our game console and PC franchises to mobile. To that end Call of Duty mobile has had a very strong start, shadowing records following its launch against early success points to the significant potential of our franchises on mobile, given the powerful combination of globally beloved IP, increasingly compute in Graphics capable mobile devices and strong execution.

And lastly, our fourth pillar, as we add new engagement models to our franchises. We continue to have a strong ramp in advertising and an industry leading position in Esports. We are pleased with this progress on our growth pillars. There are more milestones to come and driving the business to its full potential. But we see these results as a clear indication that our increased investments are positioning us for significant future growth.

I'll now provide more detail on our Q3 results and recent developments for our franchises. Activision monthly active users was $36 million in Q3. While lower year-over-year due to exclusion of Destiny and a decline in Call of Duty catalog Activision reach was better than expected. This reflected the strength of Black Ops 4 in-game content to drove sharp year-over-year growth in both reach and purchases of in-game items first last year's title. And Call of Duty is surge and reach [ph] with the launch of Call of Duty mobile on October 1, over a 100 million people download the game in its first month.

The title reached the top of the mobile app download charts in over 150 countries and regions driven by the global recognition of the franchise, strong publishing execution by the Activision team an exceptional work by Tencent's TV studio in creating an authentic Call of Duty experience. The game has tremendous quality in polish and a 4.9 Star rating in the US iOS store, monetization trends for the Battle Path and the first season event have been strong and retention is outperforming too.

Our publishing team is capitalizing on this momentum significantly increasing our user acquisition budget to continue to grow the player base. Note that this investment does limit the titles Q4 profitability, but also sets up healthy contribution for the title in 2020. With 15 years of Call of Duty content and experience the drop on, we have a raft of features content and events lined up for the future of Call of Duty mobile.

In October 25, our world-class development team at Affinity World [ph] launch Call of Duty, Modern Warfare. From the quality campaign to the breadth and depth in multiplayer universe, we think Modern Warfare stands apart from any other title. And we're confident that we will once again have the number one console franchise globally for upfront sales this year. The titles off to a great start. First week unit sell through is up high-teens versus the prior year title with strong console growth and PC units on Battle.net growing over 50% year-over-year.

We've taken significant steps to create a single highly engaged player base, with cross-play and cross progression between platforms in their move off the season pass. And we intend to keep the community engaged with a substantial pipeline of in-game content, which we expect will in turn create greater opportunities for player investment. Building off momentum as Bobby discussed, we plan to launch the new city-based Call of Duty league in January. And we have more surprises and initiatives planned to further enhance the scale and value of the overall Call of Duty franchise in the coming quarters.

Turning to Blizzard. Monthly active users were 33 million in the third quarter, modestly higher sequentially. World of Warcraft reach almost doubled sequentially in Q3 as both existing and prior players embraced the arrival of WoW classic. Blizzard's recreation of World of Warcraft as it all began 15 years ago. In Q3, Blizzard added more monthly and longer term subscription plans than in any prior quarter, both in the West and the East and reach remained well above prior levels in October with deep engagement across both Classic and Modern World of Warcraft.

And with increased resources, the team is already start to deliver an extraordinary cadence of in-game classic content. And then from Modern World of Warcraft, Blizzard last week in-build Shadowlands, the next major expansion for the franchise launching in 2020. The depth and breadth of World of Warcraft appeal is clear than ever with the franchise set for growth in 2020.

Turning to Hearthstone. As we highlighted on our last call in August, we saw a more challenging competitive landscape for the franchise in the third quarter, which drove lower reach and player investment both sequentially and year-over-year. But as discussed the expanded Hearthstone team has a substantial innovation pipeline planned for the franchise.

Last week, Blizzard unveiled the latest expansion Descent of Dragons and also announced Battlegrounds a unique Hearthstone take on the auto-battler genre [ph]. Battleground is planned as a significant engagement driver. And with the Hearthstone team innovating at a rapid pace we look forward to announcing additional content initiatives in the coming months.

On Overwatch, while player investment remained relatively low at this stage of the games life cycle, engagement benefited from the introduction of a new hero and well received gameplay adjustments. Overwatch League concluded Season 2 with the sellout crowd of fans watching the San Francisco Shock defeated Vancouver Titans in the grand finals at the Wells Fargo Center in Philadelphia. And Season 2 viewership overall grew with Average Minute Audience of 18% year-over-year.

Blizzard last week also revealed Overwatch to a major sequel for the franchise, with new heroes, maps and gameplay. This franchise's world-class multi-player experience will take a big step forward. Overwatch 2 will also introduce a significant set of new cooperative experiences taking players deep into the narrative of Overwatch with the story based gameplay for which players have long been asking, as well as a huge variety of repayable hero emissions in which players can level up and customize their favorite heroes. The response to reveal and hands on gameplay from fans was excellent. And the team is looking forward to sharing further details as development progresses.

And of course, Blizzard also recently revealed Diablo 4, the highly anticipated sequel to the genre-defining franchise. It's a quintessential action role playing game reflecting Blizzard's PC gaming for fans on PC as well as for players, on Xbox and PlayStation. And it features an expansive open world, in which players can explore independently, group up to play together or battle each other. BlizzCon attendees were able to play a hands-on demo and the feedback was great.

And Blizzard continues to work on Diablo Immortal, a collaboration with its partner NetEase that will deliver an authentic Diablo experience on mobile and development is progressing well. As Bobby said, this year's BlizzCon featured the most robust content pipeline in Blizzard history and the team is working on more projects behind the scenes, including new IP. We look forward to sharing more with you when the time is right.

Now turning to King. Monthly active users were 247 million lower year-over-year driven by declines in King's web and smaller mobile titles, but importantly on Candy Crush, King's key franchise mobile reach grew year-over-year driven by the addition of Candy Crush Friends last October. And the team continued to expand on live services, features and content for the Candy franchise driving reach and engagement across current returning and new players.

King also launched a number of initiatives in the quarter aimed at broadening payer engagement and longer term monetization, which delivered an encouraging uptake in payer conversion in Q3, but which did come at some expense to in-game net bookings in the quarter.

All that said, Candy Crush was still and once again, the top grossing franchise in the US app stores. King's advertising business also continued to grow profitably, with net bookings almost doubling year-over-year, it's advertisers embrace the value proposition of a native video ad product in a safe environment. The business remains well on track to exceed 100 million in net bookings this fiscal year.

So in summary, we are excited by the momentum we are seeing in many of our franchises and the growth opportunities they present. Our Q3 results reinforce the durability and potential of our franchises and our business and our confidence that our increased investment and focus this year sets us up for meaningful growth in the future.

I'll now hand the call over to Dennis to discuss our financial performance and our outlook. Dennis?

Dennis Durkin, Chief Financial Officer and President, Emerging Businesses

Thanks, Coddy. Today, I will review our Q3 2019 results and our outlook for Q4. Q3 GAAP and non-GAAP EPS were ahead of our prior outlook. Key factors included business overperformance, favorable cost timing, and a lower tax rate. To review the quarter, I'll start with our segment results. Activision revenue was $209 million down year-over-year against a comparable that include the release of Destiny Forsaken. Key quarterly contributors were Call of Duty, Black Ops 4, in-game and upfront revenues, and ongoing sales of Crash Team Racing.

Operating income was $26 million with an operating margin of 12%. Blizzard revenue was $394 million lower year-over-year against the comparable that included the release of World of Warcraft: Battle for Azeroth. Operating income was $74 million with an operating margin of 19%. King revenue of $500 million was roughly flat year-over-year and sequentially. Candy Crush revenues grew modestly year-over-year with the ads business almost doubling over the same period.

Operating income was $194 million with an operating margin of 39%, 3 points higher year-over-year. Across our segments in-game net bookings were $709 million lower year-over-year with the biggest drivers being the Battle for Azeroth and Forsaken expansions in the year ago quarter. We are continuing to improve our execution in this area and we are pleased with the progress we saw in Q3 for certain franchises, most notably Call of Duty.

Now let's turn to our overall consolidated results, unless otherwise indicated, we are referencing non-GAAP figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations. For the quarter, we generated Q3 GAAP revenues of $1.28 billion, a $177 million above our August guidance. This included the net recognition of deferrals of $68 million. Net bookings of $1.21 billion were $114 million above our August outlook. We incurred GAAP only restructuring and related charges of $28 million. And we generated Q3 GAAP EPS of $0.26 and Q3 non-GAAP EPS of $0.38, which was $0.18 above guidance. These figures include the net recognition of deferrals of $0.06.

From a cash flow and capital structure perspective, Q3 operating cash flow was $309 million and our cash and investments at the end of September was approximately $4.9 billion. And we ended the quarter with a net cash position of approximately $2.2 billion.

Now let's turn to our fourth quarter and full-year outlook. Looking at the release slate, in addition to Activision's launches of Call of Duty mobile on October 1 and Modern Warfare on October 25, Blizzard released Overwatch on the Nintendo Switch on October 15 and plans to release Warcraft III: Reforged in December. Q4 will also see the release of Descent of Dragons expansion and the open beta for the Battlegrounds mode for Hearthstone. And we will support other key franchises with a stream of content, services, events, and features. This includes our new in-game system for Modern Warfare, which begins in December slightly later than originally planned.

Before I provide our financial guidance, I'd like to provide some context. Firstly, we are more than delighted with the early results for World of Warcraft Classic, Call of Duty mobile, and Modern Warfare. We are entering the holiday season with strong momentum, but at the same time, we wish to remain prudent as we focus on execution for the rest of the quarter. Secondly, as we think about positioning our franchises for growth into 2020, in some cases, such as Hearthstone, Candy Crush and Call of Duty mobile, we are prioritizing reach and engagement over short-term financial results in the fourth quarter. Consistent with this, a significant proportion of the Q3 earnings upside was driven by cost timing and we intend to invest these amounts in Q4, given the abundance of potential for our franchises.

Thirdly, I would also note that the ongoing shift to digital represents a timing risk factor for sell-in versus retail sell-through dynamics and FX headwinds have modest increase since we last provided guidance. All that said, we are raising our net bookings and EPS guidance for the full year and feel great about how the business is positioned for a return to growth in 2020.

Now on to the numbers. For Q4 on a GAAP basis, we expect net revenues of $1.81 billion, including GAAP deferrals of $834 million. We expect net bookings of $2.65 billion. We expect product costs, game operations and distribution expenses of 25%. And operating expenses including software amortization of 56%. And GAAP only restructuring-related charges of $42 million. We expect GAAP tax rate of 33%. GAAP and non-GAAP share count of $774 million and EPS of $0.29. For Q4, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 25%. And operating expenses, including software amortization of 48%. We expect a non-GAAP tax rate of 30% and non-GAAP EPS of $0.43, which includes GAAP deferrals of $0.72.

On a GAAP basis for 2019, we expect net bookings of $6.32 billion, including GAAP deferrals of $10 million. We expect net bookings of $6.33 billion. Product costs, game operations and distribution expenses of 25%. Operating expenses including software amortization of 51%, and a GAAP only restructuring and related charge of $150 million. We expect the GAAP tax rate of 21%, GAAP and non-GAAP share count of $772 million, and EPS of $1.56. For 2019, on a non-GAAP basis, we expect product costs, game operations, and distribution expenses of 25%, and operating expenses including software amortization of 43%. We expect non-GAAP tax rate of 20%, and non-GAAP EPS of $2.13, which includes GAAP deferrals of $0.04.

So in summary, our early success for World of Warcraft Classic, Modern Warfare and Call of Duty mobile speaks volumes about the value and potential of our large durable and broad portfolio of fully owned intellectual property. And with the significant announcements we made at BlizzCon last week, you now can understand why we have been so excited about what's in our pipeline for the coming years. While it's not easy, creating and sustaining interactive entertainment franchises like ours is one of the biggest and largest growth opportunities in all of media and our stable of enduring franchises gives us a strong foundation to build upon.

We are encouraged by our recent progress in a number of franchises, as well as the green shoots across the rest of our portfolio. We can and will continue to maintain the disciplined operating focus that has characterized our company for many years. We remain confident that executing against our plan will position us to deliver strong results and shareholder value over the long-term.

Now I welcome our business leaders Jay, Humam and Rob as they join us for the Q&A portion of the call. Operator?

Questions And Answers

Operator

Thank you. (Operator Instruction) Our first question today will come from Michael Ng with Goldman Sachs.

Michael Ng, Analyst

Hi. Thank you very much for the question. Just on Modern Warfare with the absence of a season pass and with implementation of the new in-game system, could you talk about what that means for in-game spending growth next year versus Black Ops 4? Thank you very much.

Robert Kostich, President of Activision

Yeah. Thanks for the question, Mike. It's Rob. I think it's really important to first talk about our overarching principles and what we're trying to do. We're focused on bringing the community together, building one big community and keeping a plan together through great content and features. The changes that we've been making are certainly in service of those principles and we believe they are not -- not only great for our players, but also for growing and sustaining long term engagement, which of course is critical to our long-term success. And I do want to talk about some of the things you mentioned in some of those changes.

We did eliminate the season pass and instead we will be focused on dropping free content to the community, so everyone can enjoy it together. Tomorrow is actually going to be the first free content drop for Modern Warfare and we're excited about that and the much bigger things that are yet to come for the community. And we also implemented cross plays for the first time in the franchise to keep friends plan together, no matter what platform they are on. And I think this was actually really important and I'm seeing it and how friends groups are connecting already. Players who haven't played Call of Duty together in years are doing so and we think that's really great for the community overall.

Now, we're also implementing a new Battle Path system, which you mentioned and it's going to launch later this quarter. We feel it's the right thing to do for the game and how it's designed. And more importantly, we think it's the right thing to do for our players, that launch is still ahead of us. But we've been really encouraged by the early response from the community to the change that we're making there. So in terms of growth, we do feel good both about our long-term engagement potential as well as the new system that we're implementing.

Now I'll let Dennis speak to how we think about in-game revenue kind of this quarter and beyond, but on the content side, we have plans for seasons and events that we believe we will keep the community playing together for the long haul. Modern Warfare is really a great game. It's a deep experience, and we believe it's just scratching the surface of what it can do. We keep saying in many places that the launch of Modern Warfare is just the beginning and it truly is, there is a ton more to look forward to hear. Dennis, is there anything else you'd add?

Dennis Durkin, Chief Financial Officer and President, Emerging Businesses

Yeah. A couple of points, just to build on what you mentioned, Rob. I mean, the first thing is, we do feel great about the end game plans and a lot of the changes that you and the team have made. We're always though very careful when we're modeling these new initiatives particularly in launch quarters like this one and with the timing of it. Overall with the changes and sort of keeping the community together and the cross platform in the new economic system that we have inside the game, we think that's most importantly that's going to drive long-term engagement inside the franchise. And usually when you've got great long-term engagement, great business results follow. So we're pretty excited about what we have in store and what's coming and we think that's going to be a nice tailwind heading into 2020 for Modern Warfare.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Mike. Operator, can we have the next question please.

Operator

Certainly. Our next question comes from Mike Olson with Piper Jaffray.

Mike Olson, Analyst

Hey. Good afternoon. Thanks for taking my question. After 2019 that was maybe less robust from a pipeline perspective and you touched on this a bit, but how would you say that investors should think about the pipeline for the company over the next 12 months to 24 months? Thanks.

Coddy Johnson, President and Chief Operating Officer

Sure. Thanks, Mike. This is Coddy. But first, Dennis highlighted on the call, we're sort of particularly excited to be this side of BlizzCon and to -- have been able to have Blizzard walk through just what's coming in the upcoming content pipeline there. And when you couple that with the initiatives underway and Activision and King, we do feel that we're looking at the strongest content pipeline that this company has had in its history. And one of the reasons for that are the important steps that we've taken in over the last year to make that possible, the investments we've made in our development resources, to focus on our core franchises, that push to make sure that the content cadence across upfront, live operations in mobile, sits across all of our key franchises where appropriate.

And we took some steps as well to make sure we could fund that by de-prioritizing other areas. All-in-service of getting to this moment where we could show the content cadence for players coming up and deliver to expectations and above. I think the early results are really important signpost to look at on this growth road that we are on. When you think about World Classic, it is a major expansion coming to that universe. And in an off-year typically as you know, every other year expansion and major expansion that comes in as a significant step change impact on the reach of that franchise, similarly gotten [ph] mobile while partnered outside development to pull that off. We had to make significant investment inside our production and publishing capabilities. And again a step change in that franchise is reach and engagement.

And then Modern Warfare, which we think stands alone in terms of an experienced and as Rob highlighted, it will continue to do so. So those aren't just sort of green shoots those are real sign posted milestones of the growth that we think is possible and it points to what we think is coming, some of which concretely, WoW Shadowlands coming in 2020, Hearthstone Battlegrounds, Warcraft III: Reforged.

There are items we haven't announced the dates for, but with significant moves for the community, Diablo: Immortal Diablo 4, Overwatch. And we have a similar level of investment and focus coming up in the pipelines that are at Activision and King. And so it's when we step back, we feel like we're at this moment where we can take the significant pipeline forward. And really if you want, if you're looking from the outside and you want the strongest pipeline in the industry, we think it's here at Activision Blizzard.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Mike. Operator, can we have the next question please.

Operator

Our next question will come from Mario Lu with Barclays.

Mario Lu, Analyst

Hey, guys. Thanks for taking the question. So, just one on Overwatch, I think the share multiplayer environment you announced between Overwatch and new Overwatch 2 owners is very intriguing and unique. Anything you can share in terms of what kind of business models we can expect for Overwatch 2? Thanks.

J. Allen Brack, President of Blizzard

Hi. This is Jay. Thanks for the question. Last week at BlizzCon was a really big reveal for Overwatch 2 for us and the teams and where the reception has been great and we've been really humbled by that. One of the things that you alluded to and I think is worth really kind of articulating is, this idea that the team has around redefining a sequel and really, what does that mean. And so if you think about for PVP, we've communicated that all the players of Overwatch will play on the same maps, as players of Overwatch 2.

And in other words it be one map pool. That we've also announced that all players will have access to the same set of Heroes. And the principle for this is that no one is left behind and then we really are not splitting up the community. We've also communicated that we want to honor the collection from the existing game, and so everything that you've earned will carry forward into Overwatch 2. And the thought behind this is, we've worked hard to build a strong community and we want to move forward as one.

For PVE, as Coddy talked about we're introducing lots of content for Overwatch 2. Players really asked for a back story and a narrative in the Overwatch universe for since the very beginning and we're really excited to create a huge amount of playable content that really does that. And we also think this PVE content will bring entirely new players into the Overwatch universe.

So the overall goal is to continue to build the largest community possible in the game with excellent content and a commitment to really continuing to release different live content than you've seen historically at a higher cadence. So, stepping back to your question on the business models. We're always looking for the appropriate business model for each franchise and Blizzard we're lucky to have several different experiences or several different versions of different business models.

I think that players -- it's proven that players demand premium and differentiated content and many of the Blizzard launches are premium experiences. We don't see any reason to walk away from that given what we can offer the players.

Unidentified Speaker

Thanks. Operator, can we have the next question please?

Operator

Our next question will come from Jason Bazinet with Citi.

Ted Counihan, Analyst

Hey, guys. Ted calling in on for Jason. Thanks for the time. Just curious at the King segment. If you're able to provide any color on sort of where you plan to devote most of the focus going forward. Just given that the KPIs for Candy Crush appear to be perhaps a bit better than for King as a whole. Just wondering, if there's any sort of trade-off between sort of maintaining the durability of Candy Crush and promoting other titles?

Humam Sakhnini, President of King

Hey. Thanks for the question. This is Humam. So I think it's a theme that you've seen it across Activision, Blizzard and I think it plays itself out quite nicely as well as King, which is, we're often finding that our biggest opportunities are in our biggest franchises. I really think Candy Crush franchise is a great case in point on that. So we've increased the resources in the Candy team and you -- as you mentioned, the results are pretty evident. I think in Q3, we had the fourth consecutive quarter, we had year-on-year mobile, MAUs and net bookings growth for the Candy franchise. So really strong results from that focus on the Candy opportunity.

And I'm firmly believe that the opportunities in the Candy franchise continue to be ahead of us. We're continuing to introduce quite a bit of features and content and innovations in our live ops environment that drive client -- player engagements and we are expanding the network as you see in our MAU trend. So as we continue to focus on that I continue to see a lot more opportunity in our Candy franchise. I do want to highlight though that we are also selectively investing in new IP. And there we are taking an approach of fewer, bigger events very focused look at our pipeline.

As you well know launching new mobile IP is tough in the industry, but the combination of creative talent at King and there are sizable networks that we have gives us good advantage. And you've heard probably on previous calls, I mean talked about our advertising efforts. We continue to push hard into that and we continue to move that momentum forward. So all in all, that's the area we focused at the King level.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Ted. Operator, can we have the next question please?

Operator

And moving on to Brian Nowak with Morgan Stanley.

Matthew Harrison, Analyst

Hi guys. It's Matt on for Brian. Thanks for taking the question. Can you give an update on how Call of Duty mobile is doing in terms of attracting and retaining players now that we're in month out from lunch? And are you seeing any cannibalization there with our Modern Warfare? Thanks.

Robert Kostich, President of Activision

Hey, Matt. It's Rob. Thanks for the question. Probably the first thing I wanted to do is just step back and say that, overall, this is a pretty special time for Call of Duty across mobile, our traditional console and PC business and across the Esports. We're seeing significant success and traction on all fronts. With Call of Duty mobile, on your question we've obviously have a great game, the high quality game. We've talked about the installs over 100 million in under a month, which has been fantastic.

We're seeing strong growth in many geographies like India and Brazil, more so than we've ever had in our history. And it's providing a real step change in reach for the franchise and frankly just growing the brand in all new ways, which is great to see. We also just had a really strong launch for Modern Warfare, which suggests we're creating a really strong franchise ecosystem globally, where these products are actually complementing one another and not competing with one another. This is exciting news for us on a number of fronts, including how we think about cross promoting, our products across this ecosystem, both now and I think well into the future.

Now in terms of the mobile metrics specifically, we're obviously very pleased with the installed and we've referenced a number of times on the call. But importantly, our retention has been really strong and that's due to the great game quality and great game experience we have as well as the quality of our ongoing live operations.

We also have a compelling content pipeline ahead that we believe will continue to drive our business results. So right now we feel great about where we're at. We feel good about and really good about our prospects for the future. But I do just want to come back and close where I started, with the success on mobile with the success of Modern Warfare and with the Call of Duty League launching in January, we do think the best days for the franchise are squarely in front of us, and that's a pretty cool thing to say, given all the success we've had in the past 16 years. Thanks for the question.

Coddy Johnson, President and Chief Operating Officer

Rob, hey, it's Coddy. I just want to jump in at a few points. One is, I just note that bringing Call of Duty to mobile was one of the first and most important initiatives that Rob and his team signed up for, as they kind of stepped in to new roles. And so it's a real credit to the team and kind of reach this moment. I know that has been a road and to get to this place is awesome to see, but I think important that it's really its just the first step.

There are a number of things happening across Call of Duty to continue to expand across platforms and geographies and have this as an ecosystem that sits across mobile and console and PC at Esports. And so I think there are some really important and good things still to come. And I think that's true natures for card, but across a number of our other key franchises as well, where Call of Duty success on mobile points the way for its possible for some of our other AAA franchises.

Christopher Hickey, Senior Vice President, Investor Relations

Operator, can we have the next question please?

Operator

And next will be Mike Hickey with Benchmark Company.

Mike Hickey, Analyst

Hey, guys. Congrats on the quarter. Thanks for taking my questions. I guess just two on Hearthstone. Can you share with us sort of the impact you're seeing from competition there? And how we should think about the opportunity to return the franchise growth? Thank you.

J. Allen Brack, President of Blizzard

Hi. This is Jay. I think when we think about different games and we think about Hearthstone. I think it's natural to attract competitors. It's not something that we spend a lot of time thinking about, I think new games bring in new players, new ideas and the growth of the industry, which is great for everybody. I also think that players will try lots of new games but are going to -- come back for differentiated experiences.

So we focus on making the best experience we can and then increasing the cadence of great content and great gameplay. One of the things that the industry has seen this year is the rise of the auto-battler genre. And at BlizzCon, we announced our take on this within Hearthstone. We've already executing some positive response from the early audience feedback and we're looking forward to the wider release next week. It is an engagement driver, that's the focus is on new and returning players with this mode.

I think the Hearthstone team has really done a great job this year and I'm super proud of what they've accomplished in a very short amount of time. They saw this as an emerging genre really early in the year, something that really excited about. And then they pushed to add the mode to Hearthstone in a very Blizzard way -- in a way I think its going to turn out be very cool for players.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Mike. Operator, can we have the next question please?

Operator

And next question come from Alex Giaimo with Jefferies.

Alex Giaimo, Analyst

Thank you, guys. Just hoping to get a bit more color around the long-term mobile strategy within the portfolio with COD mobile up and running, we know Immortal is coming at some point, but would mobile makes sense for any of the other Tentpole franchises like a WoW or an Overwatch? Thank you.

Coddy Johnson, President and Chief Operating Officer

Sure. Thanks, Alex. This is Coddy. I guess I'd take first just on mobile strategy generally, remember a third of our business is on mobile already and we have the largest mobile gaming presence in the West. And so we want to build on that leadership position and we think it's a really foundation of strength to do that.

It is a massive opportunity and we think not just for Call of Duty and not just for Diablo Immortal. And it's worth of pausing and tucking for mobile Call of Duty -- mobile for why it's such a large opportunity. I think first, it shows that the AAA kind of games, we make are ready to work on mobile, because of the improving compute and graphics capability.

Obviously because of evolving player expectations, it's now the case that many of the most successful global games are RPG, first person action, strategy those all the line as you might imagine, very well with our portfolio.

We have a growing ability to execute and we're seeing that franchise, familiarity and awareness matter -- matter fundamentally and like, to the tune of hundreds of millions of people that when you reach out in the right way franchises, they're going to come in. And so that's the level of opportunity we see. In terms of what will make, you might imagine, we're looking at all of our franchises.

We want to do where it makes sense and we think about strategically in three main buckets. The first is extending existing game play. This is we call the mobile [ph] taking the best of Call of Duty quite literally maps, weapons, characters and it's brought that over mobile experience. So that's one bucket where we are looking at a number of opportunities to go do that.

The second is reimagining the IP on the mobile platform. You can think about it's like Hearthstone which is really a re-imagination of the Warcraft IP and the car game and that was very well animated. You can imagine we're pursuing a number of ideas like that. And then developing true cross platform titles that work from the start across mobile.

Some of those take time, but we are anxious to move. And you mentioned one already in the pipeline and there are more to come. And so we're excited about rolling that out over the next several quarters.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Alex. Operator, can we have the next question please.

Operator

And the next question comes from Ray Stochel with Consumer Edge Research.

Ray Stochel, Analyst

Great. Thanks for taking my question. How is retention trending for World of Warcraft Classic? And can you help us think about the long-term opportunities around running a multi-track subscription model? Thanks.

Coddy Johnson, President and Chief Operating Officer

So, you asked about Classic specifically, but I think it's important to note that we think of World of Warcraft as a single community. Watching World Classic into the existing subscription was very intentional. We made a conscious choice to have one ecosystem and one engaged base of players. The goal of that system was frictionless movement between Classic and Modern.

So now we have a large group of players and we have the challenge of keeping them engaged. And I think we have a number of different ways to do that. In Classic, you've already seen the first example with the Dire, Mau update, which was released in mid-October. And we've seen player engagement into Q4 with subscriptions in some regions continuing to grow. We also have the added benefit for Classic with a known content roadmap for players. Switching to Modern WoW, at BlizzCon we announced an expansion with World of Warcraft Shadowlands and so that's more content and more flexibility than ever before.

And so it's a good position for us to be in. Personally, I'm super happy with World of Warcraft and where it is announcing Classic two years ago was one of the highlights of our professional career and to so to see the excitement of the players and the joy that has kind of come from that is awesome for me personally.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Ray. Operator, can we have the next question please.

Operator

And we have a question from Robert Berg with Berenberg.

Robert Berg, Analyst

Yes. Hi. Thanks for taking my questions. A couple from me, please. The first on the next-generation of consoles, we've heard from EA and Ubisoft on how you're thinking about the potential tailwind for unit sales in 2020, 2021? Interested to hear how you're currently thinking about the impact of the next generation of consoles on your business? Second question is, given some of the developments on PC and mobile recently and with streaming coming, what are your latest views on the prospect for lower royalty rates across the industry over the medium term? Thanks.

Coddy Johnson, President and Chief Operating Officer

So thanks. This is Coddy I guess maybe taking a step back first, we are increasingly seeing from the industry and we think certainly true for our franchises that they exist above and beyond any single platform that their franchises that appeal broadly across multiple platforms. Just mentioned this, we believe now is eminently true on Call of Duty across PC, console and mobile. And if you go back several years ago that wouldn't have been true for Call of Duty. But now robust growth across all three of those. Overwatch of course, across PC and console meaningfully and Hearthstone across PC and mobile meaningfully.

So I would first just start with that premise that we are well above any individual console change and it is about the broader nature of our franchises across multiple platforms, of course, all that said, we're like -- we're excited when large partners want to come in and expanded their platforms. And so that includes consoles as the next-gen looks to be getting ready. We think it's an opportunity to continue to showcase our premium experiences.

We're also think increasingly you see consoles being iterative and that gives us the opportunity, we believe to keep our communities together. It's why we've made such strong investments to keep communities playing together and either put those in the market or announced that we're doing so and we think that continues with this console generation that's to come. I just remind you getting your consoles are only about a third of our business may be different from some of our competitors. And so we kind of see ourselves having robust growth pipeline across all the large platforms out there.

You asked finally just about economics and that we always look to bring our IP to bear on appropriate large platforms as long as the economics are right, I would not get into specifics about royalties at this stage, but we have a long track record of making sure that our IP is fully understood and valued by our partners.

And I just -- I think the broadest point to remember is right now you have a lot of well-funded platforms coming in looking to build out gaming reached and they are looking for great content and they're short of it. And we find ourselves we think very fortunate and well positioned to have great content to bring to bear. And we think that sets us up very well for the next several years.

Christopher Hickey, Senior Vice President, Investor Relations

Thanks, Rob. Operator, we have time for one last question.

Operator

Certainly, that question comes from Colin Sebastian with Baird.

Colin Sebastian, Analyst

Thank you. One question, please. I'm wondering what you took away from the Overwatch Esports experience in ramp, in terms of applying that knowledge to the Call of Duty league on launch next year? Thank you.

Bobby Kotick, Chief Executive Officer

Sure. Thanks, Colin. It's Bobby. Well, as you can imagine, we've learned a lot. Probably the most important thing is that we underestimated, things like the demand for the broadcast rights, sponsorships and even on the licensing front. I think we also underestimated enthusiasm that we would have for -- from prospective owners, which is why the price of the teams went up so much over the two-year period.

And then I think operationally we had the benefit of two years in a fixed location to really think about how to optimize production. But as we go out into the local markets next year, which is the big point of differentiation for us in our views between us and anybody else that's thinking about Esports is really engaging these great local entrepreneurs and professional team owners who are professional groups in actually generating revenues, marketing, new fans, new opportunities for our fans to connect to their favorite players. And so what we've learned over the last couple of years is serving us incredibly well as we launch the Call of Duty League. And in fact most of the owners are existing owners and most of them have jumped in at prices that are higher significantly than what they paid for their Overwatch teams and I think we're going to get the benefits of scale of being the biggest operator of a professional Esports League anywhere in the world. The other thing I think is we probably didn't appreciate how big the viewing audience was. And if you look at the demographic that we served, principally 18 to 34 year olds, the audience that we're serving on a global basis is bigger than the MLS for that demographic or Major League Baseball for that demographic. So there's an untapped opportunity for sponsors, for advertisers, for our licensing partners to be able to reach an audience that has become increasingly difficult to reach.

So I think from every perspective not only we learned a lot, but I think what we've done in terms of execution is the best that anybody has expected or seen in professional Esports. And so when you then think about what's happening in these franchises, whether it's the announcement we just made about Overwatch 2 or the new 100 million consumers that just came into the Call of Duty marketplace and community, we're seeing an incredible amount of growth in both the opportunity for spectators but also in audience that will be able to reach for our sponsors or broadcast partners, advertisers. And so when you look out over the course of the next 12 months to 24 months there will just be a lot bigger ecosystem for us to be able to take advantage of. And a lot more of an audience for our players, our professional players to be celebrated by and recognized by. And so we couldn't be more pleased with the progress that we've been making. And I think all these initiatives that are expanding the communities of our franchises. It just service better as we move into the local markets.

Christopher Hickey, Senior Vice President, Investor Relations

All right. Thanks, Bobby and thanks everyone for joining us today. We'll look forward to hopefully seeing many of you in-game over the coming months and then back here in early February when we release our end of your results. So thanks.

Operator

Well, thank you. That does conclude today's conference. We do thank you for your participation. Have a wonderful day.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2019-08-08
Event Description: Q2 2019 Earnings Call

Market Cap: 37787.1128509
Current PX: 49.3300018311
YTD Change($): 2.76000183105
YTD Change(%): 5.927

Bloomberg Estimates - EPS
Current Quarter: 0.401
Current Year: 2.153
Bloomberg Estimates - Sales
Current Quarter: 1366.091
Current Year: 6365.36

Q2 2019 Earnings Call

Company Participants

- Christopher Hickey, Senior Vice President of Investor Relations
- Bobby Kotick, Chief Executive Officer
- Coddy Johnson, President and Chief Operating Officer
- Dennis Durkin, Chief Financial Officer and President
- J. Allen Brack, President
- Humam Sakhnini, President
- Rob Kostich, General Manager and Executive Vice President of Call of Duty

Other Participants

- Matthew Thornton, Analyst
- Matthew Cost, Analyst
- Mike Eng, Analyst
- Kunaal Malde
- Ray Stochel
- Alex Giaimo
- Mike Hickey
- Mike Olson
- Unidentified Participant

Presentation

Operator

Good day, and welcome to the Activision Blizzard Q2 2019 Earnings Conference Call. Please note, today's call is being recorded.

At this time, I would like to turn the conference over to Christopher Hickey, Senior Vice President of Investor Relations. Please go ahead.

Christopher Hickey, Senior Vice President of Investor Relations

Good afternoon, and thank you for joining us today for Activision Blizzard second quarter 2019 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, COO; and Dennis Durkin company CFO and President of Emerging Businesses. And for Q&A, Rob Kostich, President of Activision; J Allen Brack, President of Blizzard; and Humam Sakhnini, President of King will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company, as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2018 Annual Report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, August 8, 2019.

We will present both GAAP and non-GAAP financial measures during this call. We provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions including legal fees, costs, expenses, and accruals, expenses related to debt financings and refinancings, restructuring and related charges, the associated tax benefits of these excluded items and significant discrete tax-related items including amounts related to changes in tax laws, amounts related to the potential or final resolution of tax positions and other unusual or unique tax-related items and activities. These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com for full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also an earnings presentation, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview, highlighting both GAAP and non-GAAP results.

And now I'd like to introduce our CEO, Bobby Kotick.

Bobby Kotick, Chief Executive Officer

Thank you, Chris, and thank you all for joining us today. Our second quarter results exceeded our prior outlook for both revenue and earnings per share. In the first half of 2019, we prioritized investments in our key franchises and we expect to expand reach, deepen engagement, and drive player investment as a result. We're very encouraged by the early results of this renewed focus. Our 300 million players spent tens of billions of hours every year watching and playing our games, yet we believe we're just scratching the surface in terms of fulfilling the reach, engagement, and player investment potential of our franchises.

We see even more clearly than ever before, the potential for growth across all our franchises as we create great content for new and existing platforms, leverage our wide array of business models, and capitalize on new engagement models. Each of our business units is focused on delivering more frequent, more compelling, more engaging content, and the focus is already delivering better than expected results.

This month, Blizzard is proud to be celebrating the 15th anniversary of World of Warcraft, with the release of World of Warcraft Classic. Well over 100 million players have played World of Warcraft since its launch and the upcoming release is a great example of Blizzard responding to our players encouragement. We're excited to welcome over 40,000 Blizzard fans at BlizzCon this November and millions more around the world via live stream. The teams of Blizzard are hard at work to ensure that this is truly the best BlizzCon we have ever hosted.

At Activision, more platforms, more countries, more players is the new Call of Duty Battle Cry. We intend to drive Call of Duty to greater scale than ever before through the release of modern warfare and Call of Duty mobile, and we believe we will achieve greater reach, engagement, and player investment than ever before. And at King, Candy Crush continues to crush it and it was once again the number one app on the US mobile app store. We remain the industry leader in Esports and we will broaden the audience of Call of Duty even further through the launch of Call of Duty global league. We've now sold eight teams, all at a premium to the initial Overwatch League team sales and with superb owners.

And the 2019 season of the Overwatch League continues to break viewership records. In the second quarter, the season's stage-2 finals live on ABC was the best performing Esports broadcast to date across ESPN and ABC. And both stage 2 and stage 3 recorded double-digit growth in hours watched year-over-year. Our organization and our team owners are now preparing to host games in their own markets for the next year and it really is remarkable that in just the league's third year, our owners are actually able to host games in their home markets. And we're excited to see regular season games in cities around the world as well, especially across North America, China, South Korea, France, and the United Kingdom. This content is creating great opportunities for broadcasters, sponsors, and advertisers. We believe no professional sports league has accomplished anything like we've accomplished in the three year period in all of sports history.

And our in-game advertising initiatives are continuing to grow at incredible rates, advertising net bookings doubled year-over-year in the second quarter and with the foundation for advertising initiatives now in place, we're actively exploring opportunities to leverage these capabilities across other parts of the business, especially with our Esports content. We remain excited about our growth prospects, we're laser focused on our priorities and our opportunities have never been more compelling. None of our success would be possible without the most talented, focused, committed employees in our industry and the support of our stakeholders. We're grateful for both.

Thank you. And now, Coddy will review the highlights of our operations for this quarter with you.

Coddy Johnson, President and Chief Operating Officer

Thank you, Bobby. Activision Blizzard exceeded its second quarter outlook with strong creative and commercial execution and with top line performance at Activision and favorable cost timing, driving operational upside. In our recent earnings calls, I've shared how we're increasing investment in our key franchises this year across Call of Duty, Candy Crush, Warcraft, Hearthstone, Overwatch, and Diablo. We're expanding our development teams and resources so that we can accelerate the delivery of content in our pipeline and pursue new business models, broaden our communities, and delight our players.

These expanded teams are working on innovative new content across console, PC, and mobile for both in-game content and for new releases. Most of that work underway will set us up for future growth. But we also saw encouraging early progress in several of our flagship franchises. In particular, new in-game content for Call of Duty, Hearthstone, and Warcraft reinvigorated those communities and drove improved Q2 trends and Black Ops 4 with some market improvement in deal engagement trends since the introduction of the new Alcatraz Blackout map in April and more frequent events throughout the quarter.

And our ongoing work to offer even more compelling in-game experiences delivered strong year-over-year growth for net bookings from in-game items First World War II. In Hearthstone, a great response to the Rise of Shadows expansion and a substantial new single content led to net bookings growth versus the prior quarter and versus the Q4 expansion and while the Warcraft saw growth in subscribers in the second half of the quarter, driven by both the Rise of Shadow major update late in the quarter and by building excitement around the imminent launch of World of Warcraft Classic.

Now, we recognize that these are early signs of progress and there is more work ahead, but the enthusiasm with which our communities are responding again highlights the growth potential of our franchises and we intend to build on this progress as we continue increasing investment in our key franchises in the second half.

I'll now provide more detail on our Q2 results against our three key metrics reach, engagement, and player investment. Starting with reach, which was 327 million monthly active users in Q2, Activision monthly active users were 37 million. The reach was lower year-over-year due to the exclusion of Destiny monthly active users and a decline in Call of Duty catalog, but importantly Black Ops 4 monthly active users grew year-over-year and throughout the quarter versus last year's title.

We think this is the result of the increased frequency and quality in live operations including seasonal events, new game play, and immersive new in-game experiences across the Black Ops environment. Engagement was high with hours played in Q2 growing over 50% year-over-year versus the last title and we plan to continue our investment in development talent, tools and analytics, as we look to build on this momentum in Q3 and beyond.

Elsewhere at Activision, our strategy of re-mastering our rich library of Blizzard IP continue to deliver with the Q2 release of Crash Team Racing Nitro-Fueled. The game enjoyed positive critical reviews and strong sales particularly through digital channels. Moving on to Blizzard, which had 32 million monthly active users, up slightly from Q1.

Hearthstone monthly active users increased sequentially following the release of the Rise of Shadows expansion and deeper more engaging single player content in the quarter, while the competitive environment is increasingly challenging. We see substantial opportunities ahead for the Hearthstone franchise. Our expanded Hearthstone team plans to build on the strength of its Q2 content cadence with a strong pipeline of new content and features over the coming months that we think players will love and we look forward to the team announcing their plans.

Overwatch monthly active users were relatively stable sequentially with engagement increasing following the release of the Workshop, which enables the community to flex the creativity and build their own modes, hundreds of thousands of new game modes were then created and played in millions of sessions already.

And then World of Warcraft subscriber numbers have increased since mid-May, following the release dated announcement and beta for Classic and the Rise of Azshara content update in late June. The World of Warcraft team is focused on delivering substantial incremental content in non-expansion years has resonated with both current and lapsed players. The community excitement around Classic continues to build ahead of its August 27 release. Blizzard will be supporting release with a major awareness campaign for the large community of players, who have been a part of World of Warcraft, over the last 15 years.

King monthly active users were 258 million in Q2, 4% lower year-over-year due to declining reach for their web titles and for King's smaller games more generally, but most importantly Candy Crush monthly active users grew year-over-year, driven by growth in the original Candy Crush Saga and the addition of Candy Crush Friends. King continues to expand live services, its features and content across the Candy franchise to drive both reach and engagement. In fact in recent weeks, the team released the 5,000th level for Candy Crush Saga. Just another remarkable milestone for the title, which brings me to our second key metric, engagement. The King network continue to engaged deeply with total time spent in the Candy franchise growing strongly year-over-year and across our franchises. We continue to see strong engagement from our communities. At Activision, the Call of Duty franchise saw a double-digit year-over-year growth for total hours played in the quarter and at Blizzard, daily time spent per player increased year-over-year.

As Bobby highlighted, Esports remains a growth priority for the company, where we celebrate player achievement and community passion and provide high quality spectating experiences as well as further strengthen the durability of our franchises and generate new revenue and earning streams.

Overwatch League hours viewed continue to grow year-over-year in the two stages held during Q2. Season to date viewership and average minute audience have grown well into double-digits year-over-year. And as we prepare for the new Call of Duty City-Based League starting next year, Call of Duty World League continues to enjoy momentum with average minute audience for our two events in Q2 growing around 50% year-over-year.

Our third key metric is player investment. In-game content features and services delivered approximately $800 million of in-game net bookings this second quarter. King was the biggest contributor with Candy Crush again the top grossing franchise in the US app stores, as it has been for the last two years. And King's advertising business continues to ramp with net bookings growing sequentially and doubling year-over-year. The business remains well on track to exceed $100 million in net bookings this year. For the rest of the portfolio, the largest driver of the year-on-year decline in in-game net bookings is the inclusion of Destiny in the year ago quarter, as well as the fact that for some of our franchises, we're not yet providing the flow in frequency of content that our communities expect. We did, however, see clear evidence that our investment in in-game content is (inaudible) Hearthstone net bookings grew sequentially in Q2 following the release of Rise of Shadows and introduction of single payer content outperforming Q4's extension and for Call of Duty we felt strong backups for engagement trends, matched by players investing in the new content.

Black Ops 4 net bookings for in-game items grew year-over-year versus World War II and are ahead of World War II on a comparable life-to-date basis. Looking forward, we plan to build on the strong engagement and Call of Duty franchise with new experiences in the coming months. We will continue to make great progress laying the groundwork for the new Call of Duty Esports week, which will launch with teams hosting games in their home cities in 2020. On the mobile side, Call of Duty mobile is currently in soft launch in Canada and Australia. The early performance indicators and consumer interest are very encouraging, although we continue to plan conservatively on our financials for the launch.

And on October 25th, we have the global console and PC launch for Modern Warfare, an incredible rebirth of the celebrated series developed by the team and Infinity Wars. Built on the new engine with a step change in visual, audio, and gameplay fidelity, Modern Warfare is breathtaking. There's just no other word for it. It includes a great campaign set in the current day that we think stands apart from anything else in the industry and will appeal to both existing fans and new players.

Gunfight has new 2v2 mode with dedicated close quarters match that brings a lot of fun to the franchise. The fan-favorite Special Ops co-op mode returns with more replay-ability than ever before. And as we announced last week, we think Modern Warfare delivers the industry's ultimate multiplayer playground. The game will not only feature the multiplayer game play that our fans know and love, but also modes that support 20 V 20 firefight in an epic large scale experience that will support more than 100 players. The game also delivers a phenomenal built from the ground up PC experience and for the first time in Call of Duty history, the game will support cross platform play.

Last week's multiplayer reveal featuring 36 of the world's most prolific streamers playing against one another under one roof held the number one spot on industry's top viewing platform and the response from fans has been the strongest we've seen in years and fans will get a first taste of the action in our multiplayer open beta in September. We have a number of surprises in store after that, including the largest post launch content pipeline in franchise history. We know we're in important time for the Call of Duty franchise. We feel that we're well prepared to deliver fantastic experiences across Esports, mobile, and the main game.

In summary, in Q2, we made good progress in several of our franchises we saw our communities' respond to the improved cadence and quality of in-game content enabled by our increased investment in development. We see this is a proof point that we're taking the right actions to return the core business of the growth we know is possible and the ongoing momentum in our Esports and advertising initiatives highlights the potential to further enhance the reach, engagement, and monetization of our portfolio.

I now hand the call over to Dennis to discuss our financial performance. Dennis?

Dennis Durkin, Chief Financial Officer and President

Thanks, Coddy. Today, I will review our better-than-expected Q2 2019 results as well as our outlook for Q3 and the full year. Q2 GAAP and non-GAAP EPS were ahead of our prior outlook. Key factors included business over performance and favorable cost timing as well as an equity investment gain and a lower tax rate.

To review the quarter, I'll start with our segment results. Activision revenue was $268 million down year-over-year against a comparable that included Destiny. Key quarterly contributors were Call of Duty in-game revenues and the successful launch of Crash Team Racing Nitro Refueled. Our operating income was $55 million with an operating margin of 21%, which was 4 percentage points lower year-over-year due to lower revenue and mix effects. Blizzard revenue was $384 million lower year-over-year due to a decline in in-game revenues. Operating income was $75 million with the revenue decline partially offset by lower costs.

Blizzard its operating margin was 20%. King revenue of $499 million was roughly flat year-over-year and modestly higher in constant currency. Candy Crush net bookings grew year-over-year with the ads business doubling over the same period. Operating income was $171 million and an operating margin of 34%, which is consistent sequentially and year-over-year.

Now let's turn to our consolidated results. Unless otherwise indicated, I will be referencing non-GAAP figures. Please refer to our earnings release for a full GAAP to non-GAAP reconciliations. For the quarter, we generated Q2 GAAP revenues of $1.4 billion, $81 million above our May guidance. This includes the net recognition of deferrals of $189 million.

Net bookings of $1.21 billion were $57 million above our May outlook. We incurred a GAAP only restructuring charge of $22 million. We recognized an unrealized gain on an equity investment of $38 million, which is included in our GAAP and non-GAAP EPS and we generated Q2 GAAP EPS of $0.43 and Q2 non-GAAP EPS of $0.53, which was $0.18 above guidance. These figures include the net recognition of deferrals of $0.15. From a cash flow and capital structure perspective, Q2 operating cash flow of $154 million grew strongly year-over-year due to working capital timing. We paid a cash dividend of $0.37 per common share, which was up 9% year-over-year for a total of $283 million in aggregate to shareholders of record as of March 30, 2019. Our cash investments at the end of June was approximately $4.7 billion and we ended the quarter with a net cash position of approximately $2 billion.

Now let's turn to our slate and outlook for the second half of 2019, Blizzard released Hearthstone's latest expansion Saviors of Uldum this week and is launching World of Warcraft Classic globally on August 27th. The team will continue to support Overwatch with new content and events and is preparing for the release of Warcraft III reforge later in the year.

King is planning numerous features and innovative LiveOps across its portfolio and Activision will build on the strong engagement for Black Ops 4 with additional features and seasonal content for the Call of Duty community.

At the same time, the team will be ramping marketing as they prepare for the launch and ongoing support of Call of Duty mobile and of course, Modern Warfare, our most important release of the year on October 25th.

Before I discuss the specifics of our outlook, I'd like to provide a little context. First of all, I would note that a significant proportion of the earnings upside in Q2 was driven by timing and lower than forecast costs and given the abundance of potential we see with our franchises, we still intend to invest most of these amounts during the year.

But as we turn our focus to the back half of the year, we continue to feel great about how our key H2 releases are shaping, encouraged by our progress against our key initiatives. At the same time, the environment remains competitive, the ongoing shift to digital means retail dynamics are risk factor, business models are evolving and FX headwinds have increased since we last provided guidance. As a result, we see a wider range of possible outcomes in the second half. With all that said, we feel great about how the second half is shaping up. We are maintaining our net bookings outlook for the year and are increasing our full-year GAAP and non-GAAP EPS outlook.

Now onto the numbers for Q3, on a GAAP basis, we expect net revenues of $1.1 billion, including the recognition of GAAP deferrals of $5 million. We expect net bookings of $1.1 billion. When your model Q3, bear in mind that last year benefited from the Battle for Azeroth expansion and Activision's results included the Destiny Forsaken expansion.

We expect product cost, game operations, and distribution expenses of 29% and operating expenses including software amortization of 66% and a GAAP only restructuring charge of approximately $50 million. We expect a tax rate of 23% GAAP and non-GAAP share count of 772 million and EPS of $0.05.

For Q3 on a non-GAAP basis, we expect product cost, game operations, and distribution expenses of 29% and operating expenses including software amortization of 53%, we expect a non-GAAP tax rate of 20% and non-GAAP EPS of $0.20 with no impact from GAAP deferrals. On a GAAP basis for 2019, we expect net revenues of $6.2 billion, including GAAP deferrals of $110 million. We expect net bookings of $6.3 billion. Product cost, game operations, and distribution expenses are 24%, operating expenses including software amortization of 54% and a GAAP only restructuring charge of approximately $150 million. We expect the GAAP tax rate of 22%, GAAP and non-GAAP share count of 774 million and EPS of $1.41.

For 2019 on a non-GAAP basis, we expect product cost, game operations, and distribution expenses of 24% and operating expenses including software amortization of 45%. We expect a non-GAAP tax rate of 20% and non-GAAP EPS of $2.02, which includes GAAP deferrals of $0.13.

So in summary, in Q2, we continue to make progress as we position the company to take advantage of the many growth opportunities we see across our franchises. Our combination of leading owned franchises, a direct digital connection to our consumers, best-in-class developer talent and geographic platform and business model diversity creates a powerful foundation for longer-term growth.

We still have -- the competitive environment is as dynamic as ever, but we are taking the right steps to deliver the world-class execution and quality content delivery that has characterized our company for many years. I remain confident that executing against our plan will position us to deliver strong results and shareholder value over the long term.

Now I welcome our business leaders J, Humam, and Rob as they join for the Q&A portion of the call. Operator?

Questions And Answers

Operator

Certainly. (Operator Instructions) And we'll go first to Matthew Thornton of SunTrust.

Matthew Thornton, Analyst

Hey. Good afternoon and thanks for taking the question. Maybe just on World of Warcraft, can you just talk a little bit about just the lit you're seeing from the introduction of the Classic mode as well as the recent patch, Rise of Azshara and just how sustainable you think that is here into the second half from an engagement standpoint? Thanks.

J. Allen Brack, President

Hi. This is J. First on World of Warcraft, more broadly, the team is always looking for ways to meet the demand for more content between expansions recognizing the kind of sort of the deep love that players have of the game and the value of new experiences. The recent update Rise of Azshara is a good representation of how we think about large updates for the game. WOW Classic is also part of our effort to increase available content. Players have shown a lot of support for both Classic and Rise of Azshara. Regarding Classic specifically for many years, we've really heard from players their desire to play the original version of the game and it was a great experience for me personally to announce the start of that effort at BlizzCon.

Overall, this has been a pretty significant undertaking. There has been a lot of the technology challenges, but I think the team has really fed a lot of the excitement that they've seen from the community from the overall player base. We're really proud of the work that has gone into creating the game and we're also really excited for the launch on August 27th. If you are a subscriber, WOW Classic is automagically included with your subscription, so it's greatly increasing the available content to players and is really a good way to maintain our connection to the game. We've had over 100 million players experience WOW and that's a global number. So it's a great opportunity for many players who were once part of the community to return and re-experience the game as they -- as it once was.

Now to your specific question, there is a lot of excitement around Classic and it's really exceeded our expectations already, but it's really difficult to predict sustained engagement post launch. We have seen a lot of strong interest and we'll see -- you'll see us continue to work to drive awareness around the launch in the coming weeks. I thank you for the question. I really appreciate it. Classic is something that's really close to my heart.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, can we have the next question please.

Operator

Yes. And it'll come from Brian Nowak of Morgan Stanley.

Matthew Cost, Analyst

Hi, it's Matt on for Brian. Thanks for taking the questions. So first one is just looking at the King business, can you go over sort of the key drivers and vectors for growth from here and then turning to the core, how should we think about MAU and sort of in-game monetization trends heading into the second half? Thanks.

Humam Sakhnini, President

Hey, it's Humam. Thank you for the question. So after a couple of quarters of MAU sequential growth overall King MAUs fell a bit to 258 million in Q2. I mentioned on the last call that we tried to be quite disciplined on user acquisition and we spent less in marketing in Q2 compared to Q1 and so MAUs will ebb and flow over the quarters. So with the headline MAU figure, you don't necessarily see that points underlying trends. One of the most important ones to look at it is being a use for Candy Crush, our largest franchise which were up year-on-year. And with Candy and mobile continuing to represent the larger share of our mix versus web and smaller players [ph] in portfolio, the overall year-on-year MAU trends have been improving.

And then specifically on your question on monetization, Candy Crush bookings grew year-on-year in Q2. And to me that goes on the growth story for the franchise that started happening in 2017 and 2018 and we saw it again in Q2. And these long-term trends are really kind of about what we're doing in the franchise and how we continue to invest in content and new features for our players. So we know that content drives player engagement and you heard we just released 5,000 level in the original Candy Crush, a great milestone for the game but content is much more than just adding levels. We're adding innovative features and life ops that create many different ways for our players to enjoy our games and that means that we offer fresh ways for everybody in the titles to engage with our channels whether they're just starting or whether they're at level 5,000.

So, and on top of all of this, we're adding new features, which drive monetization. So as I look forward, we have a pretty strong pipeline of these features planned for the coming quarters and they will continue to deliver these features to our players to drive engagement and also monetization.

Christopher Hickey, Senior Vice President of Investor Relations

Operator, can we have the next question please.

Operator

Of course. And that question will come from Mike Eng of Goldman Sachs.

Mike Eng, Analyst

Hi. Thank you very much for the question. I was just wondering if you could talk a little bit more about the future of the Call of Duty franchise, specifically it seems that with the focus toward Call of Duty titles that might have the potential to sustain over multiple years, we may be going toward a business model that doesn't necessarily involve annual card releases, but instead of you franchises that are perpetual live service games. Would that be consistent with what your vision for the future of Call of Duty looks like? Thanks.

Rob Kostich, General Manager and Executive Vice President of Call of Duty

Hey, Mike, it's Rob. Thanks for the question and it's a good one at that because we're taking some important steps to grow the franchise overall and there's probably a few things that I mentioned here. Now obviously Call of Duty mobile, it's going to be an ongoing live services title. We're building a huge streamer content and events to keep our players around the globe having fun for the long haul on this one. But if I look over on the console and PC side, we do still see new launches as a critical part of our future. These new releases have been and continue to be a huge engagement drivers for our community, because they bring a robust set of new experiences to our fan.

So that said, obviously we want to also build player engagement here over time as well. We're very committed on this front. You're going to start seeing that in a few ways. First with Modern Warfare, we're going to have cross platform play as Coddy mentioned and we're also not having a season pass. Now, this is important and we're doing this because we want to build one massive community, where everyone can come together and have fun each and every day and to support that community as we go forward, we're investing significant resources and post launch content, events and new ways to play that we think fans are going to really love. So what I'd say is we're really looking forward to the launch of Modern Warfare, it is a great game and we believe it's the beginning of an incredible journey for our community. Thanks.

Coddy Johnson, President and Chief Operating Officer

Hey, Mike, it's Coddy. Am I just jump on to the question, just to talk more broadly, not just Call of Duty, but also the rest of the franchises in our portfolio, because I think the question is broader really about how we think about live services and we recognize that the key to player engagement is really great ongoing and frequent content coupled with like core gameplay features and services that really keep the players engaged. And you've heard that today the investment that we're putting against that initiative and the resources are bringing to bear and the early results we're seeing are really meant to think about our franchises live services.

That said, we do see across many of our franchises major upfront launches as a very effective and important way to refresh the franchise, to drive innovation to reach out to new players, to expand the community. And so in the resources they were putting into our franchises, as you see any additional investment, we think we can get the both -- best of both worlds. We can get live services in ongoing way and then major upfront launches to really drive innovation and to refresh the franchise and expand the community. So you'll see -- you'll continue to see big launches from us, and we're looking forward to telling you more about those in due course.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Mike. Operator, can we have the next question please.

Operator

Next question will come from Kunaal Malde of Atlantic Equities.

Kunaal Malde

Hi. Thank you. Could you expand on your comments about the Overwatch League performance in the quarter and also kind of talk about what effect do you expect the home and away formats of games to have next year? Thanks.

Dennis Durkin, Chief Financial Officer and President

Hey. You bet. Hi, Kunaal, it's Dennis. I'll take this one. It's a great question, obviously because viewership is a great indicator of the health of any league -- any sports league like the Overwatch League and I know from the outside, because we are -- we have some great streaming partners and we're also on TV, it's sometimes hard to get the specific date on that. You heard in Bobby and Coddy's comments that when we looked at the 2-hour stages that were held in

Q2, the average minute audience, which is the best -- probably the best what measure of viewership was up strongly and when you look at the season to date, average minute audience is up 15% with the US actually up over 30%.

So encouraging trends there. And then demographically when we kind of parse through that even more importantly is that we're seeing growth in our younger US audience as well and that's an year, where nearly every other major traditional sport is seeing viewership decline in those audience segments. So I think this really highlights how the expanded roster this year is driving more interest in more places for the league and that also the work that we've done to enhance the viewing experience is really starting to help deliver some results. Now, let's not say we're done on that journey, there's still a lot of room for further improvement in the viewing experience and this is a key focus area for us as we think it's critical to continuing to make the broadcast not only compelling, but easily digestible for mass market audiences.

On the second part of your question around the home and away format, yeah we're excited for it next year. We think it will be a big driver of not only local fan interest in many of our markets, but also broader viewership as well. We did see some early indicators of solid progress on that this quarter with the Dallas and Atlanta home stands that brought thousand of spectators to the home arenas in those respective areas and obviously the atmosphere in those arena is actually I think translated well into the broadcast. So I think that bodes well for as we rolled out format out next year across the league, both not only for the Overwatch League, but for the Call of Duty league as well.

So yeah, still early innings to use a sports and the analogy and there's still plenty of work to do, but early signs are very encouraging.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Kunaal. Operator, can we have the next question please?

Operator

And that will come from Ray Stochel of Consumer Edge Research.

Ray Stochel

Great. Thanks for taking my question. One on Blizzard, so how do you balance Blizzard Polish, as you guys call it, an increasing demand from consumers around the speed and pace of content? Thanks.

J. Allen Brack, President

This is J. This is a question that teams really spend a lot of time considering on how to be successful, it is a priority for me personally. There is a high demand of Blizzard game content and it's a challenge we faced for a long time. I think we have made some headway over the years. At the same time, I think it's very clear that we could be doing better, and that was one of the driving reasons for us increasing the amount of developer talent at the company as well as really focusing on our priorities this year. Having more people in place to support the various initiatives that we have and the various features is really critical. It's the -- the process of iteration that we feel is really critical to us reaching the right quality levels.

It's going to take some time to further ramp up on content delivery across our franchises. But we're happy with the early progress. We've seen significant new content for Hearthstone and for World of Warcraft just this quarter, and those are both very positively received by both communities. And ultimately, that's how we're thinking about Blizzard quality. Internally, we talk about craftsmanship and to us that's about meeting our expectations as well as the player expectations and both in terms of frequency of content and in the level of polish. And so when we say that we're aiming to release more Blizzard game content for our players, it means that they can start to look forward to not just more Blizzard games, but more Blizzard quality game experiences across the board.

Christopher Hickey, Senior Vice President of Investor Relations

Right. Operator, can we have the next question please?

Operator

And that will come from Alex Giaimo of Jefferies.

Alex Giaimo

Great. Thanks for taking the question. We're just hoping to get an overall update on the advertising opportunity at King and whether you're still confident in the ability to scale that business over time?

Humam Sakhnini, President

Hey, Alex. Thanks for the question. It's Humam. So we have a lot of momentum in advertising right now and I still see a substantial opportunity for ongoing growth. I'm going to give you a little bit of color on that. So on the demand side, the natives video ad product is in safe premium environment and that's differentiated proposition for the advertisers and we're seeing both new and returning brands recognize this and as we are seeing this, we are continuing to build our sales capabilities. So we have a number of strong partnerships as well around that with ad platforms that help fill the inventory we're making available. And on the supply side, we recently introduced ads into Candy Friends, our newest Candy title and we're working on putting ads into Candy Crush Jelly Saga and at Pet Rescue Saga in the back half of the year.

So we've made good progress on both supply and demand, and we're continuing to increase impressions. As you heard, ad net bookings doubled year-on-year again in Q2. And we're well on track to exceed the 100 million mark that I talked about. And as I look ahead, we're planning to continue to grow within the King network and educate more brands and partners around the strength of this value proposition.

Coddy Johnson, President and Chief Operating Officer

Hey, Alex. It's Coddy. I might jump in as well, here just stepping back for a moment, because it's to King's credit that they've built a -- really a tremendous ad platform and set of capabilities that are delivering the results that we talked about today and that Humam just give some more color on. We also have the opportunity now to bring this capability elsewhere in the business. We are actively working on this including looking at certain new mobile experiences and also at Esports and we think there's a lot of potential to deploy we've learned across the rest of the company where it makes sense, and so overall there's -- there is momentum for us, not just in the existing ads business insight King, but we think plenty potential for further growth across the rest of the business.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Alex. Operator, can we have the next question please.

Operator

And that next question will come from Mike Hickey of The Benchmark Company.

Mike Hickey

Hey, Bobby, Coddy,Dennis, Chris. Nice quarter guys. Thanks for taking my questions. Just curious, perhaps in your Activision re-masters opportunity obviously you have a huge library of IP, there to work with. So I guess just how meaningful is re-master's business and what the opportunity for further, re-masters in the future? Thank you.

Rob Kostich, General Manager and Executive Vice President of Call of Duty

Hey Mike, it's Rob, I'll take that one. So at Activision. We have seen great results from remastering, some of these beloved games over the last couple of years. If you look at Crash N. Sane Trilogy, Spyro Reignited Trilogy, and crash team racing. They're all incredible games and our teams have done a really great job in modernizing for today's platform, but the player response to each of these have been fantastic. And I'd say, for example, if you look at Crash N. Sane Trilogy, that one sold through over 10 million copies. So, they're obviously having a big impact on our bottom line and a real impact there, but I'd say what's really important is that it's reaffirming the enduring nature of these franchises for us and as you mentioned, when you look at our IP library, we think there's a lot of IP in there. The fans are going to want to experience again. So on that one, I'd say stay tuned for some future announcements, but just beyond pure remasters, there are also a lot of opportunities now to innovate and think about totally new content within these IPs. So as we think about it, there is a lot of growth opportunities for the business over time within Activision based on our library of IP. And frankly more broadly, across the company, where the company did collectively have the ton of great IP.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Mike. Operator, can we have the next question please.

Operator

And that will come from Mike Olson of Piper Jaffray.

Mike Olson

Hey. Good afternoon. Speaking of great IP, you guys have a great track record of creating new IP. But we know how difficult that is to do and just wondering, can you talk about new IP development and how you're thinking about the opportunity there in general? Thanks.

Coddy Johnson, President and Chief Operating Officer

Sure. Thanks, Mike. Thanks for the question. This is Coddy. Happy to talk about new IP initiatives but first, I do want to just pause and emphasize that we feel fortunate to already have a number of large established franchises with global recognition and passionate communities and it's worth pausing there because we do feel strongly and see result around thinking of those as beachheads that we can build on, where there is tremendous scope to innovate inside of them and we do feel if we execute on that potential, the company should be and will be substantially larger than it is today, and we think this is not just true for ourselves, but in broadly in gaming and entertainment, where large established franchises really do give you a significant competitive advantage and we're leaning into that.

That said, it doesn't mean we're only focused on the existing portfolio franchises. We have new IP projects underway across each of the businesses. And as you mentioned, we've had a -- we've one of the best or one a top track records of putting out new IP and part of the reason for that is that we have a very rigorous green light process through which we put new ideas. We're looking at creative our commercial, at design at every stage of development from prototyping all the way through to built and testing and it's a high bar and honestly many and maybe most ideas don't make it through, but we think this -- like that rigorous approach is the right one because of the demand of the fans and the industry are increasingly significant.

You have to be disciplined about the process, not just because it's the launch of the IP, but it's about sustaining it and growing it over time. That's by far the best experience with the players when you can launch in sustaining grow, it's also by the way, by far the best business model. And it's what really drives the returns and so that's what we look for and that high bar means that it takes time for us to bring games to bear and it also means we don't talk about our plans too early, but I want to be rest assured, we have new IP initiatives underway and given our track record, we feel pretty confident about our ability to have success here over the future.

Christopher Hickey, Senior Vice President of Investor Relations

Thanks, Mike. Operator, we have time for one last question, please.

Operator

And that last question will come from Ryan Gee [ph] of Bank of America.

Unidentified Participant

Hey. Good afternoon. Thanks for taking the questions. Just 2 quick ones if I may, first regarding the soft launch testing you're doing for Call of Duty on mobile, can you maybe share some of the early feedback you're getting from the players there and whether there is anything in the data suggesting, hey, this game could be top 10 or top 20 grossing on mobile and then along the lines of mobile, can you talk briefly on what you and your partners over in China are seeing regarding the approval process there for games like Call of Duty and Diablo? Thanks.

Rob Kostich, General Manager and Executive Vice President of Call of Duty

Hey, Ryan, it's Rob. So yeah, Call of Duty mobile now has been in soft launch in Canada and Australia, the last few weeks and the early indicators, so far, very promising and we're seeing very strong and very strong results across all key metrics, including installs and retention. Players are reacting to I think loving the authentic Call of Duty gameplay, the characters in the setting and obviously an ability to play across a wide variety of a fun modes and when we look at the pre-registrations for the game -- to us it suggests a real high anticipation and organic demand for the game globally. So like I said, I do think the early signs are encouraging and now as we think about mobile, there's another interesting thing for us, which is the opportunity here for 10's of millions of people to experience Call of Duty for the first time. Now, if we get that right, this could be a step change for us in the franchise's reach. As you know, there are several mobile action games right now that are generating significant reach in revenue. So this game does have potential to be meaningful to us.

All that being said, this is a new initiative and we are always particularly careful not to get ahead of ourselves when it comes to forecasting these things, but as I mentioned, we do feel very good about what we're seeing so far. Now you asked about China and as you'd expect, we're planning very prudently there and working through the process, but we're not going to wait for China to launch this game elsewhere.

We've been keen to get this game in the community's hands as soon as it's ready and they shouldn't have to wait too much longer. Thanks for the question.

Christopher Hickey, Senior Vice President of Investor Relations

All right. Thanks everyone for joining us today. We greatly appreciate your interest and support and we look forward to seeing many of you in-game this fall and hopefully in person at BlizzCon towards the end of October. Thanks again.

Operator

And with that, ladies and gentlemen, that does conclude today's call. We would like to thank you again for your participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2019-05-02
Event Description: Q1 2019 Earnings Call

Market Cap: 37,955.63
Current PX: 49.55
YTD Change($): +2.98
YTD Change(%): +6.399

Bloomberg Estimates - EPS
Current Quarter: 0.368
Current Year: 2.187
Bloomberg Estimates - Sales
Current Quarter: 1274.143
Current Year: 6422.308

Q1 2019 Earnings Call

Company Participants

- Chris Hickey, Senior Vice President of Investor Relations
- Robert A. Kotick, Chief Executive Officer
- Coddy Johnson, Chief Operating Officer
- Dennis Durkin, Chief Financial Officer and President of Emerging Businesses
- J. Allen Brack, President & Chief Executive Officer
- Humam Sakhnini, President

Other Participants

- Alexia Quadrani, Analyst
- Colin Sebastian, Analyst
- Kunaal Malde, Analyst
- Michael Ng, Analyst
- Tim O'Shea, Analyst
- Mike Olson, Analyst
- Matthew Thornton, Analyst
- Mike Hickey, ANalyst
- Brian Nowak, Analyst

Presentation

Operator

Operator: Good day, and welcome to the Activision Blizzard Q1 2019 Earnings Conference Call.

At this time, I'd like to turn the conference over to Mr. Chris Hickey, Senior Vice President of Investor Relations. Please go ahead, sir.

Chris Hickey, Senior Vice President of Investor Relations

Thank you. Good afternoon, and thank you for joining us today for Activision Blizzard's First Quarter 2019 Conference Call. With us are Bobby Kotick, CEO; Coddy Johnson, President and COO; and Dennis Durkin, company CFO and President of Emerging Businesses. And for Q&A Rob Kostich, President of Activision; J. Allen Brack, President of Blizzard; and Humam Sakhnini, President of King will also join us.

I'd like to remind everyone that during this call, we be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available for the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2018 annual report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today May 2, 2019.

We will present both GAAP and non-GAAP financial measures during this call. We provide non-GAAP financial measures which exclude the impact of expenses related to stock-based compensation; the amortization of intangible assets and expenses related to acquisitions including legal fees costs expenses and accruals; expenses related to debt financings and refinancings; restructuring and related charges; and the associated tax benefit of these excluded items.

These non-GAAP measures are not intended to be considered in isolation from as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also an earnings presentation which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting financial overview highlighting both GAAP and non-GAAP results.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick, Chief Executive Officer

Thank you, Chris, and thank you all for joining us today. Our first quarter results exceeded our prior outlook reflecting strong operating discipline. We are refocusing our resources on our biggest franchises to deliver the operational excellence for which we are known. As we outlined last quarter, we are increasing our focus and investment on our biggest franchises in order to better execute and unlock their great potential.

In prioritizing our franchises and the communities of players invested in these franchises, we're staying true to the approach that drove our company's long-term success, doing a few things very, very well. We're continuing to selectively invest in new potential franchises, but our focus is innovation with improving franchises of which we have many.

In today's content landscape, our franchise-focused approach is more relevant than ever. Gamers are playing fewer games longer, creating and sustaining new franchises remains one of the most difficult tasks in the entertainment industry and only proven teams that have the vision, talent, scale and resources to create market break out new intellectual properties and there are even fewer of those teams that have the capabilities to sustain those games over time and meet players' ever-increasing demands for ongoing features services and content.

We're very fortunate to own some of the most enduring and popular global franchises supported by some of the very best teams in the world. Well over 0.5 billion users have played Candy Crush over the seven years since the franchise launched. Call of Duty recently passed its 15th anniversary and is one of the most successful entertainment franchises of all time with cumulative sales exceeding 300 million games. Over watching Diablo have tens and tens of millions of players and this year the Warcraft franchise celebrates its 25th birthday. Over a quarter of a century massive numbers of players have engaged in Warcraft, World of Warcraft and Hearthstone experiences.

We expect to enjoy the dual tailwinds of strong industry growth and company-specific opportunities is that we have crafted for our own intellectual properties. There are more gamers than ever before and more ways for gamers to interact with our franchisers than ever before. We have clear opportunities to grow the reach, engagement and monetization of our franchises including through some very new business models. We have vast experience in all business models including free-to-play and we are continually evaluating the most effective models to all of our games.

In addition to this opportunity for our core business, we have company-specific growth opportunities as we add new engagement and monetization models to our franchises including eSports, in-game advertising and digital consumer products and we're making great progress in these areas.

In eSports this quarter we launched the 2019 season for the Overwatch League with an expanded roster of 20 teams and strong growth in viewership with hours this season up more than 20% year-over-year. Leading brands continue to recognize the opportunity to engage a hard-to-reach demographic deeply immersed in the highest eSports experiences and in the content that has the highest production value.

We're very pleased to add Anheuser-Busch InBev, Coca-Cola and State Farm to our roster of blue-chip sponsors in the last three months. One of the critical building blocks of the Overwatch League is the city-based model with team owners around the world building fan communities who share the passion of supporting their local teams. In Q1, we announced the teams will compete in home and away matches around the world beginning in 2020.

Highlighting the excitement and atmosphere of this next phase of the Overwatch League last weekend Dallas Fuel hosted the league's first home games in front of the cellar crowd of thousands of fans, who saw them compete against the Los Angeles Valiant and the Houston Outlaws.

Following the blueprint, we established and validated with the Overwatch League we've now started the team sales process for our professional Call of Duty eSports league, and we're seeing strong demand for teams.

We've already sold five franchises. We have secured exceptional owners for each of Atlanta, Dallas, New York, Paris and Toronto, and in each case, we're partnering with existing Overwatch League team owners, who have first hand experience of our eSports vision and capabilities, and recognize the scale of the opportunity for the global city-based Call of Duty league.

We look forward to announcing more details around these cities and other team sales in the coming months. As always, we're grateful for the support of our employees, our players, our partners and our shareholders.

And now, Coddy will review the highlights of our operations for this quarter with you.

Coddy Johnson, Chief Operating Officer

Thank you, Bobby. Focus and operating discipline enabled Activision Blizzard to outperform our first quarter outlook. Strong performance for Candy Crush, better than expected sales for securon [ph] and favorable cost timing were key factors driving upside.

We also continue to reposition the business to take advantage of our future growth opportunities. So before diving into the specifics of our quarterly results, I'd like to update you on some of the most important steps, we've been taking since our last call.

As a reminder, we have four key long-term strategic growth drivers: first, a strong cadence of major content releases where we meet the growing demand of the industry's gaming communities and release our high-quality content more frequently; second, robust live operations where we make sure we deliver great content, services, features and events to continuously engage our communities and drive in-game revenues; third, extending our franchises to mobile where we build on our existing mobile leadership and extend our acclaimed console and PC franchises to the largest and fastest-growing platform; and fourth and finally, expanding the reach engagement and monetization of our franchises as we build on early success in eSports in-game advertising and consumer initiatives.

Now a critical step to realizing its growth opportunities is reinforcing our product pipeline. Now, as I discussed last quarter, we are growing our aggregate developer head count on Call of Duty, Candy Crush, Warcraft, Hearthstone, Overwatch, and Diablo by 20% this year to accelerate the delivery of content in our pipeline and give our communities more opportunities to engage.

To share some of the detail of the work underway, we're organizing the expanded development teams to better support the delivery of both upfront content and live operations with more talent working on getting the games in our pipeline out to our communities, and also more resources dedicated to following up with the volume and the quality evening game content that gaming communities increasingly expect.

We're also meaningfully increasing the number of developers working on mobile initiatives. Across our key franchises, those resources are complementing experienced, creative talent, already working on projects including mobile expansions of existing games, mobile-first re-imaginations of our franchises, and cross-platform titles. These are ambitious projects that will take time, but we're committed to delivering on the substantial opportunity they hold.

We're also investing in our tech platforms, building cross-platform tools and capabilities that make us more agile in content delivery, increase the opportunity for collaboration across our development teams, and ensure we control our tech future. And we have more resources now available to work on the optimal business models for each of our franchises, including assessing opportunities around free-to-play.

We're fortunate to have exposure to every type of gaming business model at scale in our company, and in recent quarters you've seen us experimenting with free-to-play reach initiatives across more of our portfolio.

Our inside teams are conducting tests, to understand the content, marketing and timing implications of these different business models, and to deliver for the needs of our players. We look forward to sharing more with you here in due course.

Now we are also building on the momentum of our fourth strategic driver of new engagement and revenue models, by adding resources to our esports business and continuing to invest in tech and sales resources for advertising the Q1 again highlighting progress in both these initiatives.

In addition to these investments and expanding our key franchises, we have a major program underway to integrate global and regional sales and go-to-market partnerships and sponsorships capabilities and we expect this project to help better leverage our talent, expertise, scale and productivity across our business.

While the work, I just described, will bear fruit in the future. We remain focused on delivering in the near-term as well. I'll now review our Q1 results through the lens of our three key metrics reach, engagement and player investment.

Starting with reach, the company had 345 million monthly active users in Q1. Activision monthly active users were 41 million with around half of the quarterly sequential decline due to the exclusion of Destiny monthly active users. As you've seen on previous occasions Call of Duty reach saw some impact from a more competitive backdrop.

However and importantly, our core player base remains highly engaged with Call of Duty: Black Ops 4's total hours played growing double digits year-over-year versus World War II.

We continue to release new content, modes and events to sustain reach and attract new users. But we also recognize that we need to do even more to maintain the breadth of our Call of Duty player base beyond the launch quarters and the Call of Duty team is hard at work on that for this fall's big content release excitement for which is incredibly high around the organization.

We expect that both the launch and post-launch content will bring game-changing experiences to our fans. Also in Q1, we announced that Call of Duty mobile will be coming to regions including North America, South America and Europe.

While we continue to plan prudently for this new initiative, as you would expect we see significant potential for Call of Duty on mobile over the coming years, given the franchise's, global recognition and the growing demand for first-person action games on mobile.

Q1 also saw the highly successful release of Sekiro: Shadows Die Twice, the resulted Activision's approach of selectively partnering with top quality developers, to leverage our publishing and marketing scale and expertise.

We couldn't be more pleased with the collaboration's execution and the response from suffers critically acclaimed title from gaming communities worldwide. Blizzard monthly active users were 32 million, lower year-over-year reflecting the gap since the major content launch, and the fact that we are still in the early innings of expanding our in-game content capabilities.

We highlighted last quarter that increasing the flow and the frequency of compelling in-game content and upfront releases is the number one goal set by the new Blizzard leadership team. That process will take time. We've seen encouraging signs in how recent in-game content has been received by Blizzard's communities.

Overwatch monthly active users are saw a single-digit percentage sequential decline in Q1, due to the fact that Q1 was a relatively quiet quarter for in-game content and consumers had increased choice in the team-based category this quarter.

That said, the community's enthusiasm for Overwatch was again evident in how they embraced both the archives, storm rising event in April and the new workshop mode that went to public testing last week.

For Hearthstone, April set a launch of its latest expansion Rise of Shadows resonating well with the community. Early signs are encouraging with the release driving greater player engagement than the prior two expansions. And this year the Hearthstone team has much more in store including the biggest player versus environment content in franchise history, the first wave of which will be revealed in mid-May. Also this year, Blizzard celebrated its 25th anniversary of the Warcraft franchise as well as the 15th anniversary of World of Warcraft.

Over that time Warcraft has developed a global audience with multiple award-winning games in different genres including over 100 million accounts created for World of Warcraft and over 100 million registered players for Hearthstone. Later this year, we'll celebrate the special milestone for Warcraft with some highly anticipated releases. World of Warcraft Classic will be available as part of the franchise subscription over the summer letting fans play the game just as it all began 15 years ago. In addition, a large content update to World of Warcraft called Rise of the Shadow [ph] is already on test servers and will include new zones, new dungeons and more. And Warcraft III: Reforged due this year is a complete reimagination of our real-time strategy classic rebuilt from the ground up for high-definition PC experience.

King monthly active users were 272 million in the first quarter up 2% from Q4. This second straight quarter of sequential monthly active user growth was driven by the Candy Crush franchise where monthly active users again grew both quarter-over-quarter and year-over-year. This growth in franchise monthly active users seven years after launch of Candy Crush Saga again illustrates Kings strong ability to expand its audience to new content and ongoing live operations.

Candy Crush Friends with its accessible gameplay based on learnings from the Candy series continue to attract both former and new players to the franchise. Monetization and retention trends remain strong in Q1, enabling ROI positive user acquisition that we expect to continue to contribute to financial results in the coming quarters. King continued to drive both reach and engagement through updates features and events. In fact, Candy Crush saw record time spent per daily active user in Q1, driving the King to a new high of 38 minutes for daily active user during the quarter, which brings me to our second key metric engagement.

For each of Activision Blizzard and King daily time spent per user in our games increased year-over-year and for the company overall average time spent was approximately 50 minutes. At Activision for Call of Duty: Black Ops 4 engagement of Black Ops drove double-digit growth for both total hours played in the quarter and daily time spent per player versus last year's title.

Playing games is just one of the ways in which our communities engage with our franchises. As Bobby mentioned, our professional Call of Duty city-based league initiative is off to a strong start. We are thrilled to have sold our first five teams to great owners that we already know well from our partnerships in the Overwatch League. And for Blizzard, BlizzCon returns to the Anaheim Convention Center on November 1 and 2. The Blizzard teams can't wait to host their community at the ultimate fan event in gaming.

Player investment is our third key metric. In-game content, features and services delivered approximately $800 million of in-game net bookings in the first quarter. King was the biggest contributor with 2 of the top 10 highest grossing titles in the U.S. mobile app store for the second -- for the 22nd quarter in a row. Call of Duty in-game net bookings was lower year-over-year, but the team continues to iterate around in-game features and offerings within Black Ops four testing new ways for players to participate in in-game content both for that game and for future titles.

And as mentioned, we are increasing our developer head count and investing in our platforms to ensure our teams have the resources and tools they need to deliver the in-game experiences that our players expect for the future.

In summary, during Q1, we made important progress on resetting the foundation for future growth. Increased investment in our biggest franchises sets us up to better deliver on the upfront leases and in-game content that our communities demand and to extend our franchises to mobile and new engagement models. While we position the company for the long-term, we've also remain focused on executing against our near-term financial outlook, and we are off to a solid start for 2019.

Dennis, will now review the financial results and outlook in more detail.

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

Thanks, Coddy. Today, I will review our better than expected Q1 2019 results as well as our outlook for Q2, and the full year, and to review the quarter I'll start with our segment results.

Activision revenue of $317 million, increased 2% year-over-year. Key quarterly contributors were Call of Duty in-game and catalog net bookings, and the successful launch of Sekiro. Operating income was $73 million with an operating margin of 23%, which was lower year-over-year primarily due to mix effects.

Blizzard revenue of $344 million was in line with our expectation. Operating income was $55 million lower year-over-year due to a decline for in-game revenues, partially offset by lower cost. Blizzard's operating margin was 16%. King revenue of $529 million was roughly flat year-over-year.

Candy Crush net bookings grew year-over-year with the ads business more than doubling over the same period. Operating income was $178 million with an operating margin of 34% down 2 percentage points year-over-year due to investment in marketing for Candy Crush Friends.

Now let's turn to our consolidated results. Unless otherwise indicated, I will be referencing non-GAAP figures. Please refer to our earnings release for a full GAAP to non-GAAP reconciliations. For the quarter, we generated Q1 GAAP revenues of $1.83 billion, $110 million above our February outlook. This includes the net recognition of deferrals of $567 million.

Net bookings of $1.26 billion were $83 million above our February guidance. We incurred a GAAP only restructuring charge of $57 million and generated Q1 GAAP EPS of $0.58 and Q1 non-GAAP EPS of $0.78, which was $0.15 above guidance. These figures include the net recognition of deferrals of $0.47.

In terms of cash flow and the balance sheet, in Q1 we generated operating cash flow of $450 million and ended the quarter with approximately $4.8 billion in cash and investments, and a net cash position of over $2.1 billion.

Now let's turn to our slate outlook for Q2 and for the full year. In Q2, Activision will continue to support Call of Duty: Black Ops 4 with content and updates to keep players engaged and late in Q2 Activision will release Crash Team Racing nitro fueled on the PlayStation 4, Xbox One and Nintendo Switch.

In April, Blizzard released the Overwatch Archive Storm Rising event, and its latest Hearthstone expansion Rise of Shadows. This will be followed by Hearthstone's biggest ever single-player content later this month. And the World of Warcraft team will support the game with future content and updates and events. And of course King will continue to deliver innovative features events and live ops across its portfolio.

We will follow this up in the second half of the year with our most important release, our new Call of Duty title from Activision. In addition, Blizzard will release World of Warcraft Classic and Warcraft III: Reforged and we will deliver more in-game content for Candy Crush and our other key franchises across the rest of the portfolio.

Now I'll provide just a little extra context before I turn to our guidance. First of all, we feel very good about how our content line-up is shaping up, but it's obviously still very early in the year. Our biggest and most important card launch is not until Q4 and the environment remains competitive. In addition, our earnings over performance in Q1, was primarily driven by the timing of expenses.

With the bulk of our content lineup still ahead of us, we are still planning to incur these expenses this year, particularly as we see an abundance of opportunity to invest and support our franchises including new business model opportunities as Coddy referenced.

Note that, consistent with our prior guidance, we continue to assume no material income for new mobile initiatives for Activision Blizzard this year. We also do not expect to recognize material revenue from Call of Duty esports team sales this year.

And as a result, we are reaffirming our net bookings, net revenues and EPS outlook for 2019. Now let me get into the specifics. For Q2 on non-GAAP basis, we expect net revenues of $1.32 billion including the recognition of GAAP deferrals of $165 million.

We expect net bookings of $1.15 billion. Product cost, game operations and distribution expenses of 25% and operating expenses, including software amortization of 59% and a GAAP only restructuring charge of approximately $35 million.

We expect the tax rate of 24% GAAP and non-GAAP share count of 771 million and EPS of $0.21. For Q2, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 25%, and operating expenses including software amortization 49%.

We expect a non-GAAP tax rate of 22%, and non-GAAP EPS of $0.35 which includes the recognition of GAAP deferrals of $0.12. On a non-GAAP basis for 2019, we expect net revenues of $6.03 billion including GAAP deferrals of $275 million.

We expect net bookings of $6.3 billion. Product cost, game operations and distribution expenses of 25%, operating expenses including software amortization of 55% and a GAAP-only restructuring charge of approximately $150 million.

We expect a GAAP tax rate of 24%, GAAP and non-GAAP share count of 774 million and EPS of $1.18. For 2019, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 25% and operating expenses including software amortization of 45%.

We expect the non-GAAP tax rate of 20% and non-GAAP EPS of $1.85 which includes GAAP deferrals of $0.25. So in summary, Q1 was a solid start to the year and the team did a good job of in staying focused through a time of change.

We've made clear progress in repositioning the company to take advantage of the tremendous potential in front of us. The competitive backdrop remains dynamic, but our internally owned franchises, developer talent and geographic platform and business model diversity create a powerful foundation for longer-term growth.

We still have plenty of work ahead. And we need to remain focused on execution, but I'm confident that our plan will position us to deliver strong results for all of our stakeholders over time.

Now I'll welcome our business leaders Jay, Hum and Rob as they join us for the Q&A portion of the call, Operator?

Questions And Answers

Operator

Operator: Thank you. [Operator Instructions] We'll take the first question from Alexia Quadrani with JPMorgan.

Alexia Quadrani, Analyst

Thank you very much. Just I come back to your comments on the Overwatch League, how is it performing versus your expectations? And how is that translating to sort of player engagement or monetization of the game? And I guess any further color you can give on the Call of Duty city-based league.

Robert A. Kotick, Chief Executive Officer

Sure. This is Bobby. As I've said, we continue to lead the way in professional eSports. For us the most important thing always was being able to celebrate professional players who make the commitment to our games and inspire our players every day. But I think what we found is that as a result of our esports initiatives we're creating a lot more enduring appeal in these franchises.

We think about sports and sports teams they are the ultimate examples of everlasting franchises. And the reason that we've created this city-based global league is to be able to attract that same passion and affinity that only city-based teams can really foster as we grow the fan base and as we want to deepen that engagement that our players have with our franchises.

I would say lastly, we've seen a tremendous opportunity to create value for our shareholders through our esports ambitions. So -- if you think about the last couple of years, the results that our team focused on eSports has achieved is remarkable. If you look at the amount of time it would've taken in traditional sports to sell over $0.5 billion worth of teams, I don't think there's any example of being able to do that in a couple of year period of time.

Viewership continues to grow on the Overwatch League and we're now generating much more substantial revenues from the broadcast rights and from sponsors and licensees. So from a commercial perspective, the league is doing really well. Between Overwatch League and now the five Call of Duty teams that we've sold, we have over 25 teams that have generated that $0.5 billion of revenues and the prices for the Call of Duty teams were well ahead of what the initial prices were for the Overwatch League teams. So we've got great owners. We've got a lot of commercial momentum. I think we've got a great season that we're off to this year for Overwatch League with viewership up substantially. And overall I think we continue to lead in our initiatives of professional eSports.

And with respect to -- I'll leave Jay you can answer the game question.

J. Allen Brack, President & Chief Executive Officer

Yes. I think the game sentiment the player sentiment for the game remains positive. We continue to have an active player base even though we're approaching our 30th anniversary. The teams are continuing to add features for content and for support engagement. Last week, we released in the Overwatch workshop on the public test realm. This is a mode that allows players to really be very flexible and very creative and really build their own game modes giving some of the power that the developers have to the players. Early reaction has been positive, and I think we're excited to see what players are able to create.

Over the rest of the year we'll continue to add more heroes and new maps and new experiences. And, you know, last quarter I talked about how we have very large ambitions for the Overwatch universe and how it can develop over time. And for us it's going to be a balance of working on the existing game as well as the team focusing on other work that they have. Overwatch is a huge temple franchise for Blizzard and we're continuing to dedicate the resources and the attention so that it can to continue to grow -- we can continue to grow the community and the franchise over time.

Thanks, Alexia. Operator, can we have next question, please?

Operator

Absolutely, we'll take our next question from Colin Sebastian with Baird. Please go ahead

Colin Sebastian, Analyst

Great. Thanks. Just want to follow-up on the comments on -- free-to-play and given the success in the market for free-to-play title and battle royale as well, I wonder if you could provide a little more of an update on the company's strategy to take advantage of these trends? Thank you.

Sure. This is Coddy. Thanks Colin. No specific update today, but I think you had asked how we think about the broader context of it. And as you highlighted, there's a lot of dynamic growth happening in this industry today. I think it's first worth stepping back and talking about broadly how we see that growth, because it speaks to why we reposition the company that we have.

But, we see real growth taking place in in-game revenues, in mobile, in Asia, in free-to-play and in eSports, I just mentioned and in in-game advertising. And so, for us repositioning is really about setting up the right resources to be able to dedicated to those growth initiatives and take advantage of them as we head into the coming years.

I specifically know about one of those growth areas in the industry where you see Battle Royale free-to-play coming together. And as we mentioned, we did see some a reach impact in our franchises from competitors, who combined that approach in the space.

But I think just as importantly, we see real opportunity for our franchises, where we can expand the reach of our ability to go to consumers as we look at that opportunity across our portfolio. I need to start -- our north star is always compelling content and great engaging gameplay. It has to start there.

It is why we have multiple business models in the company, because different gameplay lands itself to different kinds of monetization and what we're always trying to do is to make sure we have a growing ecosystem of a great player experience in the ecosystem of reach engagement and monetization.

But we are constantly re-examining these ecosystems. If you just look at Call of Duty for instance, over the last decade, we've done multiple things to really evolve that model with evolving player interest from different upfront pricing, to different passes, to different post-launch content approaches and offerings, and we continue to consistently examine those ecosystems.

And part of coming to this year is we're repositioning of our resources to make sure we had enough available not only to do what we've traditionally done, but to be able to test new approaches, to look at the data, to understand what consumers really want and to be able to take advantage of some of those growth opportunities.

I do want to make one thing clear that just in closing, which is -- the upfront content that we sell for a premium has significant appeal to players, and that they're very pleased by the experiences we can provide as an upfront sale. So we will continue that model. But our additional resources allow us to really look at a number of additional opportunities to take advantage of these kinds of growth areas.

Thanks. Operator, can we have a next question please.

Operator

Absolutely. We'll take our next question from Kunaal Malde with Atlantic Equities. Please go ahead

Kunaal Malde, Analyst

I want to ask about King MAUs, because we've now seen two quarters of sequential growth. So how are you thinking about the outlook for the King Player base going forward?

Humam Sakhnini, President

Yeah. Hey, Kunaal. It's Humam. Let me take that one. So as you saw we had monthly active users of 272 million across King network this quarter, and it's kind of worth just remarking I think of how strong that network is and I'm really pleased to see that we have two quarters of sequential growth. It's really the first time we saw that since Q1, 2015, which was the quarter after we launched Soda.

And I'm equally pleased that that growth didn't come at the expense of average engagement. As you heard, we had record time spent for daily active user. Now it's about 38 minutes. You might have heard us last year we talked about that we're going to put more focus on our reach initiatives, and clearly we're seeing some of that pay off.

And as I think about we also had some really strong marketing opportunities that we've been able to capitalize on, you should bear in mind we're a very, disciplined marketer. So we're always looking at positive ROI user acquisition opportunities and those do vary from quarter to quarter.

But within that framework, what we do is, look at ways that we can always unlock more marketing investments and we do that by introducing new features in our pipeline, which drive engagement and monetization and that now includes advertising which then enables us to invest more in user acquisition and feed the network.

And as an aside, we saw strong momentum in advertising in Q1. So overall, really happy to see that stabilization and we're going to continue to be very, disciplined in how we balance reach and user acquisition cost in the coming quarters.

Thanks Kunaal. Can we have a next question please?

Operator

Thank you. We'll take the next question from Michael Ng from Goldman Sachs.

Michael Ng, Analyst

Thank you so much for the question. I just have one on Hearthstone. It seems like that's -- where bookings maybe declined for several quarters now.

Is there anything specific to point to that's been driving that weakness, whether that's been competition in digital collectible cards or just a normal revenue curve for a game that's been very successful over five years?

And are you assuming any sort of inflection in the Hearthstone trajectory following the launch of Rise of Shadows in April? Thank you.

J. Allen Brack, President & Chief Executive Officer

Hi this is J. I just wanted to say that Hearthstone is a great franchise for us. The game launched a little over five years ago and it's got over 100 million players. We also feel really proud that the game has such a large global appeal.

For engagement in the game it's moved around from year-to-year depending on where the Meta game -- the Meta of the game that set at being one time. How the latest expansion is landing and sort of resonating with the community. And what sort of new features are have been introduced in the game.

We do think that Hearthstone can be larger in the future. We have a lot of confidence in the team in both, leadership of the team and in the kind of direction they're taking for the game we're adding more developers in the Hearthstone to create more of a content that the community will want.

And we also have some ideas for innovation that we want to accelerate. You mentioned Rise of Shadows. We launched that in April. And we're really happy that it drove engagement above the previous two expansions. Throughout the rest of the year you'll continue to see different things that we add into the game.

The next thing up is our highly re-playable venture. That's going to come out this month. And it has substantially more content than we released in any previous P2P experience. And so overall we feel great about the surprises that that the team have and everything in some of sort of large player community.

Thanks Mike. Operator, can we have the next question please?

Operator

Thank you. We will hear now from Tim O'Shea with Jefferies.

Tim O'Shea, Analyst

Yes thank you for taking my question. With Dennis returning to the CFOC, I just thought it made sense to hear if there's going to be any changes in terms of the philosophy around M& A and capital returns. Thank you.

Dennis Durkin, Chief Financial Officer and President of Emerging Businesses

All right, Hey! Tim. Thanks. I appreciate the question. This is Dennis. Well, you covered us for a long time so you obviously know we have a long track record of trying to be balanced, and disciplined in how we allocate capital across investing in the business strategic M&A or returning capital to shareholders via buybacks and dividends.

And the core component of that is always ensuring we have a strong balance sheet. And we for a long time viewed that as a really strategic asset for the company in that gives you a tremendous flexibility as you think about making big bets. And when we find those compelling opportunities, we're not afraid to follow-up on them. You've seen the benefits of that approach over time in both our Vivendi buyback in 2013 and also when we acquired King in 2016. In both cases we were able to deploy balance sheet cash and borrow in a disciplined fashion while we moved our way up the investment-grade credit rating grid. And with rapid change in our industry, we think it's really important to maintain this kind of strategic flexibility and be disciplined about what's best for the company for the long-term. So yes, nothing's changed in terms of how we think about capital allocation philosophy and you should expect a continuation of our disciplined balanced approach going forward.

Yes, and I'll just add Tim because I'm off to Omaha for I don't know probably the 20th time for the Berkshire Annual Meeting, as you think about it's worth well for us as a philosophy over 29 years, we're going to always be the guys that wait for that patch -- pitch. And when you think about that it's baseball analogy, we're not going to veer from the discipline that we had for that as a guiding philosophy.

Operator, can we have the next question, please?

Operator

Thank you. We'll now hear now from Mike Olson with Piper Jaffray.

Mike Olson, Analyst

Hey, good afternoon. And thanks for taking my question. I was wondering, how you're feeling about the upcoming version of Call of Duty that's coming this fall. And also what's the latest you can share related to the prospects and potentially timing for Call of Duty mobile? Thanks.

Robert A. Kotick, Chief Executive Officer

Hey, Mike, it's Rob. Thanks for the question. So we continue to feel incredibly good about this year's game coming from infinity wars. The game's going to be revealed later this quarter. I think it's going to be really clear then why we're really so excited about the release. On the mobile part of your question, obviously, we see significant potential for Call of Duty. We're starting to see first-person action games on the platform to track really potential audiences and we feel that with Call of Duty's global appeal, we can obviously see some powerful results.

Now as we've discussed before now approaching the mobile opportunity in two ways really both through internally developed content and through partnerships. And in the case of what we recently announced the Call of Duty mobile, we're working with Tini one of Tencent's top studios. And Tencent's putting a ton of resource behind the game and it continues to shape up really, really well.

The results from all the regional tests that we've had have been really encouraging as is the interest in the community. And after we announced the Call of Duty mobile is coming to region outside of China, we saw over 10 million pre-registrations like Google Play for the game which is a really strong and significant result for a new title. We're also pretty encouraged by the resumption of our approval in China, so we're not taking anything for granted here. As stated you can assume we're planning particularly prudently for that country and mobile overall. And to sum it up honestly, we feel just really good about the games that we have in the pipeline for the Call of Duty franchise this year and we're excited for their prospects. Thanks for the question.

Operator, can we have the next question, please.

Operator

Thank you. We'll now move on to Matthew Thornton with SunTrust.

Matthew Thornton, Analyst

Hey, good afternoon, everyone. Thanks for taking the question. Maybe coming back to King and Candy Crush in particular, you talked in the past about how the franchise grew through some of the network disruptions last year. And my question here is, is that growth sustainable than we've seen recently? And can we expect some acceleration as we look forward here as we start to comp some of those network disruption issues? Thanks, guys.

Humam Sakhnini, President

Hey, it's Humam again. We've had a really strong quarter for Candy franchise as you heard. And yes, the network disruption in Q2 last year did cause a step-down in reach and monetization. So when you think about the year-on-year net bookings growth it really illustrates the durability over the long-term of the franchise. I will say that since that disruption, we stepped up our internal initiatives to build more direct connections with our players.

But on the durability point, I just want to highlight how ever green the franchise is that we've created there. The Candy franchise bookings grew year-on-year in 2017, again in 2018, and now continued into Q1. Shows kind of the strength of this franchise, which first launched in 2012. And ever since Soda was launched in 2014, Candy has had two of the top 10 grossing titles, and the U.S. app stores.

And when it comes down to our ability to do a few things here within the franchise, first is successfully developing market new titles within the franchise. So we launched Candy Crush Friends in 2018 -- October 2018, and the monetization trends on that continue to remain strong. And we prudently invest in our marketing opportunities to bring in former players and new players, and I discussed that earlier. We take a very disciplined ROI approach to that.

And third, we constantly innovate within our live titles and deliver players fresh new content and features. And we really think very thoughtfully about those pieces of content that we're putting in our live titles. So, I feel really good about our ability to continue executing in these areas and to deliver ongoing growth in the Candy franchise as a result of that.

Thanks, Matt. Can we have next question please, operator?

Operator

Thank you. We'll take our next question from Mike Hickey with The Benchmark Company.

Mike Hickey, ANalyst

Hey, guys. Thanks for taking my question and congrats on a strong Q1, good start of the year. I guess I was just hopeful that you could provide some additional color or maybe some -- a little bit more visibility within your Blizzard pipeline. Thank you.

J. Allen Brack, President & Chief Executive Officer

Hi. This is J. Thanks for the question. This is an important topic for everyone, and it's super important to me personally. I said consistently that the Blizzard pipeline is larger and richer than ever before. It includes PC and console releases. It includes ongoing content for World of Warcraft, Overwatch, Hearthstone and a couple of mobile initiatives. It's critical that all these products meet the Blizzard that we're known for. We want to give the teams the space to really create excellence and release games at a better and more consistent kids.

We're pretty impatient to get all those content in front of the community and it's a reason that we have significantly increased our developer head count as we talked about last quarter. The teams are highly motivated. We feel we've got a lot to prove, both to our players and to ourselves. And lastly, we just talk about -- Coddy talked about earlier announcing BlizzCon and the show is returning November 1 and 2 to the Anaheim convention center and working really hard to make it great event.

Thanks. Operator, we have time for one last question.

Operator

Thank you. We'll take our last question from Brian Nowak with Morgan Stanley.

Brian Nowak, Analyst

Hi. This is Matthew Costa on for Brian. Thanks for taking the question. Just on the cloud gaming opportunity, there's obviously been a large number -- number of large payers going into the space between Steadier from Google and now Microsoft with Project X cloud. Can you contextualize that opportunity in your view and give any thoughts on those new platform entrants? Thank you.

Robert A. Kotick, Chief Executive Officer

Yes. Thanks for the question. It's Bobby. When you own 30 years of IP like we do, there's probably never been a better time to be in the games business.

And that's when these big well-funded companies are building out platforms that they have limited amounts of content to actually serve up to customers. I'd say that there's a great opportunity for a company like ours.

I think for starters they will all try to broaden the audience for gaming and big investments to commit to doing so. And that's just helpful for a growing market. But in each case none of these platforms can succeed without great content. And truthfully, they don't really know how to make it.

So, when you think about what will be required it will be support from us to allow them to actually build audience. And I think that we have a better opportunity than most to capitalize on all these new platforms that will be there.

In addition, to the fact that we have almost 350 million direct relationships with our own customers today and so distribution is evolving and changing in the way that we actually connect with our own customers.

So, to that I would say as you think about the next five to 10 years, there will be more ways and places to engage players and that serves us better than almost any other company.

Chris Hickey, Senior Vice President of Investor Relations

All right, thank you everyone for joining us today. And we look forward to seeing many of you I guess in L.A. for E3 perhaps next month then if not then see you on the call next quarter. Thanks for the time.

Operator

Thank you. That does conclude today's conference. Thank you all for participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2019-02-12
Event Description: Q4 2018 Earnings Call

Market Cap: 31,796.32
Current PX: 41.67
YTD Change($): -4.90
YTD Change(%): -10.522

Bloomberg Estimates - EPS
Current Quarter: 0.465
Current Year: 2.515
Bloomberg Estimates - Sales
Current Quarter: 1464.462
Current Year: 7286.571

Q4 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Dennis M. Durkin
- Rob Kostich
- J. Allen Brack
- Humam Sakhnini

Other Participants

- Colin Alan Sebastian
- Evan Wingren
- Raymond L. Stochel
- Brian Nowak
- Alexia S. Quadrani
- Mike Hickey
- Timothy O'Shea
- Brandon Ross
- Matthew C. Thornton
- Kunaal Malde

MANAGEMENT DISCUSSION SECTION

Christopher Hickey

GAAP and Non-GAAP Financial Measures

We will present both GAAP and non-GAAP financial measures during this call

We provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses, and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefit of these excluded items, and the impact of certain significant discrete tax-related items

- These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results

We encourage investors to consider all measures before making an investment decision

Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures

- There’s also an earnings presentation, which you can access with the webcast and which will be posted to the website following the call

In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results

Robert A. Kotick

Business Highlights

Performance

- We once again achieved record results in 2018
- We delivered record GAAP revenue, and GAAP and non-GAAP EPS for both fourth quarter and the year
- For 2018, we generated record GAAP revenues across all three platforms and both Activision and King achieved record segment financial results
  - While we had record performance in 2018, it didn't quite live up to our expectations
- We didn't execute as well as we hoped to in 2018 and our current outlook for 2019 falls below what is possible in an industry filled with growth opportunities

Financial Results

- We measure our success by growth in reach, engagement and player investment, and while we had record financial results in 2018, we didn't achieve the reach, engagement and player investment goals we set for ourselves
- 2019 will require significant change to enable us to achieve our long-term goals and objectives
- We're making changes to enable our development teams to create better content for our biggest franchises more quickly

Key Franchises

- Across our key franchises, we're adding development talent to ensure our teams can deliver exactly what our fans have come to expect from our games, a consistent flow of compelling content
- We'll also increase our focus on adjacent opportunities, which demonstrates potential like esports for Overwatch League and Call of Duty
- We're staffing up production on our incubation efforts faster and increasing our investment in live services, in our tools, in our Battle.net platform and in new areas like our fast-growing esports and advertising efforts, but all with an intense focus on excellence, so we never disappoint our players

Games and Initiatives

- Our pipeline is excellent and our development talent the very best in the world
- But we need to refocus our efforts so that our development and production resources are better aligned with our priorities
- We're reducing or eliminating investment in games and initiatives that weren't living up to player expectations, where our leadership teams have determined may not live up to player expectations in the future
- To drive improved execution and to fund development investment, we will in certain parts of the business reduce complexity and duplication in our back office functions, consolidate certain commercial operations, and revamp

our consumer marketing capabilities to reflect our continued migration to a largely digital network

Strategy

- While this isn't a shift in our strategy, achieving better execution requires change, change that requires new leadership and organizational commitment to change
- We operate in an industry with proven growth and real potential, and we haven't grown at the rates that reflect the opportunities our industry affords
  - We have new business unit leadership committed to serving our players, our employees and our shareholders
- And I'm also very pleased to have Dennis Durkin back as CFO and overseeing our Emerging Businesses
- His steady responsible stewardship of our capital and his strong relationships with his colleagues served us well during his five-year prior tenure as CFO
- As always, I want to thank our customers, our players and our partners, but especially today, our employees and our shareholders for their commitment and their support

Collister Johnson

Operating Highlights

GAAP Revenue, Net Bookings and EPS

- Before we discuss the important steps we are taking to reinforce the foundation for future growth, let's first review our quarterly results
- In Q4, we generated record GAAP revenues of $2.38B including the net deferral of $454mm
- Net bookings were also a record at $2.84B
- We generated Q4 GAAP EPS of $0.84 and Q4 non-GAAP EPS of $0.90, also both Q4 company records, including the network deferral of $0.39
- While GAAP revenue, net bookings and both GAAP and non-GAAP EPS were company records, our net bookings fell short of our outlook, due to factors I'll explain in our segment results

Activision Segment

- Activision Q4 segment revenues grew 6% y-over-y to $1.41B and operating income increased 14% y-over-y to $723mm with monthly active users increasing double-digits q-over-q to 53mm
- The primary driver for the Activision segment was Call of Duty, which generated more upfront sales than any other console franchise worldwide in 2018, a feat the franchise has accomplished for nine of the last ten years

Black Ops 3

- Black Ops 4 sell-through more units than Black Ops 3 in its launch quarter with PC units more than tripling and engagement was strong with average hours per player increasing vs
- Black Ops 3 as players joined Blackout, Multiplayer and Zombies

- We also saw a significant shift to digital this year, with full game downloads representing over 40% of console sell-through vs. approximately 30% for World War II.
  - However, sales of Black Ops 4 in H2 the quarter were below our outlook, due to weaker-than-expected retail demand, lower-than-anticipated pricing, and other promotional activities that didn't meet expectations
- Now, though Black Ops 4 in-game net bookings started off slower than expected following the introduction of the new in-game system, we were encouraged by the response we saw when we introduced more compelling content with the second season of events in late Q4

Destiny

- Turning to Destiny, the mutual agreement with Bungie to sell back the commercial rights to Destiny and eliminate our ongoing investment in the game did not have a material impact on Activision segment operating income in the quarter, but will free up capital and development resources for the future
- We also continued to drive strong performance for the beloved intellectual property from our library, following the successful launch of Spyro in Q4
- And the ongoing contribution of Crash Bandicoot, which has sold in over 10mm units since its 2017 release, again highlights the enduring nature of our classic franchises

Segment Revenue

- Overall, Activision delivered meaningful y-over-y growth for segment revenue and for operating income
- And with the changes we are implementing in 2019, we expect to drive even stronger performance in the years to come

Overwatch and Hearthstone

- Blizzard was a more nuanced story in Q4
- On the one hand, we grew Q4 segment revenues to $686mm and operating income to $241mm
- And Blizzard had 35mm monthly active users in the quarter, as Overwatch and Hearthstone saw sequential stability and World of Warcraft saw expected declines post the expansion release this summer
- On the other hand, the relatively consistent monthly active user trends for Blizzard's communities were not matched by in-game net bookings, which continued to soften
- In particular, Overwatch and Hearthstone both experienced sequential declines in net bookings from players making in-game purchases

Partnership with NetEase

- Lastly, Blizzard results benefited from the continued success of our business in China and the extension of our partnership with NetEase
- Building on our 11-year joint venture, the expanded agreement runs until January 2023 and reflects the substantial value and opportunity for Blizzard's content in China
  - While the majority of the economics from our renewed arrangement will be recognized over the next four years, Q4 did benefit from the agreement, which was contemplated in our outlook

- Now I'll go into more detail in a minute, but increasing the flow and the frequency of compelling in-game content and upfront releases to serve the needs of our players is the number one goal set by the new Blizzard leadership team going forward

King Growth

- Finally, King grew segment revenue and operating income y-over-y as it continued to recover from the network incident experienced in Q2
- Q4 segment revenues grew 5% y-over-y to $543mm and operating income increased 28% y-over-y to $207mm
- King monthly active users of 268mm grew sequentially for the first time since we acquired the business in Q1 2016, driven by the successful launch of Candy Crush Friends in October

Candy Crush Friends

- Candy Crush Friends is seeing strong monetization and retention trends, contributing incremental growth for the Candy Crush franchise, which overall grew net bookings and monthly active users, both q-over-q and y-over-y
- This encouraging performance sets the foundation for King to ramp its marketing support and drive further growth for Friends in 2019
- Now importantly, our advertising initiative continued to gain momentum, growing net bookings over 50% sequentially and again profitably, as the team continues to execute against this sizable opportunity

Q4 Results

GAAP Revenue, GAAP and Non-GAAP EPS

- Now taking a step back and looking at our full year results for 2018
- We delivered record GAAP revenue, GAAP and non-GAAP EPS and net bookings
- We continue to make encouraging progress in mobile, advertising and esports
  - However, in-game execution was inadequate for some of our franchises and we saw weaker than anticipated retail demand
- As you will hear from Dennis, our 2019 outlook assumes that we will not improve in-game monetization as quickly as we would like, and that it is a transition year where we have less new major content to release than we should

New Business Unit Leaders

- So, we have worked with our new business unit leaders to undertake a comprehensive examination of our business to determine the changes we need to make to improve execution and capitalize on the substantial long-term growth opportunities for our company
- We've determined that we need to refocus our best resources on our biggest opportunities and to remove an unnecessary level of complexity and duplication that has built up in certain parts of the business
- We have therefore developed a clear plan for this year to refocus and reinforce the foundation for growth

Initiatives

- This refocus includes initiatives developed by our new business unit leaders, each of whom has demonstrated the ability to combine creative excellence with a commercial focus on profitable growth
  - First, we are investing more in development for our biggest internally owned franchises across upfront releases, in-game content, mobile and geographic expansion
  - Second, we are deprioritizing initiatives that are not meeting our expectations and reducing certain non-development and administrative-related costs across our business
  - Third, we are integrating our global and regional sales and go-to-market partnerships and sponsorships capabilities across the business, enabling us to better leverage talent, expertise and scale on behalf of our business units

Restructuring Plan

- Our restructuring plan sheds investment in less productive non-strategic areas of our business and will result in a net head count reduction of approximately 8%, while also driving a significant increase in investment, focus and capabilities around our biggest franchises
- We're confident that over time this plan will enable our teams to accelerate the delivery of high-quality content to our communities
  - Specifically, as we reallocate resources and hire new talent, we are planning for the number of developers working on Call of Duty, Candy, Overwatch, Warcraft, Hearthstone and Diablo to increase in aggregate by approximately 20% over the course of the coming year
- For Call of Duty, Activision management expects additional resources to deliver more frequent content updates and events for the franchise and accelerate its expansion across platforms and geographies

Overwatch League

- We also intend to build on our experience with the Overwatch League to launch a professional city-based Call of Duty league that drives franchise engagement and represents a sizable incremental economic opportunity
- We are also increasing coordination across our Call of Duty studios with unified development leadership and more unified tools and technology to create a more consistent user experience and leverage our development scale and expertise
- For Candy, King management will increase its focus on growing reach and monetization with in-game content features and events with a substantial increase in Candy development resources
- The advertising business will continue to add engineering and direct sales resources to support our plans for strong revenue and operating income growth in 2019 and beyond

World of Warcraft

- The Overwatch team is also growing, as it focuses on delivering a significant content pipeline in the coming years and the Overwatch League remains a key strategic focus where we will grow the number of resources involved to drive an expanded product and year-on-year revenue growth
- World of Warcraft is an example of a franchise, where Blizzard has already established a regular cadence of major content and in-game operations

- Additionally, Blizzard is investing in other Warcraft games working on more ways for the community to engage, with this enduring and beloved franchise

Diablo's Development

- For Hearthstone, additional development resources will help to release content that is both broader and deeper, and to optimize the game to deliver an even better mobile experience for its global audience
- And Diablo's development head count will grow substantially, as the teams work on several projects underway for the franchise as well as the global launch of Diablo Immortal
- Overall, Blizzard's management is reinforcing its pipeline with more resources than ever before to support planned mobile titles, several PC and console releases, and whilst continued cadence of content

Upfront Launches

- Finally, as a company, we will continue to invest in breakthrough new ideas and incubation, with focused resources and some of our best creative talent
- With 2019 set to be a quieter year for upfront launches, now is the right time to implement this plan
  - Work is already underway across the company as we speak
- We expect to have completed North American components of our plan by the end of Q1, with implementation of the international components by EOY.
- And we have already started to increase developer resources on our biggest franchises, and we'll be aggressively hiring talent in the coming quarters

Summary

As we look forward to the coming years, we plan for all of our major franchises to be operating at scale and capitalizing on opportunities that include robust ongoing live operations and regular content launches both large and small, strong mobile experiences available for all of the communities to enjoy, new engagement and monetization models including where appropriate esports and advertising

And underpinning all our franchises will be our deep relationships with growing and vibrant communities which are increasingly direct and digital

In short, we are refocusing the entire company to return to the franchise focus that has fueled our long-term success and to better leverage the scale of our business for future growth

Dennis M. Durkin

Financial Highlights

Performance

- Before I discuss the 2019 and Q1 outlook, I just wanted to take a moment to say how excited I am to be back and to return to a more day-to-day operational position as the CFO as well as a leader of our Emerging Businesses
- We have a tremendous team and although we have a lot of work in front of us, I see a stronger pipeline and more opportunities for long-term growth than ever before

- As Bobby and Coddy mentioned, 2019 will be a transition year for us as we implement change to enable our teams to create better content for our biggest franchises more quickly
- Given limited frontline releases, the organizational work underway and the current competitive environment, we're planning for this year to be down y-over-y

Call of Duty Franchise

- I'll first go through the segments including slate to provide some context for the outlook, starting with Activision
- The main driver for the segment will be the Call of Duty franchise
- Heading into 2019, we have momentum to build on given the launch of Black Ops 4 with the franchise yet again number one globally in upfront sales in 2018
  - We will continue to optimize in-game content this year to drive ongoing engagement and player investment

Black Ops 4

- And in Q4, we will have another major launch for the franchise that will appeal broadly to both existing and new fans with what I can only describe now as a great step forward in the franchise that is also rooted in some of the franchise's most important history
- We have high expectations for the game, but for modeling purposes, we are conservatively planning on upfront Q4 unit sales to be lower than Black Ops 4
- We will also bring Call of Duty to mobile with our partner Tencent
  - Although, as you would expect, we take a conservative approach in assuming no material operating income from this initiative this year

Strategy

- Outside of Call of Duty, we will release Sekiro in Q1 and our strategy of reimagining classic franchises will continue with Crash Team Racing on multiple platforms later this year
- We will not generate material revenue from Destiny in 2019, following the sale of publishing rights to Bungie
- Excluding Destiny in both years, our outlook is roughly flat for net bookings for the rest of the Activision segment in 2019

Blizzard

- Turning to Blizzard, we expect materially lower financial performance this year. 2018 benefited from the release of World of Warcraft: Battle for Azeroth, whereas we are not planning a major frontline release for Blizzard in 2019
- And Blizzard exited 2018 with softness towards in-game revenues that will take time to stabilize and return to growth
- While these factors will weigh on Blizzard's financials this year, looking further ahead, Blizzard's pipeline of PC, console and mobile content is richer than ever and we expect a significant addition of development resources to accelerate the pace of delivery over time

Segment Revenue

- Finally, King is entering 2019 with momentum as it continues to recover from the network incidents it experienced in Q2
- The business will continue to face tougher comps in the first few months of the year until it crosses the anniversary of this disruption
- Nonetheless, we expect segment revenue to grow modestly y-over-y driven by growth for the Candy franchise and the continued ramp of our advertising business

Net Bookings

- Bringing all this together to the total company level, our outlook incorporates net bookings declining 13% y-over-y
- The Blizzard segment represents the majority of this y-over-y change given its 2019 release slate and in-game performance
- The lower net bookings from Destiny is also a factor
- The lower net bookings performance translates into lower segment operating income and our outlook assumes a high teens y-over-y decline
- Again, the Blizzard segment drives the majority of this change

Operating Income

- Activision segment operating income is also expected to be lower due to the following factors
- First, we are planning to invest more in Call of Duty this year including the support platform and geographic expansion
- And second, we will not generate meaningful operating income from Destiny this year
    - Although, I would note that this is consistent with our planning assumptions where we too have continued publishing the game
- King segment operating income is planned to be roughly flat, as we invest in Candy marketing to build on the encouraging start for Candy Friends

Tax Rate

- Finally, I would note that we are planning for a higher tax rate this year
- While our 2018 GAAP tax rate included one-time benefits from U.S. tax reform and our IRS settlement, both our GAAP and non-GAAP 2019 rates incorporate the full impact of new international tax provisions

Guidance

GAAP Basis and Net Bookings

- With that context, I'll detail the financial guidance for 2019 and Q1
- On a GAAP basis for 2019, we expect revenues of $6.03B, including GAAP deferrals of $275mm

- We expect net bookings of $6.3B; product costs, game operations and distribution expenses of 24%; operating expenses including software amortization of 56%; and a GAAP-only charge of approximately $150mm relating to the restructuring plan Coddy outlined

GAAP and Non-GAAP Net Interest Expense

- We expect GAAP and non-GAAP net interest expense of zero, a GAAP tax rate of 24%, GAAP and non-GAAP share count of 775mm and EPS of $1.18
- For 2019 on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 24% and operating expenses including software amortization of 46%
  - We expect a non-GAAP tax rate of 20%, and non-GAAP EPS of $1.85, which includes GAAP deferrals of $0.25

GAAP Basis

- For Q1 on a GAAP basis, we expect revenues of $1.72B, which includes the recognition of GAAP deferrals of $540mm
- We expect net bookings of $1.18B
  - Product costs, game operations and distribution expenses of 20%
  - Operating expenses including software amortization of 57%
  - And we expect approximately $100mm of the GAAP-only restructuring charge we booked in Q1
- We expect GAAP and non-GAAP net interest expense of zero, a GAAP tax rate of 24%, GAAP and non-GAAP share count of 772mm and EPS of $0.39
- And for Q1 on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 20% and operating expenses including software amortization of 43%
- We expect the non-GAAP tax rate of 22% and non-GAAP EPS of $0.63, which includes the recognition of GAAP deferrals of $0.43

Capital Allocation

- Turning to capital allocation, I wanted to spend a moment to quickly review our historical track record just as context
- As most of you know, we have always taken a disciplined and balanced approach to capital allocation
- We view a strong balance sheet as a strategic asset and while our focus in recent years has been on paying down debt with over $4B repaid in the last five years, we've also returned almost $11B to our shareholders over the last decade with around $2B in dividends and $9B in share repurchases
- With this balanced approach in mind, our Board has authorized the following; a 9% increase in our dividend to $0.37 per share payable in May; and also a new two-year $1.5B share repurchase authorization

Longer-Term Growth

- Before I conclude, I wanted to summarize the company's position heading into 2019

- We continue to have a tremendous potential in front of us
- Our combination of leading owned franchises, a direct digital connection to our consumers, best-in-class developer talent and geographic platform and business model diversity creates a powerful foundation for longer-term growth
- We must and will relentlessly focus on the world-class execution, business excellence and quality content delivery that has been the backbone of our company and business for many years
- Our plan to increase our focus on our core franchises is consistent with that approach and I'm confident that executing against our plan will position us to deliver strong results and shareholder value over the long term
- Looking ahead, I look forward to updating you on our results as we make progress throughout this year

QUESTION AND ANSWER SECTION

<Q - Colin Alan Sebastian>: And welcome back, Dennis. I appreciate the comments on the restructuring and hoping you could provide a little more color on the reallocation of resources, and in particular, discuss how and when we can expect that effort to translate to a return to growth? Thanks.

<A - Collister Johnson>: Sure. Thanks, Colin. This is Coddy. I'll take that one. I guess stepping back as we shared during the call, our plan is focused on delivering growth in reach, engagement and player investment, and there's really big three areas of it. One is refocusing on our own franchises, where we feel like we had the highest opportunity for growth. Two is making sure we have the right amount of development resources to then go deliver great content within those franchises to our player communities, and then where appropriate benefiting from company scale and removing duplication and inefficiency.

And so to do this with the new leadership teams, there's three specific and important changes as we head into 2019 that we plan to deliver. The first is investing in development on our main franchises, as I mentioned, a 20% increase to drive the content in cadence and pace. Second is reducing and eliminating initiatives that are not meeting our expectations and also areas where we can find duplication and remove it. And then third, integrating our global and regional sales and go-to-market and partnerships and sponsorships, so we can leverage scale. We know we have a global fan player base that is looking for content on a regular cadence, to come more quickly and to come across multiple platforms and we think we have set up each of our operating divisions to be able to deliver on that. But we also think we've better set up the company to be able to deliver on that as we leverage those areas, where scale can really help to bring our content and our franchises out to the world.

Now as for timing, and as you see those effects, we're only guiding to 2019 today, but what I can say is that we are confident in the growth opportunity ahead of us. Our increased focus, our investment, leaning into our big franchises, it's a sign that we are headed towards a place where growth, given the right resources, given the right plan, can be realized.

<Q - Evan Wingren>: Yeah. Just wondering if you could provide us a bit more commentary on the components of your guidance for FY2019, how you see your franchises performing and how you see the seasonality of the year unfolding.

<A - Dennis M. Durkin>: Yeah. Thanks, Evan. It's Dennis here. Happy to provide some color on that. I guess, first just kind of helicoptering up a little bit, there are a few things to think about as it relates to our outlook. I think the first point is obviously the one relative to our release slate, which is diminishing this year or down this year, and it does obviously impact our outlook.

In addition, the in-game softness that we saw exiting 2018 caused us to enter the year at a slightly lower trajectory than last year. And although we have a plan to turn that around, it's going to take some time. And so we don't actually assume a full recovery of that in 2019. And then, we also are pretty conservative in terms of how we plan for some of the newer things in our pipeline like our mobile games. We do obviously shoot for breakout hits, but it's very hard to obviously prudently plan for those in your outlook. So we're obviously more conservative on that.

And then the last piece, I would just say is relative to our tax rate. You heard a few of the comments about it being up because some of our international considerations this year. So those are the main considerations, I guess just relative to the overall outlook. As it relates to seasonality, given the limited number of product launches this year, Q4 will again be a very important quarter. Again, we've tried to take a prudent approach relative to that assuming that Call of Duty units are down y-over-y in our outlook.

I would say that the team that's building this new game for us in Activision is building what they believe is the best Call of Duty we've ever built. And so that team is certainly targeting growth even though we haven't put it in our outlook in that fashion. So I guess just stepping back, our approach relative to guidance and my approach to guidance is really, for this year is really consistent with how we've set guidance in the past. And a careful approach to guidance I think is always appropriate, but particularly this year given the changes in the industry and the amount of work we need to accomplish this year. So, thanks for the question, Evan.

<Q - Raymond L. Stochel>: Can you quickly tell us about how you're thinking about leading Activision? And then give us an update on the Call of Duty: Black Ops 4 launch and how that game is trending so far. Thanks.

<A - Rob Kostich>: Hey. Thanks for the question, Ray. So I've been at Activision for about 15 years now and I've touched just nearly every part of the business. And what I really look forward to is taking all those experiences and applying it in this broader capacity. At a high level, I'm really focused on two things right now. It's our players and our people. Very simply, I'm very committed to our players and over-delivering on their expectations. That is just something we must do. Now behind it all is our people. They're world-class. They are our foundation and we want to continue to invest in them and to create an environment for them to do their best work.

Now if I step back from an Activision perspective and look at the business, we do have a lot of opportunities right in front of us, in Mobile, in PC expansion, in geographic expansion, especially in Asia, in eSports, as was mentioned on the call already, and of course in business models that continue to arise in our industry and create opportunity for us. And as a division, we have specific initiatives against each of these in progress that we're excited about.

Now in terms of Black Ops 4, as Coddy mentioned, it delivered better unit sell-through than Black Ops 3 in its launch quarter. So what we have is a really strong foundation of players right now and our biggest objective is driving ongoing engagement with our community.

Now, the good news is, we have our best in-game content coming still. Our next event on February 19 will be what we believe is our biggest and best in-game event and it's going to have significant updates across all modes and we're looking forward to see how that lands and resonates with the community.

And then if I look even further at to what Dennis mentioned, it's worth mentioning again, this fall's launch I think is going to resonate very powerfully with our community. It is an amazing game. It's going to feature an entirely new campaign, a huge and expansive multiplayer world and of course some fun co-op gameplay.

But from day one, what gets me really excited is every time we've shown this title internally it's just created a ton of buzz. Now I wish I could tell you a lot more right now, but unfortunately you're going to have to wait, but I think it's going to be really worth it. We can't wait to share it with the world. So thanks for the question, Ray.

<A - Robert A. Kotick>: And I would just add, Ray, it's Bobby, that when you look over the last decade of Call of Duty content, I think that Rob is underselling what the internal enthusiasm is. I haven't seen this much enthusiasm that I can remember almost ever. So, we're excited about the fall release of Call of Duty content.

<Q - Brian Nowak>: One for probably J. I guess, the question, J., is what is the new management team doing just to make sure that Blizzard is back on track to executing as one of the top studios as it should be? Thanks.

<A - J. Allen Brack>: Yeah. Thanks for the question. I think one of the things that I feel like it's important for us to talk about is we're bit of a new leadership team. And as we've come together, it's clear that we believe a lot in our future and that we have a lot to prove from both the game and kind of a content delivery standpoint.

I think we have a huge amount of opportunity. We have fantastic IPs. We have lots of games that we want to create and we have a very passionate community that is hungry for all of the things that we can produce.

So we have two big goals going forward. And the first one is, of course, make excellent videogames. The second is, to find ways to deliver more content to our player communities. To meet these goals, we need to work to increase the amount of content that we're delivering. Right now we have the largest lineup of PC, console and mobile games that we've ever had, and we're working to meaningfully increase the development capacity and the development head count.

That investment in developing the talent is – has really required us to make some difficult trade-offs. We're going to – as Coddy mentioned, we're going to reduce our non-development positions at our offices around the world, specifically looking at our SG&A and non-core business units. This was a very, very difficult decision, I'd say it's a top five career difficult moment for me personally, but we're committed to doing everything that we can to help get us into a good position going forward.

We really want to serve our players and we want to serve our communities in the best possible way and be a great creative organization. As difficult as kind of all this is, I think we're happy about the things that we're working on. We're working very hard to live up to our mission and we really look forward to the community, and you all seeing the results of this increased development work over time.

<A - Rob Kostich>: Can I just say, it's really terrific for the company to have J.'s leadership. He's humble about his experiences. When you think about World of Warcraft and Hearthstone and the Warcraft franchise, it's been one of the most successfully led franchises in all of video games and we couldn't be happier to have J. in the role that he's in.

<Q - Alexia S. Quadrani>: I guess my question is, given one of your competitors' decision to launch a free-to-play Battle Royale game, are you rethinking the monetization model for any of your own games, maybe including Overwatch?

<A - Collister Johnson>: Sure. This is Coddy. Thanks for the question. I guess, maybe a couple key points. First, stepping back, one of the things that sometimes gets lost in the discussion on economic models is the player and game experience itself. Our north star is to deliver compelling and engaging gameplay, full stop. Without that there are no economics.

The second point is that the economic model has to work with the franchise and the community and the gameplay. They need to work to reinforce each other and we feel like we're in a pretty unique position, honestly across the industry and that we have multiple business models running at scale across our franchises today. We have free-to-play games, micro transaction-based games, games with an upfront charge or with a subscription. We also now have advertising, which is growing as well. And we think that provides a range of options for our product and development teams to look across and pair the best economic model with the best gameplay experience.

One thing we know though is that we need to be able to move more quickly and we need to be able to rapidly evolve with the demands of our players in the market. And that's why as I mentioned, we are investing significant development resources in our core franchises to be able to move more quickly on behalf of our players and to be able to take advantage of new business models.

And on the free-to-play part of your question in particular, obviously the most proven platform is mobile. So as we increasingly bring Activision and Blizzard IP to the mobile space, you will see us deploy more free-to-play models. Embedded in your question that was also the fact that we see competitors now on PC and console going free-to-play and I just emphasized again that we believe our investment and resources coupled with our strong IP leaves us in a really good position to take advantage of evolving business models in our industry.

The last thing, I'd say and it's just worth mentioning is that the success we see with titles like Call of Duty or even recent competitive launches shows that a really well-built, well-polished AAA experience for players can come still with an upfront charge and it can be a great player experience and a great business model. So looking ahead, we'll continue to evaluate all our games across our franchises and use the models that we think best both for the player experience and for our business.

<Q - Mike Hickey>: Just focusing on your key segment, I'm hopeful you can provide more color on your Candy Friends launch, I guess, how it went from your perspective and how it's performing now would be really helpful? Thank you.

<A - Humam Sakhnini>: Hey, Mike. It's Humam here. Thanks for the question. So, Candy Crush Friends launched in October. It's been a great addition to the franchise. The game has really got a lot of great new game modes and mechanics, and we really think it's our most polished title ever. And it's brought a lot of the franchise characters to life like never before. What I would say is that after many years of the teams operating the Candy franchise at scale they've really brought all their learnings into the Candy Friends experience. And what we're seeing is that that's paid-off. It's really showing some strong retention and the game's per-player monetization metrics are well ahead of where the franchise's other titles were at a similar point post launch.

And again, it really reiterates and demonstrates how kind of the years of experience operating Candy were funneled into the Candy Friends title. So we're off to a great start and we have more plans in 2019. The way I think about it is we're still in the launch mode with Candy Friends and this is the year where we make marketing investments to support the title. And while we're doing that, the teams have some really strong plans to drive engagement and monetization trends with some proven features in the pipeline to continue to delight the players. So overall very pleased with the momentum, and I expect that the game will really help drive the Candy Crush franchise growth in 2019.

<Q - Timothy O'Shea>: So with Overwatch League season two launching soon, I just thought it made sense for an update on that franchise. It's been over two years since the game launched and we've talked on prior calls, and again on this call about the lower revenue level. So I'm wondering, what's the strategy to address this issue? And does Blizzard have the development capacity to deliver sufficient levels of new content into this franchise? Thank you.

<A - J. Allen Brack>: Thanks for the question. This is J. I think it's important to mention the job the team has done with Overwatch. We feel really strong about the overall IP, the universe, the characters and the story potential, along with the global appeal for the game. And we really built Overwatch League around that with early good results.

Delivery of more content in Overwatch is something that's really important and something that we're focused on. The team is delivering new heroes and new maps and new experiences. And as you mentioned, the game revenue has declined recently. I think that the community engagement with the game remains strong.

There are a lot of new ideas for the Overwatch franchise. We feel like the Overwatch that you know is just a small part of what we can imagine for the overall franchise, and the team has a very clear plan. In order to deliver on that, we're going to increase the size of the Overwatch team meaningfully. But keep in mind that we're going to need to balance the existing live content with new products and different kind of support for Overwatch League. I'm really confident that the community will be very excited when we kind of release the things that we're working on.

Regarding Overwatch League specifically, we saw a great community response and lots of early success. That took a lot of focus. But overall, we think it's the right decision. It's been the right decision for the game and for the franchise. We're about to kick off the second season and that's going to start on February 14. That'll introduce eight new city teams. It will introduce home and away matches for some teams for the very first time. And the first match that's actually going to kick off is going to be a repeat of the grand finals between London and Philadelphia. So, overwatchleague.com is where you can see that.

<Q - Brandon Ross>: I was just hoping you could provide a little more color on your rationale for parting ways with Bungie and the Destiny franchise and kind of what happened with that game? Thanks.

<A - Collister Johnson>: Sure. Thanks, Brandon. This is Coddy. I guess let me say first that we're confident that this was the right decision for both parties. Bungie gets to focus on the IP that they created, and we get to focus on our biggest opportunities on our biggest franchises with our best resources.

Our decision was reached via mutual agreement with Bungie to sell back the commercial rights. And for us at least, it was rooted really in our strategy overall. First, as you know, we didn't own the underlying Destiny IP and we do for all our other major franchises, which we think is not just a differentiator for us in the industry, but also controlling the underlying IP gives us the chance to move into new experiences and new engagement models, which also come with new revenue streams, and of course, structurally higher economics when you own the IP.

And that leads to probably the second factor in our decision process, which is Destiny, it is highly critically acclaimed, high quality content, but it was not meeting our financial expectations. As we went through at the end of the year our financial planning for 2019, it indicated that Destiny would not have been a material contributor in operating income to our business.

And third, we had internal resources supplementing Bungie's work, and that means they're tying up one of our scarcest resources, which is developer time, which now under the arrangement we've reached will be freed up after a short transition period.

So late last year when we were exploring all our options on Destiny, in November after our earnings release, we learned that Bungie was willing to acquire our rights and we engaged in discussions with them and ultimately wound up consummating the deal in late December, and it was a mutual amicable agreement. And I'd just emphasize, I really do think for both parties this is the right path forward and it allows us to go implement the plan that we talked about today.

<Q - Matthew C. Thornton>: Maybe \ you could just update us on just timing around some of the mobile initiatives at both Blizzard and Activision, including China as well as rest of world. Any updated color there would be helpful. Thanks, everyone.

<A - Collister Johnson>: Sure. Thanks, Matt, for the question. This is Coddy again. As you heard in our prepared remarks, mobile is a top priority for us and we think it's one of our largest opportunities, particularly with our global IP, which we think is really well-positioned to bring to the mobile platform.

We see this every day with King where you have a franchise at scale globally, but we also see it with other great franchise IP like Hearthstone where bringing that game to mobile brought in tens of millions of new players that are engaging in an ongoing and deep way with us. The thing to note is mobile game teams, while smaller than PC or console, they still require time to prototype and to test, and particularly for us and our franchises where we have high community expectations when we bring them to market, we want to do it right.

That said, part of the announcements today and the work that we're doing and that we highlighted, is to make sure that we're adding the right resources and enough resources to accelerate our mobile pipeline. Given the size of the overall opportunity, it's not just internal. We are working with external partners. We have multiple projects underway across the portfolio in various stages of development. And as you know we've announced to Call of Duty mobile and also Diablo Immortal.

And you asked sort of about both in status. They're both hard at work. We have no additional announcements to make at this time, but in both cases we're looking to make sure that the IP is really well represented. For Diablo it's an authentic and immersive deep experience that we think getting it there has large global potential, and so it matters to get it right and we'll share more about our titles and release dates as that comes to fruition.

<Q - Kunaal Malde>: You mentioned that King advertising net bookings were more than 50% sequentially. It would be great if you could provide us with some more color and your expectations in 2019?

<A - Robert A. Kotick>: Well, this is Bobby. I would say...

<A - Humam Sakhnini>: This is Humam – go ahead, Bobby.

<A - Robert A. Kotick>: Go ahead, Humam.

<A - Humam Sakhnini>: I was just going to say, Bobby, that I'm going to sit back and just think about the business in a few phases. First, we decided that we really needed to add product that worked and is differentiated. So, we went and invested in the right teams to drive that, and I think, it's paid off. We have a pretty good and differentiated native ad product that is working quite well with player satisfaction on the inside and increasing on monetization.

And in 2017 and what you saw in 2018 was we scaled the business by lighting up more of our inventory and adding more impressions in our network, and that was a key driver as we started scaling the business. And we hit some important financial milestones in the year in 2018, first, profitability in Q1, and then growth in every quarter after that.

And I think the ad business is going to start to be meaningfully contributing to the King overall. So we expect it to cross the $100mm booking threshold this year. And as I look ahead, I think on the next phase about where the ad business heading, it's about continued scaling. So, we will continue to scale more and in fact the ad network at King and we have more work to do there to enable it in more of our games and we're continuing to educate our demand partners on kind of the power of our ad product and there's really good momentum there. And I think kind of after that, we will think about even more ways to deploy the ad product. It could be in new mobile experiences or eSports. I think the team has a ton of learnings and potential that could be applied in there.

<A - Robert A. Kotick>: Yeah, and I would just add. I think, it's an excellent team. The ad product is excellent. They've started to make real inroads in getting people to better understand what the opportunities for advertisers is, and I think that I'll just echo Humam's sentiment that there's a lot of momentum in that business.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2019-02-12
Event Description: Q4 2018 Earnings Call

Market Cap: 31,796.32
Current PX: 41.67
YTD Change($): -4.90
YTD Change(%): -10.522

Bloomberg Estimates - EPS
Current Quarter: 0.465
Current Year: 2.515
Bloomberg Estimates - Sales
Current Quarter: 1464.462
Current Year: 7286.571

Q4 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Dennis M. Durkin
- Rob Kostich
- J. Allen Brack
- Humam Sakhnini

Other Participants

- Colin Alan Sebastian
- Evan Wingren
- Raymond L. Stochel
- Brian Nowak
- Alexia S. Quadrani
- Mike Hickey
- Timothy O'Shea
- Brandon Ross
- Matthew C. Thornton
- Kunaal Malde

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Activision Blizzard Q4 2018 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Chris Hickey. Please go ahead, sir.

Christopher Hickey

Good afternoon and thank you for joining us today for Activision Blizzard's fourth quarter 2018 conference call. With us are: Bobby Kotick, CEO; Coddy Johnson, COO; and Dennis Durkin, company's CFO and President of Emerging Businesses. And for Q&A, Rob Kostich, President of Activision; J. Allen Brack, President of Blizzard; Riccardo Zacconi, CEO of King; and Humam Sakhnini, President of King will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect. A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2017 Annual Report on Form 10-K, and those on the slides that are showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, February 12, 2019.

We will present both GAAP and non-GAAP financial measures during this call. We provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses, and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefit of these excluded items, and the impact of certain significant discrete tax-related items.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also an earnings presentation, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Chris, and thank you all for joining us today. We once again achieved record results in 2018. We delivered record GAAP revenue, and GAAP and non-GAAP EPS for both fourth quarter and the year. For 2018, we generated record GAAP revenues across all three platforms and both Activision and King achieved record segment financial results. While we had record performance in 2018, it didn't quite live up to our expectations. We didn't execute as well as we hoped to in 2018 and our current outlook for 2019 falls below what is possible in an industry filled with growth opportunities.

We measure our success by growth in reach, engagement and player investment, and while we had record financial results in 2018, we didn't achieve the reach, engagement and player investment goals we set for ourselves. 2019 will require significant change to enable us to achieve our long-term goals and objectives. We're making changes to enable our development teams to create better content for our biggest franchises more quickly.

Across our key franchises, we're adding development talent to ensure our teams can deliver exactly what our fans have come to expect from our games, a consistent flow of compelling content. We'll also increase our focus on adjacent opportunities, which demonstrates potential like esports for Overwatch League and Call of Duty. We're staffing up production on our incubation efforts faster and increasing our investment in live services, in our tools, in our Battle.net platform and in new areas like our fast-growing esports and advertising efforts, but all with an intense focus on excellence, so we never disappoint our players.

Our pipeline is excellent and our development talent the very best in the world. But we need to refocus our efforts so that our development and production resources are better aligned with our priorities. We're reducing or eliminating investment in games and initiatives that weren't living up to player expectations, where our leadership teams have determined may not live up to player expectations in the future. To drive improved execution and to fund development investment, we will in certain parts of the business reduce complexity and duplication in our back office functions, consolidate certain commercial operations, and revamp our consumer marketing capabilities to reflect our continued migration to a largely digital network.

While this isn't a shift in our strategy, achieving better execution requires change, change that requires new leadership and organizational commitment to change. We operate in an industry with proven growth and real potential, and we haven't grown at the rates that reflect the opportunities our industry affords. We have new business unit leadership committed to serving our players, our employees and our shareholders. And I'm also very pleased to have Dennis Durkin back as CFO and overseeing our Emerging Businesses. His steady responsible stewardship of our capital and his strong relationships with his colleagues served us well during his five-year prior tenure as CFO.

As always, I want to thank our customers, our players and our partners, but especially today, our employees and our shareholders for their commitment and their support. And now, Coddy?

Collister Johnson

Thanks, Bobby. Before we discuss the important steps we are taking to reinforce the foundation for future growth, let's first review our quarterly results. In Q4, we generated record GAAP revenues of $2.38 billion including the net deferral of $454 million. Net bookings were also a record at $2.84 billion. We generated Q4 GAAP EPS of $0.84 and Q4 non-GAAP EPS of $0.90, also both Q4 company records, including the network deferral of $0.39. While GAAP revenue, net bookings and both GAAP and non-GAAP EPS were company records, our net bookings fell short of our outlook, due to factors I'll explain in our segment results.

Activision Q4 segment revenues grew 6% year-over-year to $1.41 billion and operating income increased 14% year-over-year to $723 million with monthly active users increasing double-digits quarter-over-quarter to 53 million. The primary driver for the Activision segment was Call of Duty, which generated more upfront sales than any other console franchise worldwide in 2018, a feat the franchise has accomplished for nine of the last ten years.

Black Ops 4 sell-through more units than Black Ops 3 in its launch quarter with PC units more than tripling and engagement was strong with average hours per player increasing versus Black Ops 3 as players joined Blackout, Multiplayer and Zombies. We also saw a significant shift to digital this year, with full game downloads representing over 40% of console sell-through versus approximately 30% for World War II.

However, sales of Black Ops 4 in the second half of the quarter were below our outlook, due to weaker-than-expected retail demand, lower-than-anticipated pricing, and other promotional activities that didn't meet expectations. Now, though Black Ops 4 in-game net bookings started off slower than expected following the introduction of the new in-game system, we were encouraged by the response we saw when we introduced more compelling content with the second season of events in late Q4.

Turning to Destiny, the mutual agreement with Bungie to sell back the commercial rights to Destiny and eliminate our ongoing investment in the game did not have a material impact on Activision segment operating income in the quarter, but will free up capital and development resources for the future. We also continued to drive strong performance for the beloved intellectual property from our library, following the successful launch of Spyro in Q4. And the ongoing contribution of Crash Bandicoot, which has sold in over 10 million units since its 2017 release, again highlights the enduring nature of our classic franchises.

Overall, Activision delivered meaningful year-over-year growth for segment revenue and for operating income. And with the changes we are implementing in 2019, we expect to drive even stronger performance in the years to come.

Blizzard was a more nuanced story in Q4. On the one hand, we grew Q4 segment revenues to $686 million and operating income to $241 million. And Blizzard had 35 million monthly active users in the quarter, as Overwatch and Hearthstone saw sequential stability and World of Warcraft saw expected declines post the expansion release this summer. On the other hand, the relatively consistent monthly active user trends for Blizzard's communities were not matched by in-game net bookings, which continued to soften. In particular, Overwatch and Hearthstone both experienced sequential declines in net bookings from players making in-game purchases.

Lastly, Blizzard results benefited from the continued success of our business in China and the extension of our partnership with NetEase. Building on our 11-year joint venture, the expanded agreement runs until January 2023 and reflects the substantial value and opportunity for Blizzard's content in China. While the majority of the economics from our renewed arrangement will be recognized over the next four years, Q4 did benefit from the agreement, which was contemplated in our outlook. Now I'll go into more detail in a minute, but increasing the flow and the frequency of compelling in-game content and upfront releases to serve the needs of our players is the number one goal set by the new Blizzard leadership team going forward.

Finally, King grew segment revenue and operating income year-over-year as it continued to recover from the network incident experienced in the second quarter. Q4 segment revenues grew 5% year-over-year to $543 million and operating income increased 28% year-over-year to $207 million. King monthly active users of 268 million grew sequentially for the first time since we acquired the business in Q1 2016, driven by the successful launch of Candy Crush Friends in October.

Candy Crush Friends is seeing strong monetization and retention trends, contributing incremental growth for the Candy Crush franchise, which overall grew net bookings and monthly active users, both quarter-over-quarter and year-over-year. This encouraging performance sets the foundation for King to ramp its marketing support and drive further growth for Friends in 2019. Now importantly, our advertising initiative continued to gain momentum, growing net bookings over 50% sequentially and again profitably, as the team continues to execute against this sizable opportunity.

Now taking a step back and looking at our full year results for 2018. We delivered record GAAP revenue, GAAP and non-GAAP EPS and net bookings. We continue to make encouraging progress in mobile, advertising and esports. However, in-game execution was inadequate for some of our franchises and we saw weaker than anticipated retail demand. As you will hear from Dennis, our 2019 outlook assumes that we will not improve in-game monetization as quickly as we would like, and that it is a transition year where we have less new major content to release than we should.

So, we have worked with our new business unit leaders to undertake a comprehensive examination of our business to determine the changes we need to make to improve execution and capitalize on the substantial long-term growth opportunities for our company. We've determined that we need to refocus our best resources on our biggest opportunities and to remove an unnecessary level of complexity and duplication that has built up in certain parts of the business. We have therefore developed a clear plan for this year to refocus and reinforce the foundation for growth.

This refocus includes initiatives developed by our new business unit leaders, each of whom has demonstrated the ability to combine creative excellence with a commercial focus on profitable growth. First, we are investing more in development for our biggest internally owned franchises across upfront releases, in-game content, mobile and geographic expansion. Second, we are deprioritizing initiatives that are not meeting our expectations and reducing certain non-development and administrative-related costs across our business. Third, we are integrating our global and regional sales and go-to-market partnerships and sponsorships capabilities across the business, enabling us to better leverage talent, expertise and scale on behalf of our business units.

Our restructuring plan sheds investment in less productive non-strategic areas of our business and will result in a net head count reduction of approximately 8%, while also driving a significant increase in investment, focus and capabilities around our biggest franchises. We're confident that over time this plan will enable our teams to accelerate the delivery of high-quality content to our communities.

Specifically, as we reallocate resources and hire new talent, we are planning for the number of developers working on Call of Duty, Candy, Overwatch, Warcraft, Hearthstone and Diablo to increase in aggregate by approximately 20% over the course of the coming year. For Call of Duty, Activision management expects additional resources to deliver more frequent content updates and events for the franchise and accelerate its expansion across platforms and geographies.

We also intend to build on our experience with the Overwatch League to launch a professional city-based Call of Duty league that drives franchise engagement and represents a sizable incremental economic opportunity. We are also increasing coordination across our Call of Duty studios with unified development leadership and more unified tools and technology to create a more consistent user experience and leverage our development scale and expertise. For Candy, King management will increase its focus on growing reach and monetization with in-game content features and events with a substantial increase in Candy development resources. The advertising business will continue to add engineering and direct sales resources to support our plans for strong revenue and operating income growth in 2019 and beyond.

The Overwatch team is also growing, as it focuses on delivering a significant content pipeline in the coming years and the Overwatch League remains a key strategic focus where we will grow the number of resources involved to drive an expanded product and year-on-year revenue growth. World of Warcraft is an example of a franchise, where Blizzard has already established a regular cadence of major content and in-game operations. Additionally, Blizzard is investing in other Warcraft games working on more ways for the community to engage, with this enduring and beloved franchise.

For Hearthstone, additional development resources will help to release content that is both broader and deeper, and to optimize the game to deliver an even better mobile experience for its global audience. And Diablo's development head count will grow substantially, as the teams work on several projects underway for the franchise as well as the global launch of Diablo Immortal. Overall, Blizzard's management is reinforcing its pipeline with more resources than ever before to support planned mobile titles, several PC and console releases, and whilst continued cadence of content.

Finally, as a company, we will continue to invest in breakthrough new ideas and incubation, with focused resources and some of our best creative talent. With 2019 set to be a quieter year for upfront launches, now is the right time to implement this plan. Work is already underway across the company as we speak. We expect to have completed North American components of our plan by the end of Q1, with implementation of the international components by end of year. And we have already started to increase developer resources on our biggest franchises, and we'll be aggressively hiring talent in the coming quarters.

As we look forward to the coming years, we plan for all of our major franchises to be operating at scale and capitalizing on opportunities that include robust ongoing live operations and regular content launches both large and small, strong mobile experiences available for all of the communities to enjoy, new engagement and monetization models including where appropriate esports and advertising. And underpinning all our franchises will be our deep relationships with growing and vibrant communities which are increasingly direct and digital.

In short, we are refocusing the entire company to return to the franchise focus that has fueled our long-term success and to better leverage the scale of our business for future growth.

I'll now turn the call over to Dennis to provide our outlook for 2019. Dennis?

Dennis M. Durkin

Thanks, Coddy. Before I discuss the 2019 and Q1 outlook, I just wanted to take a moment to say how excited I am to be back and to return to a more day-to-day operational position as the CFO as well as a leader of our Emerging Businesses. We have a tremendous team and although we have a lot of work in front of us, I see a stronger pipeline and more opportunities for long-term growth than ever before. As Bobby and Coddy mentioned, 2019 will be a transition year for us as we implement change to enable our teams to create better content for our biggest franchises more quickly. Given limited frontline releases, the organizational work underway and the current competitive environment, we're planning for this year to be down year-over-year.

I'll first go through the segments including slate to provide some context for the outlook, starting with Activision. The main driver for the segment will be the Call of Duty franchise. Heading into 2019, we have momentum to build on given the launch of Black Ops 4 with the franchise yet again number one globally in upfront sales in 2018. We will continue to optimize in-game content this year to drive ongoing engagement and player investment.

And in Q4, we will have another major launch for the franchise that will appeal broadly to both existing and new fans with what I can only describe now as a great step forward in the franchise that is also rooted in some of the franchise's most important history. We have high expectations for the game, but for modeling purposes, we are conservatively planning on upfront Q4 unit sales to be lower than Black Ops 4. We will also bring Call of Duty to mobile with our partner Tencent. Although, as you would expect, we take a conservative approach in assuming no material operating income from this initiative this year.

Outside of Call of Duty, we will release Sekiro in Q1 and our strategy of reimagining classic franchises will continue with Crash Team Racing on multiple platforms later this year. We will not generate material revenue from Destiny in

2019, following the sale of publishing rights to Bungie. Excluding Destiny in both years, our outlook is roughly flat for net bookings for the rest of the Activision segment in 2019.

Turning to Blizzard, we expect materially lower financial performance this year. 2018 benefited from the release of World of Warcraft: Battle for Azeroth, whereas we are not planning a major frontline release for Blizzard in 2019. And Blizzard exited 2018 with softness towards in-game revenues that will take time to stabilize and return to growth. While these factors will weigh on Blizzard's financials this year, looking further ahead, Blizzard's pipeline of PC, console and mobile content is richer than ever and we expect a significant addition of development resources to accelerate the pace of delivery over time.

Finally, King is entering 2019 with momentum as it continues to recover from the network incidents it experienced in Q2. The business will continue to face tougher comps in the first few months of the year until it crosses the anniversary of this disruption. Nonetheless, we expect segment revenue to grow modestly year-over-year driven by growth for the Candy franchise and the continued ramp of our advertising business.

Bringing all this together to the total company level, our outlook incorporates net bookings declining 13% year-over-year. The Blizzard segment represents the majority of this year-over-year change given its 2019 release slate and in-game performance. The lower net bookings from Destiny is also a factor. The lower net bookings performance translates into lower segment operating income and our outlook assumes a high teens year-over-year decline. Again, the Blizzard segment drives the majority of this change.

Activision segment operating income is also expected to be lower due to the following factors. First, we are planning to invest more in Call of Duty this year including the support platform and geographic expansion. And second, we will not generate meaningful operating income from Destiny this year. Although, I would note that this is consistent with our planning assumptions where we too have continued publishing the game. King segment operating income is planned to be roughly flat, as we invest in Candy marketing to build on the encouraging start for Candy Friends.

Finally, I would note that we are planning for a higher tax rate this year. While our 2018 GAAP tax rate included one-time benefits from U.S. tax reform and our IRS settlement, both our GAAP and non-GAAP 2019 rates incorporate the full impact of new international tax provisions.

With that context, I'll detail the financial guidance for 2019 and Q1. On a GAAP basis for 2019, we expect revenues of $6.03 billion, including GAAP deferrals of $275 million. We expect net bookings of $6.3 billion; product costs, game operations and distribution expenses of 24%; operating expenses including software amortization of 56%; and a GAAP-only charge of approximately $150 million relating to the restructuring plan Coddy outlined.

We expect GAAP and non-GAAP net interest expense of zero, a GAAP tax rate of 24%, GAAP and non-GAAP share count of 775 million and EPS of $1.18. For 2019 on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 24% and operating expenses including software amortization of 46%. We expect a non-GAAP tax rate of 20%, and non-GAAP EPS of $1.85, which includes GAAP deferrals of $0.25.

For Q1 on a GAAP basis, we expect revenues of $1.72 billion, which includes the recognition of GAAP deferrals of $540 million. We expect net bookings of $1.18 billion; product costs, game operations and distribution expenses of 20%; operating expenses including software amortization of 57%; and we expect approximately $100 million of the GAAP-only restructuring charge we booked in Q1. We expect GAAP and non-GAAP net interest expense of zero, a GAAP tax rate of 24%, GAAP and non-GAAP share count of 772 million and EPS of $0.39. And for Q1 on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 20% and operating expenses including software amortization of 43%. We expect the non-GAAP tax rate of 22% and non-GAAP EPS of $0.63, which includes the recognition of GAAP deferrals of $0.43.

Turning to capital allocation, I wanted to spend a moment to quickly review our historical track record just as context. As most of you know, we have always taken a disciplined and balanced approach to capital allocation. We view a strong balance sheet as a strategic asset and while our focus in recent years has been on paying down debt with over $4 billion repaid in the last five years, we've also returned almost $11 billion to our shareholders over the last decade with around $2 billion in dividends and $9 billion in share repurchases.

With this balanced approach in mind, our Board has authorized the following; a 9% increase in our dividend to $0.37 per share payable in May; and also a new two-year $1.5 billion share repurchase authorization.

Before I conclude, I wanted to summarize the company's position heading into 2019. We continue to have a tremendous potential in front of us. Our combination of leading owned franchises, a direct digital connection to our consumers, best-in-class developer talent and geographic platform and business model diversity creates a powerful foundation for longer-term growth.

We must and will relentlessly focus on the world-class execution, business excellence and quality content delivery that has been the backbone of our company and business for many years. Our plan to increase our focus on our core franchises is consistent with that approach and I'm confident that executing against our plan will position us to deliver strong results and shareholder value over the long term.

Looking ahead, I look forward to updating you on our results as we make progress throughout this year. Now I welcome our business leaders, Riccardo, Humam, Rob and J. as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] We'll go first to Colin Sebastian with Robert W. Baird.

<Q - Colin Alan Sebastian>: Great. Thanks for taking my question. And welcome back, Dennis. I appreciate the comments on the restructuring and hoping you could provide a little more color on the reallocation of resources, and in particular, discuss how and when we can expect that effort to translate to a return to growth? Thanks.

<A - Collister Johnson>: Sure. Thanks, Colin. This is Coddy. I'll take that one. I guess stepping back as we shared during the call, our plan is focused on delivering growth in reach, engagement and player investment, and there's really big three areas of it. One is refocusing on our own franchises, where we feel like we had the highest opportunity for growth. Two is making sure we have the right amount of development resources to then go deliver great content within those franchises to our player communities, and then where appropriate benefiting from company scale and removing duplication and inefficiency.

And so to do this with the new leadership teams, there's three specific and important changes as we head into 2019 that we plan to deliver. The first is investing in development on our main franchises, as I mentioned, a 20% increase to drive the content in cadence and pace. Second is reducing and eliminating initiatives that are not meeting our expectations and also areas where we can find duplication and remove it. And then third, integrating our global and regional sales and go-to-market and partnerships and sponsorships, so we can leverage scale. We know we have a global fan player base that is looking for content on a regular cadence, to come more quickly and to come across multiple platforms and we think we have set up each of our operating divisions to be able to deliver on that. But we also think we've better set up the company to be able to deliver on that as we leverage those areas, where scale can really help to bring our content and our franchises out to the world.

Now as for timing, and as you see those effects, we're only guiding to 2019 today, but what I can say is that we are confident in the growth opportunity ahead of us. Our increased focus, our investment, leaning into our big franchises, it's a sign that we are headed towards a place where growth, given the right resources, given the right plan, can be realized.

<Q - Colin Alan Sebastian>: Thanks.

<A - Christopher Hickey>: Operator, can we have the next question please.

Operator

We'll now take a question from Evan Wingren with KeyBanc Capital Markets.

<Q - Evan Wingren>: Yeah. Just wondering if you could provide us a bit more commentary on the components of your guidance for fiscal 2019, how you see your franchises performing and how you see the seasonality of the year unfolding.

<A - Dennis M. Durkin>: Yeah. Thanks, Evan. It's Dennis here. Happy to provide some color on that. I guess, first just kind of helicoptering up a little bit, there are a few things to think about as it relates to our outlook. I think the first point is obviously the one relative to our release slate, which is diminishing this year or down this year, and it does obviously impact our outlook.

In addition, the in-game softness that we saw exiting 2018 caused us to enter the year at a slightly lower trajectory than last year. And although we have a plan to turn that around, it's going to take some time. And so we don't actually assume a full recovery of that in 2019. And then, we also are pretty conservative in terms of how we plan for some of the newer things in our pipeline like our mobile games. We do obviously shoot for breakout hits, but it's very hard to obviously prudently plan for those in your outlook. So we're obviously more conservative on that.

And then the last piece, I would just say is relative to our tax rate. You heard a few of the comments about it being up because some of our international considerations this year. So those are the main considerations, I guess just relative to the overall outlook. As it relates to seasonality, given the limited number of product launches this year, Q4 will again be a very important quarter. Again, we've tried to take a prudent approach relative to that assuming that Call of Duty units are down year-over-year in our outlook.

I would say that the team that's building this new game for us in Activision is building what they believe is the best Call of Duty we've ever built. And so that team is certainly targeting growth even though we haven't put it in our outlook in that fashion. So I guess just stepping back, our approach relative to guidance and my approach to guidance is really, for this year is really consistent with how we've set guidance in the past. And a careful approach to guidance I think is always appropriate, but particularly this year given the changes in the industry and the amount of work we need to accomplish this year. So, thanks for the question, Evan.

<A - Christopher Hickey>: Operator, can we have the next question.

Operator

We will now take a question from Ray Stochel with Consumer Edge Research.

<Q - Raymond L. Stochel>: Great. Thanks so much for taking my question. This is for Rob. Can you quickly tell us about how you're thinking about leading Activision? And then give us an update on the Call of Duty: Black Ops 4 launch and how that game is trending so far. Thanks.

<A - Rob Kostich>: Hey. Thanks for the question, Ray. So I've been at Activision for about 15 years now and I've touched just nearly every part of the business. And what I really look forward to is taking all those experiences and applying it in this broader capacity. At a high level, I'm really focused on two things right now. It's our players and our people. Very simply, I'm very committed to our players and over-delivering on their expectations. That is just something we must do. Now behind it all is our people. They're world-class. They are our foundation and we want to continue to invest in them and to create an environment for them to do their best work.

Now if I step back from an Activision perspective and look at the business, we do have a lot of opportunities right in front of us, in Mobile, in PC expansion, in geographic expansion, especially in Asia, in eSports, as was mentioned on the call already, and of course in business models that continue to arise in our industry and create opportunity for us. And as a division, we have specific initiatives against each of these in progress that we're excited about.

Now in terms of Black Ops 4, as Coddy mentioned, it delivered better unit sell-through than Black Ops 3 in its launch quarter. So what we have is a really strong foundation of players right now and our biggest objective is driving ongoing engagement with our community.

Now, the good news is, we have our best in-game content coming still. Our next event on February 19 will be what we believe is our biggest and best in-game event and it's going to have significant updates across all modes and we're looking forward to see how that lands and resonates with the community.

And then if I look even further at to what Dennis mentioned, it's worth mentioning again, this fall's launch I think is going to resonate very powerfully with our community. It is an amazing game. It's going to feature an entirely new campaign, a huge and expansive multiplayer world and of course some fun co-op gameplay.

But from day one, what gets me really excited is every time we've shown this title internally it's just created a ton of buzz. Now I wish I could tell you a lot more right now, but unfortunately you're going to have to wait, but I think it's going to be really worth it. We can't wait to share it with the world. So thanks for the question, Ray.

<A - Robert A. Kotick>: And I would just add, Ray, it's Bobby, that when you look over the last decade of Call of Duty content, I think that Rob is underselling what the internal enthusiasm is. I haven't seen this much enthusiasm that I can remember almost ever. So, we're excited about the fall release of Call of Duty content.

<Q - Raymond L. Stochel>: Great. Thanks again for taking my question.

<A - Christopher Hickey>: Thanks. Operator?

Operator

Our next question will come from Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Thanks for taking my question. One for probably J. I guess, the question, J., is what is the new management team doing just to make sure that Blizzard is back on track to executing as one of the top studios as it should be? Thanks.

<A - J. Allen Brack>: Yeah. Thanks for the question. I think one of the things that I feel like it's important for us to talk about is we're bit of a new leadership team. And as we've come together, it's clear that we believe a lot in our future and that we have a lot to prove from both the game and kind of a content delivery standpoint.

I think we have a huge amount of opportunity. We have fantastic IPs. We have lots of games that we want to create and we have a very passionate community that is hungry for all of the things that we can produce.

So we have two big goals going forward. And the first one is, of course, make excellent videogames. The second is, to find ways to deliver more content to our player communities. To meet these goals, we need to work to increase the amount of content that we're delivering. Right now we have the largest lineup of PC, console and mobile games that we've ever had, and we're working to meaningfully increase the development capacity and the development head count.

That investment in developing the talent is – has really required us to make some difficult trade-offs. We're going to – as Coddy mentioned, we're going to reduce our non-development positions at our offices around the world, specifically looking at our SG&A and non-core business units. This was a very, very difficult decision, I'd say it's a top five career difficult moment for me personally, but we're committed to doing everything that we can to help get us into a good position going forward.

We really want to serve our players and we want to serve our communities in the best possible way and be a great creative organization. As difficult as kind of all this is, I think we're happy about the things that we're working on. We're working very hard to live up to our mission and we really look forward to the community, and you all seeing the results of this increased development work over time.

<A - Rob Kostich>: Can I just say, it's really terrific for the company to have J.'s leadership. He's humble about his experiences. When you think about World of Warcraft and Hearthstone and the Warcraft franchise, it's been one of the most successfully led franchises in all of video games and we couldn't be happier to have J. in the role that he's in.

<Q - Brian Nowak>: Great. Thanks.

Operator

We'll now take a question from Alexia Quadrani with JPMorgan.

<Q - Alexia S. Quadrani>: Thank you very much. I guess my question is, given one of your competitors' decision to launch a free-to-play Battle Royale game, are you rethinking the monetization model for any of your own games, maybe including Overwatch?

<A - Collister Johnson>: Sure. This is Coddy. Thanks for the question. I guess, maybe a couple key points. First, stepping back, one of the things that sometimes gets lost in the discussion on economic models is the player and game experience itself. Our north star is to deliver compelling and engaging gameplay, full stop. Without that there are no economics.

The second point is that the economic model has to work with the franchise and the community and the gameplay. They need to work to reinforce each other and we feel like we're in a pretty unique position, honestly across the industry and that we have multiple business models running at scale across our franchises today. We have free-to-play games, micro transaction-based games, games with an upfront charge or with a subscription. We also now have advertising, which is growing as well. And we think that provides a range of options for our product and development teams to look across and pair the best economic model with the best gameplay experience.

One thing we know though is that we need to be able to move more quickly and we need to be able to rapidly evolve with the demands of our players in the market. And that's why as I mentioned, we are investing significant development resources in our core franchises to be able to move more quickly on behalf of our players and to be able to take advantage of new business models.

And on the free-to-play part of your question in particular, obviously the most proven platform is mobile. So as we increasingly bring Activision and Blizzard IP to the mobile space, you will see us deploy more free-to-play models. Embedded in your question that was also the fact that we see competitors now on PC and console going free-to-play and I just emphasized again that we believe our investment and resources coupled with our strong IP leaves us in a really good position to take advantage of evolving business models in our industry.

The last thing, I'd say and it's just worth mentioning is that the success we see with titles like Call of Duty or even recent competitive launches shows that a really well-built, well-polished AAA experience for players can come still with an upfront charge and it can be a great player experience and a great business model. So looking ahead, we'll continue to evaluate all our games across our franchises and use the models that we think best both for the player experience and for our business.

<Q - Alexia S. Quadrani>: Thank you very much.

Operator

Our next question will come from Mike Hickey with Benchmark Company.

<Q - Mike Hickey>: Hey, guys. Thanks for taking my questions. Just focusing on your key segment, I'm hopeful you can provide more color on your Candy Friends launch, I guess, how it went from your perspective and how it's performing now would be really helpful? Thank you.

<A - Humam Sakhnini>: Hey, Mike. It's Humam here. Thanks for the question. So, Candy Crush Friends launched in October. It's been a great addition to the franchise. The game has really got a lot of great new game modes and mechanics, and we really think it's our most polished title ever. And it's brought a lot of the franchise characters to life like never before. What I would say is that after many years of the teams operating the Candy franchise at scale they've really brought all their learnings into the Candy Friends experience. And what we're seeing is that that's paid-off. It's really showing some strong retention and the game's per-player monetization metrics are well ahead of where the franchise's other titles were at a similar point post launch.

And again, it really reiterates and demonstrates how kind of the years of experience operating Candy were funneled into the Candy Friends title. So we're off to a great start and we have more plans in 2019. The way I think about it is we're still in the launch mode with Candy Friends and this is the year where we make marketing investments to support the title. And while we're doing that, the teams have some really strong plans to drive engagement and monetization trends with some proven features in the pipeline to continue to delight the players. So overall very pleased with the momentum, and I expect that the game will really help drive the Candy Crush franchise growth in 2019.

<Q - Mike Hickey>: Thank you.

Operator

We'll take our next question from Tim O'Shea with Jefferies.

<Q - Timothy O'Shea>: Yes. Thank you for taking my question. So with Overwatch League season two launching soon, I just thought it made sense for an update on that franchise. It's been over two years since the game launched and we've talked on prior calls, and again on this call about the lower revenue level. So I'm wondering, what's the strategy to address this issue? And does Blizzard have the development capacity to deliver sufficient levels of new content into this franchise? Thank you.

<A - J. Allen Brack>: Thanks for the question. This is J. I think it's important to mention the job the team has done with Overwatch. We feel really strong about the overall IP, the universe, the characters and the story potential, along with the global appeal for the game. And we really built Overwatch League around that with early good results.

Delivery of more content in Overwatch is something that's really important and something that we're focused on. The team is delivering new heroes and new maps and new experiences. And as you mentioned, the game revenue has declined recently. I think that the community engagement with the game remains strong.

There are a lot of new ideas for the Overwatch franchise. We feel like the Overwatch that you know is just a small part of what we can imagine for the overall franchise, and the team has a very clear plan. In order to deliver on that, we're going to increase the size of the Overwatch team meaningfully. But keep in mind that we're going to need to balance the existing live content with new products and different kind of support for Overwatch League. I'm really confident that the community will be very excited when we kind of release the things that we're working on.

Regarding Overwatch League specifically, we saw a great community response and lots of early success. That took a lot of focus. But overall, we think it's the right decision. It's been the right decision for the game and for the franchise. We're about to kick off the second season and that's going to start on February 14. That'll introduce eight new city teams. It will introduce home and away matches for some teams for the very first time. And the first match that's actually going to kick off is going to be a repeat of the grand finals between London and Philadelphia. So, overwatchleague.com is where you can see that.

<A - Christopher Hickey>: Operator, can we have the next question, please?

Operator

We'll take our next question from Brandon Ross with BTIG.

<Q - Brandon Ross>: Hi. Thanks for taking the question. I was just hoping you could provide a little more color on your rationale for parting ways with Bungie and the Destiny franchise and kind of what happened with that game? Thanks.

<A - Collister Johnson>: Sure. Thanks, Brandon. This is Coddy. I guess let me say first that we're confident that this was the right decision for both parties. Bungie gets to focus on the IP that they created, and we get to focus on our biggest opportunities on our biggest franchises with our best resources.

Our decision was reached via mutual agreement with Bungie to sell back the commercial rights. And for us at least, it was rooted really in our strategy overall. First, as you know, we didn't own the underlying Destiny IP and we do for all our other major franchises, which we think is not just a differentiator for us in the industry, but also controlling the underlying IP gives us the chance to move into new experiences and new engagement models, which also come with new revenue streams, and of course, structurally higher economics when you own the IP.

And that leads to probably the second factor in our decision process, which is Destiny, it is highly critically acclaimed, high quality content, but it was not meeting our financial expectations. As we went through at the end of the year our financial planning for 2019, it indicated that Destiny would not have been a material contributor in operating income to our business.

And third, we had internal resources supplementing Bungie's work, and that means they're tying up one of our scarcest resources, which is developer time, which now under the arrangement we've reached will be freed up after a short transition period.

So late last year when we were exploring all our options on Destiny, in November after our earnings release, we learned that Bungie was willing to acquire our rights and we engaged in discussions with them and ultimately wound up consummating the deal in late December, and it was a mutual amicable agreement. And I'd just emphasize, I really do think for both parties this is the right path forward and it allows us to go implement the plan that we talked about today.

<Q - Brandon Ross>: Thank you.

<A - Christopher Hickey>: Operator, can we have the next question please.

Operator

We'll take our next question from Matthew Thornton with SunTrust.

<Q - Matthew C. Thornton>: Hey, good afternoon everybody. Thanks for taking the question. Maybe \ you could just update us on just timing around some of the mobile initiatives at both Blizzard and Activision, including China as well as rest of world. Any updated color there would be helpful. Thanks, everyone.

<A - Collister Johnson>: Sure. Thanks, Matt, for the question. This is Coddy again. As you heard in our prepared remarks, mobile is a top priority for us and we think it's one of our largest opportunities, particularly with our global IP, which we think is really well-positioned to bring to the mobile platform.

We see this every day with King where you have a franchise at scale globally, but we also see it with other great franchise IP like Hearthstone where bringing that game to mobile brought in tens of millions of new players that are engaging in an ongoing and deep way with us. The thing to note is mobile game teams, while smaller than PC or console, they still require time to prototype and to test, and particularly for us and our franchises where we have high community expectations when we bring them to market, we want to do it right.

That said, part of the announcements today and the work that we're doing and that we highlighted, is to make sure that we're adding the right resources and enough resources to accelerate our mobile pipeline. Given the size of the overall opportunity, it's not just internal. We are working with external partners. We have multiple projects underway across the portfolio in various stages of development. And as you know we've announced to Call of Duty mobile and also Diablo Immortal.

And you asked sort of about both in status. They're both hard at work. We have no additional announcements to make at this time, but in both cases we're looking to make sure that the IP is really well represented. For Diablo it's an authentic and immersive deep experience that we think getting it there has large global potential, and so it matters to get it right and we'll share more about our titles and release dates as that comes to fruition.

<A - Christopher Hickey>: Operator, we have time for one last question please.

Operator

And we'll take our last question from Kunaal Malde.

<Q - Kunaal Malde>: Thank you. You mentioned that King advertising net bookings were more than 50% sequentially. It would be great if you could provide us with some more color and your expectations in 2019?

<A - Robert A. Kotick>: Well, this is Bobby. I would say...

<A - Humam Sakhnini>: This is Humam – go ahead, Bobby.

<A - Robert A. Kotick>: Go ahead, Humam.

<A - Humam Sakhnini>: I was just going to say, Bobby, that I'm going to sit back and just think about the business in a few phases. First, we decided that we really needed to add product that worked and is differentiated. So, we went and invested in the right teams to drive that, and I think, it's paid off. We have a pretty good and differentiated native ad product that is working quite well with player satisfaction on the inside and increasing on monetization.

And in 2017 and what you saw in 2018 was we scaled the business by lighting up more of our inventory and adding more impressions in our network, and that was a key driver as we started scaling the business. And we hit some important financial milestones in the year in 2018, first, profitability in Q1, and then growth in every quarter after that.

And I think the ad business is going to start to be meaningfully contributing to the King overall. So we expect it to cross the $100 million booking threshold this year. And as I look ahead, I think on the next phase about where the ad business heading, it's about continued scaling. So, we will continue to scale more and in fact the ad network at King and we have more work to do there to enable it in more of our games and we're continuing to educate our demand partners on kind of the power of our ad product and there's really good momentum there. And I think kind of after that, we will think about even more ways to deploy the ad product. It could be in new mobile experiences or eSports. I think the team has a ton of learnings and potential that could be applied in there.

<A - Robert A. Kotick>: Yeah, and I would just add. I think, it's an excellent team. The ad product is excellent. They've started to make real inroads in getting people to better understand what the opportunities for advertisers is, and I think that I'll just echo Humam's sentiment that there's a lot of momentum in that business.

Christopher Hickey

And that I think concludes our call today. I just wanted to on behalf of our team here thank you all for your time and engagement today. And we look forward to seeing many of you on the road or up to our next earnings call. So thanks very much.

Operator

And this concludes today's call. Thank you for your participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2018-11-08
Event Description: Q3 2018 Earnings Call

Market Cap: 47,911.95
Current PX: 62.79
YTD Change($): -.53
YTD Change(%): -.837

Bloomberg Estimates - EPS
Current Quarter: 1.306
Current Year: 2.617
Bloomberg Estimates - Sales
Current Quarter: 3051.524
Current Year: 7481.545

Q3 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- J. Allen Brack
- Riccardo Zacconi

Other Participants

- Timothy O'Shea
- Colin Alan Sebastian
- Raymond L. Stochel
- Drew Crum
- Brian Nowak
- David Karnovsky
- Michael Olson
- Brandon Ross
- Evan Wingren

MANAGEMENT DISCUSSION SECTION

Christopher Hickey

GAAP and Non-GAAP Financial Measures

We will present both GAAP and non-GAAP financial measures during this call

Non-GAAP financial measures exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses, and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefits of these excluded items, and the impact of certain significant discrete tax-related items

- These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results

We encourage investors to consider all measures before making an investment decision

Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures

- There’s also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call

In addition, we will be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary

Robert A. Kotick

Business Highlights

Opening Remarks

- Our results for Q3 exceeded our prior outlook, as we continue to entertain large audiences, drive deep engagement, and attract significant audience investment across our franchises
- Last quarter, on average, 345mm people played our games each month, and our players spent a record 52 minutes per day playing Activision, Blizzard, and King games
- Our unique advantage is the ability to create the most compelling interactive and spectator entertainment based on our own franchises combined with our direct digital connection to hundreds of millions of customers in over 190 countries
  - With these competitive advantages, we continue to connect and engage the world through epic entertainment

Now Offer Content

- Very few companies are able to consistently deliver compelling content to hundreds of millions of customers
- Fewer still can provide their audiences with flexible methods of payment for that content
- For our hundreds of millions of customers, we now offer content on phones, computers, and video game consoles, and subscription billing, direct digital download billing, virtual item sales, digital advertising, and of course, we still sell our products through tens of thousands of stores around the world

New Call of Duty

- As an example of the breadth of our capabilities, we launched Call of Duty: Black Ops 4 on October 12
- Ordinarily, we launch new Call of Duty titles this week in November
- But we believe holiday customers, of which there are millions, will benefit from more players in the game earlier

Marvel Cinematic Universe

- Our engagement to date is better than any Call of Duty content in recent years, and spectator viewing is higher than ever before
- As a franchise, Call of Duty has now generated more revenue than the Marvel Cinematic Universe in the box office, and double that of the cumulative box office of Star Wars
- We have an exciting future planned for Call of Duty players, including our new Call of Duty professional player opportunities, and lots of exciting new content in 2019 and beyond

Advertising Initiatives

- We remain focused on the key growth drivers of our business that we believe present meaningful revenue and engagement upside, including live operations, mobile, and investment in new and growing franchise engagement models

- We're pleased with our early momentum in areas like our advertising initiatives, which continue to exceed our plans, as revenues grew almost 50% sequentially

Leadership Team

- And we are further strengthening our leadership position in esports, having now sold 20 teams globally to the Overwatch League at substantially higher prices because of league financial over-performance vs. our original plans, and the energy that was brought through the first season of the league by our new owners
- As always, we thank you, our community, our shareholders, and our partners as well as our talented teams around the world for all of their support and hard work

Collister Johnson

Operating Highlights

EPS Growth

- Activision Blizzard exceeded its outlook in Q3, and we remain on track to deliver our previous upwardly revised outlook for the year and double-digit EPS growth y-over-y
- We were able to achieve these results because of our incredibly talented teams comprised of the best creative and commercial leaders in the industry and their focus on the four key growth drivers of our business

New Launches

- First, our team produced new content releases that invigorated distant communities and bring in new audiences
- Second, our growing stream of live operations, which includes content, services, features and events that engage our franchise communities and encourage new players to join
- Third, the expansion of our existing franchises onto mobile, the world's largest platform, and the creation of new franchises
- And fourth, new and growing franchise engagement revenue models such as esports leagues and digital advertising

Call of Duty, World of Warcraft, and Candy Crush

- On the first driver, our teams continued to deliver exceptional innovation and execution with major new content releases for Call of Duty, World of Warcraft, and Candy Crush
- These content releases reinforce a strong foundation for our second growth driver, live operations
- We generate over $4B a year in net bookings from in-game content, which represents the growing majority of our net bookings, yet still offer some of the best value per hour in all of entertainment
- We see the continued improvement of our live operations model as one of our largest growth opportunities with the potential to generate billions of dollars of high-margin incremental revenue as we deliver year-round in-game content for our community

Innovation

- We have robust engagement in content roadmaps in place for our key franchises, including Call of Duty, World of Warcraft, and Candy Crush
- Now, not all our franchises are experiencing the momentum we see in Call of Duty and Candy Crush
- And we have to improve the pace of innovation and the cadence of in-game content, and our franchise and business unit leaders are all now committed to achieving that goal

Hearthstone

- On our third growth driver, the expansion of our franchises onto mobile, we know that many of the most successful mobile games today are based on intellectual property originally created for consoles and PCs
- As an example, we've seen this ourselves with Hearthstone, where the fan base grew significantly when we added the mobile platform to a game that isn't even yet fully optimized for mobile success

Collaborating with Tencent

- Mobile remains the largest and fastest growing platform for gaming in the world
- And while King is a clear leader in mobile, we're still investing in Activision and Blizzard franchises for mobile releases
- For example, Activision is collaborating with Tencent on Call of Duty Mobile, taking the biggest action franchise of the last two decades to the largest gaming market in the world, and of course also to western audiences where, as Bobby pointed out, Call of Duty is already one of the most successful entertainment franchises in history

Diablo Immortal

- And last week, Blizzard announced Diablo Immortal, which will bring this tenfold franchise to a mobile audience in both the east and the west
- While fan reaction was muted to the announcement, players' hands-on experience [indiscernible] (08:19) this content confirmed what we believe, which is that Diablo mobile will be a very well received game when it releases, and players around the world will love it
- These are just two of the many mobile initiatives underway across Activision and Blizzard
- And King mobile expertise is now being shared throughout the company so our beloved PC and console franchises can expand their reach

Overwatch League

- Lastly, on our fourth driver, in new and growing franchise engagement models, Overwatch League is already well into planning its second season, and we are actively advancing how the league model and infrastructure will be applied to Call of Duty and other franchises
- And our advertising business continues to grow profitably, exceeding our plan
  - While net bookings are still relatively small, they grew almost 50% quarter on quarter
- And while investment in these new initiatives is growing, we are confident in the value they will create for our fans and for our shareholders

Reach

- So with that framing for our growth drivers, let me share our Q3 results against our three key metrics, reach, engagement, and player investment
- Starting with reach, which was 345mm monthly active users in Q3, King monthly active users were 262mm, relatively stable through Q3, which is a positive outcome following Q2 partner network challenges we described on the last call

All-new Candy Crush Friends Saga

- Importantly, monthly active users for King's largest game, Candy Crush Saga, grew y-over-y
- And in October, King launched the all-new Candy Crush Friends Saga, which builds on five years of learnings in Candy with new modes, collection mechanics, and 3D visuals that make the Candy Crush characters and our owned IP more prominent and the game really fun to play

Candy Crush Friends

- Candy Friends targets the over 0.5B people who have played Candy Crush over the last five years, for whom the innovation and accessibility of Friends should be particularly appealing
- We're now focused on Candy Crush Friends to win back former players and entice new players
- The game is off to a strong start, reaching the top of the iPhone game download charts in 93 countries
- And while still early, retention and monetization trends are very positive, and the game is on pace to drive meaningful growth for the Candy franchise in 2019

Overwatch

- At Blizzard, monthly active users were 37mm, consistent with the prior quarter
- Overwatch monthly active users were broadly stable quarter over quarter
- Hearthstone monthly active users declined, although PvP modes again attracted strong engagement
- The game continues to add new players, with the franchise reaching 100mm players to date since its launch in March 2014

World of Warcraft: Battle for Azeroth

- World of Warcraft: Battle for Azeroth launched on August 14 and set a day-one franchise record by selling through more than 3.4mm units
- Engagement grew sharply quarter on quarter, and the expansion saw strong participation in value-added services, with more content on the way in Q4
- Next year, Blizzard will celebrate World of Warcraft's 15th anniversary with events both in and out of the game
  - This includes the highly anticipated release of World of Warcraft Classic, available as part of the franchise subscription

Core Destiny Fan Base

- Activision monthly active users were 46mm, up sequentially from Q2
- This sequential growth was driven by Destiny's expansion, Forsaken, and by new reach initiatives, which grew Destiny monthly active users quarter on quarter and y-over-y
- Now while Forsaken is a high-quality expansion with strong engagement and new modes of play, it did not achieve our commercial expectations, and there's still work to do to fully reengage the core Destiny fan base

Call of Duty: Black Ops 4

- Then in October, Activision saw step-change growth in its monthly active users following the very successful launch of Call of Duty: Black Ops 4
- Building from the foundation of Black Ops 3, which was the highest grossing game in Call of Duty franchise history, Black Ops 4 is off to a strong start, with creative innovation across all modes of play, including Blackout, which we see as the ultimate AAA Battle Royale experience

Net Bookings

- Unit sell-through after the first three weeks is pacing ahead of Black Ops 3, PC sell-through more than 3 times higher, and with significant shifts to full-game downloads
- Total active users in the first three weeks are up 16% over Black Ops 3, with strong growth across all modes, and engagement and hours played is up over 20% vs Black Ops 3
- So it's worth underscoring that given Black Ops 3 generated more in-game net bookings than any other Call of Duty title, this level of engagement in Black Ops 4 should result in strong in-game revenue in Q4 and into 2019
  - This brings me to engagement

Franchises

- Across all our franchises, daily time spent per user playing our games reached a new record of 52 minutes, based on some of the franchise reach and engagement drivers just highlighted
- Usage of our games is also up significantly
- And just last month, Activision Blizzard titles accounted for seven of the top 20 most viewed games on the industry's largest streaming platform, including Black Ops 4, where viewership continues to break franchise records

Overwatch League

- In the Overwatch League, we continue to build on the success of the inaugural season, announcing another 16 sales in September, spanning Europe, Asia, and North America, all at substantially higher valuations than team prices in the first season
- Nine of our now 20 teams are based outside the U.S. reflecting the global appeal of the league

BlizzCon

- BlizzCon, which is the ultimate celebration of Blizzard community engagement, drew millions of viewers around the world by live stream and over 40,000 fans in person

- In addition to the reveal of new content for every franchise, we announced the expansion of the Diablo franchise onto mobile with Diablo Immortal, codeveloped with NetEase
- Diablo Immortal was built from the ground up for mobile as an authentic Diablo experience that will make the franchise available to hundreds of millions of people around the globe
- We're confident when the game launches, it will be a great experience for new players as well as the extremely loyal and vocal Diablo community
  - We know how eager that community is to experience even more from Diablo
- When the time is right, the team will share more about what else they have in store

Player Investments

- Turning now to player investment, in-game net bookings were over $1B in Q3, which helped to set a YTD record of $3B
- King was the biggest contributor with two of the top 10 highest grossing titles in U.S. mobile app stores for the 20th quarter in a row, and Candy Crush Saga was again number one
- As I said earlier, some of our franchises are underperforming relative to the opportunity that we see in building our live operations capabilities, and we'll continue to push innovation and new content to drive stronger engagement and in-game revenue generation
  - Black Ops 4 is a great example of how successful we can be when we focus on improving engagement in our franchises
- We made the game even more engaging with active users and hours of engagement up sharply vs Black Ops 3
- With Black Ops 3, that engagement translated into significantly higher in-game revenues
  - We hope to further that opportunity with Black Ops 4
- So we continue to execute strong in-game revenue, and monetization should follow

Summary

In summary, while there is still execution risk in the year, we're pleased with the results of our recent major content releases of World of Warcraft, Candy Crush, and Call of Duty, and we are excited by the momentum behind engagement and live operations we see in some of most critical franchises: We remain focused on improving our live-ops revenue, engagement, and in-game performance across all franchises

We continue to execute on our promising mobile initiatives and expand our franchises to new engagement models, including esports and advertising

Spencer Adam Neumann

Financial Highlights

Revenue and Operating Profit

- Today I'll review our Q3 2018 results and our outlook for Q4 and the full year
- To review the quarter, I'll start with our segment results

- At Activision, Q3 segment revenue was $397mm
- Key contributors were Call of Duty digital in-game revenue and Destiny 2: Forsaken, although the latter underperformed our expectations
- Segment operating profit of $112mm was lower y-over-y vs. a quarter that included the Destiny 2 full-game launch and continued benefits from Q2 2017 release of Black Ops Zombies downloadable content and Crash Bandicoot
- Blizzard grew segment revenue 20% y-over-y, driven by World of Warcraft: Battle for Azeroth
  - This offset lower revenue for Overwatch and Hearthstone, with the latter facing a tough comp against the record launch of the Knights of the Frozen Throne expansion in the prior year
- Segment operating profit increased 13% y-over-y, as revenue growth offset investment in strategic initiatives, including Overwatch League, other esports activities, Battle.net, and franchise incubation across multiple platforms

Operating Income

- King segment revenue and operating income were 4% and 12% lower y-over-y respectively against a particularly strong quarter last year with no partner disruption
- As we noted on the last call, we started Q3 from a lower revenue base due to Q2 partner network disruption, but saw strong engagement and increasing monetization trends through the quarter

GAAP Revenue

- Now let’s turn to our consolidated results
- Unless otherwise indicated, I’ll be referencing non-GAAP figures
- Please refer to our earnings release for full GAAP to non-GAAP reconciliations
- For the quarter, we generated Q3 GAAP revenues of $1.51B, which was $22mm above our August outlook
  - This includes the net deferral of $146mm
- Net bookings of $1.66B were $43mm above our August outlook

GAAP and Non-GAAP EPS

- We generated Q3 GAAP EPS of $0.34 and Q3 non-GAAP EPS of $0.42, which was $0.18 and $0.05 above outlook respectively
- These figures include the net deferral of $0.10
- GAAP EPS benefited from a discrete tax item resulting from adjustments made to the provisional amount initially recorded for the U.S. Tax Reform Act

Cash Flow and Capital Structure Perspective

- Now from a cash flow and capital structure perspective, Q3 operating cash flow was $253mm, and we ended the quarter with approximately $3.4B in cash and investments

- Our strong cash position enabled us to pay down $1.7B of high-yield notes and floating rate debt in the quarter, reducing our go-forward net interest expense by roughly $40mm on an annualized basis
- In parallel, we expanded our revolver capacity from $250mm to $1.5B to provide us with increased levels of liquidity
  - These actions further strengthened our balance sheet and increased our financial flexibility

Outlook

Marketing and Other Commercial Initiatives

- Now let's turn to our fourth-quarter and our full-year outlook
- Before getting into the specifics, I want to provide some context
- As we noted on our last few calls, earnings in the year are heavily weighted towards our fourth quarter
- We expect Q4 to benefit from major content releases, strong in-game revenue, and key marketing and other commercial initiatives

World of Warcraft, Call of Duty, and Candy

- Our recent major launches for World of Warcraft, Call of Duty, and Candy were all very successful and will set the stage for continued opportunities in 2019
- Some of our other franchises, like Destiny, are not performing as well as we'd like, and we're working to accelerate the pace of live operations innovation and improve the speed with which we release new content to keep our players engaged and to provide new opportunities for monetization

FX Rate Headwind

- Also, our better performance than our outlook in Q3 included timing benefits and FX rate headwinds
- FX represents an approximately $40mm reduction to H2 revenue since we last provided a full-year outlook
- While we recognize that we face market and franchise headwinds and will continue to have execution risk through the end of the CY, we're confident in our strategy and in our team, and we're maintaining our revenue and non-GAAP EPS outlook for the FY.

GAAP Basis

- For Q4, on a GAAP basis, we expect: net revenues of $2.236B, including GAAP deferrals of $812mm; product cost, game operations, and distribution expenses of 23%; and operating expenses, including software amortization, of 55%
- We expect GAAP interest expense of $6mm, a tax rate of 28%, a GAAP and non-GAAP share count of 776mm, with EPS of $0.43

Expenses, Tax Rate and EPS

- For Q4 on a non-GAAP as redefined basis, we expect product costs, game operations, and distribution expenses of 23%, operating expenses including software amortization of 47%

- And we expect non-GAAP interest expense of $5mm, a tax rate of 23%, and non-GAAP EPS of $0.64, which includes GAAP deferrals of $0.63
- For 2018, on a GAAP basis we expect:
    - Net revenues of $7.355B, including GAAP deferrals of $120mm
    - Product costs, game operations, and distribution expenses of 23%
    - Operating expenses including software amortization of 53%

GAAP Interest Expense

- And we expect GAAP interest expense of $113mm, a tax rate of 9%, and GAAP and non-GAAP share count of 772mm, with EPS of $1.94
- And for 2018 on a non-GAAP as redefined basis, we expect product costs, game operations, and distribution expenses of 23%; operating expenses including software amortization of 44%
- And we expect non-GAAP interest expense of $70mm, a tax rate of 18%, and non-GAAP EPS of $2.46, which includes GAAP deferrals of $0.12

New Launches

- The foundation of our business remains strong
- Recent launches further strengthen our enduring franchises
- We’re focused on driving strong engagement and in-game performance across our entire portfolio, and we’ll continue to make progress in our mobile expansion and new engagement models, including leagues and advertising
- We’re committed to driving our four key growth pillars while maintaining the fiscal discipline that our shareholders expect, and we continue to see opportunities across the entire landscape of interactive entertainment

QUESTION AND ANSWER SECTION

<Q - Timothy O'Shea>: Just wondering if you could update us on the Call of Duty: Black Ops 4 launch, and maybe with an update on how that game is performing post-launch. Thank you.

<A - Collister Johnson>: Sure. Hey, Tim. This is Coddy. Well, we’re confident and we’re energized by the performance of Black Ops 4. The launch, as I said, is off to a strong start on both console and PC. As Bobby said, there’s a lot more time left now given the decision we made to launch it earlier in the holiday window and in the gift-giving window, which we think is a good opportunity for players to come in and join this highly engaging game.

And the Call of Duty team is doing what it knows how to do well, which is build a deeply engaging experience. And it’s just worth highlighting again what we know so far in some of the stats coming through, which is that vs. prior title and vs. Black Ops 3, total active users are up significantly. And overall engagement, again, vs. both the prior title and Black Ops 3, is up over 20%.

So that first period of building that deep engagement block of players that really want to come in and play is off to a good start. But we built it, as we said on multiple occasions, for long-lasting engagement. We doubled down on multiplayer in Zombies, which are already strong engagement drivers, and we added to that the kind of content and progression and system designs that you see in there to give deep playability and content for months and years to come. And we added Blackout, which is a deeply appealing mode, particularly for those who are looking for that AAA Battle Royale experience.

So the next step is just to continue to build out on the live system operations, the design. And really what is happening now is the live engagement or responding to players and seeing where they go and building the services and features that engage them even more deeply. So looking at it, we see a great run coming for Black Ops 4 and really for the franchise as a whole.

<Q - Colin Alan Sebastian>: I guess I'd like to focus a little bit on the leadership transition of Blizzard, and if you could put a finer point on what we should expect to see change and what should stay the same. And also related to that, if you could provide a little more color on the pipeline from Blizzard. Thank you.

<A - J. Allen Brack>: Hi, this is J. I'd like to just start off by saying that Blizzard is a hugely storied studio, and I couldn't be more honored to take on the role. I have been at Blizzard for more than a decade, but have really been a fan of their games my entire life.

Today, I have a strong view on many of our franchises, and I'm actively working to get a broader outlook on certain teams, certain commercial groups, esports operations that I don't already have a good view of from my previous job. Coming out of that process, I feel like I'll have a larger perspective on what the next chapter for Blizzard's growth is going to look like.

We're going to need to continue to invest in content in our existing franchises, and there's work to do to improve in some areas to better serve our communities and to create more content for all of our fans. That's our number one focus. And we'll continue to invest in the reach of the different franchises that we have to acquire more players globally across all platforms, including PC, console, and mobile. Right now, we have the strongest multiyear pipeline we've ever had, which is a huge opportunity, and delivering against that pipeline is our number one priority.

I think Blizzard's focus is always going to be on delivering quality game play first. And we have a strong culture of values, and we want to create more content and deliver more games. And we think that's going to lead to more players, more engagement, and it's going to lead to great business results.

<Q - Raymond L. Stochel>: How should we think about King's pipeline and your efforts in mid-core mobile titles vs. your historical success in more casual titles? Thanks.

<A - Riccardo Zacconi>: Hi, Ray. It's Riccardo here. So when I think about our development efforts, our focus is first to fall on cash flow and our franchises, and in particular on Candy Crush, since it's our largest franchise. We have a large network of users playing our casual games, and this is the key reason why our first priority is to retain and engage them. And for doing this, we invest in a steady stream of new content and the new features for our live franchise games, and we also develop new titles for our established franchises.

Last month we released Candy Crush Friends. It's our newest title in the Candy franchise. And it's a key part of our strategy to retain and engage existing players, but also to win back our large lapsed audience. You heard Coddy earlier. Candy Crash Friends is off to a great start. It exceeds our expectations on some key metrics, and I think it's the most polished Candy Crush game we have ever released. The characters are brought to life like we have never done before. And Candy Crush Friends strengthens the Candy franchise as a whole as we are going into 2019, and I'm very excited about this game in the future – and its future. This is for casual.

We invested actively also in other genres and other games where we see opportunities, and we do this both internally and through partnerships. Earlier this year, we released Royal Charm Slots in a partnership with PLAYSTUDIOS. The game has not yet met our expectations around retention and monetization, and so the team is still working on it.

In regards to mid-core, we released Legend of Solgard in August. It's our first mid-core launch. And mid-core is a space we want to develop a strong position over the long term, and this game will allow us to learn more about the genre and how to build out the space.

<Q - Drew Crum>: You touched on this a little bit, but maybe spend a little more time on the health of the Destiny franchise and just what you've seen in terms of engagement post the Forsaken launch. Thanks.

<A - Collister Johnson>: Sure, thank you. This is Coddy. I guess I'd start by reiterating that Forsaken is a high-quality expansion of content into the universe. Honestly, it's the highest-quality content we've seen in the franchise to date. It really came out of Activision and Bungie working together to address community concerns post-Destiny 2 holistically. Talking to players, we knew it came from users really doing a fundamental review of how to offer a deeper end-game, greater powers and greater rewards, and engage players who seemed to be really enjoying the content. In particular, it was very well received both by reviewers and by the community, and has ongoing deepening engagement by those that are playing it.

At BlizzCon, we announced that Destiny, the base game is free for two weeks, meaning download it by November 18, and you get to keep the base game forever. We did that because we want the whole community loaded up and able to play it, but also because it's a live game. And once you're in it, with the ongoing features and services and content, there's really deep engagement that takes place. And part of it was also because we have not yet seen the full core reengage in Destiny, which has led to the underperformance against our expectations to date. Some players we think are still in wait-and-see mode. So when you're in, you're deeply engaged. If you're not, we're hoping now is the time to work and to bring players back in and to win them back.

<Q - Brian Nowak>: Just on Diablo Immortal, can you give us a little more color on Diablo Immortal, and how we should think about the timing of that?

<A - J. Allen Brack>: Hi, this is J. So we've seen some interesting reaction to the announcement. I think that it's clear that there are a lot of players who are eager for more Diablo PC and console content. I think that came through loud and clear from BlizzCon. And frankly, we feel fortunate to have a community that cares so much about that franchise. The commitment and the engagement of our community is, I think, one of the things that makes Blizzard very special. It's something that we really appreciate, and we like to hear the things that they articulate as to what they want to hear next and what we can do better, frankly.

Diablo is an important tent-pole franchise for Blizzard Entertainment, and we have – one of the things we said is we have multiple teams working on multiple different projects for the Diablo community. We feel that Diablo Immortal is going to deliver a very authentic Diablo experience, and we're not going to compromise on that mission. Launching the game is only going to be the beginning. There's going to be ongoing support, and we're only going to release the game when we feel like it is meeting the community's very high standards. In the end, Diablo Immortal is going to fulfill that, and we think that people are going to experience it, and we think that they're going to love it.

Regarding I think the opportunity for Diablo and specifically on mobile, I think it is a very significant opportunity. Mobile is the biggest platform in gaming today. And taking a game like mobile onto that platform in a way that is really reflecting our quality standards I think can really open a lot of – it can open that franchise and other franchises to a global audience, including people who don't have PCs, or especially in China where Blizzard is a very, very strong western brand.

Regarding the timing, that's something that we'll talk about as we go forward. It is very important that we release the game and it is an excellent, excellent experience when it is released.

<A - Robert A. Kotick>: One other thing to add, Brian, is when we got the feedback from people who actually had the chance on a hands-on basis to play the game, it was really positive.

<Q - David Karnovsky>: Just for King, can you provide an update on your advertising outlook and maybe what the contribution of ad revenue was in the quarter or YTD? Thanks

<A - Riccardo Zacconi>: Hi, it's Riccardo here. So as you heard earlier from Bobby, the ads business is performing above plan in Q3. The team has great momentum as we head into the year end, and this is off the back of some strong progress in scaling our network and in building demand.

Our ads team has worked closely with the game teams to integrate ads into the key titles.

And in Q3, we made good progress in each of these areas. The number of video ad impressions on the platform nearly doubled in Q3 vs. Q2, and we're seeing a strong growth in the number of advertisers committing to meaningful campaigns on our platform as well as growth in the average spend by these clients.

We're now going to build on this progress. First of all, we're focused on scaling further the ads across our network, and we're doing this by enabling ads for even more players in the games where ads are already implemented and also introducing ads to more games.

And then we're also building an even greater demand on the sales side. We believe that rewarded video is a great format for brand advertisers because it associates brands with a positive experience in the game and therefore a positive experience in the player's mind. And because with over 90% completion rate, this leads to a strong brand recall. So we think that the rewarded video is a great format, and it's a format that is unique to games.

In the longer term, we want to roll out the ads business also to the other parts of the Activision Blizzard group. And so I think if I have to summarize, I feel very good about the progress this year in ads. And as the ads business continues to scale, I expect it to become an even more meaningful contributor in 2019.

<Q - Michael Olson>: I was wondering if you could provide more color on the World of Warcraft launch to date as well as just any info you could share on plans for more content in between major releases. Thanks.

<A - J. Allen Brack>: Hi, Mike. This is J. Obviously, this is a question that is very near and dear to me. I worked on World of Warcraft for more than 12 years. Battle for Azeroth is another great World of Warcraft expansion and is performing in line with expectations. I'm really proud of the team, who over the last few years has done just an amazing job of really delivering great expansions at a regular cadence, but also adding more content and updates than ever before.

The expansion launch that we have for Battle for Azeroth and the ongoing content is really how we are going to continue to engage players between expansions. The WoW team has a very strong content plan as a follow-on for Battle for Azeroth. The first content update is called Tides of Vengeance, and it's going to come out the week of December 10. It'll feature two new raids, a new war front, new island expeditions, new allied races. We have some classic battlegrounds from World of Warcraft that we're remastering, and we're going to add some seasonal content as well. Later planned updates are going to add new zones, dungeons, and raids for people to explore and additional PvP arena. As always, we have a really close relationship with the community and try to respond to all the player feedback and continue to listen and make improvements in the game.

For 2019, something we've been working on for a while that I'm also very excited about is the return of World of Warcraft Classic to the community. We announced at BlizzCon that anyone with a World of Warcraft subscription will have access to both the modern World of Warcraft as well as WoW Classic.

<Q - Brandon Ross>: You mentioned earlier PC sales for Black Ops 4 were up three times over Black Ops 3. Any way you could give additional color on the Black Ops PC performance on Battle.net and maybe how you think about the game's future on PC? Thanks.

<A - Collister Johnson>: Sure, thanks. This is Coddy. I think first, it's worth stepping back to remember why we decided to make the investment in PC around Black Ops 4 and development resources in the way it's archictected to the platform to go to market. And there will be five or six reasons in there.

And so just to frame those so that we can pressure test how we're doing against them, the first is it opens up Call of Duty to a broader, more global audience as we take it to platforms that reach around the world like PC. Second, because of the nature of the game and the kinds of modes and engagement that we're seeing really lend themselves to PC, particularly for multiplayer for Battle Royale, of course. Third, because we're now able as a company to integrate Call of Duty with the Battle.net platform, which is a big thing and a very important development. And it's not only just a compelling best-in-class PC platform, we also have a much deeper and richer understanding of our players because they're now on our network and on our platform.

We think the time is right for Call of Duty, as you know and as we've talked about, to be expanding across platforms and to be working across console and PC together. And then obviously, PC comes with better profitability, given that it's entirely digital. And because it's on our platform, the economics accrue to us.

So those are the five or six things about why we would do this. And the investment really does seem to be paying off. As you said, the size of our PC business is growing multiples, which is good and a good start. And we've been able to launch it to scale on Battle.net to markets we have not had access to before in Asia, particularly in Korea, but also other markets still to come in Asia. And so there's an expansion for us there, particularly with the kinds of modes of play that we're seeing.

We also see, I think importantly, the broader PC community rallying around this title. A lot of that has to do with streamers and influencers who are coming in and really having fun as they play inside the game. And Activision has always had good relationships with influencers and streamers. But in this case, we've really taken it to the next level to service the community, to bring in those influencers and streamers, and give broad viewership and access to what's happening in that game.

So as we go forward, we think there's a lot of opportunity here. It's our own digital platform. There are many options for us in terms of how we market it and how we price it and promote it to new audiences around the world. And so we'll be leaning into that this quarter as we head into next year.

<Q - Evan Wingren>: I'm just wondering about the pace of digital downloads in Call of Duty, what you're seeing through the launch, and what you are expecting on a go-forward basis. Thanks.

<A - Spencer Adam Neumann>: Sure, Evan. This is Spencer. I'll take this one. So as you may recall, we talked about Call of Duty: World War II last year where we saw about a 30% full-game download mix, which was up pretty consistently with what we've seen in the past few years, about 5 points y-over-y. And based on what we're seeing so far in sell-through, we expect to see more than a 5-point shift this year. It's certainly too early to tell, but the full-game download mix has definitely been heavier, and that's a good thing for us. Digital brings us closer to our consumer. And again, as we talked in recent calls, it improves our overall economics. And that's just the console digital mix. The overall digital mix for Call of Duty should further benefit from the PC focus that Coddy was just discussing and that great collaboration between the Activision team and Blizzard on Battle.net.

And I should also say that this overall digital shift, it's certainly an ongoing consumer-driven trend, but it's also a lot of great work for our teams to create compelling digital offerings that are really driving additional digital adoption from our perspective, so overall, a lot of nice trends there.

We should also point out when we talk about this that Call of Duty is a mass-market game, so all channels are important to us while we are certainly driving digital adoption. And we'll see where we land here, Evan. We'll know a lot more as we get through the holiday season. But overall, the trends are strong. It's a long-term positive for our business with a lot of runway ahead.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2018-11-08
Event Description: Q3 2018 Earnings Call

Market Cap: 47,911.95
Current PX: 62.79
YTD Change($): -.53
YTD Change(%): -.837

Bloomberg Estimates - EPS
Current Quarter: 1.306
Current Year: 2.617
Bloomberg Estimates - Sales
Current Quarter: 3051.524
Current Year: 7481.545

Q3 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- J. Allen Brack
- Riccardo Zacconi

Other Participants

- Timothy O'Shea
- Colin Alan Sebastian
- Raymond L. Stochel
- Drew Crum
- Brian Nowak
- David Karnovsky
- Michael Olson
- Brandon Ross
- Evan Wingren

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone, and welcome to the Activision Blizzard Q3 2018 earnings conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Christopher Hickey, Senior Vice President of Investor Relations. Please go ahead, sir.

Christopher Hickey

Thank you. Good afternoon and thank you for joining us today for Activision Blizzard's third quarter 2018 conference call. With us are: Bobby Kotick, CEO; Coddy Johnson, COO; and Spencer Neumann, CFO. And for Q&A, J. Allen Brack, President of Blizzard; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect.

A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2017 Annual Report on Form 10-K, and those on the slides that are showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, November 8, 2018.

We will present both GAAP and non-GAAP financial measures during this call. Non-GAAP financial measures exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses, and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefits of these excluded items, and the impact of certain significant discrete tax-related items.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call. In addition, we will be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you all for joining us today.

Our results for the third quarter exceeded our prior outlook, as we continue to entertain large audiences, drive deep engagement, and attract significant audience investment across our franchises. Last quarter, on average, 345 million people played our games each month, and our players spent a record 52 minutes per day playing Activision, Blizzard, and King games.

Our unique advantage is the ability to create the most compelling interactive and spectator entertainment based on our own franchises combined with our direct digital connection to hundreds of millions of customers in over 190 countries. With these competitive advantages, we continue to connect and engage the world through epic entertainment.

Very few companies are able to consistently deliver compelling content to hundreds of millions of customers. Fewer still can provide their audiences with flexible methods of payment for that content. For our hundreds of millions of customers, we now offer content on phones, computers, and video game consoles, and subscription billing, direct digital download billing, virtual item sales, digital advertising, and of course, we still sell our products through tens of thousands of stores around the world.

As an example of the breadth of our capabilities, we launched Call of Duty: Black Ops 4 on October 12. Ordinarily, we launch new Call of Duty titles this week in November. But we believe holiday customers, of which there are millions, will benefit from more players in the game earlier.

Our engagement to date is better than any Call of Duty content in recent years, and spectator viewing is higher than ever before. As a franchise, Call of Duty has now generated more revenue than the Marvel Cinematic Universe in the box office, and double that of the cumulative box office of Star Wars. We have an exciting future planned for Call of Duty players, including our new Call of Duty professional player opportunities, and lots of exciting new content in 2019 and beyond.

We remain focused on the key growth drivers of our business that we believe present meaningful revenue and engagement upside, including live operations, mobile, and investment in new and growing franchise engagement models. We're pleased with our early momentum in areas like our advertising initiatives, which continue to exceed our plans, as revenues grew almost 50% sequentially.

And we are further strengthening our leadership position in esports, having now sold 20 teams globally to the Overwatch League at substantially higher prices because of league financial over-performance versus our original plans, and the energy that was brought through the first season of the league by our new owners. As always, we thank you, our community, our shareholders, and our partners as well as our talented teams around the world for all of their support and hard work.

And now on to Coddy.

Collister Johnson

Thanks, Bobby.

Activision Blizzard exceeded its outlook in Q3, and we remain on track to deliver our previous upwardly revised outlook for the year and double-digit earnings per share growth year over year. We were able to achieve these results because of our incredibly talented teams comprised of the best creative and commercial leaders in the industry and their focus on the four key growth drivers of our business.

First, our team produced new content releases that invigorated distant communities and bring in new audiences. Second, our growing stream of live operations, which includes content, services, features and events that engage our franchise communities and encourage new players to join. Third, the expansion of our existing franchises onto mobile, the world's largest platform, and the creation of new franchises. And fourth, new and growing franchise engagement revenue models such as esports leagues and digital advertising.

On the first driver, our teams continued to deliver exceptional innovation and execution with major new content releases for Call of Duty, World of Warcraft, and Candy Crush. These content releases reinforce a strong foundation for our second growth driver, live operations. We generate over $4 billion a year in net bookings from in-game content, which represents the growing majority of our net bookings, yet still offer some of the best value per hour in all of entertainment. We see the continued improvement of our live operations model as one of our largest growth opportunities with the potential to generate billions of dollars of high-margin incremental revenue as we deliver year-round in-game content for our community.

We have robust engagement in content roadmaps in place for our key franchises, including Call of Duty, World of Warcraft, and Candy Crush. Now, not all our franchises are experiencing the momentum we see in Call of Duty and Candy Crush. And we have to improve the pace of innovation and the cadence of in-game content, and our franchise and business unit leaders are all now committed to achieving that goal.

On our third growth driver, the expansion of our franchises onto mobile, we know that many of the most successful mobile games today are based on intellectual property originally created for consoles and PCs. As an example, we've seen this ourselves with Hearthstone, where the fan base grew significantly when we added the mobile platform to a game that isn't even yet fully optimized for mobile success.

Mobile remains the largest and fastest growing platform for gaming in the world. And while King is a clear leader in mobile, we're still investing in Activision and Blizzard franchises for mobile releases. For example, Activision is collaborating with Tencent on Call of Duty Mobile, taking the biggest action franchise of the last two decades to the largest gaming market in the world, and of course also to western audiences where, as Bobby pointed out, Call of Duty is already one of the most successful entertainment franchises in history.

And last week, Blizzard announced Diablo Immortal, which will bring this tenfold franchise to a mobile audience in both the east and the west. While fan reaction was muted to the announcement, players' hands-on experience [indiscernible] (08:19) this content confirmed what we believe, which is that Diablo mobile will be a very well received game when it releases, and players around the world will love it.

These are just two of the many mobile initiatives underway across Activision and Blizzard. And King mobile expertise is now being shared throughout the company so our beloved PC and console franchises can expand their reach.

Lastly, on our fourth driver, in new and growing franchise engagement models, Overwatch League is already well into planning its second season, and we are actively advancing how the league model and infrastructure will be applied to Call of Duty and other franchises. And our advertising business continues to grow profitably, exceeding our plan.

While net bookings are still relatively small, they grew almost 50% quarter on quarter. And while investment in these new initiatives is growing, we are confident in the value they will create for our fans and for our shareholders.

So with that framing for our growth drivers, let me share our Q3 results against our three key metrics, reach, engagement, and player investment. Starting with reach, which was 345 million monthly active users in Q3, King monthly active users were 262 million, relatively stable through Q3, which is a positive outcome following the Q2 partner network challenges we described on the last call.

Importantly, monthly active users for King's largest game, Candy Crush Saga, grew year over year. And in October, King launched the all-new Candy Crush Friends Saga, which builds on five years of learnings in Candy with new modes, collection mechanics, and 3D visuals that make the Candy Crush characters and our owned IP more prominent and the game really fun to play.

Candy Friends targets the over 0.5 billion people who have played Candy Crush over the last five years, for whom the innovation and accessibility of Friends should be particularly appealing. We're now focused on Candy Crush Friends to win back former players and entice new players. The game is off to a strong start, reaching the top of the iPhone game download charts in 93 countries. And while still early, retention and monetization trends are very positive, and the game is on pace to drive meaningful growth for the Candy franchise in 2019.

At Blizzard, monthly active users were 37 million, consistent with the prior quarter. Overwatch monthly active users were broadly stable quarter over quarter. Hearthstone monthly active users declined, although PvP modes again attracted strong engagement. The game continues to add new players, with the franchise reaching 100 million players to date since its launch in March 2014.

World of Warcraft: Battle for Azeroth launched on August 14 and set a day-one franchise record by selling through more than 3.4 million units. Engagement grew sharply quarter on quarter, and the expansion saw strong participation in value-added services, with more content on the way in Q4. Next year, Blizzard will celebrate World of Warcraft's 15th anniversary with events both in and out of the game. This includes the highly anticipated release of World of Warcraft Classic, available as part of the franchise subscription.

Activision monthly active users were 46 million, up sequentially from Q2. This sequential growth was driven by Destiny's expansion, Forsaken, and by new reach initiatives, which grew Destiny monthly active users quarter on quarter and year over year. Now while Forsaken is a high-quality expansion with strong engagement and new modes of play, it did not achieve our commercial expectations, and there's still work to do to fully reengage the core Destiny fan base.

Then in October, Activision saw step-change growth in its monthly active users following the very successful launch of Call of Duty: Black Ops 4. Building from the foundation of Black Ops 3, which was the highest grossing game in Call of Duty franchise history, Black Ops 4 is off to a strong start, with creative innovation across all modes of play, including Blackout, which we see as the ultimate AAA Battle Royale experience.

Unit sell-through after the first three weeks is pacing ahead of Black Ops 3, PC sell-through more than 3 times higher, and with significant shifts to full-game downloads. Total active users in the first three weeks are up 16% over Black Ops 3, with strong growth across all modes, and engagement and hours played is up over 20% versus Black Ops 3. So it's worth underscoring that given Black Ops 3 generated more in-game net bookings than any other Call of Duty title, this level of engagement in Black Ops 4 should result in strong in-game revenue in Q4 and into 2019.

This brings me to engagement. Across all our franchises, daily time spent per user playing our games reached a new record of 52 minutes, based on some of the franchise reach and engagement drivers just highlighted. Usage of our games is also up significantly. And just last month, Activision Blizzard titles accounted for seven of the top 20 most viewed games on the industry's largest streaming platform, including Black Ops 4, where viewership continues to break franchise records.

In the Overwatch League, we continue to build on the success of the inaugural season, announcing another 16 sales in September, spanning Europe, Asia, and North America, all at substantially higher valuations than team prices in the first season. Nine of our now 20 teams are based outside the U.S. reflecting the global appeal of the league.

BlizzCon, which is the ultimate celebration of Blizzard community engagement, drew millions of viewers around the world by live stream and over 40,000 fans in person. In addition to the reveal of new content for every franchise, we announced the expansion of the Diablo franchise onto mobile with Diablo Immortal, codeveloped with NetEase.

Diablo Immortal was built from the ground up for mobile as an authentic Diablo experience that will make the franchise available to hundreds of millions of people around the globe. We're confident when the game launches, it will be a great experience for new players as well as the extremely loyal and vocal Diablo community. We know how eager that community is to experience even more from Diablo. When the time is right, the team will share more about what else they have in store.

Turning now to player investment, in-game net bookings were over $1 billion in Q3, which helped to set a year-to-date record of $3 billion. King was the biggest contributor with two of the top 10 highest grossing titles in U.S. mobile app stores for the 20th quarter in a row, and Candy Crush Saga was again number one. As I said earlier, some of our franchises are underperforming relative to the opportunity that we see in building our live operations capabilities, and we'll continue to push innovation and new content to drive stronger engagement and in-game revenue generation.

Black Ops 4 is a great example of how successful we can be when we focus on improving engagement in our franchises. We made the game even more engaging with active users and hours of engagement up sharply versus Black Ops 3. With Black Ops 3, that engagement translated into significantly higher in-game revenues. We hope to further that opportunity with Black Ops 4. So we continue to execute strong in-game revenue, and monetization should follow.

In summary, while there is still execution risk in the year, we're pleased with the results of our recent major content releases of World of Warcraft, Candy Crush, and Call of Duty, and we are excited by the momentum behind engagement and live operations we see in some of most critical franchises: We remain focused on improving our live-ops revenue, engagement, and in-game performance across all franchises. We continue to execute on our promising mobile initiatives and expand our franchises to new engagement models, including esports and advertising.

Spencer will now review the financial results in more detail.

Spencer Adam Neumann

Thanks, Coddy. Today I'll review our Q3 2018 results and our outlook for Q4 and the full year. To review the quarter, I'll start with our segment results.

At Activision, Q3 segment revenue was $397 million. Key contributors were Call of Duty digital in-game revenue and Destiny 2: Forsaken, although the latter underperformed our expectations. Segment operating profit of $112 million was lower year over year versus a quarter that included the Destiny 2 full-game launch and continued benefits from the Q2 2017 release of Black Ops Zombies downloadable content and Crash Bandicoot.

Blizzard grew segment revenue 20% year over year, driven by World of Warcraft: Battle for Azeroth. This offset lower revenue for Overwatch and Hearthstone, with the latter facing a tough comp against the record launch of the Knights of the Frozen Throne expansion in the prior year. Segment operating profit increased 13% year over year, as revenue growth offset investment in strategic initiatives, including Overwatch League, other esports activities, Battle.net, and franchise incubation across multiple platforms.

King segment revenue and operating income were 4% and 12% lower year over year respectively against a particularly strong quarter last year with no partner disruption. As we noted on the last call, we started Q3 from a lower revenue base due to the Q2 partner network disruption, but saw strong engagement and increasing monetization trends through the quarter.

Now let's turn to our consolidated results. Unless otherwise indicated, I'll be referencing non-GAAP figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated Q3 GAAP revenues of $1.51 billion, which was $22 million above our August outlook. This includes the net deferral of $146 million. Net bookings of $1.66 billion were $43 million above our August outlook.

We generated Q3 GAAP EPS of $0.34 and Q3 non-GAAP EPS of $0.42, which was $0.18 and $0.05 above outlook respectively. These figures include the net deferral of $0.10. GAAP EPS benefited from a discrete tax item resulting from adjustments made to the provisional amount initially recorded for the U.S. Tax Reform Act.

Now from a cash flow and capital structure perspective, Q3 operating cash flow was $253 million, and we ended the quarter with approximately $3.4 billion in cash and investments. Our strong cash position enabled us to pay down $1.7 billion of high-yield notes and floating rate debt in the quarter, reducing our go-forward net interest expense by roughly $40 million on an annualized basis. In parallel, we expanded our revolver capacity from $250 million to $1.5 billion to provide us with increased levels of liquidity. These actions further strengthened our balance sheet and increased our financial flexibility.

Now let's turn to our fourth-quarter and our full-year outlook. Before getting into the specifics, I want to provide some context. As we noted on our last few calls, earnings in the year are heavily weighted towards our fourth quarter. We expect Q4 to benefit from major content releases, strong in-game revenue, and key marketing and other commercial initiatives.

Our recent major launches for World of Warcraft, Call of Duty, and Candy were all very successful and will set the stage for continued opportunities in 2019. Some of our other franchises, like Destiny, are not performing as well as we'd like, and we're working to accelerate the pace of live operations innovation and improve the speed with which we release new content to keep our players engaged and to provide new opportunities for monetization.

Also, our better performance than our outlook in Q3 included timing benefits and FX rate headwinds. FX represents an approximately $40 million reduction to second half revenue since we last provided a full-year outlook. While we recognize that we face market and franchise headwinds and will continue to have execution risk through the end of the calendar year, we're confident in our strategy and in our team, and we're maintaining our revenue and non-GAAP EPS outlook for the fiscal year.

For Q4, on a GAAP basis, we expect: net revenues of $2.236 billion, including GAAP deferrals of $812 million; product cost, game operations, and distribution expenses of 23%; and operating expenses, including software amortization, of 55%. We expect GAAP interest expense of $6 million, a tax rate of 28%, a GAAP and non-GAAP share count of 776 million, with EPS of $0.43.

For Q4 on a non-GAAP as redefined basis, we expect product costs, game operations, and distribution expenses of 23%, operating expenses including software amortization of 47%. And we expect non-GAAP interest expense of $5 million, a tax rate of 23%, and non-GAAP EPS of $0.64, which includes GAAP deferrals of $0.63.

For 2018, on a GAAP basis we expect: net revenues of $7.355 billion, including GAAP deferrals of $120 million; product costs, game operations, and distribution expenses of 23%; operating expenses including software amortization of 53%. And we expect GAAP interest expense of $113 million, a tax rate of 9%, and GAAP and non-GAAP share count of 772 million, with EPS of $1.94.

And for 2018 on a non-GAAP as redefined basis, we expect product costs, game operations, and distribution expenses of 23%; operating expenses including software amortization of 44%. And we expect non-GAAP interest expense of $70 million, a tax rate of 18%, and non-GAAP EPS of $2.46, which includes GAAP deferrals of $0.12.

The foundation of our business remains strong. Recent launches further strengthen our enduring franchises. We're focused on driving strong engagement and in-game performance across our entire portfolio, and we'll continue to make progress in our mobile expansion and new engagement models, including leagues and advertising.

We're committed to driving our four key growth pillars while maintaining the fiscal discipline that our shareholders expect, and we continue to see opportunities across the entire landscape of interactive entertainment.

We'll now open the call up for Q&A. Operator?

Q&A

Operator

Thank you. [Operator Instructions] And we'll take the first question from Tim O'Shea of Jefferies.

<Q - Timothy O'Shea>: Yes, thank you for taking my question. Just wondering if you could update us on the Call of Duty: Black Ops 4 launch, and maybe with an update on how that game is performing post-launch. Thank you.

<A - Collister Johnson>: Sure. Hey, Tim. This is Coddy. Well, we're confident and we're energized by the performance of Black Ops 4. The launch, as I said, is off to a strong start on both console and PC. As Bobby said, there's a lot more time left now given the decision we made to launch it earlier in the holiday window and in the gift-giving window, which we think is a good opportunity for players to come in and join this highly engaging game.

And the Call of Duty team is doing what it knows how to do well, which is build a deeply engaging experience. And it's just worth highlighting again what we know so far in some of the stats coming through, which is that versus prior title and versus Black Ops 3, total active users are up significantly. And overall engagement, again, versus both the prior title and Black Ops 3, is up over 20%.

So that first period of building that deep engagement block of players that really want to come in and play is off to a good start. But we built it, as we said on multiple occasions, for long-lasting engagement. We doubled down on multiplayer in Zombies, which are already strong engagement drivers, and we added to that the kind of content and progression and system designs that you see in there to give deep playability and content for months and years to come. And we added Blackout, which is a deeply appealing mode, particularly for those who are looking for that AAA Battle Royale experience.

So the next step is just to continue to build out on the live system operations, the design. And really what is happening now is the live engagement or responding to players and seeing where they go and building the services and features that engage them even more deeply. So looking at it, we see a great run coming for Black Ops 4 and really for the franchise as a whole.

<A - Christopher Hickey>: Thank you. Operator, can we have the next question, please?

Operator

Yes, and our next question will come from Colin Sebastian of Robert W. Baird.

<Q - Colin Alan Sebastian>: Great, thank you. I guess I'd like to focus a little bit on the leadership transition of Blizzard, and if you could put a finer point on what we should expect to see change and what should stay the same. And also related to that, if you could provide a little more color on the pipeline from Blizzard. Thank you.

<A - J. Allen Brack>: Hi, this is J. I'd like to just start off by saying that Blizzard is a hugely storied studio, and I couldn't be more honored to take on the role. I have been at Blizzard for more than a decade, but have really been a fan of their games my entire life.

Today, I have a strong view on many of our franchises, and I'm actively working to get a broader outlook on certain teams, certain commercial groups, esports operations that I don't already have a good view of from my previous job. Coming out of that process, I feel like I'll have a larger perspective on what the next chapter for Blizzard's growth is going to look like.

We're going to need to continue to invest in content in our existing franchises, and there's work to do to improve in some areas to better serve our communities and to create more content for all of our fans. That's our number one focus.

And we'll continue to invest in the reach of the different franchises that we have to acquire more players globally across all platforms, including PC, console, and mobile. Right now, we have the strongest multiyear pipeline we've ever had, which is a huge opportunity, and delivering against that pipeline is our number one priority.

I think Blizzard's focus is always going to be on delivering quality game play first. And we have a strong culture of values, and we want to create more content and deliver more games. And we think that's going to lead to more players, more engagement, and it's going to lead to great business results.

<A - Christopher Hickey>: Operator, can we have the next question, please?

Operator

Certainly, your next question will come from Raymond Stochel of Consumer Edge Research.

<Q - Raymond L. Stochel>: Great, thanks for taking my question. How should we think about King's pipeline and your efforts in mid-core mobile titles versus your historical success in more casual titles? Thanks.

<A - Riccardo Zacconi>: Hi, Ray. It's Riccardo here. So when I think about our development efforts, our focus is first to fall on cash flow and our franchises, and in particular on Candy Crush, since it's our largest franchise. We have a large network of users playing our casual games, and this is the key reason why our first priority is to retain and engage them. And for doing this, we invest in a steady stream of new content and the new features for our live franchise games, and we also develop new titles for our established franchises.

Last month we released Candy Crush Friends. It's our newest title in the Candy franchise. And it's a key part of our strategy to retain and engage existing players, but also to win back our large lapsed audience. You heard Coddy earlier. Candy Crash Friends is off to a great start. It exceeds our expectations on some key metrics, and I think it's the most polished Candy Crush game we have ever released. The characters are brought to life like we have never done before. And Candy Crush Friends strengthens the Candy franchise as a whole as we are going into 2019, and I'm very excited about this game in the future – and its future. This is for casual.

We invested actively also in other genres and other games where we see opportunities, and we do this both internally and through partnerships. Earlier this year, we released Royal Charm Slots in a partnership with PLAYSTUDIOS. The game has not yet met our expectations around retention and monetization, and so the team is still working on it.

In regards to mid-core, we released Legend of Solgard in August. It's our first mid-core launch. And mid-core is a space we want to develop a strong position over the long term, and this game will allow us to learn more about the genre and how to build out the space.

<A - Christopher Hickey>: Thanks, Riccardo. Operator, can we have the next question, please?

Operator

And our next question will come from Drew Crum of Stifel.

<Q - Drew Crum>: Okay, thanks. Good afternoon, guys. You touched on this a little bit, but maybe spend a little more time on the health of the Destiny franchise and just what you've seen in terms of engagement post the Forsaken launch. Thanks.

<A - Collister Johnson>: Sure, thank you. This is Coddy. I guess I'd start by reiterating that Forsaken is a high-quality expansion of content into the universe. Honestly, it's the highest-quality content we've seen in the franchise to date. It really came out of Activision and Bungie working together to address community concerns post-Destiny 2 holistically. Talking to players, we knew it came from users really doing a fundamental review of how to offer a deeper end-game, greater powers and greater rewards, and engage players who seemed to be really enjoying the content. In particular, it was very well received both by reviewers and by the community, and has ongoing deepening engagement by those that are playing it.

At BlizzCon, we announced that Destiny, the base game is free for two weeks, meaning download it by November 18, and you get to keep the base game forever. We did that because we want the whole community loaded up and able to play it, but also because it's a live game. And once you're in it, with the ongoing features and services and content, there's really deep engagement that takes place. And part of it was also because we have not yet seen the full core reengage in Destiny, which has led to the underperformance against our expectations to date. Some players we think are still in wait-and-see mode. So when you're in, you're deeply engaged. If you're not, we're hoping now is the time to work and to bring players back in and to win them back.

<**A - Christopher Hickey**>: Operator, can we have the next question, please?

Operator

Our next question comes from Brian Nowak of Morgan Stanley.

<**Q - Brian Nowak**>: Thank you for taking my question. Just on Diablo Immortal, can you give us a little more color on Diablo Immortal, and how we should think about the timing of that?

<**A - J. Allen Brack**>: Hi, this is J. So we've seen some interesting reaction to the announcement. I think that it's clear that there are a lot of players who are eager for more Diablo PC and console content. I think that came through loud and clear from BlizzCon. And frankly, we feel fortunate to have a community that cares so much about that franchise. The commitment and the engagement of our community is, I think, one of the things that makes Blizzard very special. It's something that we really appreciate, and we like to hear the things that they articulate as to what they want to hear next and what we can do better, frankly.

Diablo is an important tent-pole franchise for Blizzard Entertainment, and we have – one of the things we said is we have multiple teams working on multiple different projects for the Diablo community. We feel that Diablo Immortal is going to deliver a very authentic Diablo experience, and we're not going to compromise on that mission. Launching the game is only going to be the beginning. There's going to be ongoing support, and we're only going to release the game when we feel like it is meeting the community's very high standards. In the end, Diablo Immortal is going to fulfill that, and we think that people are going to experience it, and we think that they're going to love it.

Regarding I think the opportunity for Diablo and specifically on mobile, I think it is a very significant opportunity. Mobile is the biggest platform in gaming today. And taking a game like mobile onto that platform in a way that is really reflecting our quality standards I think can really open a lot of – it can open that franchise and other franchises to a global audience, including people who don't have PCs, or especially in China where Blizzard is a very, very strong western brand.

Regarding the timing, that's something that we'll talk about as we go forward. It is very important that we release the game and it is an excellent, excellent experience when it is released.

<**A - Robert A. Kotick**>: One other thing to add, Brian, is when we got the feedback from people who actually had the chance on a hands-on basis to play the game, it was really positive.

<**A - Christopher Hickey**>: Operator, can we have the next question, please?

Operator

Certainly, we'll move on to Alexia Quadrani of JPMorgan.

<**Q - David Karnovsky**>: Hi, this is David Karnovsky on for Alexia. Just for King, can you provide an update on your advertising outlook and maybe what the contribution of ad revenue was in the quarter or year to date? Thanks

<A - Riccardo Zacconi>: Hi, it's Riccardo here. So as you heard earlier from Bobby, the ads business is performing above plan in Q3. The team has great momentum as we head into the year end, and this is off the back of some strong progress in scaling our network and in building demand.

Our ads team has worked closely with the game teams to integrate ads into the key titles.

And in Q3, we made good progress in each of these areas. The number of video ad impressions on the platform nearly doubled in Q3 versus Q2, and we're seeing a strong growth in the number of advertisers committing to meaningful campaigns on our platform as well as growth in the average spend by these clients.

We're now going to build on this progress. First of all, we're focused on scaling further the ads across our network, and we're doing this by enabling ads for even more players in the games where ads are already implemented and also introducing ads to more games.

And then we're also building an even greater demand on the sales side. We believe that rewarded video is a great format for brand advertisers because it associates brands with a positive experience in the game and therefore a positive experience in the player's mind. And because with over 90% completion rate, this leads to a strong brand recall. So we think that the rewarded video is a great format, and it's a format that is unique to games.

In the longer term, we want to roll out the ads business also to the other parts of the Activision Blizzard group. And so I think if I have to summarize, I feel very good about the progress this year in ads. And as the ads business continues to scale, I expect it to become an even more meaningful contributor in 2019.

<A - Christopher Hickey>: Operator, can we take the next question, please?

Operator

Up next we have Mike Olson of Piper Jaffray.

<Q - Michael Olson>: Hey, good afternoon. I was wondering if you could provide more color on the World of Warcraft launch to date as well as just any info you could share on plans for more content in between major releases. Thanks.

<A - J. Allen Brack>: Hi, Mike. This is J. Obviously, this is a question that is very near and dear to me. I worked on World of Warcraft for more than 12 years. Battle for Azeroth is another great World of Warcraft expansion and is performing in line with expectations. I'm really proud of the team, who over the last few years has done just an amazing job of really delivering great expansions at a regular cadence, but also adding more content and updates than ever before.

The expansion launch that we have for Battle for Azeroth and the ongoing content is really how we are going to continue to engage players between expansions. The WoW team has a very strong content plan as a follow-on for Battle for Azeroth. The first content update is called Tides of Vengeance, and it's going to come out the week of December 10. It'll feature two new raids, a new war front, new island expeditions, new allied races. We have some classic battlegrounds from World of Warcraft that we're remastering, and we're going to add some seasonal content as well. Later planned updates are going to add new zones, dungeons, and raids for people to explore and additional PvP arena. As always, we have a really close relationship with the community and try to respond to all the player feedback and continue to listen and make improvements in the game.

For 2019, something we've been working on for a while that I'm also very excited about is the return of World of Warcraft Classic to the community. We announced at BlizzCon that anyone with a World of Warcraft subscription will have access to both the modern World of Warcraft as well as WoW Classic.

<A - Christopher Hickey>: Thanks. Operator, can we take the next question?

Operator

And our next question will come from Brandon Ross of BTIG.

<**Q - Brandon Ross**>: Hi, thanks for taking the question. You mentioned earlier PC sales for Black Ops 4 were up three times over Black Ops 3. Any way you could give additional color on the Black Ops PC performance on Battle.net and maybe how you think about the game's future on PC? Thanks.

<**A - Collister Johnson**>: Sure, thanks. This is Coddy. I think first, it's worth stepping back to remember why we decided to make the investment in PC around Black Ops 4 and development resources in the way it's archictected to the platform to go to market. And there will be five or six reasons in there.

And so just to frame those so that we can pressure test how we're doing against them, the first is it opens up Call of Duty to a broader, more global audience as we take it to platforms that reach around the world like PC. Second, because of the nature of the game and the kinds of modes and engagement that we're seeing really lend themselves to PC, particularly for multiplayer for Battle Royale, of course. Third, because we're now able as a company to integrate Call of Duty with the Battle.net platform, which is a big thing and a very important development. And it's not only just a compelling best-in-class PC platform, we also have a much deeper and richer understanding of our players because they're now on our network and on our platform.

We think the time is right for Call of Duty, as you know and as we've talked about, to be expanding across platforms and to be working across console and PC together. And then obviously, PC comes with better profitability, given that it's entirely digital. And because it's on our platform, the economics accrue to us.

So those are the five or six things about why we would do this. And the investment really does seem to be paying off. As you said, the size of our PC business is growing multiples, which is good and a good start. And we've been able to launch it to scale on Battle.net to markets we have not had access to before in Asia, particularly in Korea, but also other markets still to come in Asia. And so there's an expansion for us there, particularly with the kinds of modes of play that we're seeing.

We also see, I think importantly, the broader PC community rallying around this title. A lot of that has to do with streamers and influencers who are coming in and really having fun as they play inside the game. And Activision has always had good relationships with influencers and streamers. But in this case, we've really taken it to the next level to service the community, to bring in those influencers and streamers, and give broad viewership and access to what's happening in that game.

So as we go forward, we think there's a lot of opportunity here. It's our own digital platform. There are many options for us in terms of how we market it and how we price it and promote it to new audiences around the world. And so we'll be leaning into that this quarter as we head into next year.

<**A - Christopher Hickey**>: All right, we have time for one last question.

Operator

Thank you. And we'll take our final question from Evan Wingren of KeyBanc Capital Markets.

<**Q - Evan Wingren**>: Thanks. I'm just wondering about the pace of digital downloads in Call of Duty, what you're seeing through the launch, and what you are expecting on a go-forward basis. Thanks.

<**A - Spencer Adam Neumann**>: Sure, Evan. This is Spencer. I'll take this one. So as you may recall, we talked about Call of Duty: World War II last year where we saw about a 30% full-game download mix, which was up pretty consistently with what we've seen in the past few years, about 5 points year over year. And based on what we're seeing so far in sell-through, we expect to see more than a 5-point shift this year. It's certainly too early to tell, but the full-game download mix has definitely been heavier, and that's a good thing for us. Digital brings us closer to our consumer. And again, as we talked in recent calls, it improves our overall economics. And that's just the console digital

mix. The overall digital mix for Call of Duty should further benefit from the PC focus that Coddy was just discussing and that great collaboration between the Activision team and Blizzard on Battle.net.

And I should also say that this overall digital shift, it's certainly an ongoing consumer-driven trend, but it's also a lot of great work for our teams to create compelling digital offerings that are really driving additional digital adoption from our perspective, so overall, a lot of nice trends there.

We should also point out when we talk about this that Call of Duty is a mass-market game, so all channels are important to us while we are certainly driving digital adoption. And we'll see where we land here, Evan. We'll know a lot more as we get through the holiday season. But overall, the trends are strong. It's a long-term positive for our business with a lot of runway ahead.

Spencer Adam Neumann

I think that's the last question. I just want to thank everybody for joining us today. We look forward to sharing our holiday results next quarter, and we'll talk to you next year.

Christopher Hickey

Thanks very much for joining us.

Operator

That does conclude today's teleconference. Thank you all for your participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2018-08-02
Event Description: Q2 2018 Earnings Call

Market Cap: 54,374.98
Current PX: 71.32
YTD Change($): +8.00
YTD Change(%): +12.634

Bloomberg Estimates - EPS
Current Quarter: 0.546
Current Year: 2.615
Bloomberg Estimates - Sales
Current Quarter: 1697.053
Current Year: 7486.952

Q2 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Michael Morhaime
- Riccardo Zacconi

Other Participants

- Colin Alan Sebastian
- Doug Creutz
- Christopher Merwin
- Michael J. Olson
- Drew Crum
- Brandon Ross
- Evan Wingren
- Matthew C. Thornton
- Timothy O'Shea

MANAGEMENT DISCUSSION SECTION

Christopher Hickey

GAAP and Non-GAAP Financial Measures

We will present both GAAP and non-GAAP financial measures during the call

We will also provide non-GAAP financial measures, which reflect the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefit of these excluded items and the impact of certain significant discrete tax-related items

Non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results

We caution investors to consider all measures before making an investment decision

Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures

There's also a PowerPoint overview you can access with the webcast and which will be posted to the website following this call

In addition, we will also be posting a financial overview that has both GAAP and non-GAAP results in a one-page summary

Robert A. Kotick

Business Highlights

Revenues, EPS, Audience Investment, Assets and Capabilities

- Our results for Q2 exceeded our prior outlook and we delivered record H1 revenues and EPS
- Our franchises continue to entertain large audiences, drive deep engagement and attract significant audience investment
- We have unique assets and capabilities

Content Data

- Many of today's successful technology companies commercialize content data helps create, either user-generated content or content produced by outside parties, and usually through a single type of monetization, either advertising or subscription fees, as examples
- We are both
- We deliver our own content, interactive and live linear programming on mobile devices, personal computers and game systems in almost every country of the world
- And we are one of the world's best creators of program produced content
- Over 350mm consumers consume our content each month and when they engage, they spend roughly 50 minutes per day and can invest in our content through purchases from both online and physical retailers, subscriptions, downloadable content, virtual and physical items and through participation in digital advertising
- Virtually all of our content is based on intellectual property we own and created by our wholly owned studios in the U.S. and Canada, Europe and Asia, and staffed by the most talented programmers, designers, artists and animators in the world
- We are in a privileged position
- We have a direct digital connection with our customers
- We are a creator of premium content, and we have multiple monetization models at scale

Audiences Enthusiasm

- Our success is driven by the enthusiasm our audiences have for our games and for the linear content inspired by our games
- Perhaps most importantly, the loyalty our audiences have for our franchises comes from an unwavering commitment we have to creating the very best content, year after year
- We do this in recognition of the commitment our audiences make to us and the sense of belonging, meaning and purpose our communities uniquely engender
- The engagement of our community members builds passion for our franchises that extends well beyond games, as we saw this past weekend with millions of spectators watching the Overwatch League Finals
  - And we'll see this loyalty on display again in November when we host the Overwatch World Cup Finals in Anaheim

Franchises

- We're just scratching the surface on the full potential of our eight, $1B franchises and our network of hundreds of millions of users
- We've taken some of the most important first steps in meeting our fans' desires to have more of their favorite franchises in their everyday lives
- In the last year, we've paved the way as the industry leader in esports, making our franchises even more enduring
- We're also making important progress across all our mobile initiatives, which will increase the reach of games significantly

Grand Finals Event

- Last weekend, the Overwatch League held its inaugural Grand Finals event at the Barclays Center in New York
- The event was the culmination of a very successful inaugural season
- Our incredibly talented employees built a global competitive league from the ground up
- And in our first season alone, we brought celebrating our players to a new level, our live event and viewing experience and world-class production quality on par with the best of professional sports
- We teamed up with 12 extraordinary team owners

Traditional and Esports Partners

- We attracted some of the best traditional and esports partners, bringing years of invaluable experience to the league
- We brought the power of professionalized esports to multiple partners
- We signed media rights deals with the leaders in streaming and traditional broadcast and attracted global brands to serve as inaugural season sponsors
- And we held the sold-out championship in New York's Barclays Center with millions of global viewers watching the finals, including through our own MLG network and broadcast partners like Disney and Amazon
- Our unique approach to esports, with a focus on city-based teams, professional players, structured economics and premium content has already started to pay off for our partners, our shareholders and, most importantly, our players
- Today, we announced the first set of Season 2 team sales, welcoming new team owners from across the globe into the league
  - These great partners have seen the success of the Overwatch League and the opportunity to help build this sport of the future
- We're thrilled to partner with them and look forward to announcing additional new partners for Season 2 throughout the rest of this year

Overwatch League Model

  - As the mainstream popularity of esports continues to grow, we're well-positioned to leverage the success of our Overwatch League model to develop new esports opportunities in the future
  - While esports give our existing fans a new and everlasting way to celebrate their favorite games and expands the appeal to broader audiences, our mobile initiatives will expand their access to our iconic franchises by making them available to hundreds of millions of new players around the world

Mobile Initiatives

- We have multiple mobile initiatives underway, including some with partners with strong mobile experience and local market knowledge
- Today's Call of Duty mobile game announcement with Tencent is part of our effort to ensure our very best franchises are available to mobile audiences in all geographies
- We had a record last six months and we're excited about our upcoming releases, including World of Warcraft: Battle for Azeroth, Call of Duty: Black Ops 4, and a major franchise release from King
- As always, we thank you, our shareholders and our partners, as well as our talented teams around the world for all of your support and hard work

Collister Johnson

Operating Highlights

Revenues and Earnings

- Activision Blizzard delivered record H1 revenues and earnings and exceeded our second quarter guidance
- We did this by providing our passionate and engaged communities with a steady stream of content, services, features and events
  - And this recurring flow of content across our diverse portfolio of franchises allows us to deliver consistent results even in quarters without major content releases

Major Launches

- Of course, major launches are still an important driver to keep our communities vibrant to invigorate existing players and to bring in new players
- And in H2 2018, we have a number of major launches which we expect to drive strong full-year results
- We are also driving longer term growth, as Bobby mentioned, by meeting our fans' desire to have more of their favorite franchises in their everyday lives

Mobile Initiatives

- So in addition to a growing esports community and business exemplified by the great inaugural season of the Overwatch League, we are starting to see some of our mobile initiatives progress from the research and development phase to release planning
- Now given the size of the overall mobile opportunity, we are taking a multi-pronged approach, leveraging both internal and external resources to bring compelling experiences to our fans

New Collaboration with Tencent

- To that end, we announced today a new collaboration with Tencent for Call of Duty mobile, which will bring the best-selling console franchise of the last two decades to tens of millions of Chinese mobile gamers
- Call of Duty mobile in China is built by one of Tencent's top mobile studios, with deep shooter experience and a great track record
- And Tencent will leverage its massive network, broad distribution channels, and local marketing expertise as the game rolls out through testing and launch in the coming months
- We also expect progress on our other mobile initiatives in H2, including a major new launch from one of King's established franchises

Reach, Engagement and Player Investment

- As we work on these growth initiatives, we remain focused on our three strategic pillars of reach, engagement and player investment
- On reach, the company had 352mm monthly active users this quarter, down year-on-year, but as I mentioned, that's in advance of the big releases coming out later this year
- Activision had 45mm of these monthly active users, with Call of Duty: WWII still holding a larger active player base than the prior release

Call of Duty: Black Ops 4

- In this quarter, we revealed Call of Duty: Black Ops 4 which we expect to once again be the number one console title globally
- Set to release on October 12, Black Ops 4 will include game play innovations across multiple modes
- We think it will have the deepest and most engaging multiplayer experience in franchise history, the largest zombies offering ever at launch, and a phenomenal PC version built specifically for the platform and available exclusively on Blizzard's battle.net

Blackout

- The game also heralds the arrival Blackout which combines Black Ops' signature combat, characters, game play, vehicles, lore and maps into one battle royale mode with the biggest map in Call of Duty history
- This week, the community had their first glimpse of Blackout footage in the tease trailer and the response was overwhelmingly positive
- We've been playing all the game's modes and we think they deliver everything the community loves about Block Ops and more
- We can't wait for you to see the game and hopefully play it this weekend with our worldwide multiplayer beta, and then for the first time in franchise history, we are excited to say there will be a second beta in September where fans will have a chance to play Blackout as well
- And the community's excited too

- Preorders are strong, and Black Ops 3 monthly active users grew q-over-q and in June reached their highest level this year as over 15mm players geared up for the next installment of this great franchise

Destiny, Bungie and Activision

- Turning to Destiny, Bungie and Activision continue to make updates in engaging content for Destiny's fans
- Destiny 2's second expansion, Warmind, was released in Q2 with a higher attach rate than Destiny 1's second expansion, and Destiny 2 monthly active users grew q-over-q

Forsaken

- Now the next big step in the franchise is Forsaken, the major expansion coming out in September
- We think this release will drive strong community engagement, particularly around the innovation in Gambit, a new competitive co-op mode which we think could be transformative for the way people play in first-person action games

Crash Bandicoot and Spyro Reignited Trilogy

- Activision's strategy to reimagine its rich library of beloved IP continued in Q2, with its successful launch of Crash Bandicoot on Xbox One, Switch and PC
- Crash continues to exceed expectations with the strong performance in new platforms showing pent up demand that we have for our classic franchises
- And in September, Activision will launch the Spyro Reignited Trilogy on PlayStation and Xbox
- The great team at Toys For Bob have remade three classic Spyro games from the ground up and we think Spyro's passionate fans are going to love it

Blizzard

Battle for Azeroth

- Moving on to Blizzard, which had 37mm monthly active users, again ahead of their big second-half content push which starts on August 14 when Blizzard will release Battle for Azeroth, the latest expansion for World of Warcraft
- Battle for Azeroth adds to the already deep World of Warcraft universe with an array of new zones, dungeons, raids, items and creatures
- Players will get to unlock new races to make characters more customizable than ever, and Blizzard has added even more social features, letting players stick to their friends and family even outside their guild
- Momentum remains high ahead of the launch with preorders coming in strong

Overwatch and Hearthstone

- For Overwatch, Blizzard is building on the excitement around the Overwatch League with more esports events and a continuous stream of in-game content in H2, including seasonal events, maps, heroes and new cosmetic items

- And for Hearthstone, anticipation for the Boomsday project expansion is running high with pre-purchases tracking ahead of any prior expansion at this same time in prerelease
- We think some of that momentum is due to a new offering that gives players more choice, including a premium bundle with extra card packs and an alternate hero

King

Live Services, Features and Content

- Turning to King, monthly active users were 270mm
- King continued its focus on expanding live services, features and content to its hundreds of millions of engaged players around the world and executed well, growing revenue year-on-year
- King did see some impact in the quarter to its network due to technical system changes made by some third-party partners in response to data initiatives
  - These changes inadvertently impacted some users' ability to play and invest
- Our team worked with partners to address the issues and stabilize net bookings, and King's innovations in live ops events and marketing went on to deliver encouraging results in the quarter

Core Mobile Platform

- On our core mobile platform, monthly active users for our largest game, Candy Crush Saga, were stable q-over-q and grew y-over-y, and engagement trends remain strong, with time spent per DA use stable at 36 minutes, which brings me to our second strategic pillar, engagement
- As Bobby shared, we saw significant engagement in particular around esports with interest in the playoffs and championships for the Overwatch League running above even our own high expectations
- In the Call of Duty World, they continued to enjoy momentum with minutes watched up 50% y-over-y and now heads into its own championships later this month in Columbus, Ohio

Player Investment

- Turning to our third strategic pillar, player investment
- In-game content, features and services continue to be a major driver for our business and delivered $1B of in-game net bookings in Q2 and a record that was approximately $2B YTD
- Activision had record second quarter in-game net bookings, driven by Call of Duty: WWII, Black Ops 3 and Destiny 2
- King had two of the top 10 highest-grossing titles in the U.S. mobile app stores for the 19th quarter in a row with Candy Crush Saga again the number one grossing game on mobile in the U.S. and Candy Crush overall franchise net bookings growing strongly, up double digits year-on-year, and King's advertising business profitable for Q2 in a row with net bookings ramping from last quarter

Summary

In summary, we continued to perform in our core business while investing in building internal capabilities for a broader set of experiences around our franchises, including mobile, esports and advertising

You're seeing early traction on some of those initiatives, including upcoming mobile releases, clear momentum for the Overwatch League and a ramping advertising business

Spencer Adam Neumann

Financial Highlights

Segment Results

- Today I will review our better than expected Q2 2018 results
- I'll also review our outlook for Q3 and the remainder of the year
- To review the quarter, I'll start with our segment results

Activision

- Activision grew revenue 7% y-over-y, driven by double digit growth in in-game net bookings
- Call of Duty: WWII's digital season continued to outperform the prior release, while Destiny 2 saw strong participation in its Warmind expansion
- Operating income for the segment was down slightly relative to prior year with modestly lower margins from product mix

Blizzard

- Blizzard revenue and operating margin declined y-over-y
- This reflects the timing of major content releases and investment in key growth initiatives, including Overwatch League, MLG Network, battle.net and mobile incubation, all consistent with our discussion on the prior quarter's call
- Bolstered by the release of Battle for Azeroth in August, we expect Blizzard to return to y-over-y growth and margin expansion in H2

King

- King grew revenue and operating income 5% and 3% respectively over prior year
- Net bookings growth from continued live title innovation and monetization improvements more than offset the negative network breach impact from third party partners that Coddy referenced

Revenues, Net Bookings and EPS

- Now let's turn to our consolidated results
- Unless other otherwise indicated, I'll be referencing non-GAAP figures
- Please prefer to our earnings release for full GAAP to non-GAAP reconciliations
- For the quarter, we generated Q2 GAAP revenues of $1.64B, $86mm above our May guidance

  - This includes the net recognition of deferrals of $256mm
- Net bookings of $1.38B were $35mm above our May guidance
- We generated Q2 GAAP EPS of $0.52 and Q2 non-GAAP EPS of $0.62, which was $0.26 and $0.16 above guidance respectively
  - These figures include the net recognition of deferrals of $0.21

Pricing and Tax Rate

- During Q2, we entered into a closing agreement with the IRS to settle certain intercompany transfer pricing arrangements
- We expect to pay approximately $345mm in cash related to the settlement, mostly in H2
- The settlement was the primary reason second quarter GAAP and non-GAAP earnings had a lower than anticipated tax rate
- And following the settlement, we now expect our full year tax rates to decrease with a GAAP tax rate of 13% vs. 18% previously and a non-GAAP tax rate of 18% vs. 20% previously

Cash Flow and Capital Structure

- From a cash flow and capital structure perspective, Q2 operating cash flow of $9mm includes the impact from higher y-over-y cash taxes and some working capital timing
- On a trailing 12-month basis, operating cash flow of $2.08B is up modestly over prior year
- We paid a cash dividend of $0.34 per common share, which was up 13% y-over-y for a total of $259mm in aggregate to shareholders of record as of March 30, 2018
- Our cash and investments at the end of June was approximately $5B, with domestic cash of roughly $4B as a result of our repatriation activity in Q2
- And we ended the quarter with a net cash position of approximately $540mm
- We indicated on our last call that we have board authorization to pay down as much as $1.8B of debt this year, and we now expect to utilize the full authorization in Q3

Guidance

Before I turn to the specifics of our outlook, I'll provide some context on overall guidance and phasing of earnings for the remainder of the year

As I said on the last two calls, we expect revenues and operating income for 2018 to be more back-end loaded, given the timing of our major releases and content slate relative to prior year

Q3

- Specifically, with regard to Q3, last year, King benefited from the promotion of the Candy TV show and a particularly strong monetization lift
- And Activision benefited from the launch of Destiny 2, as well as a full quarter of Black Ops III Zombies Chronicles

- And in Q3 this year, we'll have additional marketing expenses ahead of the early Q4 launch of Call of Duty
- Conversely, Q4 of this year will fully benefit from two major releases, the August launch of World of Warcraft: Battle for Azeroth and the early Q4 release of Black Ops 4
- So we're expecting a very strong final quarter, contributing meaningfully higher mix of full year revenue and earnings relative to last year
- Now, while we still have a lot of execution ahead of us in H2, we remain confident in our franchises, in our pipeline and in our full-year outlook

Revenues, EPS and Expenses

- Despite FX headwinds over the last quarter, we're maintaining our full-year guidance for revenue and we're raising our GAAP EPS forecast to reflect a lower tax rate from the IRS settlement that I mentioned earlier
- With that context, for Q3, on a GAAP basis, we expect net revenues of $1.490B, including GAAP deferrals of $125mm; product cost, game operations and distribution expenses of 27%; operating expenses including software amortization of 59%; and we expect GAAP interest expense of $62mm; the tax rate of 18%; GAAP and non-GAAP share count of 772mm; and EPS of $0.16
- Interest expense is elevated due to one-time costs related to our planned debt pay down
- For Q3, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 27%; operating expenses, including software amortization of 49%; and we expect non-GAAP interest expense of $20mm; the tax rate of 18%; and non-GAAP EPS of $0.37, including GAAP deferrals of $0.10

2018

- For 2018, on a GAAP basis, we expect net revenues of $7.355B, including: GAAP deferrals of $120mm; product costs, game operation and distributions expenses of 24%; and operating expenses, including software amortization of 52%
- We expect GAAP interest expense of $130mm; the tax rate of 13%; GAAP and non-GAAP share count of 774mm with EPS of $1.84
- And for 2018, on a non-GAAP basis, we expect: product costs, game operations and distribution expenses of 24%; operating expenses, including software amortization of 44%; and we expect non-GAAP interest expense of $86mm; the tax rate of 18%; and non-GAAP EPS of $2.46, including GAAP deferrals of $0.12

Conclusion

In conclusion, in Q2, we delivered better than expected results and sequential stability

We're looking forward to important launches in H2 and all the while, we continue to make progress executing against our strategic initiatives, including mobile, the Overwatch League and advertising

QUESTION AND ANSWER SECTION

<Q - Colin Alan Sebastian>: My question is with the first season now complete for the Overwatch League, I was hoping you could reflect on some of the key learnings from the season and more broadly, what we can expect going forward from the franchise. Thanks.

<A - Michael Morhaime>: Hi, Colin. This is Mike from Blizzard. So Bobby talked about some of the success that we had in Season 1. I'd like to have a shout-out to the team for delivering an awesome experience that definitely exceeded our expectations. Because of that success, as Bobby mentioned, we've already added two new great partners for Season 2, and we think that there will be more to come as well.

Just quickly, I attended the Grand Finals last weekend in Brooklyn. I know many people listening were there as well. I hope everybody enjoyed it as much as I did. It was awesome to be part of the player and fan celebration, and we think that's just a start of a growing movement that will recognize and celebrate the best of Blizzard esports in the future as well.

Looking forward, there's a lot more for Overwatch fans to enjoy in the coming months, including esports, in-game content, consumer products. For esports, we have the Overwatch League All-Star Game later this month at the Blizzard Arena. We have the World Cup Finals at BlizzCon in November. There's a ton that we've been working on in game as well. Our most recent hero, Wrecking Ball has done a great deal to generate buzz and engagement in the community. There's a lot of excitement for our upcoming seasonal events, Summer Games 2018, and we have some announcements that we'll be making about new content at gamescom and at a fan festival in Seoul, South Korea, in August.

We also, in addition to our partnerships with sponsors on the esports side, we've also announced some new consumer products partners for the game. We have LEGO, Nerf, UNIQLO and Kellogg, and we think those partnerships will help us bring Overwatch to fans and new audiences throughout the world. So very excited about the future of Overwatch.

<Q - Doug Creutz>: You mentioned that Call of Duty preorders are looking strong. I wondered if you'd be willing to get a little bit more granular on that, maybe any comparison you can give to some of your better selling Call of Duty titles in the past. And then maybe anything else that you guys are looking at in terms of interest in the title that you think might be interesting. Thank you.

<A - Collister Johnson>: Sure. Thanks, Doug, could hear your voice. This is Coddy. Well, I'd just start at a high level. We have strong expectations for the game. We feel good about the development underway. We feel great about the community interest and fan response we're seeing. And as you said, preorders are strong. I'll give some context about how we think about the franchise and the strength of it so far.

I guess it starts first, stepping back, just remembering that the Black Ops sub-franchise has over 200mm registered players to date and over 15B hours of game play and is known and really has this sort of incredibly deep and appealing ongoing engagement universe that it provides to fans. And we think Black Ops 4 really builds on that trend.

We're seeing it already now just with engagement even before launch. We had a really highly watched, and even to us, like really, really well received reveal event, as you may remember, back in May. And we had that hands on multiplayer at E3 and we had major zombies announcements at Comic-Com. All three of those were building momentum. And what we're seeing now is this surge of excitement build in advance of the multiplayer beta that kicks off tomorrow, and we hope many on this call will be playing it with us.

We've also seen a tremendous amount of interest in the new Blackout mode. As I said, we teased it earlier this week and we just saw an overwhelmingly positive response to the trailer we put out. We think fans are really hungry for it. And we see it also in the play tests that we're doing, both with our own teams and in confidential tests that we bring consumers through. There's this moment-to-moment creation that happens now, which in many of Call of Duty games in the past was scripted.

But in this, the players are generating kind of the wild helicopter rides the take-downs from ATVs and truck beds, the powers and abilities that you find as you move through the map. It's putting in the hands of the fans this massive experience. And we think it really speaks to [indiscernible] (29:29) as well. It's just sort of masters of creating content that's fun to play for hours and weeks and as you've seen, in June for years on end. And we think Black Ops 4 leans into that. So we're fired up for the October 12 launch and we think it might be one of the best installments of Call of Duty that we've made to date.

<Q - Christopher Merwin>: Could you talk about how you could compare the impact of Fortnite to engagement for core franchises in Q2 relative to Q1? Monetization title grew pretty significantly quarter-on-quarter and so just curious if there was any incremental headwinds to the business. Are you factoring in any further headwinds from Fortnite to the rest of the year? Thanks.

<A - Spencer Adam Neumann>: Sure. Hey, Chris. It's Spence. We're glad to hear your voice. We thought we lost you there. So welcome back.

<Q - Christopher Merwin>: Sorry about that.

<A - Spencer Adam Neumann>: Thanks for the question. Look, I guess at the highest level, no, no problem. We, as I think you heard, we delivered strong Q2 results with overall stability in revenue and earnings compared to the prior quarter. And we achieved that performance against the backdrop of what you point out, which is there's very strong consumer interest around games that are centered around this battle royale.

And I mentioned on our last call, and it continues to be the case, that we believe we're seeing some impact across certain franchises, primarily on engagement, including players that seem to be splitting some of their time between our games and trying something new. But overall, it looks like to us like these battle royale games are highly incremental to the industry. They're bringing new players. It's increasing engagement. And for the gaming sector as a whole, as Bobby talked in the last call, it's making gaming more mainstream.

So this overall dynamic once again shows that innovation and fresh content draws in players and it expands the gaming community. And as we tried to underscore today, we remain laser focused on driving innovation within our franchises and in compelling content that we believe will excite both existing and new players and sustain engagement over long periods of time. So we think you're going to see a lot of that in the year ahead when we release Battle for Azeroth in a couple of weeks and again in a big way when we release Call of Duty Black Ops 4 in October. Thanks.

<Q - Michael J. Olson>: Wondering if you could just update us on King advertising progress?

<A - Riccardo Zacconi>: Hi, Mike. It's Riccardo here. So let me start saying that the advertising business has momentum. So we ramped the business in Q2 and we see encouraging progress both on the direct and indirect channels. In the past, you heard me say that the King network offers a audience at scale, a branch leaf environment and industry-leading completion rates and ad recall. So now we are seeing advertisers and agencies, both of them starting to see the power of this combination.

Our teams, if we look at our teams, both the advertising team and the game teams are continuing to work very closely together on delivering a positive advertising experience and also innovative products, which adds to the player experience. In Q2, we saw growth off a small base, and we will continue to take a measured the approach to the roll-out. We all introduce ads in new games and to new player segments after an expansive testing phase.

So I will say in brief, I would summarize our position as we have momentum, and we expect the ad revenues to continue ramp in H2 and to make a more meaningful contribution in 2019.

<Q - Drew Crum>: I'm hoping you can provide more of an update on the Destiny franchise and just your expectations for the major expansion this fall? Thanks.

<A - Collister Johnson>: Got it. Thanks, Drew. This is Coddy. I'll take that one. As you'll remember, we've talked a lot about listening to the Destiny community to provide a deeper ongoing experience, more engaging moment to moment gameplay and a series of updates with better rewards in the ongoing live game. And the team at Bungie and the team here at Activision have made a lot of strides in doing that, particularly the last two quarters, with the ongoing improvements to the end game and the overall gameplay experience.

But in particular, with the Warmind expansion in May, that really showed us the ability to evolve the game and regrow engagement and regrow users. And now, that community, that's the most positive place since Destiny 2 launched last September. And so, now we have this big step with the launch of Forsaken which happens next month.

The encouraging part is players have had a great response so far with engagement online around the content announcement, hands-on gameplay of E3, which honestly led to the highest social sentiment we've seen in three years of E3; and a lot of excitement around Gambit, which brings this whole new way to play that's both cooperative and competitive between teams. And we really do think it could be transformative.

So we feel good about the content to come and the engagement we've seen in the community overall, and we feel really good about what Forsaken would do to build on that momentum. So we're excited for it, and we're in that countdown period now to put it in the hands of our fans.

<**Q - Brandon Ross**>: In your press release, you mentioned strong presales for Battle of Azeroth. Is there any further color you could give us there? And what are your current expectations overall for the expansion maybe relative to other World of Warcraft expansions? Thanks.

<**A - Michael Morhaime**>: Thanks, Brandon. This is Mike. So we're about two weeks away from the launch. Excitement is definitely building for this expansion, both inside Blizzard and with the World of Warcraft community. We've seen strong engagement as we released content updates, including the Battle for Azeroth pre-patch. And we've also had special story-based content to bridge players from Legion, our previous expansion, into the new expansion.

We just started releasing some new animated shorts called the Warbringers series. They tell the story of Battle for Azeroth. Those pieces have racked up more than 8mm views on YouTube already, and we're very, very excited about that. And we're gearing up for another major story drop pretty soon. We also removed a hurdle into how players can get started with the game. So we no longer require a box purchase up front. That's been met with a lot of positivity by gaming press and the community.

As Coddy mentioned, preorders have been strong. As always, we have some great content coming. The team's done a great job working both on the expansion, as well as on ongoing content and increasingly improve the steady stream of content in between expansions which we think is very important. I'll also point out we're celebrating a big milestone with World of Warcraft. Today marks the 5,000th day that World of Warcraft has been in operation, and I think that a big kudos to the team for continuing to work on content and keep the game fresh, even after all this time.

So there's a lot to look forward to in the next couple weeks and also beyond that. We're very excited about the expansion and the momentum heading into the launch.

<**Q - Evan Wingren**>: One of the main questions that we get from investors on the near term is about the holiday release schedule, and it seems particularly full, at least at the high end of games. I guess I would ask, do you agree? And if so, how do you think about the risk and potential for the industry to grow sales above prior years?

<**A - Spencer Adam Neumann**>: Hey. Thanks for the question, Evan. It's Spence. I'll take this one. This is a question that feels like the company probably gets every year, and it makes sense because it seems like every year there is strong competition in gaming. It's not just in 2018. There's competitive games in all years that draw gamers' time and attention. And now as you point out, this year may be a bit more crowded than others, but we're used to the competition and we really like the hand we're dealt.

And the number one factor driving our game success is our own game quality and the fun and innovation we bring to the experience. And across our business, we've got the most talented teams in the industry, who know how to make great games that people want to play regardless of what's happening, frankly.

So if you look at the rest of the year, we've got a number of major franchise releases that are shaping up to deliver amazing experiences to our passionate communities. Between Battle for Azeroth in August, Destiny 2: Forsaken in September, Black Ops 4 in October and a major release from King, we think we're extremely well positioned across our portfolio to drive growth. So as I said earlier, we've got plenty of execution ahead of us but we're confident in our great franchises heading into the holiday season.

<**Q - Matthew C. Thornton**>: Maybe another one on King, so maybe this is for Riccardo. Could you talk a little bit about how King's reach and the slate will develop kind of as we work through the back half of the year?

<A - Riccardo Zacconi>: Hi, Matthew. Indeed it's me. It's Riccardo. So let me answer first the question on reach and then we address then the question on the slate. On reach, in Q2 , we saw a decrease after a few quarters of improved stability. We had 270mm monthly active users in Q2. Now, Q2 is a seasonally slow quarter, and here we were down 5% vs. the previous quarter.

Now as you heard earlier from Spence, monthly active users would have been higher were it not for technical changes at some third-party partners which temporarily impacted some users' ability to both play and invest. This said, we are encouraged by some of the trends, our player base that show that our reach initiatives are paying off. So for example, Candy Crush mobile monthly active users grew y-over-y, and we see a strong engagement across our network, with time spent per player remaining high.

In regards to the slate, in Q2 we released Royal Charm Slots and we will continue to optimize the game in the next quarters. And we also plan to launch more games before the end of the year, including a major launch from one of our large established franchises. When we think about slate, we do not just think about new game launches, but we also think about fresh content and updates in the live games. And here, we aim to continue to accelerate the delivery of new features in the live games.

<Q - Timothy O'Shea>: So since E3, investors have been focused on these emerging streaming platforms. I'm curious, what is your position on cloud gaming and streaming? Thank you.

<A - Collister Johnson>: Thanks, Tim. This is Coddy. So over the long term, we think cloud-based gaming and streaming is a very strong positive for the industry, and particularly for us. It should ultimately accelerate growth in an already growing industry. First, it has the potential to significantly expand the reach of our big screen experiences to audiences that don't have a console. And in some cases don't have a PC, depending on the streaming system you're talking about.

And second, even for existing gamers, streaming systems, they should be able to provide more easily accessible experiences, reducing friction, enabling deeper ongoing engagement throughout the day as the content is more available.

And third, we think we in particular are well placed to take advantage of streaming cloud-based gaming when it comes. We have deep, strong franchises that certainly benefit from exposure to broader audiences. We have vibrant player communities who are looking for, right now for additional ways to access the franchises that they love. And as a company that creates our content, fully owns our IP, has some of the best IP in gaming we think, we're well positioned to take advantage of any associated economics that the streaming platforms may bring to bear.

So I mean, as you might expect, we're in dialogue with large global tech platform providers about their cloud infrastructure and potential streaming solutions. But we also think that there are some important hurdles to overcome before streaming becomes widely adopted. There's a number of them, but just as one example, latency requirements mean a lot in gaming. Live measured in milliseconds can disrupt the gaming experience in a way that, it doesn't really matter for watching a movie or a TV show. And so we feel like there's still work to be done before the tech is ready for mainstream adoption. So we do think this will happen. Probably not in the near term and we're well positioned when it does.

I would want to say though, for us, the bigger unlock over the near term is to broaden the global reach of our franchises through mobile. And as you've heard, we think it's a large opportunity. We have really deeply engaged communities who are really looking for experiences to have with them throughout the day. And when you look at our incubation pipeline, or when we look at it, we get really excited about what that future can bring. And we're, as you heard in today's call, we're focused on expanding that area of our business. And we're really excited to take next steps over the coming quarters

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2018-08-02
Event Description: Q2 2018 Earnings Call

Market Cap: 54,374.98
Current PX: 71.32
YTD Change($): +8.00
YTD Change(%): +12.634

Bloomberg Estimates - EPS
Current Quarter: 0.546
Current Year: 2.615
Bloomberg Estimates - Sales
Current Quarter: 1697.053
Current Year: 7486.952

Q2 2018 Earnings Call

Company Participants

- Christopher Hickey
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Michael Morhaime
- Riccardo Zacconi

Other Participants

- Colin Alan Sebastian
- Doug Creutz
- Christopher Merwin
- Michael J. Olson
- Drew Crum
- Brandon Ross
- Evan Wingren
- Matthew C. Thornton
- Timothy O'Shea

MANAGEMENT DISCUSSION SECTION

Operator

Good day everyone and welcome to Activision Blizzard's Q2 2018 Earnings Conference Call. Today's call is being recorded. And now it's my pleasure to turn the conference over to Chris Hickey, Senior Vice President of Investor Relations. Please go ahead, sir.

Christopher Hickey

Thank you. Good afternoon and thank you for joining us today for Activision Blizzard's second quarter 2018 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, COO; and Spencer Neumann, CFO; and for Q&A, Mike Morhaime, CEO of Blizzard and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call, we will be making be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation, and while we believe them to be true, they ultimately may prove to be incorrect.

A number of factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2017 Annual Report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events and circumstances after today, August 2, 2018.

We will present both GAAP and non-GAAP financial measures during the call. We will also provide non-GAAP financial measures, which reflect the impact of expenses related to stock-based compensation, the amortization of intangible assets and expenses related to acquisitions, including legal fees, costs, expenses and accruals, expenses related to debt financings and refinancings, restructuring charges, the associated tax benefit of these excluded items and the impact of certain significant discrete tax-related items. Non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We caution investors to consider all measures before making an investment decision.

Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also a PowerPoint overview you can access with the webcast and which will be posted to the website following this call. In addition, we will also be posting a financial overview that has both GAAP and non-GAAP results in a one-page summary.

I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Chris, and thank you all for joining us today. Our results for the Q2 exceeded our prior outlook and we delivered record first half revenues and earnings per share. Our franchises continue to entertain large audiences, drive deep engagement and attract significant audience investment. We have unique assets and capabilities.

Many of today's successful technology companies commercialize content data helps create, either user-generated content or content produced by outside parties, and usually through a single type of monetization, either advertising or subscription fees, as examples. We are both. We deliver our own content, interactive and live linear programming on mobile devices, personal computers and game systems in almost every country of the world. And we are one of the world's best creators of program produced content.

Over 350 million consumers consume our content each month and when they engage, they spend roughly 50 minutes per day and can invest in our content through purchases from both online and physical retailers, subscriptions, downloadable content, virtual and physical items and through participation in digital advertising. Virtually all of our content is based on intellectual property we own and created by our wholly owned studios in the U.S. and Canada, Europe and Asia, and staffed by the most talented programmers, designers, artists and animators in the world.

We are in a privileged position. We have a direct digital connection with our customers. We are a creator of premium content, and we have multiple monetization models at scale. Our success is driven by the enthusiasm our audiences have for our games and for the linear content inspired by our games. Perhaps most importantly, the loyalty our audiences have for our franchises comes from an unwavering commitment we have to creating the very best content, year after year.

We do this in recognition of the commitment our audiences make to us and the sense of belonging, meaning and purpose our communities uniquely engender. The engagement of our community members builds passion for our franchises that extends well beyond games, as we saw this past weekend with millions of spectators watching the Overwatch League Finals. And we'll see this loyalty on display again in November when we host the Overwatch World Cup Finals in Anaheim.

We're just scratching the surface on the full potential of our eight, $1 billion franchises and our network of hundreds of millions of users. We've taken some of the most important first steps in meeting our fans' desires to have more of their favorite franchises in their everyday lives. In the last year, we've paved the way as the industry leader in esports, making our franchises even more enduring.

We're also making important progress across all our mobile initiatives, which will increase the reach of games significantly. Last weekend, the Overwatch League held its inaugural Grand Finals event at the Barclays Center in New York. The event was the culmination of a very successful inaugural season. Our incredibly talented employees built a global competitive league from the ground up. And in our first season alone, we brought celebrating our players to a new level, our live event and viewing experience and world-class production quality on par with the best of professional sports.

We teamed up with 12 extraordinary team owners. We attracted some of the best traditional and esports partners, bringing years of invaluable experience to the league. We brought the power of professionalized esports to multiple partners. We signed media rights deals with the leaders in streaming and traditional broadcast and attracted global brands to serve as inaugural season sponsors. And we held the sold-out championship in New York's Barclays Center with millions of global viewers watching the finals, including through our own MLG network and broadcast partners like Disney and Amazon.

Our unique approach to esports, with a focus on city-based teams, professional players, structured economics and premium content has already started to pay off for our partners, our shareholders and, most importantly, our players. Today, we announced the first set of Season 2 team sales, welcoming new team owners from across the globe into the league. These great partners have seen the success of the Overwatch League and the opportunity to help build this sport of the future. We're thrilled to partner with them and look forward to announcing additional new partners for Season 2 throughout the rest of this year.

As the mainstream popularity of esports continues to grow, we're well-positioned to leverage the success of our Overwatch League model to develop new esports opportunities in the future. While esports give our existing fans a new and everlasting way to celebrate their favorite games and expands the appeal to broader audiences, our mobile initiatives will expand their access to our iconic franchises by making them available to hundreds of millions of new players around the world.

We have multiple mobile initiatives underway, including some with partners with strong mobile experience and local market knowledge. Today's Call of Duty mobile game announcement with Tencent is part of our effort to ensure our very best franchises are available to mobile audiences in all geographies.

We had a record last six months and we're excited about our upcoming releases, including World of Warcraft: Battle for Azeroth, Call of Duty: Black Ops 4, and a major franchise release from King. As always, we thank you, our shareholders and our partners, as well as our talented teams around the world for all of your support and hard work.

And now, Coddy will review our operational highlights from the quarter.

Collister Johnson

Thank you, Bobby. Activision Blizzard delivered record first half revenues and earnings and exceeded our second quarter guidance. We did this by providing our passionate and engaged communities with a steady stream of content, services, features and events. And this recurring flow of content across our diverse portfolio of franchises allows us to deliver consistent results even in quarters without major content releases.

Of course, major launches are still an important driver to keep our communities vibrant to invigorate existing players and to bring in new players. And in the second half of 2018, we have a number of major launches which we expect to drive strong full-year results.

We are also driving longer term growth, as Bobby mentioned, by meeting our fans' desire to have more of their favorite franchises in their everyday lives. So in addition to a growing esports community and business exemplified by the great inaugural season of the Overwatch League, we are starting to see some of our mobile initiatives progress from the research and development phase to release planning.

Now given the size of the overall mobile opportunity, we are taking a multi-pronged approach, leveraging both internal and external resources to bring compelling experiences to our fans. To that end, we announced today a new collaboration with Tencent for Call of Duty mobile, which will bring the best-selling console franchise of the last two decades to tens of millions of Chinese mobile gamers. Call of Duty mobile in China is built by one of Tencent's top mobile studios, with deep shooter experience and a great track record. And Tencent will leverage its massive network, broad distribution channels, and local marketing expertise as the game rolls out through testing and launch in the coming months.

We also expect progress on our other mobile initiatives in the second half of the year, including a major new launch from one of King's established franchises. As we work on these growth initiatives, we remain focused on our three strategic pillars of reach, engagement and player investment.

On reach, the company had 352 million monthly active users this quarter, down year-on-year, but as I mentioned, that's in advance of the big releases coming out later this year. Activision had 45 million of these monthly active users, with Call of Duty: WWII still holding a larger active player base than the prior release.

In this quarter, we revealed Call of Duty: Black Ops 4 which we expect to once again be the number one console title globally. Set to release on October 12, Black Ops 4 will include game play innovations across multiple modes. We think it will have the deepest and most engaging multiplayer experience in franchise history, the largest zombies offering ever at launch, and a phenomenal PC version built specifically for the platform and available exclusively on Blizzard's battle.net.

The game also heralds the arrival Blackout which combines Black Ops' signature combat, characters, game play, vehicles, lore and maps into one battle royale mode with the biggest map in Call of Duty history. This week, the community had their first glimpse of Blackout footage in the tease trailer and the response was overwhelmingly positive.

We've been playing all the game's modes and we think they deliver everything the community loves about Block Ops and more. We can't wait for you to see the game and hopefully play it this weekend with our worldwide multiplayer beta, and then for the first time in franchise history, we are excited to say there will be a second beta in September where fans will have a chance to play Blackout as well.

And the community's excited too. Preorders are strong, and Black Ops 3 monthly active users grew quarter-over-quarter and in June reached their highest level this year as over 15 million players geared up for the next installment of this great franchise.

Turning to Destiny, Bungie and Activision continue to make updates in engaging content for Destiny's fans. Destiny 2's second expansion, Warmind, was released in Q2 with a higher attach rate than Destiny 1's second expansion, and Destiny 2 monthly active users grew quarter-over-quarter.

Now the next big step in the franchise is Forsaken, the major expansion coming out in September. We think this release will drive strong community engagement, particularly around the innovation in Gambit, a new competitive co-op mode which we think could be transformative for the way people play in first-person action games.

Activision's strategy to reimagine its rich library of beloved IP continued in the second quarter, with its successful launch of Crash Bandicoot on Xbox One, Switch and PC. Crash continues to exceed expectations with the strong performance in new platforms showing pent up demand that we have for our classic franchises. And in September, Activision will launch the Spyro Reignited Trilogy on PlayStation and Xbox. The great team at Toys For Bob have remade three classic Spyro games from the ground up and we think Spyro's passionate fans are going to love it.

Moving on to Blizzard, which had 37 million monthly active users, again ahead of their big second-half content push which starts on August 14 when Blizzard will release Battle for Azeroth, the latest expansion for World of Warcraft. Battle for Azeroth adds to the already deep World of Warcraft universe with an array of new zones, dungeons, raids, items and creatures. Players will get to unlock new races to make characters more customizable than ever, and Blizzard has added even more social features, letting players stick to their friends and family even outside their guild. Momentum remains high ahead of the launch with preorders coming in strong.

For Overwatch, Blizzard is building on the excitement around the Overwatch League with more esports events and a continuous stream of in-game content in the second half of the year, including seasonal events, maps, heroes and new cosmetic items.

And for Hearthstone, anticipation for the Boomsday project expansion is running high with pre-purchases tracking ahead of any prior expansion at this same time in prerelease. We think some of that momentum is due to a new offering that gives players more choice, including a premium bundle with extra card packs and an alternate hero.

Turning to King, monthly active users were 270 million. King continued its focus on expanding live services, features and content to its hundreds of millions of engaged players around the world and executed well, growing revenue year-on-year.

King did see some impact in the quarter to its network due to technical system changes made by some third-party partners in response to data initiatives. These changes inadvertently impacted some users' ability to play and invest. Our team worked with partners to address the issues and stabilize net bookings, and King's innovations in live ops events and marketing went on to deliver encouraging results in the quarter.

On our core mobile platform, monthly active users for our largest game, Candy Crush Saga, were stable quarter-over-quarter and grew year-over-year, and engagement trends remain strong, with time spent per DA use stable at 36 minutes, which brings me to our second strategic pillar, engagement.

As Bobby shared, we saw significant engagement in particular around esports with interest in the playoffs and championships for the Overwatch League running above even our own high expectations. In the Call of Duty World, they continued to enjoy momentum with minutes watched up 50% year-over-year and now heads into its own championships later this month in Columbus, Ohio.

Turning to our third strategic pillar, player investment. In-game content, features and services continue to be a major driver for our business and delivered $1 billion of in-game net bookings in the second quarter and a record that was approximately $2 billion year-to-date. Activision had record second quarter in-game net bookings, driven by Call of Duty: WWII, Black Ops 3 and Destiny 2.

King had two of the top 10 highest-grossing titles in the U.S. mobile app stores for the 19th quarter in a row with Candy Crush Saga again the number one grossing game on mobile in the U.S. and Candy Crush overall franchise net bookings growing strongly, up double digits year-on-year, and King's advertising business profitable for the second quarter in a row with net bookings ramping from last quarter.

In summary, we continued to perform in our core business while investing in building internal capabilities for a broader set of experiences around our franchises, including mobile, esports and advertising. You're seeing early traction on some of those initiatives, including upcoming mobile releases, clear momentum for the Overwatch League and a ramping advertising business.

Spence will now review the Q2 numbers and second half outlook in more detail. Spence?

Spencer Adam Neumann

Thanks, Coddy. Today I will review our better than expected Q2 2018 results. I'll also review our outlook for Q3 and the remainder of the year. To review the quarter, I'll start with our segment results.

Activision grew revenue 7% year-over-year, driven by double digit growth in in-game net bookings. Call of Duty: WWII's digital season continued to outperform the prior release, while Destiny 2 saw strong participation in its Warmind expansion. Operating income for the segment was down slightly relative to prior year with modestly lower margins from product mix.

Blizzard revenue and operating margin declined year-over-year. This reflects the timing of major content releases and investment in key growth initiatives, including Overwatch League, MLG Network, battle.net and mobile incubation, all consistent with our discussion on the prior quarter's call. Bolstered by the release of Battle for Azeroth in August, we expect Blizzard to return to year-over-year growth and margin expansion in the second half.

King grew revenue and operating income 5% and 3% respectively over prior year. Net bookings growth from continued live title innovation and monetization improvements more than offset the negative network breach impact from third party partners that Coddy referenced.

Now let's turn to our consolidated results. Unless other otherwise indicated, I'll be referencing non-GAAP figures. Please prefer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated Q2 GAAP revenues of $1.64 billion, $86 million above our May guidance. This includes the net recognition of deferrals of $256 million. Net bookings of $1.38 billion were $35 million above our May guidance. We generated Q2 GAAP EPS of $0.52 and Q2 non-GAAP EPS of $0.62, which was $0.26 and $0.16 above guidance respectively. These figures include the net recognition of deferrals of $0.21.

During Q2, we entered into a closing agreement with the IRS to settle certain intercompany transfer pricing arrangements. We expect to pay approximately $345 million in cash related to the settlement, mostly in the second half of the year. The settlement was the primary reason second quarter GAAP and non-GAAP earnings had a lower than anticipated tax rate. And following the settlement, we now expect our full year tax rates to decrease with a GAAP tax rate of 13% versus 18% previously and a non-GAAP tax rate of 18% versus 20% previously.

From a cash flow and capital structure perspective, Q2 operating cash flow of $9 million includes the impact from higher year-over-year cash taxes and some working capital timing. On a trailing 12-month basis, operating cash flow of $2.08 billion is up modestly over prior year. We paid a cash dividend of $0.34 per common share, which was up 13% year-over-year for a total of $259 million in aggregate to shareholders of record as of March 30, 2018.

Our cash and investments at the end of June was approximately $5 billion, with domestic cash of roughly $4 billion as a result of our repatriation activity in Q2. And we ended the quarter with a net cash position of approximately $540 million. We indicated on our last call that we have board authorization to pay down as much as $1.8 billion of debt this year, and we now expect to utilize the full authorization in Q3.

Before I turn to the specifics of our outlook, I'll provide some context on overall guidance and phasing of earnings for the remainder of the year. As I said on the last two calls, we expect revenues and operating income for 2018 to be more back-end loaded, given the timing of our major releases and content slate relative to prior year. Specifically, with regard to Q3, last year, King benefited from the promotion of the Candy TV show and a particularly strong monetization lift. And Activision benefited from the launch of Destiny 2, as well as a full quarter of Black Ops III Zombies Chronicles. And in Q3 this year, we'll have additional marketing expenses ahead of the early Q4 launch of Call of Duty.

Conversely, Q4 of this year will fully benefit from two major releases, the August launch of World of Warcraft: Battle for Azeroth and the early Q4 release of Black Ops 4. So we're expecting a very strong final quarter, contributing meaningfully higher mix of full year revenue and earnings relative to last year. Now, while we still have a lot of execution ahead of us in the second half, we remain confident in our franchises, in our pipeline and in our full-year outlook.

Despite FX headwinds over the last quarter, we're maintaining our full-year guidance for revenue and we're raising our GAAP EPS forecast to reflect a lower tax rate from the IRS settlement that I mentioned earlier.

With that context, for Q3, on a GAAP basis, we expect net revenues of $1.490 billion, including GAAP deferrals of $125 million; product cost, game operations and distribution expenses of 27%; operating expenses including software amortization of 59%; and we expect GAAP interest expense of $62 million; the tax rate of 18%; GAAP and non-GAAP share count of 772 million; and EPS of $0.16. Interest expense is elevated due to one-time costs related to our planned debt pay down.

For Q3, on a non-GAAP basis, we expect product costs, game operations and distribution expenses of 27%; operating expenses, including software amortization of 49%; and we expect non-GAAP interest expense of $20 million; the tax rate of 18%; and non-GAAP EPS of $0.37, including GAAP deferrals of $0.10.

For 2018, on a GAAP basis, we expect net revenues of $7.355 billion, including: GAAP deferrals of $120 million; product costs, game operation and distributions expenses of 24%; and operating expenses, including software amortization of 52%. We expect GAAP interest expense of $130 million; the tax rate of 13%; GAAP and non-GAAP share count of 774 million with EPS of $1.84.

And for 2018, on a non-GAAP basis, we expect: product costs, game operations and distribution expenses of 24%; operating expenses, including software amortization of 44%; and we expect non-GAAP interest expense of $86 million; the tax rate of 18%; and non-GAAP EPS of $2.46, including GAAP deferrals of $0.12.

In conclusion, in Q2, we delivered better than expected results and sequential stability. We're looking forward to important launches in the second half and all the while, we continue to make progress executing against our strategic initiatives, including mobile, the Overwatch League and advertising.

Now I welcome Mike and Riccardo as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] Go first to Chris Merwin at Goldman Sachs, please. And please check your mute button.

<A - Christopher Hickey>: Chris, are you there? While we're waiting for Chris, we'll go to the next question, operator.

Operator

Okay. Thank you. And we'll go next to Colin Sebastian at Robert Baird.

<Q - Colin Alan Sebastian>: Great. Thanks. Good afternoon. Very nice quarter. My question is with the first season now complete for the Overwatch League, I was hoping you could reflect on some of the key learnings from the season and more broadly, what we can expect going forward from the franchise. Thanks.

<A - Michael Morhaime>: Hi, Colin. This is Mike from Blizzard. So Bobby talked about some of the success that we had in Season 1. I'd like to have a shout-out to the team for delivering an awesome experience that definitely exceeded our expectations. Because of that success, as Bobby mentioned, we've already added two new great partners for Season 2, and we think that there will be more to come as well.

Just quickly, I attended the Grand Finals last weekend in Brooklyn. I know many people listening were there as well. I hope everybody enjoyed it as much as I did. It was awesome to be part of the player and fan celebration, and we think that's just a start of a growing movement that will recognize and celebrate the best of Blizzard esports in the future as well.

Looking forward, there's a lot more for Overwatch fans to enjoy in the coming months, including esports, in-game content, consumer products. For esports, we have the Overwatch League All-Star Game later this month at the Blizzard Arena. We have the World Cup Finals at BlizzCon in November. There's a ton that we've been working on in game as well. Our most recent hero, Wrecking Ball has done a great deal to generate buzz and engagement in the community. There's a lot of excitement for our upcoming seasonal events, Summer Games 2018, and we have some announcements that we'll be making about new content at gamescom and at a fan festival in Seoul, South Korea, in August.

We also, in addition to our partnerships with sponsors on the esports side, we've also announced some new consumer products partners for the game. We have LEGO, Nerf, UNIQLO and Kellogg, and we think those partnerships will help us bring Overwatch to fans and new audiences throughout the world. So very excited about the future of Overwatch.

<Q - Colin Alan Sebastian>: Great.

<A - Christopher Hickey>: Thanks, operator. Can he we have the next question, please?

Operator

Thank you. And we'll go to Doug Creutz at Cowen & Company.

<Q - Doug Creutz>: Hey. Thank you. You mentioned that Call of Duty preorders are looking strong. I wondered if you'd be willing to get a little bit more granular on that, maybe any comparison you can give to some of your better selling Call of Duty titles in the past. And then maybe anything else that you guys are looking at in terms of interest in the title that you think might be interesting. Thank you.

<A - Collister Johnson>: Sure. Thanks, Doug, could hear your voice. This is Coddy. Well, I'd just start at a high level. We have strong expectations for the game. We feel good about the development underway. We feel great about the community interest and fan response we're seeing. And as you said, preorders are strong. I'll give some context about how we think about the franchise and the strength of it so far.

I guess it starts first, stepping back, just remembering that the Black Ops sub-franchise has over 200 million registered players to date and over 15 billion hours of game play and is known and really has this sort of incredibly deep and appealing ongoing engagement universe that it provides to fans. And we think Black Ops 4 really builds on that trend.

We're seeing it already now just with engagement even before launch. We had a really highly watched, and even to us, like really, really well received reveal event, as you may remember, back in May. And we had that hands on multiplayer at E3 and we had major zombies announcements at Comic-Com. All three of those were building momentum. And what we're seeing now is this surge of excitement build in advance of the multiplayer beta that kicks off tomorrow, and we hope many on this call will be playing it with us.

We've also seen a tremendous amount of interest in the new Blackout mode. As I said, we teased it earlier this week and we just saw an overwhelmingly positive response to the trailer we put out. We think fans are really hungry for it. And we see it also in the play tests that we're doing, both with our own teams and in confidential tests that we bring consumers through. There's this moment-to-moment creation that happens now, which in many of Call of Duty games in the past was scripted.

But in this, the players are generating kind of the wild helicopter rides the take-downs from ATVs and truck beds, the powers and abilities that you find as you move through the map. It's putting in the hands of the fans this massive experience. And we think it really speaks to [indiscernible] (29:29) as well. It's just sort of masters of creating content that's fun to play for hours and weeks and as you've seen, in June for years on end. And we think Black Ops 4 leans into that. So we're fired up for the October 12 launch and we think it might be one of the best installments of Call of Duty that we've made to date.

<Q - Doug Creutz>: Great. Thank you.

<A - Christopher Hickey>: Can we have the next question, please, operator.

Operator

And we'll go to Chris Merwin at Goldman Sachs.

<Q - Christopher Merwin>: Hey. Great. Thank you. Could you talk about how you could compare the impact of Fortnite to engagement for core franchises in the Q2 relative to the 1Q? Monetization title grew pretty significantly quarter-on-quarter and so just curious if there was any incremental headwinds to the business. Are you factoring in any further headwinds from Fortnite to the rest of the year? Thanks.

<A - Spencer Adam Neumann>: Sure. Hey, Chris. It's Spence. We're glad to hear your voice. We thought we lost you there. So welcome back.

<Q - Christopher Merwin>: Sorry about that.

<A - Spencer Adam Neumann>: Thanks for the question. Look, I guess at the highest level, no, no problem. We, as I think you heard, we delivered strong Q2 results with overall stability in revenue and earnings compared to the prior quarter. And we achieved that performance against the backdrop of what you point out, which is there's very strong consumer interest around games that are centered around this battle royale.

And I mentioned on our last call, and it continues to be the case, that we believe we're seeing some impact across certain franchises, primarily on engagement, including players that seem to be splitting some of their time between our games and trying something new. But overall, it looks like to us like these battle royale games are highly incremental to the industry. They're bringing new players. It's increasing engagement. And for the gaming sector as a whole, as Bobby talked in the last call, it's making gaming more mainstream.

So this overall dynamic once again shows that innovation and fresh content draws in players and it expands the gaming community. And as we tried to underscore today, we remain laser focused on driving innovation within our franchises and in compelling content that we believe will excite both existing and new players and sustain engagement over long periods of time. So we think you're going to see a lot of that in the year ahead when we release Battle for Azeroth in a couple of weeks and again in a big way when we release Call of Duty Black Ops 4 in October. Thanks.

<Q - Christopher Merwin>: Okay. Thank you.

Operator

And we'll go next to Mike Olson at Piper Jaffray.

<Q - Michael J. Olson>: Hey, good afternoon. Thanks. Wondering if you could just update us on King advertising progress?

<A - Riccardo Zacconi>: Hi, Mike. It's Riccardo here. So let me start saying that the advertising business has momentum. So we ramped the business in Q2 and we see encouraging progress both on the direct and indirect channels. In the past, you heard me say that the King network offers a audience at scale, a branch leaf environment and industry-leading completion rates and ad recall. So now we are seeing advertisers and agencies, both of them starting to see the power of this combination.

Our teams, if we look at our teams, both the advertising team and the game teams are continuing to work very closely together on delivering a positive advertising experience and also innovative products, which adds to the player experience. In Q2, we saw growth off a small base, and we will continue to take a measured the approach to the roll-out. We all introduce ads in new games and to new player segments after an expansive testing phase.

So I will say in brief, I would summarize our position as we have momentum, and we expect the ad revenues to continue ramp in the second half of the year and to make a more meaningful contribution in 2019.

<Q - Michael J. Olson>: Thank you.

<A - Christopher Hickey>: Thanks. Operator, can we have the next question, please?

Operator

Certainly, and that is from Drew Crum at Stifel.

<Q - Drew Crum>: Okay. Thanks. Good afternoon, everyone. I'm hoping you can provide more of an update on the Destiny franchise and just your expectations for the major expansion this fall? Thanks.

<A - Collister Johnson>: Got it. Thanks, Drew. This is Coddy. I'll take that one. As you'll remember, we've talked a lot about listening to the Destiny community to provide a deeper ongoing experience, more engaging moment to moment gameplay and a series of updates with better rewards in the ongoing live game. And the team at Bungie and the team here at Activision have made a lot of strides in doing that, particularly the last two quarters, with the ongoing improvements to the end game and the overall gameplay experience.

But in particular, with the Warmind expansion in May, that really showed us the ability to evolve the game and regrow engagement and regrow users. And now, that community, that's the most positive place since Destiny 2 launched last September. And so, now we have this big step with the launch of Forsaken which happens next month.

The encouraging part is players have had a great response so far with engagement online around the content announcement, hands-on gameplay of E3, which honestly led to the highest social sentiment we've seen in three years of E3; and a lot of excitement around Gambit, which brings this whole new way to play that's both cooperative and competitive between teams. And we really do think it could be transformative.

So we feel good about the content to come and the engagement we've seen in the community overall, and we feel really good about what Forsaken would do to build on that momentum. So we're excited for it, and we're in that countdown period now to put it in the hands of our fans.

<Q - Drew Crum>: Great. Thanks.

<A - Christopher Hickey>: Thanks, Drew. Operator, can we have the next question, please?

Operator

Certainly, and that's from Brandon Ross at BTIG.

<Q - Brandon Ross>: Hi. Thanks for taking the question. In your press release, you mentioned strong presales for Battle of Azeroth. Is there any further color you could give us there? And what are your current expectations overall for the expansion maybe relative to other World of Warcraft expansions? Thanks.

<A - Michael Morhaime>: Thanks, Brandon. This is Mike. So we're about two weeks away from the launch. Excitement is definitely building for this expansion, both inside Blizzard and with the World of Warcraft community. We've seen strong engagement as we released content updates, including the Battle for Azeroth pre-patch. And we've also had special story-based content to bridge players from Legion, our previous expansion, into the new expansion.

We just started releasing some new animated shorts called the Warbringers series. They tell the story of Battle for Azeroth. Those pieces have racked up more than 8 million views on YouTube already, and we're very, very excited about that. And we're gearing up for another major story drop pretty soon. We also removed a hurdle into how players can get started with the game. So we no longer require a box purchase up front. That's been met with a lot of positivity by gaming press and the community.

As Coddy mentioned, preorders have been strong. As always, we have some great content coming. The team's done a great job working both on the expansion, as well as on ongoing content and increasingly improve the steady stream of content in between expansions which we think is very important. I'll also point out we're celebrating a big milestone with World of Warcraft. Today marks the 5,000th day that World of Warcraft has been in operation, and I think that a big kudos to the team for continuing to work on content and keep the game fresh, even after all this time.

So there's a lot to look forward to in the next couple weeks and also beyond that. We're very excited about the expansion and the momentum heading into the launch.

<Q - Brandon Ross>: Thank you.

<A - Christopher Hickey>: Thanks, Brandon. Operator, can we get the next question, please?

Operator

Yes, sir. And we'll go to Evan Wingren at KeyBanc Capital Markets.

<Q - Evan Wingren>: Thanks. One of the main questions that we get from investors on the near term is about the holiday release schedule, and it seems particularly full, at least at the high end of games. I guess I would ask, do you agree? And if so, how do you think about the risk and potential for the industry to grow sales above prior years?

<A - Spencer Adam Neumann>: Hey. Thanks for the question, Evan. It's Spence. I'll take this one. This is a question that feels like the company probably gets every year, and it makes sense because it seems like every year there is strong competition in gaming. It's not just in 2018. There's competitive games in all years that draw gamers' time and attention. And now as you point out, this year may be a bit more crowded than others, but we're used to the competition and we really like the hand we're dealt.

And the number one factor driving our game success is our own game quality and the fun and innovation we bring to the experience. And across our business, we've got the most talented teams in the industry, who know how to make great games that people want to play regardless of what's happening, frankly.

So if you look at the rest of the year, we've got a number of major franchise releases that are shaping up to deliver amazing experiences to our passionate communities. Between Battle for Azeroth in August, Destiny 2: Forsaken in September, Black Ops 4 in October and a major release from King, we think we're extremely well positioned across our portfolio to drive growth. So as I said earlier, we've got plenty of execution ahead of us but we're confident in our great franchises heading into the holiday season.

<Q - Evan Wingren>: Thank you.

<A - Christopher Hickey>: Thanks, Evan. Operator, can we have the next question, please?

Operator

Certainly. And that's from Matthew Thornton at SunTrust.

<Q - Matthew C. Thornton>: Yeah, good afternoon. Thanks for taking the question. Maybe another one on King, so maybe this is for Riccardo. Could you talk a little bit about how King's reach and the slate will develop kind of as we work through the back half of the year?

<A - Riccardo Zacconi>: Hi, Matthew. Indeed it's me. It's Riccardo. So let me answer first the question on reach and then we address then the question on the slate. On reach, in Q2 , we saw a decrease after a few quarters of improved stability. We had 270 million monthly active users in Q2. Now, Q2 is a seasonally slow quarter, and here we were down 5% versus the previous quarter.

Now as you heard earlier from Spence, monthly active users would have been higher were it not for technical changes at some third-party partners which temporarily impacted some users' ability to both play and invest. This said, we are encouraged by some of the trends, our player base that show that our reach initiatives are paying off. So for example, Candy Crush mobile monthly active users grew year-over-year, and we see a strong engagement across our network, with time spent per player remaining high.

In regards to the slate, in Q2 we released Royal Charm Slots and we will continue to optimize the game in the next quarters. And we also plan to launch more games before the end of the year, including a major launch from one of our large established franchises. When we think about slate, we do not just think about new game launches, but we also think about fresh content and updates in the live games. And here, we aim to continue to accelerate the delivery of new features in the live games.

<A - Christopher Hickey>: Operator, we probably have time for one last question.

Operator

Certainly. And we'll go to Tim O'Shea at Jefferies.

<Q - Timothy O'Shea>: Yes. Thank you for taking my question. So since E3, investors have been focused on these emerging streaming platforms. I'm curious, what is your position on cloud gaming and streaming? Thank you.

<A - Collister Johnson>: Thanks, Tim. This is Coddy. So over the long term, we think cloud-based gaming and streaming is a very strong positive for the industry, and particularly for us. It should ultimately accelerate growth in an already growing industry. First, it has the potential to significantly expand the reach of our big screen experiences to audiences that don't have a console. And in some cases don't have a PC, depending on the streaming system you're talking about.

And second, even for existing gamers, streaming systems, they should be able to provide more easily accessible experiences, reducing friction, enabling deeper ongoing engagement throughout the day as the content is more available.

And third, we think we in particular are well placed to take advantage of streaming cloud-based gaming when it comes. We have deep, strong franchises that certainly benefit from exposure to broader audiences. We have vibrant player communities who are looking for, right now for additional ways to access the franchises that they love. And as a company that creates our content, fully owns our IP, has some of the best IP in gaming we think, we're well positioned to take advantage of any associated economics that the streaming platforms may bring to bear.

So I mean, as you might expect, we're in dialogue with large global tech platform providers about their cloud infrastructure and potential streaming solutions. But we also think that there are some important hurdles to overcome before streaming becomes widely adopted. There's a number of them, but just as one example, latency requirements mean a lot in gaming. Live measured in milliseconds can disrupt the gaming experience in a way that, it doesn't really matter for watching a movie or a TV show. And so we feel like there's still work to be done before the tech is ready for mainstream adoption. So we do think this will happen. Probably not in the near term and we're well positioned when it does.

I would want to say though, for us, the bigger unlock over the near term is to broaden the global reach of our franchises through mobile. And as you've heard, we think it's a large opportunity. We have really deeply engaged communities who are really looking for experiences to have with them throughout the day. And when you look at our incubation pipeline, or when we look at it, we get really excited about what that future can bring. And we're, as you heard in today's call, we're focused on expanding that area of our business. And we're really excited to take next steps over the coming quarters.

<Q - Timothy O'Shea>: Thanks.

Christopher Hickey

And that concludes the call. So thank you everybody for joining us, and we look forward to talking to you next quarter.

Robert A. Kotick

I think you said it. Thanks, Chris. Congrats on your first call. Thanks everyone for joining today, and we'll talk to you soon. Thanks so much.

Operator

And ladies and gentlemen, once again that does conclude today's conference, and again I'd like to thank everyone for joining us today.

Q1 2018 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Michael Morhaime
- Riccardo Zacconi

Other Participants

- Eric J. Sheridan
- Evan Wingren
- Christopher Merwin
- Todd Michael Juenger
- Brian Nowak
- Michael J. Olson
- Timothy O'Shea
- Colin Alan Sebastian

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone. Welcome to Activision Blizzard's Q1 2018 earnings conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Amrita Ahuja, Senior Vice President of Investor Relations. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's first quarter 2018 conference call.

Before we start the call, we want to share with you an extraordinary error that was made by The Wall Street Journal earlier today, which caused trading volatility in our stock. The Wall Street Journal made a mistake and prematurely released a completely inaccurate headline, reporting our Q1 revenues as $1.7 billion instead of our actual Q1 2018 GAAP revenues of a record $1.97 billion. Not only did they report inaccurately, they did so in violation of our written embargo agreement. They have since issued an apology.

Our actual results are now clarified and reflect our strong performance and plans for growth, including a record first quarter well ahead of our outlook and consensus and increased guidance for 2018.

So today to review those results, we have with us: Bobby Kotick, CEO; Coddy Johnson, COO; and Spencer Neumann, CFO. And for Q&A Dennis Durkin, Chief Corporate Officer; Mike Morhaime, CEO of Blizzard; and Riccardo Zacconi, CEO of King will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect.

A number of things could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2017 Annual Report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revision to any forward-looking statement to reflect events or circumstances after today, May 3, 2018.

We will present both GAAP and non-GAAP financial measures during this call. We also provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses, and accruals related to acquisitions, including the acquisition of King Digital Entertainment; expenses related to debt financings and refinancings; restructuring charges and the associated tax benefits.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com, for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also a PowerPoint overview which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks, Amrita, and thank you all for joining us today. This was another record quarter for Activision Blizzard, with GAAP revenues of $1.97 billion, driven by record quarterly digital, in-game, and mobile net bookings. We also achieved an all-quarter record non-GAAP EPS of $0.78, surpassing our prior outlook by $0.13. And we generated record Q1 operating cash flow of $529 million, up nearly 30% year over year.

Our continued ability to set new records speaks to the breadth and enduring nature of our portfolio of franchises against the backdrop of a large and growing interactive industry.

Gaming is constantly evolving and innovating, which often expands the marketplace, and the success of Fortnite is no exception. This game is attracting new players of all ages and gender and it is helping gaming become even more mainstream entertainment.

Our biggest franchises are anchored by communities of tens of millions of players. And while many of our players try new games, they always come back to the franchises that are the foundation of the communities that they are a part of.

World of Warcraft, Call of Duty, and Candy Crush are great examples. These longstanding franchises are driving innovation into games at a regular pace with new in-game content, social features, and regular updates added to their ever-evolving rich game universes. World of Warcraft is on a very positive trajectory, with strong presales for the upcoming expansion content. And Candy Crush is demonstrating growth, holding both the number one and two grossing mobile spots in the U.S. for the second quarter in a row.

We see strength across the whole portfolio, including Overwatch, where total franchise engagement is up, and Call of Duty, where the digital season and reach have been strongly ahead of last year. And of course, we're all very excited about the highly anticipated Black Ops 4 release.

Gaming remains the most engaging form of entertainment, and it's projected to grow faster than any form of media except messaging, even faster than social media in terms of time spent. We estimate that the interactive entertainment industry exceeded $120 billion in total revenues last year and grew at 20% year over year. We are the largest standalone interactive entertainment company, and yet we represent less than 10% of this rapidly growing industry, which illustrates the sizable opportunity we see ahead.

Our core games business has always been our growth engine in terms of results and intellectual property creation. That will only get stronger as we focus on two especially large opportunities ahead of us. First, mobile gaming, which represents a unique opportunity for us to dramatically expand our reach to new and existing players, and we're leveraging our powerful franchises across the company in the creation of our new mobile franchises and titles. Second, we have room to grow our high-margin and recurring in-game revenue streams through a persistent focus on continuing to add value to all of our players' experiences.

We continue to be the leading innovators in professional esports. The inaugural regular season of the Overwatch League is progressing well, with millions of viewers each week and average viewing time of over an hour, which provides our multiple global broadcast partners and sponsors with access to a highly engaged and hard-to-reach audience.

The Overwatch League continues to thrive, and our players are getting even broader recognition of their incredible talents in mainstream media. We see even greater opportunity with the playoffs and Grand Finals still to come. And we've begun sales of our next round of Overwatch League teams. And over time, we believe our esports initiatives could rival traditional sports for audience interest, advertiser interest, sponsors, ticket sales, and merchandise sales, both virtual and physical.

Our five-year growth plan is in its earliest innings, and our greatest challenge remains prioritization of opportunity, which is an enviable challenge to have. We have the finest talent in our industry, and we continue to attract the very best and brightest people, drawn to the excitement, opportunity, and rewards our company provides.

We have a very exciting remainder of this year, and we thank you, our shareholders, as well our talented driven teams around the world for all of your support.

Now Coddy will review the highlights of our operations of this record quarter.

Collister Johnson

Thank you, Bobby. As Bobby said, Activision Blizzard had another record quarter, growing year over year and setting top and bottom line records. We were able to deliver these results because of our incredible teams with some of the world's best creative, technical, and operational talent, because of our passionate communities and strong franchises, which have some of the world's most dedicated and engaged players, spectators, and fans. And because our teams continue to find more and more ways to serve our communities in those franchises with ongoing year-round streams of content, features, and services, so that even in quarters without large content releases, we can deliver records.

Before diving into the specifics of the quarter, it's worth building on what Bobby shared about one of the genres where we already have some of the world's largest franchises and communities, the shooter genre. The new battle-round modes that have recently entered the space have compelling survivor mechanics and large in-game player pools. They have also brought tens of millions of completely new players into gaming, both on traditional platforms like console and PC, but also on newer platforms for the genre like mobile. We are very, very encouraged by this.

The shooter genre was already one of the largest and growing. We are already one of the largest players in that space. New modes that attract new players bring us new opportunities to expand our own communities and to benefit from the significant pipeline of innovation that we have planned for our franchises.

As you saw this quarter, many of our franchises delivered records, with continued success across our three strategic pillars of reach, engagement, and player investment. On reach, the company had 374 million monthly active users this quarter. And for the second quarter in a row, King stabilized its player base of overall monthly active users just slightly down from last quarter and overall engagement remaining strong, with King's daily time spent per user at record levels. Importantly, the largest part of King's audience, Candy Crush monthly active users on mobile, grew for the second quarter in a row. And King plans to grow its network even further with new game launches planned for later this year and beyond.

Activision's successful 2017 launches for Call of Duty, Destiny, and Crash Bandicoot continue to draw large audiences, with 51 million monthly active users this quarter, up 7% over last year. Call of Duty grew year over year with players engaging across the franchise, including in Call of Duty: World War II. And as we look ahead to the fall, Activision plans to again be number one globally with Call of Duty: Black Ops 4.

The studio behind the Black Ops franchise is Treyarch, known for innovation and highly engaging games, with Black Ops sub-franchise drawing over 200 million players and 15 billion hours played to date. Treyarch is now hard at work to deliver yet another amazing game. And everything about it will be community and engagement first, giving players more of the gameplay features and modes that they love and bringing all of it to players earlier than ever before in October. Tune in on May 17 when Activision will share more at the Black Ops 4 global reveal.

Now on our last call, we talked about the Destiny 2 sentiment issues and the plan to address them. The next step in that plan is the launch of Destiny 2's second expansion, Warmind, set for next week, featuring fresh updates and new content from our partner Bungie that make the gameplay more rewarding and the endgame more fulfilling. Bungie has a number of additional updates planned for the remainder of the year as well as a large expansion in the fall.

Activision continues to bring its rich library of owned IP back to some of the world's most passionate fans. Crash Bandicoot's launch on Facebook last year was a phenomenal success. And Activision plans to bring Crash to new audiences this summer on additional platforms like PC, Xbox One, and Switch. And then in September, Activision will release a new remastered collection of Spyro the Dragon on PlayStation and Xbox. Like Crash, it will be three games in one, the Spyro Reignited Trilogy. And what we know is that when we bring back our beloved IP in the right way, the community responds. And the Spyro reveal trailer has already had tens of millions of views, and preorders are well ahead of expectations.

Blizzard continues to engage audiences across platforms with 38 million monthly active users this quarter. World of Warcraft is releasing more content more regularly than ever before, leading to higher engagement sequentially, over-performance versus the prior expansion at this point in time, and strong community participation with in-game purchases. The next expansion, Battle for Azeroth, launches worldwide on August 14 and is already off to a great start, with preorders ahead of plan.

Hearthstone continued to reach and engage its large global audience last quarter, first with a novel promotion of under the Year of the Mammoth, which offered new and existing players a chance to expand their decks and gameplay at a great value. Blizzard also recently released a new player versus environment mode, Monster Hunts, on the back of the most recent expansion, and engagement has been great so far.

Overwatch continues to grow its community and engagement remains strong, with the most recent seasonal event, Retribution, having the highest participation rate to date. Now Overwatch's performance is driven by a commitment to the player community. And with its ongoing stream of seasonal events, maps, and heroes, Overwatch was recently recognized as the world's best evolving game.

To that end, Overwatch has now added new and innovative links between the game and the spectating experience for Overwatch League, which brings me to our second pillar, deepening engagement. Esports is, as you know and as Bobby said, a priority for the company. It's where we celebrate player achievement and community passion and provide awesome spectating experiences for a rapidly growing number of esports fans, nowhere more so than Overwatch League, which continues to reach millions each week.

We are seeing increased engagement for the franchise overall, with the hours combined spent playing and watching Overwatch growing quarter over quarter. And as Bobby said, this is even before the playoffs and Grand Finals later this summer. Overwatch League and its partners also introduced new engagement programs like token drops, cheermotes, and the new Twitch league pass, which deliver even better viewing experiences and new revenue opportunities.

And given all this progress, there is very strong demand for Overwatch League expansion teams. The league will therefore be highly selective in this approach, adding just a handful of teams in key strategic markets by end of year. More broadly, building out the Overwatch League allowed the company to develop a unique set of capabilities and infrastructure, and we plan to begin applying them to other franchises in the near future, including to Call of Duty. To that end, Call of Duty's 2018 World League completed its first phase in mid-April and continues to have strong viewership, with cumulative hours watched doubling year over year.

Turning last to our third strategic pillar, player investment, in-game content features and services continue to both engage our fans and contribute significantly to our results, delivering a Q1 record of $1 billion of in-game net bookings. King continues to drive player investment and had its highest net bookings quarter since Q1 of 2015, with 3% sequential growth and 13% growth year over year. And for its core business on mobile, King had its highest net bookings quarter ever.

Just as importantly, the absolute number of paying players increased quarter over quarter. And for over four years, King has had two of the top 10 games in U.S. app stores. And now, for the second quarter in a row, King had the top two games with Candy Crush Saga and Candy Crush Soda Saga, once again showing the remarkable durability of this franchise. King is also ramping up its advertising business. Supported by industry-leading viewability, completion, and ad recall rates, King continues to attract new advertisers and importantly has repeat advertises now coming across multiple industries.

Finally, on player investment, Call of Duty's strong launch last year led to growth year on year for in-game net bookings with World War II 's Q1 second only to that of Black Ops III. And there's more on horizon for Call of Duty fans this digital season, including additional in-game content and seasonal events.

So looking back, we had a great quarter that was a result of strong franchises with incredible teams innovating on behalf of passionate and growing communities. Looking ahead, we have a growth path that builds on these strengths and, as Bobby said, over time increasingly includes mobile as a primary building block that expands our player and spectator communities. We are investing in our core franchises on mobile. And as I said on the last call, we hope to see early results later this year with more meaningful impact in future years.

In summary, our franchises are as strong as ever. We are investing and building internal capabilities for the future with mobile, esports, advertising, and other forms of content and all the while delivering record results.

Spencer now will review those numbers in more detail.

Spencer Adam Neumann

Thanks, Coddy. Today I'll review our better than expected Q1 2018 results as well as our outlook for the full year. Once again, we outperformed our guidance thanks to our incredibly talented teams, our strong global portfolio of owned intellectual property, our compelling offerings of year-round content, and our commitment to relentless prioritization and fiscal discipline.

Now turning to the specifics of the quarter, I'll start with our segment results, where revenue and operating income grew by double-digit percentages year over year, setting a new Q1 operating income record while we continued to invest in new capabilities. This performance was primarily driven by our in-game content, with net bookings growing by double-digit percentage year over year for all three segments.

King grew segment revenue by 13% year over year and operating income by 15%. Margins also improved year over year, with segment operating margin at 36%. The King teams focused on continually investing and innovating in its live titles resulted in the Candy Crush franchise achieving its highest net bookings since Q4 2013.

Activision grew segment revenue and operating income substantially year over year on the strength of Call of Duty: World War II. Growth in the Call of Duty digital season in particular drove a Q1 record for segment operating margin.

Blizzard grew segment revenue to a new Q1 record, driven by in-game content across their portfolio of franchises, strong World of Warcraft presales, and the launch of the Overwatch League.

Margins decreased year over year, as Blizzard continues to invest in key growth initiatives, including the Overwatch League, MLG Network, Battle.net, and mobile incubation efforts. We expect these strategic investments to pay off in the coming years.

Now let's turn to our consolidated results. Before I continue, I wanted to quickly review ASC 606, the new accounting standard for revenue recognition. We've now adopted the new standard, which is reflected in our Q1 results. The prior-period results have not been restated. While ASC 606 affects our GAAP revenue recognition and some quarterly timing, it's not expected to materially impact our annual segment results, cash flows, or financial performance as reviewed for internal management purposes. Please refer to our 10-Q for more information.

Also, unless otherwise indicated, I'll be referencing non-GAAP figures, so please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated record Q1 GAAP revenues of $1.97 billion, $145 million above our February guidance. This includes the net recognition of deferrals of $581 million. Net bookings were also a Q1 record of $1.38 billion, which is $104 million above our February guidance. We generated an all-quarter record GAAP EPS of $0.65 and an all-quarter record non-GAAP EPS of $0.78, which was $0.13 above guidance. These figures include the net recognition of deferrals of $0.40.

Now from a cash and capital structure perspective, our business performance continues to deliver strong cash flow, with record Q1 operating cash flow of $529 million, an increase of 29% over last year. We finished the quarter with approximately $5.3 billion in cash and investments, $4.4 billion in aggregate debt outstanding, and a net cash position of roughly $860 million.

Looking ahead, we're maintaining our balanced approach to capital allocation, with board authorization to pay down as much as $1.8 billion of debt this year and plan to pay a cash dividend on May 9 of $0.34 per common share, which is a 13% increase over 2017.

We also recently had positive credit rating developments, receiving an upgrade from both Moody's and S&P. Each agency has now upgraded our rating three times in about 2.5 years, as we continue to demonstrate the strength, diversity, and recurring nature of our business.

Before I turn to the specifics of our upcoming slate and outlook, I'd like to provide some context. Based on the strength of our Q1 beat and our confidence in our franchises and pipeline, we are raising our full-year outlook modestly. As I said on our last call, we expect revenues and operating income for 2018 to be more back-end loaded than 2017 given the timing of our content slate relative to the prior year.

For example in Q2 of last year, we had Black Ops III, Zombies remastered maps, the Crash launch, and the Diablo Necromancer update. While we don't have those launches in Q2 this year, we do have an amazing full-year lineup as well as a continuous stream of content, features, and services throughout Q2 and the year, as I'll discuss in a moment. In addition, the back half of this year features not only an exciting Call of Duty: Black Ops 4 but also another major release for the year with Blizzard's World of Warcraft expansion.

Now let's turn to the specifics of our slate and outlook for 2018. In terms of slate for Q2, for Activision, Call of Duty's digital season will continue with additional map packs, content, and events. Destiny 2 will release its second expansion along with other content and feature updates, and Crash will be released on additional platforms.

Earlier this month, Blizzard released a new Hearthstone expansion and Overwatch seasonal event. Blizzard also plans to release more content and features across its portfolio, including a second anniversary event for Overwatch. And of course, King will continue to deliver innovative live ops across its portfolio. In addition, marketing spend will begin to ramp in Q2 to support the heavy back-half release schedule.

So for Q2 on a GAAP basis, we expect: net revenues of $1.555 billion, including the net recognition of deferrals of $205 million; product cost and game operations and distribution expenses of 22%; and operating expenses, including software amortization, of 57%. We expect GAAP net interest expense of $68 million, a GAAP tax rate of 23%, GAAP and non-GAAP share count of 771 million, and GAAP EPS of $0.26.

For Q2 on a non-GAAP basis, we expect: product costs and game operations and distribution expenses of 22%; operating expenses, including software amortization, of 48%. We expect non-GAAP net interest expense of $30 million, a tax rate of 20%, and non-GAAP EPS of $0.46, including the net recognition of deferrals of $0.15.

Now turning to the 2018 full-year outlook, our strong Q3-Q4 release slate includes not only Blizzard World of Warcraft expansion, Battle for Azeroth, and Call of Duty: Black Ops 4, but also Spyro the Dragon Reignited Trilogy, Destiny's major expansion, King's new launches, as well as the continued ramp of growth initiatives such as advertising.

Q1 over-performance benefited in part from timing, and we still have a lot to deliver in the year. Still, as I just mentioned, we feel great about the remainder of the year, and we're modestly raising our full-year outlook.

On a GAAP basis, we expect full-year revenues of $7.355 billion, including deferrals of $120 million; product costs and game operations and distribution expenses of 22% and operating expenses including software amortization of 53%. Our GAAP net interest expense is expected to be $135 million, and our GAAP tax rate is expected to be 18%. We expect 775 million fully diluted shares both for GAAP and non-GAAP, and GAAP EPS is expected to be $1.79.

For 2017 on a non-GAAP basis, we expect product costs and game operations and distribution expenses of 22% and operating expenses including software amortization of 44%. We expect non-GAAP net interest expense of $94 million, a tax rate of 20%, and non-GAAP EPS of $2.46, including deferrals of $0.05.

In summary, our results this quarter once again illustrate the power of our franchises. We expect them to continue to consistently deliver into the future while we invest prudently in exciting new businesses. And as always, we'll focus on fiscal discipline and operational excellence across the company.

Now I welcome Dennis, Mike, and Riccardo as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] We'll hear first from Eric Sheridan with UBS.

<Q - Eric J. Sheridan>: Thanks for taking the question. Maybe going back to Fortnite, I wanted to know if we can get any color on any impact on either engagement or monetization across some of your key titles. And what are the key learnings you have as a management team from what you've seen from Fortnite that you might apply to your own titles? Thanks so much.

<A - Spencer Adam Neumann>: Sure, Eric. This is Spence, I'll take this one. So as Bobby and Coddy mentioned earlier, the Battle Royale mode, it's contributing to the innovation and expansion we're seeing in the industry. It's not only bringing the younger audiences and millions of new gamers that both Coddy and Bobby mentioned into the shooter genre, where we're already a leader in the space, but importantly, it's also highlighting the ability to successfully bring immersive gaming experiences like Battle Royale to mobile in both Western and Eastern audiences, or markets I guess. And that's really encouraging as we think about our future mobile opportunities and our growth opportunities generally as gaming becomes increasingly mainstream.

So yes, we've seen some near-term impact from Battle Royale. But as you heard on the call today, our business continues to perform at record levels. We've got one of the broadest and most diverse portfolios of successful franchises across genres, across platforms, and across business models. And we're continuously innovating within those existing franchises, and we've got a really exciting future development pipeline. So when you put all that together, we feel great about where we're positioned and our ability to continue to deliver on our growth plans going forward.

<A - Robert A. Kotick>: And, Eric, this is Bobby. I would just add the long history of our company. When we see people innovate in an interesting and impactful way, we are very quick to figure out how to capture inspiration from innovation. And so we as a company, in our DNA, in our culture, when we see things that appeal to our audiences, we are very good at being inspired by those.

<Q - Eric J. Sheridan>: Thanks so much.

Operator

We'll hear next from Evan Wingren with KeyBanc.

<Q - Evan Wingren>: Thanks. Coming to Black Ops, how do you anticipate this edition of Black Ops will differ from historical Call of Duty games that you guys have released?

<A - Collister Johnson>: Thanks, Evan. This is Coddy. I'll take that one, and glad to. As I said in prepared remarks, Black Ops for us is going to be an awesome game, given the community, really just an incredible experience for us, gameplay features and modes. And we think not just for existing community members, but also for a significant number of new players that are coming into the shooter genre. There is a number of reasons for the strength of our belief. First is it's just Black Ops. It's the most played Call of Duty sub-franchise to date, and that's saying something in a franchise like Call of Duty, which had the success it's had.

The Black Ops III iterations so far over eight years have drawn in 200 million players and billions and billions of hours of gameplay. And by the way, that's still ongoing. As we speak, there is millions of people playing in the Black Ops franchise right now. And it leads to the second advantage, which is what we see from those billions of hours of gameplay, where we get to see in depth and real time what really engages our players. Black Ops 4 builds on that and on everything Treyarch has learned about what players love to play.

And so that's the third main area, is the confidence we have in Treyarch and their ability to execute on their creative vision. It's an incredible developer with a deep understanding of the community and the first-person genre, but also a real proven track record of innovation, including Zombies and multiple multi-player innovations that have really transformed the industry.

And it's a most important last point, which is that this is a game that's not going to just build on our strengths. It will continue to push the envelope in innovation. You'll see that in the core game itself, where we have a number of new exciting developments to roll out very soon, but also in the game's appeal on growth platforms like PC, where we've invested significant dedicated resources and design time to make sure we can deliver a great PC game to serve that community. So very soon, May 17, we'll have a lot more to say at the Black Ops 4 global reveal, and I hope you tune in. You should.

<Q - Evan Wingren>: Thank you.

Operator

We'll hear next from Chris Merwin with Goldman Sachs.

<Q - Christopher Merwin>: Okay, thanks for taking my question. I was wondering if you could talk about how Overwatch League viewership has been trending relative your expectations so far. I think in the prepared remarks, you mentioned that you started a second round of team sales already, so maybe you could comment about how that's going and how we should be thinking about the value of the new teams you might sell. Thanks.

<A - Robert A. Kotick>: So this is Bobby.

<A - Michael Morhaime>: Go ahead, Bob.

<A - Robert A. Kotick>: Sorry, you go first, Mike.

<A - Michael Morhaime>: Okay. I wanted to say we're extremely happy with both the launch and how the inaugural season for Overwatch League has been going so far. The league is definitely outperforming our expectations, starting with viewership. Viewership has been very strong and consistent each week. We've had millions of fans tuning in, and our average viewer spends about an hour – over an hour of watching each day. Our broadcast partners like Twitch and MLG and our partners in China have been great.

We've also been introducing some exciting new engagement programs that are unique to esports. We have partnered with some great sponsors as well like HP, Intel, Toyota, T-Mobile, and Sour Patch Kids, and these sponsors now have access to a highly engaged and hard-to-reach audience. We've been adding to our esports team. We've recently added professionals with strong sports marketing and broadcast expertise. And so we think that overall this has been a great success. We think it's good for the whole ecosystem. It's good for owners, our owners who have partnered with us on this exciting new venture. It's great for the players, who have increased stability as well as a great venue to showcase their talent. And it's great for the Overwatch franchise, which has benefited from increased total engagement.

<A - Robert A. Kotick>: Sorry, Mike. Go ahead.

<A - Michael Morhaime>: Okay. With respect to team sales, we are currently in process. We've been meeting with potential new owners in new geographies. Demand has been really strong globally. We don't have an update on exact timing, but we do expect to add new teams to the league this year. And so looking ahead, we're heading towards the end of our inaugural season. We'll be holding our playoffs, Grand Finals, and an All Star game this summer. And so we've got a lot of great stuff planned. We're very excited. And I'll turn it over to Bobby.

<A - Robert A. Kotick>: You said most of what I was going to say and probably better than I could have said it. But the only thing that I was going to point out is that for our almost 40 million players, what I think the league has really done is it's reinforced that the thing that they spend hours and hours a day playing is something that they feel like is now being validated in a way that it never has before in a video game.

And so all of our players in almost 190 countries around the world feel like this is truly a recognition of the sense of belonging that they get playing the game and the sense of accomplishment they feel playing the game. And I think more than anything, that's been an enormous benefit as a result of the creation of the league.

<Q - Christopher Merwin>: Okay, thank you.

Operator

And from Sanford Bernstein, we'll hear from Todd Juenger.

<Q - Todd Michael Juenger>: Hi, thanks for taking the question. I'd like to ask about King, if I could, so probably for Riccardo. So, Riccardo, I'd love to hear what you can share with us about what you're continuing to do to drive the reach of King, and just any other general insights you have to share with us on current trends you're seeing in your space. Thanks.

<A - Riccardo Zacconi>: Hi, Todd. This is Riccardo. So first of all, I would like to say that to grow again the reach is a key priority for us. So in Q1, we had 285 million monthly active users. This is slightly down sequentially, but we stabilized the active user base over the last several quarters, which I believe is a very important achievement. And if I look at the other metrics, these are also very encouraging. Daily active users were stable across the network. And specifically, daily active users in the Candy franchise increased slightly.

Now we have achieved this focusing primarily on the player experience in the live games. In live games, we have increased the pace of releasing fresh content. So we have released more levels. We have released live operations. We have released new features, and we will do more of this. Further on, we believe there is an opportunity to grow the reach, not only innovating in the game, but also innovating in the marketing.

Now, to change the trend more meaningfully requires major new game launches. Our best teams are at work building a great pipeline, and we have as we speak games at various stages of development. We have games at the conceptual level. We have game prototypes, and we have games in production. And we have games that we will release, as you heard earlier, this year.

<**Q - Todd Michael Juenger**>: Fantastic, thank you.

Operator

Next we'll hear from Brian Nowak with Morgan Stanley.

<**Q - Brian Nowak**>: Thanks for taking my question. I'm curious for an update on Destiny. Maybe talk about some of the challenges you've seen on it over the course of the last six months. And what are the biggest steps you think you need to implement in Destiny to fix it, bring back the users, and drive monetization higher?

<**A - Collister Johnson**>: Sure, thanks. This is Coddy. I'll take that one. I guess the first thing, one of the best parts about Destiny is just how passionate and engaged that community is. And the bright side of that is it gives us the chance to really build and iterate upon the feedback. As I said in the prepared remarks, the three things that we know we're going to do and that the community is looking for is make the player more powerful, provide more rewards, and make the endgame more meaningful. As we look ahead, we have a chance to continue to build on that, particularly in feedback that really engages the community.

And so maybe just as an example to share, Bungie recently hosted a large cohort of the top worldwide Destiny players onsite up at their studio in Seattle. And they walked through the roadmap of features and updates they're planning, but they also gave hands-on with not just Warmind, the expansion coming out shortly, but also with a part of the big fall release planned for later this fall, and it was a very positive response to the three things I just mentioned, the power and the rewards and the need for endgame.

But even more of what's coming this fall into the innovations and gameplay there, including to what we think will be an incredibly engaging new mode, one that introduces a whole new style of play for first-person shooter gaming generally and certainly for the shooter space that Destiny created. It's a really exciting development. It's one of the things that we feel really speak to the community when it comes out in the fall, and we're really excited to share more about that. We won't do that until E3. So as to this next expansion, head over to E3. We hope we'll you see there and be able to talk more about it.

<**Q - Brian Nowak**>: Okay, great. Thanks.

Operator

We'll hear now from Mike Olson with Piper Jaffray.

<**Q - Michael J. Olson**>: Hey, good afternoon, maybe back to Riccardo on King. Riccardo, could you update the expected timeline for more material King ad revenue? And can you talk about some of your findings during this testing period? And how extensive should we expect the raw to be as far as how much of the King portfolio is ready for advertising? And then lastly, will advertising change any game design or gameplay mechanics? Thank you.

<**A - Riccardo Zacconi**>: Hi, Mike, Riccardo here. Thank you for your questions. Let me start first giving an update on how the business is going. So I'm pleased, I'm very pleased with the progress that our ad business has made in Q1. We hit an internal milestone. The business is still relatively small but was modestly profitable this quarter. So the goal is to build a strong long-term business, and we will ramp up further the investments during the year.

And the other thing we've done is, a key priority is to build a strong team, and we have continued to build out our leadership team and our capabilities in this area. We have made some key hires in product development, in B2B marketing, and in measurement and insights. And we have also continued to work on our ads product offering. We have introduced new placements and new times where ads appear in the player journey.

As Coddy mentioned earlier, our ad products perform well. Players are completing our reader views more than 90% of the time, and our ad recall rates are much higher than industry norm. Our ad teams are working very closely with the game teams to create ad experiences that are supportive of the gameplay. So for example, you can get a booster watching an ad, and that can help you in the game.

And in regards to the rollout of our ad business, currently ads are live in certain games, including the Candy Crush franchise, but we have not turned yet on ads for all the players in these games. We are taking a measured approach where we AB test before showing ads to new segments of players. So we expect the ad business to ramp throughout the year, particularly in the second half, as we serve more players.

<Q - Michael J. Olson>: Thank you.

<A - Amrita Ahuja>: Operator?

Operator

We'll go now to Jefferies' Tim O'Shea.

<Q - Timothy O'Shea>: Yes, thank you for taking my question. So there are some other big markets like China, like mobile, where free-to-play is the dominant business model already. So I'm just wondering if Fortnite's success, if it changes how you think about the $60 full-price business model for console games going forward. Thanks.

<A - Collister Johnson>: Sure. Hey Tim, this is Coddy. Thanks for the question. I'd say broadly we think in a growing industry like ours that there's room for multiple business models to succeed in parallel. We see this just in our own portfolio across Activision Blizzard. Right now, today, we have a full range of business models, free-to-play, subscription, upfront payments, downloadable content packs, ongoing micro transactions, all of these succeeding at scale. And so it's like there's no one in a better position to see the nature of how you think about bringing a value proposition to consumers.

We think it's true of our industry broadly as well, where that direct ongoing interactive connection with players and audiences, it allows an enormous amount of iteration and innovation on how to provide the most satisfying avenues for investment. We get to see that real time in the loop that we create and the things that we roll out.

But not just in interactive, we think there's a number of areas across broader entertainment that prove this out as well, where multiple business models work at the same time. Just in linear viewership, you have Netflix and YouTube, both coexisting, both growing, both with their own kind of value propositions. And for us, that's really the most important piece is the value proposition, the North Star. And for us, that is deeply compelling and engaging gameplay. When we get that right and we find the fun and deliver that rich, meaningful, ongoing experience for players, we think we have the ability to deliver the right business model that supports and adds to the experience. We do think $60 games will continue to be an important part of that equation. And we believe the level of investment in content, in features, and in services that we provide will continue to make that a very attractive proposition for players.

<Q - Timothy O'Shea>: Thanks, Coddy.

Operator

And our final question today will be from Colin Sebastian with Robert Baird.

<Q - Colin Alan Sebastian>: Great, thanks. My question is related to World of Warcraft, including higher engagement that you're seeing with the title. And in particular, I'm wondering what we should expect then in terms of WoW usage and engagement leading up to and following the launch of Azeroth this summer. Thank you.

<A - Michael Morhaime>: Hi, Colin. This is Mike. Thanks for the question. Before I go into the expansion, I just want to quickly thank the World of Warcraft team for their amazing work in delivering great content for that community. Over the last couple of years, they have really shifted their pipelines and invested in not only the expansions, but also creating ongoing and an increasingly steady stream of content in between expansions, which is really important to keep people engaged all the way from one expansion to the next.

Battle for Azeroth is our next expansion. And at Blizzard, we're really excited about this expansion. It's coming along great. And it looks like our players are also very excited about it. As Coddy mentioned, our presales are ahead of plan. As always, this expansion features some exciting new features. I'm just going to mention a couple of them that we're particularly excited about. Island Expeditions, where players will explore unchartered islands that include randomly generated elements, we've built AI that will give players a different experience every time they visit an island, and that's to create a highly dynamic experience.

And Warfront, where players will join large groups and get the feeling of being part of a massive battle with different objectives. Warfront is a throwback to Warcraft real-time strategy roots, and we think that players, veterans and new players will really enjoy it. We designed these new features with our players in mind. We think they should get increased engagement as well as more replayable content, so that's really important with a game as massive as World of Warcraft.

This is some really exciting stuff that we're adding. We just entered wider beta testing. Player feedback has been excellent so far. So when the expansion launches in August, we are looking forward to millions more joining us in World of Warcraft.

<Q - Colin Alan Sebastian>: Thanks, Mike.

Operator

And it's time for closing remarks. I'd like to turn things over to our CFO, Spencer Neumann.

Spencer Adam Neumann

Thank you, I'll make this quick. I have a happy organizational announcement to make and I'll do while we have everybody on the call. So first, I want to congratulate Amrita, our fearless leader in Investor Relations, on a promotion. Amrita is going to become the next CFO of Blizzard, which we're ecstatic about. I hope you guys have all gained an appreciation for Amrita and her skills and capabilities over the years in her three years leading Investor Relations, as the company has been on a tremendous growth curve. We've exceeded performance of all kinds of indices during that three-year period, and we really appreciate all of her efforts along the way. And she's a star in the organization and we're looking forward to the next chapter for her.

And I'm excited to announce, even though we've got very big shoes to fill, that we're thrilled with our new head of Investor Relations that is coming onboard next week. His name is Chris Hickey. Chris is someone who many of you on the phone or on the call may know. He comes from Atlantic Equities, where he's not only an equity analyst, he's a co-founder of the firm, so he's really an entrepreneur at heart as well, and we couldn't be more happy to have him join our team. Chris knows our company well. He knows our industry. He's covered a number of industries across not just gaming, but technology, payments, and services. So he'll be joining officially on May 14.

Amrita, since she's not going far, will ensure a smooth transition as well as Colin and Jason and the team have done a terrific job supporting all of us, especially as Amrita has been transitioning down to Blizzard. So hopefully you all welcome Chris to the team. We're really happy to have him be part of the Activision Blizzard family, and I'm sure you'll get to know a lot more of him in the coming months and years ahead. So thank you.

Operator

And that will conclude today's conference. We do thank you all for joining us. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2018-02-08
Event Description: Q4 2017 Earnings Call

Market Cap: 49,774.03
Current PX: 65.83
YTD Change($): +2.51
YTD Change(%): +3.964

Bloomberg Estimates - EPS
Current Quarter: 0.417
Current Year: 2.669
Bloomberg Estimates - Sales
Current Quarter: 1428.737
Current Year: 7407.458

Q4 2017 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Riccardo Zacconi
- Michael Morhaime
- Eric Hirshberg

Other Participants

- Christopher Merwin
- Laura Martin
- Matthew C. Thornton
- Timothy O'Shea
- Michael Olson
- Brandon Hoffman
- Eric J. Sheridan
- Evan Wingren
- Colin Alan Sebastian

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Activision Blizzard's Q4 2017 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Amrita Ahuja, Senior Vice President of Investor Relations. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's fourth quarter 2017 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, President and COO; and Spencer Neumann, CFO. And for Q&A Dennis Durkin, Chief Corporate Officer; Mike Morhaime, CEO of Blizzard; Eric Hirshberg, CEO of Activision; and Riccardo Zacconi, CEO of King will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect.

A number of things could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2016 annual report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, February 8, 2018.

We will present both GAAP and non-GAAP financial measures during this call. We provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses and accruals related to acquisitions, including the acquisition of King Digital Entertainment; expenses related to debt financings and refinancings; restructuring [Technical Difficulty] (00:01:56) tax benefits of these excluded items along with significant discrete tax-related items such as those results from the Tax Cuts and Jobs Act enacted in December 2017.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also a PowerPoint overview which you can access through the webcast and which will be posted to the website following the call. In addition, we'll also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

Starting this quarter, we are introducing a new operating metric, net bookings. Net bookings is defined as net amount of products and services sold digitally or sold in physically in the period and is equal to revenues plus the impact from deferrals.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks, Amrita, and thank you all for joining us today. This was a record quarter and a record year for Activision Blizzard. We delivered record quarterly net bookings of $2.6 billion and record annual net bookings of $7.2 billion. We delivered record segment operating income of $2.4 billion and record non-GAAP EPS of $2.21 a share, above our initial February outlook of $1.70.

We also delivered record annual operating cash flow of $2.2 billion. Each part of our business reached new milestones and demonstrated the durable and enduring nature of our franchises. Activision celebrated strong Call of Duty momentum and their best operating income year ever. Blizzard delivered their highest operating income ever for a year with no major game releases and King returned to growth with the Candy Crush franchise stronger than ever. 2017 was also an important year for us for preparation of our future growth initiatives. We invested in new services, features, content and experiences to connect and engage audiences all across our franchises.

One example is the launch of the Overwatch League. Witnessing the passion of players at the opening matches of Blizzard Arena and the millions of spectators connecting via live stream from around the world was a thrilling moment in our history and a milestone in esports growth. Watching fans road trip across the country, spectators in the stands wearing team jerseys, gears in the game wearing team skins, audiences leaping to their feet after daring play and viewing parties around the world, these were also moments that created an incredibly rewarding experience and demonstrated the emergence of professional competition as a way to celebrate our players.

Launching a professional league is an ambitious undertaking and our team's executed on countless fronts, attracting 12 world-class team owners representing cities in Asia, Europe and North America, signing numerous league and team level sponsors, bringing esports spectating and production values to new heights and forming immediate distribution strategy that provides broad reach and fair value for our premium content while also preserving distribution on own platforms.

Overwatch League matches are broadcast live in our MLG Network and Twitch and will be available on other broadcast outlets throughout the world. In its first week, the league reached 10 million unique viewers and had more than 280,000 average viewers on a per minute basis. In the week since, we've seen sustained levels of viewership globally with new spectators joining each week as the excitement continues to grow.

Of course, we're building this league for the long-term and we're pleased with the early strong momentum that we have, which has created value for players, spectators, team owners, partners and sponsors. Our efforts have already led to increased global demand for expansion teams, which we expect to start selling later this year. We also believe in the growth potential of each new opportunity we are pursuing, whether in-game advertising, consumer products, cinematic productions or esports, all of these support our communities and help to drive engagement with our franchises. Each new experience we provide that enables our players to demonstrate their passion creates a virtuous cycle of engagement, investment and growth.

It's still early days for many of these efforts, but making progress in these strategic growth areas will be an important focus for us in 2018 and beyond. I have the privilege to lead one of the best teams in the entire business world. And as I begin my 28th year at the helm, I've never been more energized to pursue with focus and determination, the great growth opportunities that lie ahead. Also this quarter, we announced that Reveta Bowers joined our board of directors. Reveta brings an immense amount of experience in leadership from education and media institutions such as Common Sense Media, where she chairs the national board of directors, and from the Walt Disney Company where she served as a director for 10 years. We're thrilled to have her as our newest board member.

And now, here's Coddy to review the highlights of our operations this quarter.

Collister Johnson

Thank you, Bobby. Activision Blizzard had a record year and throughout 2017, we broke records and posted strong results each quarter by providing an ongoing year round stream of content, services, features and events, both large and small to our passionate and deeply engaged communities. While achieving these records, we also made important investments to drive future growth. We invested in marketing to grow our franchise reach, and new services and features to enable more audience engagement and player investment and in new growth verticals to celebrate our fans.

Let's dive into to our first strategic pillar, audience reach, which was 385 million monthly active users this quarter, up from 384 million in Q3. Starting with King, on our last call, we discussed a number of initiatives underway to stabilize King's user base. Those ongoing efforts include releasing fresh and compelling features, events and content into the live games, ROI positive marketing to attract and engage new players and a strong pipeline of new titles to expand the network. Several of these initiatives enabled King to finish Q4 with 290 million monthly active users and to grow time spent per user to a record of 37 minutes. The Candy Crush franchise, in particular, was up in monthly active users quarter-over-quarter while also driving increased engagement with higher daily active users and higher time spent per player.

Activision had the top two grossing console game releases in North America and two of the top five worldwide, beating the 55 million monthly active users in Q4, up double digits quarter-over-quarter and matching the prior quarterly record.

Call of Duty: WWII was the top grossing console game worldwide in 2017, making it the number one franchise globally; a spot the franchise has held for eight of the last nine years. Call of Duty: WWII also set a new franchise milestone with their biggest launch quarter sell-through on current gen consoles, higher even than Black Ops III. The game also set a PlayStation record as the biggest day one digital release ever. We've seen a steady march upward on full game downloads for Call of Duty over the last several years and there's plenty of runway still ahead. All of this strong performance coupled with a great Black Ops III Digital season earlier in the year, means that the most successful video game franchise over the last 20 years continues to be healthy and vibrant and will carry strong momentum into 2018.

Right on this fall we plan to continue to exceed fans' expectations with the new release from Activision's Treyarch, the creators of Black Ops, the most successful sub-franchise in Call of Duty history, and we cannot wait to share more about that with you on future calls.

Turning now to Destiny. Destiny 2 had an impressive launch, highly rated and second only to Call of Duty as the highest grossing console in North America in 2017. It added a critically-acclaimed PC version with distribution [indiscernible] (00:10:12) and the attach rate of Destiny 2's first expansion released in December was higher than that of Destiny 1's.

That said, we haven't yet sustainably expanded Destiny community, but Bungie is hard at work improving the game. And the good news is that the Destiny community is a deeply committed vocal passionate player base that's responded well in the past and we've made improvements based on their sentiment.

To that end, last week, Bungie released an update outlining both the changes we made and the changes that are coming. So far these changes have been received positively and the team has a robust slate of services, features and seasonal events still to come. There are also two epic adventures on the horizon with expansion two in May and a major content launch later this year. There is magic in this franchise and we're committed to meeting our own and our players' expectations in the coming quarters.

Crash Bandicoot continued to have strong sales in Q4 after successful summer launch. Crash's performance shows how valuable our library of IP can be and brought back such players in a compelling new way. We look forward to exploring other beloved IP in future offerings as well.

Blizzard is celebrating its 27th anniversary today. Happy birthday, Blizzard. A lot of things have changed over the past 27 years as the business has grown across genres, platforms and geographies, but a few things have not, including Blizzard's commitment to put players first and to release games at an incredibly high level of quality. Blizzard finished the year with 40 million monthly active users continuing a six-quarter streak of 40 million monthly active users or more.

Overwatch continues to attract new players and the most recent Blizzard World content has been well received by the community. Overwatch's model of delivering year-round content with seasonal events, new heroes and new mass continues to drive strong engagement. Hearthstone's monthly active users increased year-over-year this quarter as players enjoy the latest expansion, Kobolds and Catacombs, and the introduction of new free content.

While net bookings did not match the prior expansion's record performance, players did log more playtime, which brings me to our second strategic pillar, deepening engagement. For Activision Blizzard and King overall, daily time spent per user was over 50 minutes for the second quarter in a row, placing us on par with Facebook's time per day across Facebook, Instagram and Messenger.

Now that 50 minutes per day is just the time spent in our games. It does not include the growing popularity of watching our games on other online platforms. For the year, Activision Blizzard had 7 of the top 20 games on Twitch; the next closest publisher had just two, demonstrating the broad esports appeal of our franchises. Bobby already shared that launching the Overwatch League was a key milestone for us and that we're seeing strong early momentum. Call of Duty World League also opened its next season in December and is off to a good start, selling out each of its World League global events and the season's launch event more than doubled viewership hours over the prior year.

Turning now to our third pillar, player engagement. In-game services features and content continued to engage our fans and help drive our results, delivering a Q4 record of over $1 billion of in-game net bookings and an annual record of over $4 billion. We focus on our offering compelling content for our communities wherever they play. Activision had some of the industry's best-selling downloadable content in 2017, including Zombies Chronicles for Call of Duty: Black Ops III, which was the number one add-on offering of the year for PlayStation North America. This is notable and impressive given that Chronicles came out nearly two years after Black Ops III launched and illustrates the value of releasing great content to our engaged communities wherever they are playing.

Just as impressively, player investment in additional virtual goods and services surpassed investment in downloadable content in 2017 for Call of Duty and for Destiny. And we expect that to be the same for 2018. Activision has a great digital roadmap ahead including Destiny 2's expansion pass and Call of Duty: WWII's season pass. King was the biggest contributor to our record year of in-game net bookings. King continues to have two of the top 10 grossing games on U.S. iOS and Android app stores, a level of performance they've delivered for over four years now.

For the first time, King actually held both the number one and the number two spots at the same time with Candy Crush Saga and Candy Crush Soda Saga, respectively, demonstrating their more remarkable durability with Candy Crush franchise. Overall, King had an incredible year in 2017, delivering not only four straight quarters of growth in consumer spend on Candy Crush, but also new mobile net bookings record with their biggest year, their best quarter in Q3 and their best week ever in Q4.

Finally, we continue to make progress on our company-wide mobile pipeline. We are hard at work on initiatives across a number of our franchises. We plan to see some early results later this year and for the bulk of our new mobile opportunities to be driving growth in 2019 and beyond. In summary, 2017 was our best year yet because of the broad-based success we delivered and because of the groundwork we made to realize significant growth in years ahead. We have a great slate on the road for 2018 and beyond. And we look forward to continuing to serve our passionate fans, communities and audiences around the world.

Spence will now review the 2017 numbers in more detail and discuss 2018 guidance. Spence?

Spencer Adam Neumann

Thanks, Coddy. So today I'll review our Q4 and 2017 results as well as our outlook for 2018. Q4 was another strong quarter capping off a record-setting year with record quarterly and annual revenues, driven by record annual digital revenues as our business is now 78% digital and record in-game revenues consistent with our entertainment as a service model. With increasingly diversified business, we generated for the first time over $2 billion in annual revenues on each of three interactive platforms: console, PC and mobile and with record profits, record annual non-GAAP operating income and earnings per share and record cash flows. Each of Activision, Blizzard and King contributed to our over-performance for the year, delivering record annual total segment revenues and operating income. And as Bobby noted, this was without the benefit of a new full game release from Blizzard, underscoring the strength of our continuous engagement model.

Activision had an impressive fourth quarter capping off their best year ever with segment records for operating income of over $1 billion and operating margin of over 38%. Activision's performance was driven primarily by the resurgence of the Call of Duty franchise, with the successful launch of Call of Duty: WWII as well as strong sales for Crash Bandicoot. Q4 segment revenues and operating income increased 16% and 32% over prior year respectively, with the full year growing at similarly strong rates.

King had an outstanding year with revenue and operating income up 7% and 12% respectively. On a pro forma basis, that includes the 2016 pre-acquisition period for King. This is a major accomplishment. It's testament to the strong execution of the King team, their increased prioritization on the Candy Crush franchise and other live titles and their intense focus on leveraging their platform to drive continuous improvements in engagement, game features and player investment. While margins expanded year-over-year, we did see some compression in Q4 as King strategically invested in marketing live titles to profitably drive reach.

Blizzard also delivered a $2.1 billion of revenue and $712 million of operating income. Blizzard generated record results per the year with no major game release, fueled by a steady stream of content and events across their franchises, in particular, Overwatch, Hearthstone and World of Warcraft. Revenue, operating income and segment operating income margin were down year-over-year as expected given the difficult comp to last year's World of Warcraft expansion and Overwatch release. We did see some incremental margin compression in Q4, primarily due to additional marketing initiatives. Nonetheless, with 33% full year OI margins, the team did a nice job delivering a core business while investing in key growth initiatives across the Overwatch League, mobile incubation and MLG Network.

Now before I turn to our consolidated results and 2018 guidance, a brief note on U.S. tax reform. Our 2017 GAAP results include incremental expense of $794 million due to the impact of significant discrete tax-related items, primarily related to the impact of the Tax Cuts and Jobs Act enacted in December of 2017. The charge related to tax reform is a reasonable estimate, but is preliminary and includes a one-time tax on accumulated overseas profits and the revaluation of deferred tax assets and liabilities. As a result of the U.S. tax reform, we expect a reduction in our future effective tax rate which we will reflect in our 2018 guidance. We'll also now have repatriation opportunities for international cash that enable more efficient global cash management and capital structure flexibility.

So now let's turn our consolidated results. Unless otherwise indicated, I'll be referencing non-GAAP figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations. For the quarter, we generated record GAAP revenues of $2.04 billion, $343 million above our November guidance. This includes the net deferral of revenues of $597 million. As already mentioned, this quarter, we are introducing a new operating metric, net bookings which were a record $2.64 billion.

We had a GAAP loss per share of $0.77 including a $1.03 expense from the impact of the significant discrete tax related items that I just mentioned. Adjusted to exclude these discrete tax related items, we would have delivered earnings per diluted share of $0.27, ahead of our guidance of $0.10. We had non-GAAP EPS of $0.49 in Q4, ahead of guidance of $0.36 and both GAAP and non-GAAP EPS figures include net deferrals of $0.45. For the year, we generated record GAAP revenues of $7.02 billion. That's $1 billion above our initial 2017 guidance. This includes the net deferral of revenues of $139 million. Net bookings were a record $7.16 billion.

We generated GAAP EPS of $0.36 which includes a $1.04 expense from the impact of discrete tax related items in Q4. Excluding the discrete tax related items, we would have delivered record GAAP EPS this year of $1.39, ahead of initial guidance last February of $0.72. We generated record non-GAAP EPS of $2.21, ahead of our initial guidance last February of $1.70. These figures include net deferrals of $0.07.

So now looking at cash flow and capital structure. Our strong business performance for the year also delivered record annual operating cash flow of $2.21 billion and Q4 operating cash flow of $1.16 billion, finishing the year with approximately $4.8 billion in cash and investments. With regard to capital structure, we had some positive developments throughout the year and continue to take a balanced approach overall. In Q2, we received another upgrade from S&P to BBB and entered into a leverage neutral $1.2 billion refinancing at locked-in attractive long-term interest rates.

We paid down $500 million in debt and finished the year with approximately $4.44 billion of aggregate debt outstanding. And we increased our annual dividend 15% to $0.30, paying out $226 million to shareholders in May. Now we're heading into 2018 with a strong balance sheet and additional flexibility. We ended the year with a net cash position of $335 million, and as discussed, the recent tax reform allows us to repatriate the cash we're holding overseas more efficiently. This year we'll, once again, take a balanced approach to capital allocation. Our board has authorized a 13% increase in our dividend to $0.34 per share, payable in May and further debt pay-down of over $1 billion. In addition, our $1 billion stock repurchase authorization remains in effect for another year.

Now, let's turn to our outlook for 2018. But before doing so, and before a review the numbers, I wanted to quickly discuss ASC 606 and its impact on our guidance. While ASC 606 will affect our GAAP revenue recognition, it's not expected to materially impact our annual segment results, cash flows or financial performance as reviewed for internal management purposes. We do expect that there'll be some quarterly movements within the year, so please refer to the investor fact were provided on our website for more information on ASC 606.

Now turning to our 2018 slate. From an operating income perspective, we expect each of our segments to grow in 2018. While we also continue to invest in new releases, mobile pipeline and our future growth initiatives including advertising, esports leagues and MLT Network. We expect in-game revenues to be a primary driver of our growth for both the top and bottom line. Coming off a record year in 2017, we expect in-game net bookings to grow by a double-digit percentage in 2018 as we continue to innovate and deliver more engaging content to our players.

Now given the timing of launches in 2018 and the continued ramp up of our new initiatives, we expect our performance to be further weighted to the back half of the year relative to what we saw in 2017. We expect Blizzard to grow year-over-year with the release of World of Warcraft: Battle for Azeroth this summer. And I'm glad to say the presales for Azeroth kicked off last week and are off to an encouraging start. In addition, Blizzard has exciting plans for live ops and additional in0game content across franchises, including Hearthstone's three expansions in 2018 and Overwatch's in-game events. Blizzard will also start to see the benefit of its investment initiatives as we expect the Overwatch League to be profitable in 2018, its first full year of operations. We expect Activision to grow modestly year-over-year driven primarily by Call of Duty's digital season of content and the exciting new release planned for Q4.

As Coddy mentioned, Activision and Bungie are hard at work on Destiny 2 to improve endgame engagement through regular updates and events, which we anticipate will benefit performance later this year with the release of a new expansion in May and a major expansion in the second half of the year.

And we expect King to be up year-over-year, driven by ongoing live operations across the portfolio and two or more new releases during the year including Social Casino. As we've indicated on prior calls, we'll begin to ramp our ad business in 2018. We expect a minor positive profit contribution weighted towards the back half of the year as we continue to roll out additional video ad products, methodically develop capabilities and infrastructure and build the business for the significant opportunity that we see over the long-term.

Now turning to the numbers for guidance. On a GAAP basis, for 2018, we expect revenues of $7.35 billion including GAAP deferrals of $100 million. We expect record net bookings of $7.45 billion. We expect product cost of 22%, operating expenses of 53%. Our GAAP net interest expense is expected to be $136 million and our GAAP tax rate is expected to be 20%. We expect 776 million fully diluted shares both for GAAP and non-GAAP and GAAP EPS is expected to be $1.78. For 2018 on a non-GAAP basis, we expect product costs of 22% and operating expenses of 44%. We expect non-GAAP net interest expense of $95 million, and we expect a non-GAAP tax rate of 20%. We also expect non-GAAP EPS of $2.45, including a GAAP deferral of $0.05.

Now let's turn to our Q1 outlook. On a GAAP basis for Q1, we expect revenues of $1.82 billion, including GAAP deferrals of negative $540 million. We expect net bookings of $1.28 billion growing year-over-year. We expect product cost of 20%, operating expenses of 53% and our GAAP net interest expense is expected to be $30 million, our GAAP tax rate expected to be 20%. We expect 771 million fully diluted shares both for GAAP and non-GAAP and GAAP EPS is expected to be $0.47. For Q1 on a non-GAAP basis, we expect product cost of 20%, operating expenses of 43%. We expect non-GAAP net interest expense of $29 million, a tax rate of 20% and non-GAAP EPS of $0.65 including a GAAP deferral of negative $0.34.

In closing, in 2017, our inspired teams across Activision, Blizzard and King demonstrated the enduring nature of our franchises. We believe the combination of leading owned IP and franchises, a direct digital connection to our consumers, best-in-class content capabilities and creative excellence, geographic platform and business model diversity and continued fiscal discipline, focus and business prioritization provides an incredibly powerful engine for sustained financial performance, driving meaningful growth in 2018 and beyond.

Now I welcome our business leaders Eric, Mike, Riccardo and Dennis as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

[Operator Instructions] Our first question comes from Chris Merwin with Goldman Sachs.

<Q - Christopher Merwin>: Hi. Great. Thank you and congrats on a great quarter and year. So this one's for Riccardo. We've seen some pretty impressive growth for King lately as you've invested in some more frequent content updates and we've seen improved player engagement as a result. But beyond I guess the improvement in monetization for King, can you talk bit more about the pipeline and the two or more new releases in 2018 that you mentioned in the prepared remarks? Thank you.

<A - Riccardo Zacconi>: Hi, Chris. Here is Riccardo. So we have several teams working on new games, first of all. And those are games using the existing franchise IP as well as new IP. So we're creating also new IP. And these games are at various stages of production and it's a multi-year pipeline. So as you heard before in 2018, we planned to release at least two new games, including Social Casino in partnership with PLAYSTUDIOS.

I would like to highlight that we set ourselves a very high bar for new game launches. We will only launch games of the highest quality and we will only launch them when they're ready. When we think about games pipeline, it's not just about new games, it's also new content for our existing live games where we develop new features and live ops. In 2017, we focus these developments on increasing engagement and increasing monetization. And this has allowed us to hit several mobile bookings milestones. As we heard earlier, we had in Q3, our highest ever mobile bookings quarter and in Q4, we hit our highest ever mobile booking week.

In 2018, we will continue focusing on engagement and monetization, but we will also focus these new features on reach initiatives. So we expect to continue to drive positive engagement and monetization as well as we expect to attract new users. So if I think about it, we exited 2017 with a strong momentum and I believe that we have a great pipeline, both of new titles and new content for our live games.

<A - Amrita Ahuja>: Operator?

Operator

We'll take our next question from Laura Martin with Needham.

<Q - Laura Martin>: Good afternoon. Let's talk about the Overwatch League. It sounds like everything is going great. Could you sort of give us an update on how it did benchmark against your expectation? And what surprised you both on the upside and downside? And then on the monetization, as we're modeling 2018, you said you're going to sell some more team. Could you talk about monetization generally and then whether you think that teams will sell for more than the first 12 teams? Thanks.

<A - Michael Morhaime>: Hi. Thanks. This is Mike from Blizzard. First off, I want to take a moment to thank everyone on the Overwatch League team for the amazing job they've done. Overwatch League was an ambitious undertaking. It required support and collaboration across Activision Blizzard starting from the Overwatch game team, all the way up to Bobby, who, as you know, has been a strong supporter of the League from the beginning as well as from a host of stakeholders in the community. I want to especially thank all the pro players who compete, the team owners who really got behind our vision for the League, our partners over at Twitch and our sponsors who believed in what we were building. I want to also thank the viewers who tune in, especially those people who are coming to the studio and bringing their passion and energy and filling up the stands. They're an inspiration to everyone who works on Overwatch League.

It's really been wonderful to see how everything has worked out so far. We're very pleased with the high-quality production that we have been able to enjoy every week. The games have been exciting to watch and the reception from our viewers has been really spectacular. So, so far everything has either met or exceeded our expectations. We made a landmark two-year media rights deal within Twitch and more than 10 million people tuned in to week one worldwide.

We had an impressive audience per minute of over 400,000 on opening day. We've also been very happy that several major brands have partnered with Overwatch League, including Intel, HP, Toyota, T-Mobile and Sour Patch Kids. While we're pleased, it's important to note that this is only the beginning. Our focus is going to be on continued growth of the audience through improvements to the broadcast and the live viewer experience. In the mid to long term, we think the audience growth is the key to seeing impact both to the bottom line results and to the company as a whole. And I think also to drive popularity in the game as well. In terms of selling expansion teams, we're very excited with the reaction and the interest in expansion teams and pretty confident to say that the price is going to go up.

<A - Amrita Ahuja>: Operator?

Operator

We'll take our next question from Matthew Thornton with SunTrust.

<Q - Matthew C. Thornton>: Yeah. Good afternoon. Thanks for taking the question. Maybe one for Eric on Destiny 2. Can you kind of give us a little more color just on the trends you're seeing around player engagement, in-game monetization and then, again, a little more color just about how you're thinking about the game and the plans for 2018? Thanks so much.

<A - Eric Hirshberg>: Yeah absolutely, Matt. Happy to talk about Destiny 2. And I want to start just by putting it all in context because we did have a successful launch of the game. As Coddy mentioned, it was the number two game in North America, the number four game globally and it was also very well received. It had an 87 rating, that was a full 10 points of improvement over Destiny 1 and it received 120 awards and nominations. And on top of that, we saw very positive sentiment and new franchise high levels of engagement for the first couple of months post-launch.

Now after that, meaning after players have poured significant amount of hours already into the game, we have definitely seen some real sentiment issues surface in a couple of areas. And we got plans to address those. For example, one of the things we wanted to do with Destiny 2 was to make the game a little less of a grind based on feedback we heard and we also want to provide players with more direct pass to getting the game's best rewards and that actually allowed our core players to consume the content faster than we anticipated and that has led to an increase in players calling for more challenges and better rewards in the ongoing game.

Now this is a live game and responding to player feedback is a part of the process in this game, in any live game, and we feel we have the right plans in place to address the concerns. Last week, Bungie posted a detailed roadmap of the changes that we have coming over the next several months. And thus far, those plans have been very well received as have the change that we've already put into the game itself already and the sentiment has already starting to shift.

And also remember that we have a great expansion coming in May and a major expansion coming at the end of the year, and those events have always been opportunities for us to reengage our community and win back people who have churned out. This is an incredibly passionate group of players and that passion is a good thing even when the sentiment is critical because it shows how deeply people care about the game and we think that's one of the things that makes us a great franchise, and we're fully committed to listening to and communicating with our community more frequently and more transparently than ever and making the right changes to improve the experience, and we think we have the right path forward.

Operator

We'll take our next question from Tim O'Shea with Jefferies.

<Q - Timothy O'Shea>: Yes. Hi. Thank you for taking my question. So, Coddy touched on this in the opening remarks, but I wanted to get a better sense of where Call of Duty finished the year in terms of full game downloads. And then maybe if you could give us a little color on what your expectations are going forward? Thank you.

<A - Spencer Adam Neumann>: Great. This is Spence. Thanks for the question, Tim. See as you recall, I mentioned last quarter that we are seeing this consumer-led shift to full game downloads in our console business. It's similar to what we've already experienced in the games business on PC platforms and of course, digital translation is not unique to gaming. It's impacting pretty much every form of entertainment consumption. So, now the good news for us is, as I also discussed last call, it's good for our business. It brings us closer to our consumer and with better economics. So with that context, Call of Duty finished the year at about a 30% digital mix and we mentioned last year that our digital mix was about 20% to 25% on Call of Duty. So this year's performance, it's essentially in line; actually, a bit of an acceleration in that historical 5 percentage point increase we've been seeing in the past few years.

And I should underscore that these are big absolute numbers when we're talking about Call of Duty because it's such a mass-market game. As Coddy mentioned, Call of Duty: WWII was the biggest day one digital release ever for PlayStation, and in aggregate, it represented the biggest Activision digital title ever released on console. As we look forward, Tim, we'd expect the mix shift in 2018 to be similar to what we saw for Call of Duty this year. It's obviously a bit tough to predict with certainty given that it's ultimately consumer-driven, but I know that our teams – they're going to continue to innovate with compelling digital offers and other strategies that deliver value to the community and they'll also continue to support our important retail partners. So overall, the trends remain strong. They're positive for our business and the good news is we've got quite a bit of runway ahead of us.

<A - Amrita Ahuja>: Operator?

Operator

Up next, we have Mike Olson with Piper Jaffray.

<Q - Michael Olson>: All right. Thanks. Good afternoon and thanks for taking my question. I just have one. You talked about the opportunity to the actual League, but could you talk about the Overwatch League impact on Overwatch, the game itself, as it relates to engagement, monetization and/or core game sales? Thanks.

<A - Michael Morhaime>: Thanks for the question. This is Mike, again. The Overwatch League has increased overall engagement with the franchise between viewership and gameplay. When you consider the hundreds of thousands of fans watching each match and average watch time a little over an hour each night, we're tapping into a whole new avenue for players to express their passion for Overwatch. Of course, there are other positive for the game overall. The Overwatch League has driven a ton of buzz and awareness for the game. And so as that increases, our players have new ways to customize their playing experience with in-game digital skins as well as physical merchandise, and we've seen our players respond well to both of those.

We're also looking forward to launching additional initiatives to tie the viewing experience better with the play experience. We think that over the long-term, the League will bring in new players as people see the excitement on the League and they even start to train to become the next pro player. Outside of the League, we have additional plans to keep Overwatch fresh and players engaged. We already released a new map called Blizzard World in January. We have the Lunar New Year event launching today and there's additional plans later this year for new heroes and seasonal events to come out as well.

<A - Amrita Ahuja>: Operator?

<Q - Michael Olson>: Thank you.

Operator

Our next question comes from Brian Nowak with Morgan Stanley.

<Q - Brandon Hoffman>: Hi. This is Brandon Hoffman on for Brian Nowak. So you had strong performance for Call of Duty: WWII and there's excitement about digital in 2018. Can you talk a bit about the COD pipeline going forward? Thank you.

<A - Spencer Adam Neumann>: Absolutely. The COD pipeline is one of my favorite topics. Before we talk about WWII, I think it's worth stepping back and talking about how pleased we are with the state of the Call of Duty franchise overall. Obviously, Call of Duty: WWII was the number one console videogame in the world in 2017 and that makes Call of Duty the number one franchise in the world, eight of the last nine years. And Call of Duty: WWII also delivered the biggest launch quarter we've seen on current generation consoles, even higher than Black Ops III as I think Coddy mentioned.

And engagement on WWII has also been strong. Not quite as strong as we've seen from the Black Ops franchise, which of course has been our stickiest games, but we have seen strong participation with our first two seasonal events, the Winter Siege and The Resistance, and we have actually a more robust calendar of those types of events in the game than we've ever had before. So our strategy of bringing Call of Duty content to whatever game our fans are choosing to play is really continuing to pay off because also in 2017, we saw that in Black Ops III, the Zombies Chronicles piece was the number one top-selling add-on content on PlayStation last year which is all the more remarkable given that it was released almost two years after the launch of the original game. So that of course set the stage for the game we have planned later this year, which is being developed by our team at Treyarch. Now, as you know, they have developed some of our most successful games ever and they've proven time and again that they know how to keep our players engaged for the long haul.

So overall I'd say our strategy for Call of Duty is working. WWII is a blockbuster. We've got a thriving Black Ops community. It was excited for the upcoming Treyarch developed game. And I honestly really wish I could say more about what we have in the pipeline because I'm so excited about it, but suffice it to say, I think we have the best three-year slate in Call of Duty's history, which is really saying something given this franchise's history. And I think we've got multiple different game universes that we know our players love on tap; so obviously more to come on that.

Operator

Our next question comes from Eric Sheridan with UBS.

<Q - Eric J. Sheridan>: Thanks for taking the question. I wondered if you could talk a little bit about some of the moves you've made whether it be investments, acquisitions, to position the company for the advertising opportunity across King? And then the second one would be how do you think about extending those capabilities or assets across other brands or platforms of the company in the coming years? Thanks so much.

<A - Riccardo Zacconi>: Hi, Eric. It's Riccardo here. Advertising for us is a strategic focus given the opportunity we have with our large and engaged audience. So, we are prioritizing investments across multiple areas. First of all, we are building a world-class team, and we are investing in our teams on several dimensions on the ad product, in engineering, in sales and in analytics. And we have already people in place. And this year, we plan to scale these teams further.

Second, we are investing in creating great ad products. And by that I mean, ad experiences that resonate with our highly engaged players and that are well-integrated into the gameplay and also deliver real value to our advertisers. So to get this right, we have embedded the ad teams within our game teams, including in Candy.

So third, we're investing in our own ad tech infrastructure. In 2017, we've seen early success with a dozen of global brands buying advertising across a number of territories in five different games. And we have seen repeat buys as a result of the strong completion and viability metrics. In 2018, as you heard Spence earlier, we are expecting only a modest bottom line contribution from ads as we plan to ramp the video ads opportunity and as we continue to invest in the significant opportunity for the long-term. For the second part of the question, I will hand over to Coddy.

<A - Collister Johnson>: Okay. Thanks, Riccardo, and thanks for the question, Eric. I think first, we have to step back and know that we have several key initiatives underway. We are building out capability in one area of the business, enables flexibility and option value to bring that capability to other areas of the business over time. Overwatch League could be a great example of this, where the focus now is completely and solely on Overwatch success, but over time the professional city-based league approach, the infrastructure, the know-how, the team, the processes, the support structure could logically go on to support other franchises that have strong esports momentum.

And so that's what, broadly, the way you think about these areas and advertising, we think, is another good example of this. And for us specifically, I think we have the opportunity probably in a couple of areas that are impacting. The first and foremost one is the opportunity that Riccardo just spoke to. Ads for the King mobile network is our primary focus right now. It's the first step in building out internal ad products, tech deck team and infrastructure. The second we do have a near-term opportunity to bring relevant advertising to our esports audiences. We're already off to a good start there with Overwatch League media-rights sponsorships, advertiser interest. But we see further opportunity in our owned MLG platform. And over time, third, there could be opportunities in other areas of the company particularly as we explore ad-based experiences across new games that are suited to that form of media.

If you then just step all the way back, we have over 50 minutes of engagement per day in our games right now and that's not yet including all the time spent watching gameplay in our franchises. So we think there's a pretty compelling opportunity to do what you said, which is to able to bring advertising to other brands and platforms across our network.

<A - Amrita Ahuja>: Operator?

Operator

Our next question comes from Evan Wingren with KeyBanc.

<Q - Evan Wingren>: Thanks. This is for Mike. I'm just wondering what are your expectations for World of Warcraft: Battle of Azeroth in terms of the size, engagement or any other innovation of the game for this expansion?

<A - Michael Morhaime>: Thanks for the question. So at Blizzard, we always get excited about new launches, and we, in addition to our players, are very excited about Battle for Azeroth's features which include new allied races to give players even more character customization options. The players who preordered the expansion have been including early access to some of the allied races already and that has helped drive early pre-orders. We're very pleased with the results so far. Battle for Azeroth also includes two huge continents for players to explore as well as some new game play modes. War front is a new cooperative mode where players will band together in massive battles inspired by Warcraft's RTS roots. And the Island Expeditions mode will include randomized elements for small groups to enjoy with great replay ability, which is very important in the games like World of Warcraft. Content always drives engagement. So just like we did with Legion, we're planning a steady stream of content after launch to maintain engagement.

As for what's ahead in 2018 with Battle for Azeroth, we're looking forward to sharing more in the months to come and releasing the expansion this summer. There's a ton of buzz right now in the community and at Blizzard. The team is very excited about this expansion.

Operator

And our last question comes from Colin Sebastian with Robert Baird.

<Q - Colin Alan Sebastian>: Thanks guys. Good afternoon. I guess, I just wanted some clarification on where development stands for some of the new mobile titles in the pipeline, not only in King which I think was already addressed, but across Blizzard and Activision, following up on some of the announcements on personnel last year perhaps? Thank you very much.

<A - Collister Johnson>: Yeah. Hey Colin, this is Coddy. Thanks for the question. So you're right. I'd probably break the mobile efforts and new games into two buckets. The first you mentioned, which is the ongoing efforts at King under mobile pipeline. It's just worth highlighting, they are taking a very focused approach on development. And as mentioned, we expect to have two or more new releases during the year. In addition to ongoing updates inside their existing live games which really are just in the live games, initiatives in and of themselves that drive new players and bring in new audiences. So there's, as you know, and as we speak to a lot, there's real focus there. But the second opportunity is to take our very successful PC and console franchises and extend them to mobile. And we think this is the time to do it. And it's an exciting opportunity for a few reasons. First mobile gaming is, of course, not very much at scale, large and growing, with billions of people around the world.

We essentially have mini console or PC in our pocket. And the second reason that the technology we feel has advanced a point where we feel there's a mobile platform now that can fulfill the requirements of our core IP. There's also for us we think a really important opportunity in Asia, where we already have some of the most successful non-mobile franchises. And as you know, many of the top mobile games there now are based on existing console or PC IP. That was their roots in console and PC. They moved to mobile. And we think there's an opportunity for us as well over time to explore our IP on mobile in that region. We obviously want to get this right. We want to do it well at super high quality for our players and audiences who matter a great deal to us. So it takes investment and time, but we do plan to see some early results later this year from our mobile investments, and we expect more meaningful impact in 2019 and beyond. So we're working hard on the pipeline and we'll have more news to share down the road.

Robert A. Kotick

Okay, I think that's the last question, right? So well, thank you all for joining the call today. We appreciate it. We appreciate your time and we look forward to seeing or speaking with you and speaking with you over the next few weeks and months. Thanks.

Operator

And that does conclude today's conference. We thank you for your participation.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2017-11-02
Event Description: Q3 2017 Earnings Call

Market Cap: 49,486.71
Current PX: 65.45
YTD Change($): +29.34
YTD Change(%): +81.252

Bloomberg Estimates - EPS
Current Quarter: 0.886
Current Year: 2.132
Bloomberg Estimates - Sales
Current Quarter: 2426.792
Current Year: 6788.333

Q3 2017 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Riccardo Zacconi
- Michael Morhaime
- Eric Hirshberg

Other Participants

- Colin Alan Sebastian
- Mike J. Olson
- Evan Wingren
- Timothy O'Shea
- Matthew C. Thornton
- Andrew Edward Crum
- Brian Nowak
- Scott D. Krasik

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard's Third Quarter 2017 Earnings Conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Amrita Ahuja. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's third quarter 2017 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, COO; and Spencer Neumann, CFO. And for Q&A, Dennis Durkin, Chief Corporate Officer; Mike Morhaime, CEO of Blizzard; Eric Hirshberg, CEO of Activision; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect.

A number of things could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. These include the risk factors discussed in our SEC filings, including our 2016 annual report on Form 10-K and those on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, November 2, 2017.

We will present both GAAP and non-GAAP financial measures during this call. We also provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets, expenses, including legal fees, costs, expenses and accruals related to acquisitions, including the acquisition of King Digital Entertainment; expenses related to debt financings and refinancings; restructuring charges and the associated tax benefits.

These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also a PowerPoint overview, which you could access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results in a one-page summary sheet.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks, Amrita. This was another strong quarter. We delivered record results and exceeded our prior outlook. Our audience is among the largest of any platform and this quarter, we achieved a new milestone for daily time spent per user of over 50 minutes, which is in line with some of the most engaging online connected platforms in the world.

We remained focused on building enduring franchises over the long term and helping to grow strong and highly engaged communities around them. When we focus on serving our communities and investing in new ways to help people connect with our franchises and each other across many different types of content and platforms, we create opportunities for delivering growth across reach, engagement and player investment.

A great example of this is BlizzCon. Tomorrow, the 11th celebration of the Blizzard community kicks off in Anaheim, California. This is one of the highlights of the year for the company as BlizzCon exemplifies how our games bring people together from all walks of life and all parts of the world.

Gaming through events like BlizzCon provides players with a true sense of belonging and a recognition that through our games we can help break down the barriers that seem to be dividing much of the world. Over the next couple of days, over 30,000 people will join us from around the globe, with millions more joining virtually including via the live stream and our virtual ticket. The attendance and viewership are great examples of the incredible passion of the Blizzard community, whether hosting esports championships, unveiling epic cinematics, offering compelling new game play experiences and consumer products, or simply providing a space for players to connect. BlizzCon reflects the scale and diversity of the broader opportunities open to the company today.

We remain excited about our growth prospects, many of which are progressing quickly. The launch of the Overwatch League begins with regular season play on January 10, and we believe 2018 will be the year that esports becomes even more broad in its appeal.

This morning, we announced large Overwatch League sponsorship deals with both Hewlett-Packard and Intel. And these are two great examples of forward-thinking initiatives by two important companies that will help us deliver a great experience for the community and invest in the future of the League.

Our employees across Activision Blizzard and King continue to be recognized for their commitments to excellence and execution. We were named to the Fortune 500, Fortune 100 Best Companies to Work For and Fortune's Most Admired companies. This quarter, we're proud to have been recognized in the top 10 of Fortune's first-ever Future 50 list, which recognize the world's most innovative and forward-looking companies.

Marrying vision and creativity with consistent execution over the long term has always been the blueprint for our success. And we're going to keep working hard to approach our future with the same discipline. We're very grateful for the support of all our employees, our player communities, our partners and our stakeholders and shareholders in this effort.

And now, here's Coddy to review the highlights of our operations this quarter.

Collister Johnson

Thank you, Bobby. 2017 continues to be a record-setting year. We surpassed last year's high watermark for year-to-date revenues and earnings per share, we delivered record revenues in Q3 and we outperformed our guidance by more than $200 million on revenue and by $0.13 on non-GAAP EPS.

Given this over-performance and the confidence we have in our plans, we are raising our outlook again, for the year. Our performance is made possible by our incredible teams whose commitment to delivering creative and commercial excellence, engages our communities and enables our company to grow.

I want to highlight, in particular, that in Q3, our teams demonstrated two important aspects of our strategy. First, the ability to serve our communities with a broad range of experiences, large and small across full games, expansions, content drops, features and services. And second, the ability to drive meaningful results from those investments.

We saw this from Activision and Bungie with launch of Destiny 2, a major new game for the franchise, which is now the biggest console release for the year in the U.S. We also saw see this from Blizzard with Hearthstone's Knights of the Frozen Throne expansion, built upon iconic characters and lore, which became a franchise's best-performing expansion to-date.

And we saw this from King with Candy Crush where continuous ongoing feature and content updates allowed this franchise to have its largest quarter since 2013 and return to the number one position in the U.S. app store.

King's Q3 performance is worth underscoring for a moment. They reclaimed their number one mobile publishers spot in the U.S., they grew revenues for the third sequential quarter to the highest level seen in 10 quarters, and they achieved record mobile gross bookings.

King did all of this by focusing on the player experience and the live titles and by increasing the pace and success with which they release content, services and feature updates.

Let's now dive deeper into our first strategic pillar, audience reach, which was 384 million monthly active users this quarter. Activision MAUs were a Q3 record of $49 million driven by launch of Destiny 2 and continued strong performance by the Call of Duty franchise, which helped Activision achieved record Q3 segment revenue and record Q3 operating income.

Destiny 2 is off to a strong start and after the PC launch is now ahead of Destiny 1 on total consumer spend, on time spent per player, attach rate to the expansion packs and average revenue per user. Destiny 2 also achieved a new high watermark in digital full game downloads at over 50% of console sell-through. And last week, we introduced Destiny to PC gamers for the first time, opening up the franchise to new global audiences and future growth opportunities.

We were thrilled to launch on Blizzard's Battle.net platform where we have an end-to-end connection with consumer and can drive enhanced player experiences, better insights and better company economics.

The Call of Duty franchise had a record Q3 MAUs providing even more momentum around tomorrow's highly anticipated release of Call of Duty: World War II. We're enthusiastic about the return to the gritty, authentic, boots-on-the-ground gameplay that the franchises is known for and innovations like war mode and a brand-new take on Call of Duty Zombies. The game is great. Pre-orders have been strong with a higher digital mix than prior Call of Duty titles and sentiment is running high among the community.

As we've said before, we think Activision has the right game at the right time and a complete package for gamers all over the world. Call of Duty has been the number one console franchise worldwide for seven of last eight years. We expect to continue that streak this year.

Blizzard also set a Q3 record for reach with 42 million MAUs driven by a steady stream of content, feature and service updates. This is now the fourth quarter in a row that Blizzard achieved record quarterly MAUs without a full game release, hiding again the strategy of continuous year-round content and services to engage our audiences and bring in new players. Notably MAUs grew year-over-year for both Overwatch and Hearthstone and the Overwatch community now has over 35 million registered players.

King's MAUs were down quarter-over-quarter to 293 million. As discussed on our last call, King has a number of initiatives underway to grow audience size but these initiatives will take time as the team rolls them out to the community. I do want to highlight King's continued success around user engagement. Live updates released this quarter led to record highs both for the frequency of which players return to play and the overall time spent per player per day. And this brings me to our second strategic pillar, engagement.

As Bobby mentioned, the company set a new milestone for daily time spent per user at over 50 minutes, placing us on par with Facebook's time per day, which is over 50 minutes across Facebook, Instagram and Messenger. Blizzard driven engagement with compelling content updates across much of their portfolio. Overwatch introduced new content for seasonal events, including Summer Games in Q3 and Halloween Terror last month, driving participation and customization items.

World of Warcraft released a large content update leading to stable MAUs versus prior quarter and strong participation in value-added services. And Hearthstone saw time spent rise by double-digit percentage year-over-year on the strength of the Knights of the Frozen Throne expansion. Blizzard also released a number of key updates on the Battle.net platform. As mentioned, Battle.net welcomed its first non-Blizzard game Destiny 2 on PC and ahead of that launch, the Battle.net team released a new mobile app and a strong collection of social features in a desktop app, enabling players to stay connected both inside and outside their games and across devices.

Our groundbreaking efforts in esports drive engagement as well by celebrating our players and recognizing their achievements in new ways. As Bobby mentioned, we continue to make great progress on the Overwatch League. The 12 inaugural teams have now been unveiled their names and logos and fans will soon be able to celebrate their favorite team and players through both physical and digital merchandise. The Overwatch team is hard at work on refining the spectator viewing experience to make the game even more fun to watch, including team jerseys for in-game heroes, and new camera angles to get a better view of gameplay.

Pre-season competition begins next month at the Blizzard Arena Los Angeles. I was recently at the facility and can say that the arena and overall spectator experience are awesome. Over the past week, Blizzard hosted opening week competitions across a number of franchises for BlizzCon at the arena. We look forward to seeing some of you at the championship matches later this week in Anaheim. We have a number of other exciting new esports events in the pipeline, including the Call of Duty World League's upcoming season, which features the largest prize pool in franchise history.

Turning now to our third and final pillar, player investment. In-game services, features and content continue to be a recurring driver for our business resulting in a Q3 record of over $1 billion for in-game purchases and record year-to-date performance. King was the biggest contributor.

Bookings per paying user rose for the ninth quarter in a row to new record and the total number of paying players also rose for the first time since Q1 of 2016. King had two of the top 10 grossing games in the U. S., a level performance they have held for four consecutive years and as mentioned, Candy Crush returned to the number one position on the iOS and Android app stores in the U. S. for the quarter, highlighting the durability of the franchise that is now celebrating its fifth anniversary.

Candy Crush franchise's gross bookings were up 17% quarter-over-quarter and up 22% year-over-year, bringing the franchise back to its strongest bookings since Q4 of 2013. King is making progress on their pipeline and new games as well. The social casino game in partnership with Playstudios is currently in live testing and is now expected to launch globally in early part of next year and a strong pipeline of full game releases are in development for next year and beyond.

In advertising, King made progress this quarter in testing and product refinement. Player test continue to show that advertising can improve the player experience and provide advertisers with the premium performance.

King is actively building out advertising capabilities around sales, serving and targeting. And during 2018, King expects to ramp inventory with a deliberate and methodical rollout of ad product types, user cohorts and [ph] other. (13:42)

Both Activision and Blizzard also had strong quarter for player investment not only in their live games, but also in reimagined and re-mastered experiences from the libraries, including Blizzard's StarCraft: Remastered and Activision's Crash Bandicoot and Modern Warfare re-mastered.

Just as importantly, Activision continued to introduce content and feature updates for Call of Duty: Black Ops III, which resulted in relatively stable quarter-over-quarter in-game purchases for that franchise. This approach of continuing to provide content and features for the community wherever they are playing, even years after the initial launch, opens up growth opportunities for years to come.

In summary, our record performance in the quarter and our record performance year-to-date are the result of our team's passionate dedication to serve the growing communities across our franchises. That dedication is now extending into new growth levers like esports, consumer products and advertising, and we're excited about our growth prospects ahead.

Spence will now review the Q3 numbers and Q4 outlook in more detail. Spence?

Spencer Adam Neumann

Thanks, Coddy. Today, I'll our review our better-than-expected Q3 results as well as our outlook for Q4 and our raised outlook for the full year. I'll start with our Q3 segment results. We delivered record Q3 segment revenue and operating income, up 16% and 10%, respectively, and record year-to-date performance.

Importantly, we saw strength across all of our segments with each of Activision Blizzard and King contributing to our over performance for the quarter compared to guidance. By focusing on our strategic pillars of reach, engagement and player investment across our breadth of leading franchises, we were able to outperform our outlook, deliver strong results in the quarter and prudently invest in long-term growth initiatives.

King had a great quarter. The business delivered segment revenues of $528 million, up 15% year-over-year; operating income of $208 million, up 51% year-over-year; and operating margin of 39%, which was up 9 percentage points year-over-year, and all of which also meaningfully over performed prior quarter.

As Coddy mentioned, King's revenues have now grown for the third sequential quarter to the highest they've been since the first quarter of 2015 and mobile gross bookings grew to an all-time record. This is the result of really strong execution by the King team and their commitment to continuous community engagement, data-driven platform insights and capabilities and consistent delivery of new, impactful game features. Following the King acquisition early last year, the team further prioritized resources on Candy Crush and live franchised tiles. We're seeing the benefits of this discipline and focus.

Activision had a record third quarter, including segment revenues of $759 million; operating income of $261 million; and operating margin of 34%, driven by the successful launch of Destiny 2, the ongoing engagement of Call of Duty community and continued contribution from our library with Crash Bandicoot.

Activision doubled revenues and more than doubled operating income year-over-year, leading to record Q3 and record year-to-date financial performance. Blizzard's $531 million in segment revenues and $168 million of operating income were driven by the strength of the World of Warcraft, Hearthstone and Overwatch franchises. Performance was down year-over-year as expected, given the difficult comp to last year's Q3, which featured both a World of Warcraft expansion and the first full quarter following Overwatch's release.

Now let's turn to our consolidated results. Unless otherwise indicated, I'll be referencing non-GAAP figures, which include the impact of deferrals. Please refer to our earnings release for full GAAP to non-GAAP reconciliations. So for the quarter, we generated GAAP revenues of $1.62 billion, which was $233 million above our August guidance. This includes the net deferral of revenues of $284 million. We generated GAAP EPS of $0.25 and non-GAAP EPS of $0.47 in Q3, which were $0.16 and $0.13 above guidance, respectively. These figures include net deferrals of $0.13.

For the year-to-date on a GAAP basis, we generated record revenues of $4.97 billion, up 8% year-over-year and EPS of $1.12, up 19% year-over-year. On a non-GAAP basis, we generated operating margin of 37% and record EPS of $1.73.

Looking at cash flow and capital structure; we delivered Q3 operating cash flow of $379 million, finishing the quarter with approximately $3.7 billion in cash and investments, about one-third of which is held domestically. And we ended the quarter with approximately $4.4 billion of aggregate debt outstanding for a net debt position of roughly $800 million.

So now let's turn to our Q4 outlook. In Q4, we'll continue our strategy of delivering a steady stream of content and services to our community, including updates for Blizzard's Hearthstone and Overwatch franchises and execution against a robust slate of features and live ops across King's titles. As you know, Activision released Destiny 2 on PC on October 24 and we have plans to release our first expansion and add-on content for that franchise on December 5. And of course, Activision releases the much anticipated Call of Duty: World War II tomorrow. So lots happening this quarter.

For Q4, on a GAAP basis, we expect net revenues of $1.7 billion, with a GAAP deferral of $635 million. Product cost of 24%, operating expenses of 67%. We expect GAAP and non-GAAP interest expense of $41 million, a GAAP tax rate of 36% and GAAP to non-GAAP share count of 769 million shares with GAAP EPS of $0.10. For Q4, on a non-GAAP basis, we expect product cost of 24%, operating expenses of 52%, a tax rate of 27% and non-GAAP EPS of $0.36 with a GAAP deferral of $0.46.

Now turning to our raised 2017 full-year outlook, which passes through Q3 business over performance and also raises Q4 outlook. On a GAAP basis, we expect revenues of $6.675 billion with a GAAP deferral of $175 million. Product cost of 23%, operating expenses of 58%. Our GAAP interest expense is expected to be $174 million and GAAP tax rate at 14%. We expect 767 million fully diluted shares with – for both GAAP and non-GAAP and GAAP EPS is expected to be $1.22.

For 2017 on a non-GAAP basis, we expect product cost of 23%, operating expenses of 43% and non-GAAP interest expense of $156 million with a tax rate of 24% and non-GAAP EPS of $2.08, and we have a GAAP deferral of $0.08.

So with the robust Q4 product and feature slate, we're working really hard to finish the year strong. We plan to build on that momentum in 2018 and beyond with a franchise-driven strategy across our core interactive games and emerging opportunity areas. As always, we'll pursue these initiatives with fiscal discipline, intense prioritization and a focus on shareholder value.

Now I welcome our business leaders, Eric, Mike, Riccardo and Dennis as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] And we'll take our first question from Colin Sebastian with Robert W. Baird. Your line is open.

<Q - Colin Alan Sebastian>: Thanks, guys and congrats on another strong quarter. I have two questions. The first one is how are you thinking about driving further improvements in bookings at King based on what we've seen for the quarter and year-to-date thus far? Thank you.

<**A - Riccardo Zacconi**>: Hi, Colin. It's Riccardo here. Maybe before I answer your question just want to highlight that 2017 has been a great year for gross booking growth. And this quarter has been the third quarter of sequential gross booking growth and Candy regains the number one slot in the U.S. app store, and we are now the leading developer in the U.S. and this has also been, as you heard before, the highest ever quarter in mobile gross bookings. So I think we're very proud of that. And I'm very proud of what the team has achieved.

Now, we have achieved these results by executing on our strategy. We used our proven system to deliver content and features that our players love, and we also focused more resources on live operations to increase the cadence of our updates. If you think of our network and of the size of our network and the experience over the years, we have a unique opportunity to better understand really what players like, what players want. And so we developed a portfolio of features and content and we test these features and content with our players. And when we get these right, we add to the player experience and this converts into higher player engagement and greater player investment.

We can see the results of this virtuous loop in our Q3 results. However, I would like to point out that this quarter, our system delivered an exceptional hit rate, and this has led to a greater amortization growth than usual. So over time, while we don't expect the same level of increase every quarter, we remain confident in our long-term ability to deliver innovation and growth with this rigorous process.

<**Q - Colin Alan Sebastian**>: Great. And may be as a follow-up – sorry, the follow-up was just mentioning some of the reach initiatives for King that you first talked about on the last call, if you could expand on those as well? Thank you.

<**A - Riccardo Zacconi**>: Sure. Sure. So reach is a key priority for us and we have two approaches to stabilize and then grow the reach. We are focusing on marketing and we're focusing on product. On the marketing side, the goal is to drive new installs and to regain less players. Here we're focused on innovating how we market our live titles. So as an example of innovation is the partnership with CBS and Lionsgate in the U.S. for the Candy Crush TV show.

On the product side, here we focus on the live games, and we're working on new content and new features to drive greater player retention. So the teams are now prioritizing this initiative alongside our monetization and engagement initiatives and that as you heard earlier, have been so successful in driving gross bookings.

On top of these initiatives, we're also working on new game launches. New game launches have always been proven as driving reach and having a positive impact on reach. And our development teams are now working really hard on prototyping and developing new titles for the coming years. I would like to point out that reach is everyone's problem. We're all focused on reach and changing the reach trajectory, however, will take time. We have the team, and we have the focus to do it.

Operator

And we'll take our next question from Mike Olson with Piper Jaffray. Please go ahead.

<**Q - Mike J. Olson**>: Thanks. Good afternoon and congrats on a strong quarter. You've talked about esports as an investment in the near-term without material profits. Can you help quantify near-term milestones and other benefits that having the leagues can offer such as the marketing for Overwatch and other titles? And what are the plans for additional leagues beyond the Overwatch League? Thank you.

<**A - Robert A. Kotick**>: Thanks, Mike. It's Bobby, I'll answer that. In fact, today, we're having our first owners meeting for the Overwatch League, and we view that as a major growth initiative and a very sizable standalone opportunity for the company. We're building the league for the long-term and, in our view, the opportunity, rivals, what you see in professional sports for a lot of perspectives but starting with the demographics to the audience.

The first season is really about building a solid foundation, delivering world-class viewing experience, distributing the content as broadly as we can to our audiences around the world, making sure that we have that strong and growing global fan base and really building the league revenues in the key three areas that we've outlined in the past. And today was a great announcement in that regard in sponsorships, in the sale of broadcasting media rights and in licensing.

And we've got a really great group of owners who I just came from. We've got some of the great entrepreneurs in sports, some of the great entrepreneurs of the endemic esports businesses. And they are all focused on driving local marketing campaigns to build out their fan bases in the markets that they serve. I think we're off to a very good start in the sponsorship front with the announcements that we've made today. And we'll continue to deliver new news and information as we get closer to our January 10 launch date. So it will clearly benefit the franchise from a marketing perspective, but it is a great business opportunity in and of itself.

As far as other leagues – right now, we are so focused on executing Overwatch League as best as we can that we're not really planning on announcing anything else right now. And look, I would say, that the greatest single benefit that we get from celebrating our professional players is that these are people who make an incredible investment and commitment into our games and we have the opportunity to really celebrate and recognize and reward them in an exceptional way. And we think that that has the most tremendous value to our players and to the company.

<A - Michael Morhaime>: This is Mike. I just want to add, we're incredibly excited about the launch of the league on January 10. We really view this as sort of building a foundation for this league that we don't expect will scale overnight. Sports leagues take time to build. But with the foundation that we're building, we're really excited about what the future will hold, and we think it will benefit players, teams, fans and have a really long-term potential for the Overwatch League.

In terms of how the league might benefit the franchise overall, we really view that as being tied – what is good for the league is good for the Overwatch game as well. So, incredibly excited about the inaugural season.

Operator

We'll take our next question from Evan Wingren with KeyBanc Capital Markets.

<Q - Evan Wingren>: Thanks. And appreciate the clarity on the Destiny digital data. Just wondering, how has the total engagement trended for Destiny 2 to-date, may be compared to Destiny 1 over that same timeframe on a like-for-like basis?

<A - Eric Hirshberg>: Hey, thanks, Evan. It's Eric. We're very happy with the performance of Destiny 2 thus far. With just a month of sales, it's already, as Coddy mentioned, the bestselling console game of the year-to-date in the United States. But beyond that we've also improved on pretty much all the other important metrics that we look at. We're now ahead of Destiny 1 in total consumer spend. Hours per player reached a new franchise record and average revenue per user was up as well. We also have a very strong attach rate to the Expansion Pass, which we think is a great indication of our fans' ongoing commitment to engagement with the franchise.

So we know our fans wanted a game with a great engaging story, with great characters and a more accessible experience overall. And we think we lived up to their high expectations on those measures. And we also know that our fans are already hungry for more. And as I've said on past calls, we now have not just Bungie but multiple AAA teams developing content for Destiny and we're planning on having more content than ever before to support Destiny 2, starting with the first expansion that's coming on December 5.

And also, we launched Destiny on PC, which we expect to open up new geographies where we think Destiny is going to be really well received. So we've got events coming, we've got compelling in-game content coming, we've got strong marketing and events planned through the holidays, so we've got good momentum there.

Operator

And we'll take our next question from Tim O'Shea with Jefferies. Please go ahead.

<Q - Timothy O'Shea>: Yes. Hi. Thank you for taking my question. So, look, very impressive with Destiny 2's digital mix accounting for over 50% of sell-through. So it does seem like full game downloads are picking up steam in the console business and I thought you might update us on where you see this trend heading in the next year? Thank you.

<A - Spencer Adam Neumann>: Thanks, Tim. This is Spence. I'll take this one. Let me first underscore that we've got great retail partners. Retail is going to continue to be important for us on console for some time to come, but, that said, this consumer trend that we're seeing and the shift to full game digital downloads, it's real, it's a strong tailwind for our business, and it's a good thing. That digital connection, it brings us closer to our consumer and it creates better economics. It's roughly $10 of direct profit improvement and then there's also indirect savings and margin benefit and even some working capital benefits.

But I guess, getting back to your question on the trends, I believe we mentioned last year that our historical digital mix was about 20% to 25% for Call of Duty and more in the 30% to 40% range for Destiny and Overwatch on console. And historically, we've been seeing that digital mix increase at about 5 points a year.

As you point out, with Destiny 2 digital at over 50% console sell-through so far, we believe we're seeing some acceleration in that digital shift. And while that's consumer-led move, I'd be remiss if I don't point out just for a moment that our team put together some really compelling digital premium packages and drove a lot of credit for creating packages that clearly resonated with Destiny's community and delivered a lot of value.

So as we look to the kind of finish out the year and into the back half of Q4, we'd expect retail actually to gain some share as we reach a broader audience. But we do still expect to end the year well ahead of the original Destiny digital mix. I guess, I should point out that when you look at a franchise like Call of Duty, there's different dynamics there. So it's not like-for-like. Call of Duty, as you know, is a more mass-market game and the more mass you get, the higher the retail share. So while we're seeing higher digital preorders as well on World War II relative to any prior Call of Duty title, that digital mix is still well below what we're seeing for Destiny 2.

So with CoD, we may still also see that acceleration from the 5 point historical rate, but again, it's a consumer-led shift predominantly, and we'll have to wait and just see how the quarter lands. Overall, though, this is a good news for our business, it's a nice trend. There's a lots of runway to go to expand that digital full game sales footprint and grow that connection with our players.

<Q - Timothy O'Shea>: Great. Thanks, Spence, and congratulations on the quarter.

<A - Spencer Adam Neumann>: Thanks.

Operator

And we'll take our next question from Matthew Thornton with SunTrust.

<Q - Matthew C. Thornton>: Yeah. Hey, good afternoon. Thanks for taking the question guys. Maybe just following up on the prior comments on Call of Duty, I know there's a bunch of leading indicators that you guys track versus prior releases, including total preorders and preorder mix. Can you just walk us through where we stand on all those leading indicators that you think are relevant? Thanks.

<A - Eric Hirshberg>: Sure, Matt. This is Eric. I'll take that one. The good news is all indications are very strong. We've got preorders that are strong, awareness and purchase intent which, of course, we also track at the top of the scale. And anticipation amongst our community is at a fever pitch that we're very excited about. The other thing that sets us up well is the fact that we had our Monthly Active Users on the Call of Duty franchise at a record high in Q3, and it's always great for our new content launches when we have people hyper engaged with the franchise.

So as Coddy mentioned, Call of Duty has been the number one console franchise worldwide, seven of the last eight years. We expect to extend that streak this year. And obviously, our community is excited that we're returning to the sort of grittier, boots-on-the-ground authentic military setting that the franchise's roots, but we didn't – it's also important to know that we didn't just do that. I think that's the headline, but we didn't rest on those laurels. We're also bringing a bunch of really cool innovations like an entirely new way to play multiplayer called War Mode which is more team-based and collaborative than any mode we've had before. That was a huge hit in the beta that we did as well as Sledgehammer's take on Call of Duty: Zombies, which is literally sort of jump out of your seat scary, so kind of a really new experience there.

I guess, all in all, we just feel like everything has really come together with this game whether you're a current fan playing one of our past Call of Duty games, or whether your fan who's maybe even taken a break from the franchise, we feel like this is the game that's going to bring our entire community back together and bring new people in as well.

Operator

And we'll take our next question from Drew Crum with Stifel.

<Q - Andrew Edward Crum>: Okay. Thanks. Good afternoon, everyone. Can you discuss in a little more detail recent performance and trends you're seeing across World of Warcraft and Hearthstone? And how you're thinking about the pace of investments for these franchises going forward? Thanks.

<A - Michael Morhaime>: Hi. This is Mike. Thanks for the question. So we continue to be very happy with both of those – with the strength of both of those franchises.

And I'd tell you on the World of Warcraft side, we are investing more than ever. The team has been hard at work delivering on our commitment to the community to deliver more content, more consistently between expansions, that's been going really well. Since Legion was launched in August of last year, we had – we've added multiple content updates and the updates have been really well received by the community. We've seen engagement up versus last year, when you look at time spent per player and also frequency of play.

On the Hearthstone side, Hearthstone's continuing to do really well. Engagement has been really strong throughout the year driven by our successful content launches and our innovative event specifically, with the last expansion, Knights of the Frozen Throne. As you heard, it's had a franchise record for expansion sales and also drove strong engagement with time spent, up double-digit percentage year-over-year and MAUs were also up year-over-year as well.

Operator

And we'll take our next question from Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Thank you. My question Happy Call of Duty Eve! one of the question on King. Could you just talk to sort of the biggest learnings on the King advertising side, kind of what drives the business from here? And what are some of the big milestones you're looking for on the advertising business into 2018?

<A - Riccardo Zacconi>: Hey, Brian. This is Riccardo. So the advertising business, the first priority in the advertising business has been to build a strong ad team, and we now have industry-proven leadership onboard and we are making great progress in filling other key roles in the team as we grow the advertising organization.

Our vision for the business is to deliver great experiences for the players that also drive results for the marketeers. And we have made progress on several dimensions. We have, first of all, been developing several ad formats with a particular focus on those that are supportive of the gameplay. So an example of such an ad format is rewarded video ads where players receive an in-game benefit for initiating and for viewing an ad. And in this respect, I'm encouraged by what I'm seeing. We're steadily enabling more of our player cohorts to see ads as a consequence of that.

We're also growing traction with advertisers from a range of industries. For example, entertainment, tech, banking, and we're seeing traction in key markets, in the U.S. and in the U.K. As a result of this, the team has started increasing the volume of impressions.

On the sales side, we're seeing traction in the direct sales, and we're also continuing to make resource and partnership investments to build on this momentum we are seeing in programmatic buying.

Looking forward, we will continue to develop the business with a focus on aligning the experience of our players with the delivery of key metrics for the advertisers. You heard Coddy earlier and, basically, we expect to ramp up the advertising business during 2018. So if I have to summarize, in short, I'm very excited about the opportunity that advertising provides for King, for our players, and for advertisers.

<Q - Brian Nowak>: Okay. Thanks.

Operator

And we'll take our final question from Scott Krasik with Buckingham Research. Please go ahead.

<Q - Scott D. Krasik>: Hey, everyone. Thanks for taking my question. Great quarter. I'm not sure who's more excited for the new Blizzard content, gamers or investors. But for those who have not gone to BlizzCon, is there a way for you to tease any of the upcoming announcements? Thanks.

<A - Michael Morhaime>: Well, first, we're going to have to get you to BlizzCon one of these days, but it's just an amazing community event. And getting to see the passion of our players and the amazing skill of the pro-players in-person is pretty incredible. But even if you're not there in person, you can still watch the opening ceremonies for free at BlizzCon.com. That starts at 11:00 A.M. Pacific tomorrow. And also you can access all the esports content across all of our games for free, including the championships for the Overwatch World Cup and Heroes of the Storm, StarCraft 2, World of Warcraft Arena, esports tournaments, as well as the Hearthstone invitational.

Also, if you would like to access all [ph] BlizzCon offers, which includes the (42:26) channels and community contests and other events like the Muse concert, you can also buy the virtual ticket for $39.99. So got a little plug in there. But in terms of the latest news and everything, we have a number of different announcements that we will be making at the show, but you're going to have to wait until tomorrow to hear about that. So thank you very much for the question.

<Q - Scott D. Krasik>: Okay. Thanks.

<A - Spencer Adam Neumann>: Okay.

<A - Amrita Ahuja>: I think that was the last question?

<A - Spencer Adam Neumann>: That's the last question?

<A - Amrita Ahuja>: Yeah.

Spencer Adam Neumann

Okay. All right. Well, I want to thank everyone for joining the call today, and we look forward to speaking with you next quarter. Thanks.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2017-08-03
Event Description: Q2 2017 Earnings Call

Market Cap: 57,112.03
Current PX: 74.91
YTD Change($): +11.59
YTD Change(%): +18.304

Bloomberg Estimates - EPS
Current Quarter: 0.492
Current Year: 2.616
Bloomberg Estimates - Sales
Current Quarter: 1666.333
Current Year: 7482.826

Q2 2017 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Collister Johnson
- Spencer Adam Neumann
- Eric Hirshberg
- Riccardo Zacconi
- Michael Morhaime

Other Participants

- Colin Alan Sebastian
- Mike J. Olson
- Timothy O'Shea
- Doug Creutz
- Matthew C. Thornton
- Evan Wingren
- Brian Nowak
- Raymond L. Stochel

MANAGEMENT DISCUSSION SECTION

Operator

Operator: Good day, everyone, and welcome to the Activision Blizzard's Q2 2017 Earnings Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Amrita Ahuja. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard second quarter 2017 conference call. With us are Bobby Kotick, CEO; Coddy Johnson, COO; and Spencer Neumann, CFO. And for Q&A, Thomas Tippl, Vice Chairman; Dennis Durkin, Chief Corporate Officer; Mike Morhaime, CEO of Blizzard; Eric Hirshberg, CEO of Activision; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements given in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they ultimately may prove to be incorrect.

A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factor section of our SEC filings, including our 2016 annual report on Form 10-K which is on file with the SEC and those indicated on the slide that is showing. The company undertakes no obligation to release publicly any revision to any forward-looking statements to reflect events or circumstances after today, August 3, 2017.

We will present both GAAP and non-GAAP financial measures during this call. However, as discussed on our July 29, 2016 conference call, due to updated compliance and disclosure interpretations issued by the SEC staff in May 2016, we are no longer able to present non-GAAP financial measures excluding the impact of deferrals.

On this call and in the future unless otherwise specified, we will continue to provide non-GAAP financial measures which exclude the impact of expenses related to stock-based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses, and accruals related to acquisitions including the acquisition of King Digital Entertainment, expenses related to debt financings and refinancing, restructuring charges, and the associated tax benefits. These non-GAAP measures are not intended to be considered in isolation from, as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release which is posted on www.activisionblizzard.com for our full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results in a one-page summary.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks, Amrita. Q2 was another strong quarter. We exceeded our prior outlook and delivered record first-half revenues. The engagement of our communities remains strong and we believe our momentum can continue through the rest of the year. Our success continues to be the result of our focus on our players and our audiences. Investing in creative and commercial excellence is framed by the three pillars we have shared with you before – one, expand our reach; two, deepen engagement; and three, provide more opportunity for player investment.

Our teams work tirelessly to deliver the most immersive and engaging experiences for our players. This content provides the connection between hundreds of millions of players around the world. We then enhance these connections with our franchises through initiatives like esports, television and film, and now consumer products. These additional touch points create more value for our shareholders by creating value and engagement for our audiences.

Here are some of the ways we created value for our audiences this quarter. We released new updates across many of our leading franchises this quarter, driving engagement and delivering nearly $0.5 billion of segment operating income, the most we've achieved in a single quarter without new full game releases for any franchise. We also announced the first team sales for the Overwatch League, the first major global city-based professional esports league. We have the very best teams with the very best resources dedicated to celebrating and rewarding the world's best professional Overwatch players.

Overwatch, with more than 30 million players has captured imaginations and driven strong global engagement. We organized our league around major cities, taking a proven model from competition in traditional sports. Our announced team owners and their locations, New England, New York, Los Angeles, Miami, Orlando, San Francisco, Shanghai and Seoul and the many more we expect to announce, represent the very best in esports and traditional sports.

We continue to invest in improving our ability to execute and innovate across the company. This quarter, we made some exciting additions to our management team to equip our company with the leadership we need to capitalize on the biggest opportunities we see ahead.

Coddy Johnson rejoined the company as our new President and COO. Coddy proved himself as a transformational leader during the eight years he previously spent with us including as Chief Operating and Financial Officer of Activision Publishing, and we're excited that he rejoined the company for this next growth phase of our business. Later, you'll hear from Spencer Neumann in his new role as CFO, bringing a wealth of experience from a long career at The Walt Disney Company, most recently as Chief Financial Officer and Executive Vice President of Global Guest Experience of the Parks and Resorts division. We're also joined by Thomas Tippl, our Vice Chairman; and Dennis

Durkin, our Chief Corporate Officer, and all of our business unit heads.

As always, our success is the result of the dedication of our players, fans, employees and partners. We cannot thank enough for their enthusiasm and support.

Coddy will now review the highlights of our operations for this quarter.

Collister Johnson

Thank you, Bobby. It's great to be back at Activision Blizzard at such an exciting time of growth and opportunity for the company. As Bobby mentioned, we have incredible communities of players and fans. The joy of our work, what we do each day is to support our teams in building out some of the world's best creative environments and strongest commercial capabilities on behalf of those communities that they can play, connect and engage as deeply as possible. When we get that right, we have the ability to serve our hundreds of millions of audience members with an ongoing stream of content, features, events and products that they love.

The business strategy underlying that work is based on the three pillars you heard from Bobby. We invest in creative and commercial excellence in order to expand reach, deepen engagement and provide more opportunity for player investment which then allows for reinvestment in creative and commercial excellence and for the growth cycle to continue.

We saw this strategy work especially well this quarter with our teams providing more regular content and feature updates across our franchises in our library, leading to our biggest first half of the year in company history, with record revenues driven by digital growth. In Q2, our revenues exceeded our outlook by more than $200 million and earnings per share surpassed our expectations by $0.17.

Given this sizable over-performance and confidence in our plans, we are raising our outlook for the year. Let's start with audience reach, which was 407 million monthly active users this quarter. Blizzard did not have any new full game releases this quarter, yet a strong stream of content updates across Blizzard franchises drove an all-time MAU record of 46 million, up 38% from last year and up 12% from the last quarter. Blizzard's community has now more than doubled in MAUs since early 2015, underscoring the ability to grow audience reach across the portfolio of platforms, regions, genres and business models.

Notably, the Overwatch community continues to grow its MAUs up each and every quarter since launch and, in Q2, set another all-time MAU record with the release of two seasonal events, and Hearthstone MAUs increased to an all-time record for the franchise, fueled by the new expansion, Journey to Un'Goro.

Activision had 47 million MAUs for the quarter, driven by Call of Duty which continues to have a large and active player base across a number of its titles, many of which received updates during the quarter. In particular, the release of Zombies Chronicles, Activision's first large content drop to a community in year two after a game launch, helped to grow Call of Duty: Black Ops III MAUs quarter-over-quarter.

Activision expects to expand the Call of Duty community this fall with a highly anticipated release of Call of Duty: World War II on November 3. We see great momentum for World War II, not only from key indicators like pre-orders, stated purchase intent and hands-on player feedback, but also from more qualitative measures like video views, social sentiment and engagement which are up year-over-year.

We just debuted Call of Duty: World War II's Zombies mode, which is now our most liked Zombies trailer ever, and we can't wait for players to experience the game during our upcoming beta exclusively on PlayStation 4 on August 25 available for all of those who pre-ordered the game.

Activision along with partner Bungie showcased the upcoming launch of Destiny 2 at multiple events this summer to great enthusiasm. We're excited that Destiny 2's PC version earned E3 Game Critics' PC Game of Show and even more excited that it will be on Blizzard's Battle.net, making it the first non-Blizzard game ever on the platform. Publishing on an owned platform will provide an enhanced player experience, better insights and better economics.

With the PC beta still to come, the Destiny 2 console beta had more players than the first Destiny beta and pre-order levels are now above the first Destiny at this same point in time prelaunch. Destiny 2 full game pre-orders also have the highest digital mix in Activision's history.

Finally, Activision's release of the remastered Crash Bandicoot for PS4 showed the powerful combination of our deep library of beloved IP and our team's ability to create great new content for our communities. The game has outperformed even our most optimistic expectations and with the number one console title globally in June based on units. Notable given it was only available on one platform for two days in the month.

Turning now to our second strategic pillar, engagement, Blizzard's focus on compelling in-game content led to all-time record DAUs and Q2 record play time. In Overwatch, April's Uprising player-versus-environment game mode was well received with record play time. And more recently, the May anniversary event drove strong engagement and record participation in customization items.

Hearthstone's Journey to Un'Goro was one of the best received expansions to-date with record DAUs and World of Warcraft continues to benefit from more regular content updates that Blizzard adds in between major expansions. Time spent in the game is up year-over-year. The Legion expansion continues to outperform the last expansion, and Blizzard plans to release this quarter another large content drop with more details to be revealed at gamescom.

King's MAUs were down year-over-year and quarter-over-quarter. Numerous efforts are now underway to grow audience size, but these will take time as the team experiments with reach driving initiatives and continues to develop new creative content for the community. We have, however, seen good success with our live ops and new features, which continue to drive strong engagement. As illustrated by the frequency with which players reengage each month, it remains at an all-time high. To put this in perspective, the time spent per player per day inside King franchises is 35 minutes, higher than that of Instagram or Snapchat.

Our groundbreaking initiative in esports drive engagement and celebrate our players and their achievements in new ways. We made strong progress this quarter on the Overwatch League as Bobby already mentioned. That progress was a meaningful milestone toward establishing a league-based professional competition as a standalone business. We now have a sustainable structure, in which to invest for the long term, with the very best partners from traditional sports and from esports.

Blizzard also recently announced a live-streaming media rights partnership, which showed the value of our broadcast content. Just as importantly though, the partnership carved out a number of future opportunities for mediate rights sales including those related to the Overwatch League. Progress in the Overwatch League also set the stage for Activision's Call of Duty World League. The CWL will wrap up a great season of competition with our upcoming Championship event, and we are well positioned for upcoming season.

Turning now to our third pillar, providing opportunity for player investment; in-game content continues to be a consistent driver for our business, delivering another $1 billion quarter for in-game purchases. King was the biggest contributor with bookings per paying user rising for the eighth quarter in a row to a new record.

Strong engagement and player investment led to an increase in mobile bookings both year-over-year and quarter-over-quarter. King continued to have 2 of the top 10 grossing games in the U.S. for the 15th quarter in a row and King continued to develop a strong pipeline with both new features across the live games portfolio, multiple new games ahead including a promising publishing partnership with PlayStudios in the social casino segment slated for release later this fall.

King also continues to build out its advertising business which we believe is an important long-term opportunity. We now have new industry-proven leadership in place driving the advertising business. The team is focused on the creation of premium video ad products that can improve player experience, deliver value to advertisers, and create meaningful new revenue streams. Given the growth of the overall mobile advertising ecosystem and the relative brand safety of our network in particular, we think this is a meaningful opportunity for the future.

This quarter, King also entered into a partnership with Facebook Audience Network for its static display ad inventory. The partnership monetizes a portion of King's impressions while the team continues to work toward the long-term video ad opportunity.

Both Activision and Blizzard also had a strong quarter for player investment. Call of Duty's Black Ops Zombies not only drove purchases of that specific piece of content at a recommended $30 price, but also led to higher engagement which in turn led to even more add-on purchases by our players. The strength of our strategy in providing great content wherever our fans engage can be seen in the fact that Call of Duty's in-game purchases were roughly in line with last year's record Q2 performance, all on the strength of great content provided across a number of Call of Duty titles.

Blizzard experienced strong participation with in-game content for Overwatch and Hearthstone and also for Diablo, as the necromancer class, originally debuted in Diablo II, was introduced to Diablo III and embraced by the player community.

Stepping back, the success of our ongoing stream of content, features, events and products to our communities coupled with additional opportunities from our vast library highlights a really strong model both for our fans and their enjoyment and for the company as a high-margin business. We have one of the largest catalogs of owned intellectual properties including game titles that go back to the [ph] early 1990s (16:04) and we have hundreds of millions of players in 196 countries, one of the largest digitally connected audiences in the world. This makes it an incredible time to be a part of Activision Blizzard. Our momentum, driven by our inspired team's enabling year-round engagement for our players, drives both near-term performance and future growth opportunities like esports, ads, mobile and consumer products.

Spence will now review the numbers in more detail.

Spencer Adam Neumann

Thanks, Coddy. I'm thrilled to be here with all of you today and to be part of the Activision Blizzard team. I come here with a deep appreciation for the power of beloved global franchises that build enduring emotional connections with the community. That's the foundation of Activision Blizzard and it's why I believe we have such a bright future.

Today, I'll review our better-than-expected Q2 results, which capped off a record first half. I will also review our outlook for Q3 and our raised outlook for the full year. To review the quarter, I would like to start with our segment results. As a reminder, our segment results, unlike our consolidated results, are still presented excluding the impact of deferrals as they always have been.

Each of our segments contributed to our over-performance this quarter. We outperformed our outlook due to the combined power of our franchise breadth, a steady stream of content serving our uniquely engaged community and our talented teams. At the aggregate level, we delivered combined segment operating income of $476 million which, as Bobby indicated, represents a record for a quarter without a new full game franchise release.

Activision generated operating income of $87 million, roughly flat year-over-year with strong Call of Duty performance across the overall franchise, offsetting expected lower performance on Infinite Warfare. Our strategy of providing content wherever our players engage drove this upside, as did improved performance across Activision's catalog, including a very positive reception to Crash Bandicoot.

Blizzard's $225 million of operating income was the largest segment earnings contributor in the quarter, led by the strength of the Overwatch, World of Warcraft and Hearthstone franchises. Operating income was down year-over-year as expected given the comp to last year's significant Q2 Overwatch release.

And King delivered $164 million of operating income in the quarter, which was slightly down year-over-year, but relatively flat sequentially. Continued growth in per-player engagement and player investment led to stable year-over-year revenues with Candy Crush franchise.

Now let's turn to our consolidated results. Unless otherwise indicated, I'll be referencing non-GAAP as redefined figures, which include the impact of deferrals. If you'd like to calculate metrics as we used to report them, you would add the impact of deferrals to our non-GAAP as redefined figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated GAAP revenues of $1.63 billion, $206 million above our May guidance. This includes the net recognition of deferred revenues of $213 million for the quarter. We generated GAAP EPS of $0.32 and non-GAAP EPS of $0.55 in Q2, which was $0.17 above guidance. These figures include the net recognition of deferrals of $0.12. The over-performance in the quarter versus guidance was driven largely by business over-performance as well as some expense timing.

From a capital structure perspective, we continued our positive rating agency momentum and received another upgrade from S&P to BBB. We also entered into a leverage-neutral $1.2 billion refinancing that locked in attractive long-term interest rates, bringing our blended cost of debt to 3.6% and provided a better staggering of debt maturities.

We delivered Q2 operating cash flow of $265 million, finishing the quarter with approximately $3.3 billion in cash and investments, about one-third of which is held domestically and approximately $4.4 billion of aggregate debt outstanding for a net debt position of approximately $1.2 billion at quarter-end.

Lastly, we paid a cash dividend of $0.30 per common share, which was up 15% year-over-year for a total $226 million in aggregate to shareholders of record as of March 30, 2017.

Now let's turn to our slate and outlook for Q3. Our Q3 slate continues our strategy of delivering a steady stream of content and services to our community, including Blizzard's Hearthstone expansion, Knights of the Frozen Throne, additional maps for Activision's Infinite Warfare, and new features and live ops across King titles.

In addition, Blizzard is launching a remastered version of the original StarCraft on August 14. This will offer new and veteran players the same classic StarCraft game play with 4K graphics, modern conveniences like cloud saves, and connectivity to Blizzard's updated Battle.net ecosystem for an enhanced social and competitive experience. And of course, Activision has two major releases in the back half of the year. We'll launch Destiny 2 on console on September 6 with the PC launch to follow on October 24. We'll also continue the marketing ramp for the November 3 release of Call of Duty: World War II.

For Q3 on a GAAP basis, we expect net revenues of $1.385 billion including GAAP deferrals of $315 million, product costs of 23% and operating expenses of 67%. We expect GAAP interest expense of $41 million, a tax rate of 30%, GAAP and non-GAAP share counts of 766 million, and GAAP EPS of $0.09.

For Q3 on a non-GAAP, as redefined, basis, we expect product costs of 23% and operating expenses of 49%. We expect non-GAAP interest expense of $40 million, a tax rate of 25%, and non-GAAP EPS of $0.34 including a GAAP deferral of $0.11. And just to remind everyone if you'd like to calculate non-GAAP metrics as we used to report them, you'd start with our non-GAAP, as redefined, EPS guidance of $0.34 and add the impact of deferrals for $0.11.

Before I turn to our 2017 outlook, I'd like to provide some detail on the impact of the Overwatch League. With the recently-announced sale of seven teams, we do expect some revenue upside to Q4, but it will be modest given the recognition of team sale proceeds over multiple years. Further, from an operating income perspective, the revenue recognition of team sales will be partially offset by the investment required to launch the league including inaugural season marketing.

As we look ahead to the first season, we see a number of important upcoming milestones, including standing up league operations, supporting team's development of player rosters, attracting sponsors, elevating the viewer experience and securing media distribution. We're investing in this league for the long term. Over time, we expect to recognize additional revenues related to both more team sales and multiple league revenue streams. We see this as a substantial long-term value driver for the business.

Now, turning to our raised 2017 full-year outlook, which passes through business over-performance from Q2 and now includes the Overwatch League's modest revenue contribution and roughly breakeven EPS contribution. On a GAAP basis, we expect revenues of $6.4 billion including GAAP deferrals of $175 million, product cost of 22% and operating expenses of 60%. Our GAAP interest expense is expected to be $174 million, and our GAAP tax rate is expected to be 16%.

We expect 767 million fully diluted shares both for GAAP and non-GAAP redefined. And GAAP EPS is expected to be $1.05. For 2017, on a non-GAAP basis, as redefined, we expect product cost of 22% and operating expenses of 45%. We expect non-GAAP interest expense of $156 million, a tax rate of 24% and non-GAAP EPS of $1.94, including a GAAP deferral of $0.06. And if you would like to calculate non-GAAP metrics as we use to report them, you would start with our non-GAAP, as redefined, EPS guidance of $1.94, you add the impact of deferrals or $0.06.

In closing, I just want to echo Bobby and Coddy's sentiment. This is such an exciting time in Activision Blizzard. By delivering engaging content, features and services to our community, including in-game content and remastered IP from our unparalleled library, we can increasingly generate digital, recurring, high-margin revenue opportunities.

Our core games business has never been stronger, and it's also powering future growth vectors like esports, advertising, consumer products, TV and film, and mobile. We believe we have tremendous opportunities ahead of us and, as always, we remain focused on rigorous prioritization, operational excellence, fiscal discipline and long-term shareholder value.

Now I welcome our business leaders Eric, Mike, Ricardo, Dennis and Thomas as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you, sir. [Operator Instructions] And we'll take our first question from Colin Sebastian with Robert Baird.

<Q - Colin Alan Sebastian>: Great. Thanks and congratulations on another strong quarter. Now that you've announced the first group of team sales for the Overwatch League, I was hoping you could expand on the longer term opportunities and perhaps more specifically a timeframe around some of the key milestones that we should be looking for in the coming quarters. Thank you.

<A - Robert A. Kotick>: I'll take that, Colin. Look, there is great momentum that we're seeing in the league. And when you think about what we have planned in terms of the next round of team announcements, that will continue the momentum. That, to me, was the biggest milestone, was getting that great blend of endemic teams of professional sports owners. And if you think about whether it's in tech or in esports or in professional sports, we're assembling the very best owners for all of these sports.

We've announced the first seven and I think what you're going to see is that probably the most important milestones are, as we get towards the latter part of the year and we start to kick off competition, when you see what we're doing in terms of the broadcast rights and sponsorship opportunities, but from every perspective, I think we think we've organized the league in the best way that will allow us to celebrate our players and our fans.

And if you think about over 30 million players today, this is a very large audience. Even if your spectators were only coming from your player population, that is a very, very large audience to be able to have advertisers and sponsors and partners for it. So I'd say we're off to a really great start. And you'll hear more about future team sales over the balance of the year, but we couldn't be happy with the progress that we've made so far and it's really exciting.

Operator

And we'll take our next question from Mike Olson with Piper Jaffray.

<Q - Mike J. Olson>: All right. Good afternoon and thanks for taking my question. Can you talk about early learnings from the Destiny 2 beta? How are you feeling as far as pre-orders at this point, particularly for the package that includes first year DLC? Thank you.

<A - Eric Hirshberg>: Hey, Mike. It's Eric. I'll take that. So the beta went great and there is a lot of excitement about Destiny 2 overall and a lot of positive signs pretty much anywhere you look. First of all, we have a tremendous amount of confidence in the game at its closing. We think it's going to be a great game. And we received almost universally positive feedback from both the press and the fans after people got their hands on the beta. And I think it's also worth noting that Destiny won 45 awards at E3 and we think it's continuing to close strong.

We also have very strong pre-orders. And Coddy mentioned this broadly, but the specifics are the number one position on Nielsen's unaided awareness and next choice purchase intent. And while no one of those data points is ever predictive in a vacuum, we found that when you have all three of those trending positively, it's usually a very good thing.

And then there are also several firsts at Destiny 2, the way we're going to market that are designed to bring the franchise to a broader audience starting with the fact that we've got a great PC game. Of those 45 awards, one of them is the official Best of Show for PC at E3. We've actually added a number of languages and localizations to make the game more appealing and accessible to more audiences around the world. And of course, I think our watershed partnership with Blizzard is going to bring Destiny to the most passionate PC fans anywhere in the world, so puts it on the best possible stage.

And finally, maybe most importantly with a game like this, Destiny is so engaging that the follow-on content is almost as important if not as important at the main game. And as I mentioned on earlier calls, we've completely changed our approach to tapping that by widening our stable of AAA developers so that we can keep up with the demand, it's a high class problem, but we haven't been able to do that in the past, keep up the demand for more content.

And I think that fans agree with the importance of that, which is evidenced by the fact that such an overwhelmingly high percentage of the pre-orders thus far are from one of our elevated SKUs which include the Season Pass and the follow-on content. So, lots of good signs. The beta being just one of them and we're really excited and have confidence we have a great game.

Operator

And we'll take our next question from Tim O'Shea with Jefferies.

<Q - Timothy O'Shea>: Yes. Hi. Congratulations on the quarter and thank you for taking my question. So how do you think about audience reach on the King network versus engagement and how do you grow it? Thanks.

<A - Riccardo Zacconi>: Hi, Tim. It's Riccardo here. So when we think about our network, we think primarily about audience reach and audience engagement. And we're focused on increasing both. In the live games, we have been primarily focused on increasing the audience engagement and we have done this through fresh content, new features and live operations. And we have seen great results, with impact reflected in the high DAU and MAU ratio as well as in the retention of the most engaged players. And this has resulted in an increase – in a continued increase of our player monetization. Candy Crush, which is a title which is now five years old, has recently hit again the number one grossing in the U.S. App Store charts. And we also see great results in our other live games.

In regards to audience reach, we think we have more work to do and this will take some more time. But we are very focused on it. The audience reach we know that we can, let's say, impact the audience reach with new titles. Here, we have our teams focused on developing multiple new titles for the long term, in particular focusing strategically first of all on our casual genre for our existing audience. But we're also looking at extending into new genres, in particular at mid core. Here we have of course big opportunities within the company, the wider company and we are exploring mobile opportunities for some of the company's existing powerhouse franchises, like the partnership we have announced recently with Activision Publishing for Call of Duty.

In the near term, we're also working on a social casino title in partnership with PlayStudios and we expect to release this title by the end of the year. In regards to audience reach, we also believe that there are opportunities to stabilize and grow the audience reach in the live games. The team so far has been focused on engagement and monetization features, and they will continue to focus on engagement and monetization features where we've been successful, but we will also start focusing more on features that can impact reach as well.

Operator

Thank you. We'll take our next question from Doug Creutz with Cowen and Company.

<Q - Doug Creutz>: Thanks. Could you maybe talk a little more about the structure of the Overwatch economics? How you're sharing revenue with the team owners? So, what were some of the key points that encouraged your partners that they could make money off this over the long term? Thanks.

<A - Spencer Adam Neumann>: Hey, Doug. This is Spence. I'll take a shot at this one. So we were really deliberate in structuring this business to attract the best owners and players in order to position the Overwatch League for long-term success. And that starts with optimizing alignment between the league which we own with the teams and our players. So at the league level, we're establishing a pool of shared league-wide revenues composed of media rights and consumer products, league-level sponsorship and a portion of league-related digital in-game merchandise.

And then we'll net those league costs like marketing and production and league operations against those revenue streams and share the resulting amount 50-50 between the league and the teams. And then at the team level, we've got these fantastic entrepreneurial owners, and we wanted to be sure we developed the structure that enabled those owners to not only fund player and team operations, but also create real incremental value at the local level.

So in addition to their league participation, the teams have their own local revenue streams including the more traditional areas like ticket sales and concessions and local sponsorships and local merch sales. But they'll also have more unique opportunities such as the ability to host certain nonprofessional Overwatch matches.

And so – and then lastly when we think about the players, we established minimum salaries, benefits and bonuses for players so that we're providing a security and stability required to attract the best talent on the planet. So I guess if we step back, we position the league and the team owners to invest alongside one another to build value at both the league and the local level, leveraging the capabilities and infrastructure that we each bring to bear for the benefit of our players and our fans. So we've got plenty of work to do here and we're getting ready for the launch later this year and we look forward to sharing more progress soon.

Operator

And we'll go next to Matthew Thornton with SunTrust.

<Q - Matthew C. Thornton>: Hey. Good afternoon. Thanks for taking the question. The Activision segment was really strong this go around. Maybe can you talk a little bit about Call of Duty, how that's tracking, and in particular as we think about World War II in 4Q, maybe just how we're tracking relative to prior releases? Any color there would be helpful. Thanks.

<A - Eric Hirshberg>: Hey, Matt. So the trends are really good in World War II, and I'll talk about those, but I think it's also perhaps first important to step back and look at the Call of Duty franchise overall, which remains incredibly strong. We had strong MAUs this quarter with audiences at a relevant scale across multiple titles. And importantly, despite the headwinds that we talk about on IW, both MAUs and OI are both in line with our record Q2 performance from last year despite those headwinds. So our strategy of bringing content and adding content wherever our players choose to play is really paying off, and I think that's what drove the positive performance you referenced in the quarter.

We had that for Infinite Warfare and Modern Warfare Remastered. We continue to season the content that was scheduled for those, we also brought the Zombies Chronicles which Coddy mentioned, which was remastered, some of our most beloved content from the Black Ops Zombies canon, and that also speaks to the strength of that catalog and our ability to continue to delight fans with new versions of that. So it really does speak to the size and strength and stability of Call of Duty that we can do this across multiple titles and I can't think of another franchise that can.

On World War II specifically, probably most importantly, we think we have the right game at the right time. And I can tell you that those who have played it, the return to boots on the ground, the return to human scale, authentic military content and context for the franchise is a welcome change and very well timed. And everything that fans have touched by the way is a lot more than unusual. We had multiplayer hands-on at E3 for only the second time in our history this year.

Everything that consumers have put their hands on, we've gotten really positive response from fans as well as from critics. And there's a couple of data points which show that. First of all, the reveal trailer was the most liked video in Call of Duty history, and we've got a pretty great history with that. And we had the most organic views of any CoD reveal trailer ever.

The hands-on multiplayer at E3 was well received and the Zombies trailer that we revealed at Comic-Con went on to become our most liked Zombies trailer ever with an overwhelmingly positive sentiment as well. So the good news is you don't have to take my word for any of this. Our beta starts on August 25 on PlayStation and I hope all of you are going to join us and play.

Operator

And we'll take our next question from Evan Wingren with KeyBanc Capital Markets.

<Q - Evan Wingren>: Thanks. You talked a little bit about King advertising in your prepared remarks and I wonder if you would just give us an update on how the rollout of King ads is going.

<A - Riccardo Zacconi>: Hi, Evan. It's Riccardo again. Sure. So we are continuing to work to build out this new business, and our first priority is to build a very strong team. As you heard earlier, we made significant progress recently, adding a great new leader to drive this business forward. And in terms of update on the business itself, we put the player experience first.

So our focus is, first of all, on creating a really compelling ad format. And we define this as an ad format which is well integrated into the game play and that provides value for the player as well as value for the advertiser. And currently, we are evaluating the results of these first ad format tests, and we are continuing the work on creating more premium video ad products.

We're also widening the variety of ad formats beyond video. As you heard before, we had signed a partnership with Facebook to offer their image ad product, and so we are introducing image ads, and this format will allow us to monetize our global audience. So, overall, we feel very excited about this opportunity. We think it's a very substantial opportunity given the size and the engagement of our network. And so I will give you an update at a later date on further progress.

Operator

Thank you. And we'll go next to Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Thanks for taking my question. Could you talk at a high level how Blizzard is allocating its time and resources right now? What percent of man-hours are spent on new IP versus existing IP? And I guess I'd be curious to hear you talk about how you think about Blizzard's new IP pipeline the next three to five years. Thanks.

<A - Michael Morhaime>: Hi, Brian. Thanks. This is Mike. First and foremost, I'd just say that the bulk of our focus continues to be supporting our existing players and releasing high-quality content for our existing games. This quarter is a great example of that approach. We delivered a consistent flow of updates and new content across all of our games, and that has driven record engagement even without a new game launch. We're also really excited about the future. In addition to supporting all of our live games, we're committed to incubating new initiatives and we're also thinking about different platforms, especially mobile.

In terms of new IP, our pipeline is in a better position than ever before in our history. Last year, Allen Adham, who cofounded Blizzard with me and Frank Pearce, returned to the company to take on the task of coordinating our efforts in this regard. And this includes some great ideas that we'd already started to explore. So we now have multiple dedicated incubation teams that are being led by some of our most experienced game designers at Blizzard.

I should say that creating new Blizzard-quality games on any platform will take time. And as we've shown in the past, we're not going to release any games that we don't feel live up to our expectations or those of our players. When we do bring new experiences to current or new platforms for new and existing IPs, there're going to be ideas that our teams are passionate about and that we think there's a large audience for.

Operator

And we'll take our final question today from Ray Stochel with Consumer Edge Research.

<Q - Raymond L. Stochel>: Great. Thanks for taking the call, and congrats on the success of Crash. I'm wondering what do you see as the long-term opportunity in remastered nostalgic titles. And do you see opportunities within your own portfolio of owned IP? Thanks.

<A - Eric Hirshberg>: Hey, Ray. It's Eric. So first, we knew that there was a passionate audience out there for Crash. Full disclosure myself among them, but we had no idea – it's hard to tell whether that's a vocal minority or whether that's a real mass audience until you put something out there. And Crash has surpassed all of our expectations by a pretty wide margin. And a couple of stats that underscore that point where it was the number one selling console game in June based on units, even though it was only available for two days during that month. And Sony reported this morning, well timed, I guess for this call, that Crash is the most downloaded game on the PlayStation store in July.

So as to your broader question, I think this is just another example of us really listening to our communities and our fans and offering them great content where they want to engage which is one of our core strategies. So we think we have other great IP in our portfolio that we're considering of course, but we've already – this isn't new behavior for us. We've already shown the power of this with Modern Warfare Remastered last year with Zombies Chronicles that we talked about. Obviously, Crash Bandicoot is another great example.

So this is a strategy that clearly has our attention, and while there are no new announcements today, I think you can be confident that there will be more activity like this in the future with more great IP. The other opportunity beyond remastered is to look at some of our classic IP and ask whether or not it could be reborn on a new platform like what we're going with Skylanders on mobile. So I think that our IP library is an asset that, when done right, can be very powerful.

<A - Collister Johnson>: I'll jump in just for a second. Ray, it's Coddy. Echo Eric's points, but even more broadly across the company, in looking ahead, Spence already shared the Blizzard plans to release a remastered version of StarCraft in Q3. We wind up additional releases of that kind of beloved fan favorite content going forward. Eric said, no announcements today, but there's just a beloved IP out there that our communities love to engage in, and it's worth a further step back, which is we are really in a transition – a tailwind, strong transition to game to the service model where we have these passionate and deeply engaged, digitally connected communities to which we can provide an ongoing stream of services, features, events, content. And it is a really strong model, both for our fans and our players and their communities, and a chance to really connect online with each other, but also for the company as a business.

And you can expect us to continue to pursue this, to look for additional ways to engage our digitally connected audiences, hundreds of millions of fans and players both on our large franchises which we're doing and Eric mentioned as well as in our most popular nostalgic intellectual properties and also new opportunities. And that's powerful combination between the digitally connected audience that very few engage and our ability to have inspired teams deliver content to them is it's a strong model and I think we're still in the early days of exploring it. And I think you'll see us continue to pursue that in the calls to come.

Robert A. Kotick

I think that wraps. Thanks, everyone, for your time today. We'll look forward to speaking with you next quarter. Thanks.

Operator

And that does conclude today's conference. Thank you for your participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2017-05-04
Event Description: Q1 2017 Earnings Call

Market Cap: 57,112.03
Current PX: 74.91
YTD Change($): +11.59
YTD Change(%): +18.304

Bloomberg Estimates - EPS
Current Quarter: 0.492
Current Year: 2.616
Bloomberg Estimates - Sales
Current Quarter: 1666.333
Current Year: 7482.826

Q1 2017 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Michael Morhaime
- Riccardo Zacconi
- Eric Hirshberg

Other Participants

- Timothy L. O'Shea
- Colin Alan Sebastian
- San Q. Phan
- Evan Wingren
- Michael Olson
- Doug Creutz
- Brian Nowak

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard's Q1 2017 Earnings Call. Today's call is being recorded, and at this time I would like to turn the conference over to Amrita Ahuja, SVP of Investor Relations. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard first quarter 2017 conference call. With us are Bobby Kotick, CEO; Thomas Tippl, COO; and Dennis Durkin, CFO. And for Q&A, Mike Morhaime, CEO of Blizzard; Eric Hirshberg, CEO of Activision; and Riccardo Zacconi, CEO of King will also join us.

I would like to remind everyone that during this call we will be making statements that are not historical facts. The forward-looking statements given in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true they ultimately may prove to be incorrect. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factor section of our SEC filings, including our 2016 annual report on Form 10-K, which is on file with the SEC and those indicated on the slide that is showing. The company undertakes no obligation to release publicly any revision to any forward-looking statements to reflect events or circumstances after today, May 4, 2017.

We will present both GAAP and non-GAAP financial measures during this call. However, as discussed on our July 29, 2016 conference call, due to updated compliance and disclosure interpretations issued by the SEC staff in May 2016, we are no longer able to present non-GAAP financial measures excluding the impact of deferrals. On this call and in the future, we will continue to provide non-GAAP financial measures which exclude the impact of expenses related to stock based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses, and accruals related to acquisitions, including the acquisition of King Digital Entertainment, expenses related to debt financing and refinancing, restructuring charges, and the associated tax benefits. These non-GAAP measures are not intended to be considered in isolation from, as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release which is posted on www.Activisionblizzard.com for our full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures.

There's also a PowerPoint overview, which you can access with the webcast and which will be posted on the website following the call. In addition we will also be posting a financial overview highlighting both GAAP and non-GAAP results in a one-page summary.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Amrita. And thank you for joining us today. This quarter we achieved record revenues, earnings per share, and cash flow, and over-performed our prior guidance. The size and engagement of our community remains strong. We continue to invest in both in-game growth opportunities, as well as adjacent opportunities, like consumer products, advertising, and esports. One of our big priorities is to unlock the full potential of professional esports by opening the sale of teams and media rights of our leagues. Over the years, we've become a leader in creating world class competitive experiences, sustainable franchises that engage hundreds of millions of people around the world, through gameplay competition and connecting players and communities. This success is driven by our ability to tap into the timeless power of communities, anchored through organized competition.

Throughout history, sports has helped bring communities together. City and country loyalties form the basis for spectator enthusiasm, generations of engaged audiences and traditions anchored in scheduled competitions. Until the 20th century though, sports like football, baseball and basketball were still hobbies for gifted amateurs. Then professional leagues emerged like the Premier League, the NFL, or the NBA. The value of sports in our everyday lives has grown exponentially, and so have the commercial opportunities that we see in sports. We actually believe the same opportunity to further professionalize esports now exists, and we think the impact can be as significant as the traditional sports we know and love.

The franchises we've built over the years deliver competitive experiences as enduring as traditional sports, but with unique strength and value for brands. Our players are digital natives competing in almost every country in the world. The esports audience includes some of the hardest to reach and most sought-after demographics for marketers and advertisers, with the share of millennials two to three times higher than any of the big four U.S. sports. We're incredibly excited to launch the Overwatch League later this year. We believe by celebrating and rewarding our players, and recognizing their accomplishments, our professional players will become the role model and inspired competitors of the 21st century. The competitions we're creating around the world will attract sponsors and advertisers resulting in broadcast revenues, licensing, sponsorship and ticket sales, and most importantly, amazing spectator experiences. Through MLG, we're building the first dedicated global channel for esports, the over the top ESPN of video games.

To put the Overwatch League opportunity in context, around 240 million people today watch approximately 7 billion hours of NFL content annually. This drives $12 billion in revenues including more than $6 billion in media rights revenues. The NBA today has roughly 175 million viewers watching around 2 billion hours total with more than $5 billion in revenues and a $1.8 billion of those from media rights. With hundreds of millions of people already watching esports and playing our games, over the long term our goal is to create opportunities that we believe could be of a similar scale. We're also going to combine delivery of our spectator content with unique advertising opportunities that includes the ability for advertisers to have better targeting and analytics, much more so than what you would see in traditional forms of broadcast advertising today. And with over 400 million MAUs and extremely high levels of engagement, our potential to generate meaningful advertising revenue is substantial. In particular, we believe our initiatives for advertising in King mobile games is a large and untapped opportunity and we're continuing to make progress with our testing and development of our ads platform, Ad King.

Our results this past quarter demonstrate our ability to execute successfully against the many opportunities for shareholder value creation we have and as we have done for 26 years.

And now Thomas will share the details on the quarter with you.

Thomas Tippl

Thank you, Bobby. We're off to a very strong start this year. We delivered record Q1 revenues of $1.7 billion and record digital revenues of $1.4 billion. We grew year-over-year, over-performed our guidance for the quarter, and are raising our guidance for the full year. Our results continue to be driven by focus and execution against our three strategic pillars. First, expanding our audiences, second deepening engagement, and third providing more opportunities for player investment.

Let's start with audience reach, which was 431 million monthly active users this quarter. Blizzard had 41 million MAUs for the quarter, up 58% versus last year and relatively stable versus the prior quarter, despite no new full-game releases. Blizzard's fastest growing new IP ever, Overwatch, continues to grow from an MAU perspective, setting another high water mark this quarter. In less than a year since launch, Overwatch has 30 million registered players and has become Activision's eighth $1 billion franchise. Hearthstone continues to attract new players as well, reaching 70 million registered players life-to-date. MAUs also grew year-over-year and quarter-over-quarter despite no new content in Q1.

Activision had 48 million MAUs for the quarter, down year-over-year due to weakness in last holiday's Infinite Warfare release as discussed on our Q4 call. However, Call of Duty continues to have a large and active community of players across Infinite Warfare, Modern Warfare Remastered and Black Ops III. And we expect the community to grow with the next game in the series, Call of Duty: World War II, releasing November 3.

When Activision greenlit this game more than 2.5 years ago, the team knew it was time to return the franchise to its roots, and fans are already sharing their excitement for Call of Duty: World War II. Activision revealed the game at a global live stream from London last week, which became the most watched live stream in Call of Duty history, and the reveal trailer has gone on to become the most liked trailer in Call of Duty history, and became the fastest video to reach 10 million views in Call of Duty history, which it did in one day. Additionally, though it's still very early, pre-orders are off to a very strong start. Call of Duty: World War II will deliver the gritty authentic cinematic experience, which Call of Duty is known for.

Activision along with its partners at Bungie also recently revealed the much anticipated Destiny 2, which is set for release on September 8. Destiny was the biggest new video game franchise launch of all time when it was released, and early leading indicators including pre-orders for Destiny 2 are very strong as well. The team is taking great care in designing the game to appeal to existing and new fans, including PC players for the first time. Activision is also localizing the game for more markets, which should enable us to reach new audiences. And at launch, we're offering an expansion pass for Destiny 2, containing two future expansions, along with a continuous calendar of other events. Encouragingly, the SKUs that contain the expansion pass have attracted the majority of pre-orders so far. We believe the combination of a great game, the new opportunity to reach PC players, and a robust content plan post-launch highlight the opportunity ahead. We look forward to sharing more about both Destiny 2 and Call of Duty: World War II in the months ahead.

Turning to our next strategic pillar, our compelling games, deep gameplay and consistent follow-on content drove not only large communities, but also deep engagement with about 40 billion hours of gameplay over the past 12 months. Blizzard continues to see strong engagement from its players with time spent increasing by a double digit percentage year-over-year to a new Q1 record. Overwatch again had strong engagement this quarter thanks in part to the Lunar

New Year event, which like the three seasonal events before it, drove record engagement in the game. Overwatch's latest seasonal event released on April 11. This event named Uprising included a player versus environment game mode, which drew record hours of player engagement, demonstrating that Overwatch can appeal to players beyond player versus player competition.

In April, Blizzard also launched Heroes of the Storm 2.0, with a more powerful progression system, reward pack loot chests, and new battleground, and more compelling heroes, all of which brought players back into the game. Blizzard's strategy to release content and feature updates more regularly in World of Warcraft has been paying off with time spent up year-over-year, and with overall performance ahead of the prior expansion. At the end of the quarter, Blizzard released the game's second major patch since Legion came out with more content to come later this year. To round out the terrific performance of Blizzard's games, Hearthstone set a new all-time record in daily active users in April with the release of the new expansion, Journey to Un'goro.

King's MAUs were down slightly versus prior quarter, but community engagement trends continue to set new highs with an increase in total playtime versus prior quarter. Time spent by daily active user is now a record 35 minutes. King also had the highest DAU to MAU ratio since 2013, with stability in DAUs versus the prior quarter. This performance shows that King's focus on live ops and new content for core franchises continues to keep our large and loyal audience engaged. And this bodes well for King's biggest growth opportunity, advertising.

Esports is an important and growing engagement driver for our community, and there were many highlights this quarter. Activision held Call of Duty World League events in Atlanta, Dallas, London, Paris, and Sydney, and Blizzard kicked off the StarCraft II World Championship Series, Hearthstone Championship Tour, and Heroes of the Storm Global Championship with major international events, along with the third Heroes of the Dorm college tournament in Las Vegas. In addition, the Overwatch APEX League completed its second season in Korea and this year's Overwatch World Cup was announced as part of a busy year of Overwatch esports, as Blizzard gears up for the Overwatch League. And we have more to come down the road, including the recently announced CWL Championship. This is Call of Duty's biggest competitive event of the year, and will be held in August in Orlando with 32 teams from around the world competing for a prize pool of $1.5 million as part of the largest CWL season long prize pool to-date of $4 million.

Turning next to the third pillar of our strategy, providing opportunities for more player investment. Blizzard saw an increase in total in-game purchases by almost 30% year-over-year, primarily driven by Overwatch and World of Warcraft, highlighting once again the virtuous cycle of engagement leading to more player investment, all of which starts with great new content. Later this month, Activision's Call of Duty: Black Ops III fans will be getting a new content offering called Zombies Chronicles, a remastered collection of the franchise's most beloved zombies content. This is our most significant new content update yet in the second year following a Call of Duty release as we now have better player engagement opportunities than we've ever had with our catalog games.

King not only increased engagement, but also increased player investment this quarter. Bookings per paying user rose for the 7th quarter in a row to a new record. King continues to have two of the top ten grossing games in the U.S. for the 14th quarter in a row, and importantly the Candy Crush franchise showed continued stability with mobile bookings growing versus prior quarter. King has a number of projects in development, including a promising new publishing partnership with PlayStudios in the social casino segment, slated for later this year. This is an attractive mobile gaming genre and will allow us to provide great content for our existing player base, as well as attract new players to the King network.

As we discussed last quarter, we also have a number of mobile incubation projects underway across the company, many of which are based on our proven IP. Since King became part of the Activision Blizzard family last year, we've been looking at ways to work together to create even more great gaming experiences for our large player network. Last month, we announced that King and Activision are partnering on the creation of a Call of Duty mobile game, and we're excited about the potential of bringing these two great teams together.

In summary, we are off to a terrific start in 2017, with continued success keeping our large audiences engaged across a growing portfolio and on a variety of platforms. We are also pleased with the early momentum we are seeing for

Destiny 2 and Call of Duty: World War II and the continued progress on new growth opportunities, like advertising, esports and consumer products. We are excited about our prospects and stay tuned for further updates in the weeks and months ahead.

Dennis will now review the numbers in more detail.

Dennis M. Durkin

Thanks, Thomas. Today I will review our better than expected Q1 results, our outlook for Q2, and our raised outlook for the full year. Once again, we outperformed our guidance thanks to the strength of our global portfolio of owned IP, which delivered record Q1 revenues, digital revenues, earnings per share, and cash flow.

To review the quarter, I'd like to first start with our segment results. As a reminder, our segment results, unlike our consolidated results, are still presented excluding the impact of deferrals as they always have been. At an aggregate level, combined segment operating income was up 41% year-over-year on an as reported basis. Operating income also grew on a pro forma basis, when including a full quarter of King last year. This is despite expected Call of Duty headwinds and shows the strength and broad diversity of our portfolio. As anticipated, Activision Publishing's Q1 results were down due to lower in-game digital sales. As mentioned on our Q4 call, we expect Activision to have a back-end loaded year with the two exciting releases in the second half of Destiny 2 and Call of Duty: World War II.

King's relatively stable daily player base and continued growth in per-player engagement and player investment led to sequential revenue growth of 9% and an increase in operating income quarter-over-quarter. Blizzard's revenue grew 50% year-over-year, while operating income nearly doubled driven primarily by the success of Overwatch as well as strong continued engagement in World of Warcraft. So the strong 2016 tailwinds for the Blizzard business continue into 2017.

Now let's turn to our consolidated results. Unless otherwise indicated, I will be referencing non-GAAP as redefined figures which include the impact of deferrals. If you would like to calculate metrics as we used to report them, you would add the impact of deferrals to our non-GAAP as redefined figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter we generated record Q1 GAAP revenues of $1.73 billion, $176 million above our February guidance, and $271 million or 19% above Q1 last year. This includes the net recognition of deferred revenues of $530 million for the quarter. We generated record GAAP EPS of $0.56 and record non-GAAP EPS of $0.72 in Q1, which was $0.21 above guidance. These figures include the net recognition of deferrals of $0.41. The over-performance in the quarter versus guidance was driven by a combination of business over-performance as well as timing of expenses. Our digital revenues once again grew to a Q1 record, $1.4 billion, up 50% versus last year. The strong digital performance led not only to year-over-year operating margin expansion, but also strong cash flow generation. We delivered record Q1 operating cash flow of $411 million, up 22% year-over-year.

From a balance sheet perspective, we paid down $500 million of debt in Q1, ending the quarter with $4.4 billion of aggregate debt outstanding. We finished the quarter with approximately $3.3 billion in cash and investments, with about $1.3 billion held domestically. And next week on May 10 we plan to pay a cash dividend of $0.30 per common share, a 15% increase over 2016, to shareholders of record from the close of business on March 30, 2017.

Now let's turn to our slate and outlook for Q2. Our Q2 slate includes one of Blizzard's busiest stretches of in-game content releases, including momentum from the March 28 World of Warcraft content update; a new Hearthstone expansion, Journey to Un'goro; the Overwatch Uprising event; and the Heroes of the Storm 2.0 launch with more content to come in the upcoming months. King will continue to drive live ops across its portfolio, albeit with some typical seasonality expected in Q2.

Activision expects to release Call of Duty's second map pack as well as a free update in Destiny. In addition, they will launch new zombies content for Black Ops III, as well as new content and updates across the portfolio to keep players engaged while at the same time beginning the ramp in sales and marketing spend for our major releases later this year.

For Q2 on a GAAP basis, we expect net revenues of $1.425 billion, including the net recognition of GAAP deferred revenues of $225 million, product cost of 23%, and operating expenses of 64%. We expect GAAP interest expense of $37 million, a tax rate of 26%, GAAP and non-GAAP share count of 764 million, and EPS of $0.15.

For Q2 on a non-GAAP as redefined basis, we expect product costs of 23%, and operating expenses of 48%. We expect non-GAAP interest expense of $36 million, tax rate of 24% and non-GAAP EPS of $0.38, which includes the net recognition of GAAP deferrals of $0.11. Just to remind everyone, if you would like to calculate non-GAAP metrics as we used to report them, you would start with our non-GAAP as redefined EPS guidance of $0.38 and remove the net recognition of deferrals for $0.11.

Now to our 2017 full year outlook. Though it is still early in the year and we have a lot left to deliver, including our major launches in the second half of the year, we are raising our full year outlook. Also, as we mentioned on our last call, emerging new revenue streams like team sales for the Overwatch League and the associated media rights are not embedded in our current guidance. On a GAAP basis, we expect revenues of $6.1 billion including GAAP deferrals of $230 million, product cost of 22%, and operating expenses of 62%. Our GAAP interest expense is expected to be $157 million and our GAAP tax rate is expected to be 17%. We expect 767 million fully diluted shares, both for GAAP and non-GAAP redefined, and GAAP EPS is expected to be $0.88, up $0.16 versus our previous guidance.

For 2017 on a non-GAAP basis as redefined, we expect product costs of 22% and operating expenses of 46%. We expect non-GAAP interest expense of $149 million, a tax rate of 24%, and non-GAAP EPS of $1.80, up $0.10 from our previous guidance, including a GAAP deferral of $0.08. If you would like to calculate non-GAAP metrics as we used to report them, you would start with our non-GAAP as redefined EPS of $1.80 and add the impact of deferrals, or $0.08.

So in summary, 2017 is off to a very strong start. Our record performance and cash flow generation speak to the strong year-round trends in our core business. We have a lot left to deliver later this year, but we are seeing some promising early data points on our two major launches ahead with Call of Duty and Destiny. Our strong owned IP portfolio combined with promising emerging business opportunities like esports, advertising and consumer products provides us with a compelling opportunity for growth in 2018 and beyond. And as always, with so many great opportunities ahead of us, we remain focused on operational excellence, capital discipline and long term shareholder value creation.

Now I welcome our business leaders, Eric, Mike, and Riccardo as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] And at this time, we'll take a question from Tim O'Shea with Jefferies.

<Q - Timothy L. O'Shea>: Yes, so first congratulations on the quarter, and thank you for taking my question. So I was just wondering if you could provide more detail on the Call of Duty: World War II release this November, and maybe specifically what you have planned to bring more players into the game. Thanks.

<A - Robert A. Kotick>: Hey, thanks, Tim. Maybe the easiest way to answer the question is to go a little deeper into the data that Thomas started to share on our prepared remarks. Preorders, as Thomas said, are off to a very strong start. But we also track a number of other softer measures to indicate strong positive interest in the game and we're off to a great start with most of those as well. The reveal trailer has become the most liked video in Call of Duty history, and also now has the most organic views of any Call of Duty reveal trailer we've ever made. We also set a new high watermark with the views of the live stream. That's both for Call of Duty and for Activision overall. And the livestream also was extremely positively received, with a 95% like to dislike ratio. And then probably equally important as the positive indicators is the – that the negative social media sentiment, which you know we – was an issue last year, has virtually evaporated at about 0.2% at reveal. So, I think, we're going to have a great game. And I think we have the right game at the right time. Obviously there's a lot of thirst from the community to go back to boots on the ground, but we didn't stop there. We're also going to be bringing some real innovations to the game which are obviously designed to keep it fresh and make it even more appealing for more different types of players, and those are going to be on display when we bring hands on multiplayer to E3 next month, and that's only the second time in our history that we've done that. And for context, the other time was Black Ops III. So obviously we have a lot of confidence in what we're going to be showing. So early days, obviously, but we're off to a strong start. And while we're obviously only talking today about Call of Duty: World War II, I have the benefit of knowing what we have in the pipeline, and I think that we – I've got a lot of confidence that our fans are going to be excited to play all the games that we've got cooking up for them over the next several years.

Operator

And this time we'll take a question from Colin Sebastian with Robert Baird.

<Q - Colin Alan Sebastian>: Thanks, guys. My question for Bobby or Mike around Overwatch, and you must be encouraged by the pace of growth with the user base. I'm wondering just how large of a market opportunity you think there is for this game, how you plan on maintaining that pace of growth, and on a related note if you could provide an update on the progress of the Overwatch League, including timing of league sales and kick off of the league. Thanks.

<A - Michael Morhaime>: Hi, Colin. Thanks for the question. This is Mike. So right now we're heading towards Overwatch's launch anniversary later this month, and we're incredibly happy with the community that's developed around the game, how many people have already tried the game and how they're staying with us nearly a year after the launch. Our first quarter MAUs were higher than we've seen all of last year, so that's great. We've seen new players come into the game when we release new types of gameplay through our seasonal events. And we have a lot of opportunities to continue doing that.

We're also pleased with how successful Overwatch has been globally across the Americas, Europe, and Asia as well as our strong presence on both PC and Console. But we're tapping into the biggest genre in the world, so we think there's still a lot of room for growth across both regions and platforms. We think the Overwatch IP is incredibly strong and has potential across a number of different mediums. Our out of game linear media via comics and animated shorts has been really successful in fueling passion for the game's lore. And we think there's an ongoing opportunity there as well. Our existing esports community is really strong and it's growing. The Overwatch League is poised to accelerate that even more. So we're early in Overwatch's story with many growth opportunities still ahead. As far as the Overwatch League timing, we are working to launch the league later this year. You'll hear more about that in the coming months and I can turn it over to Bobby to talk a little bit more about how the team sales process is going.

<A - Robert A. Kotick>: Yeah, as far as the team selling process is concerned, Colin, if you look back at the history of when we started this, it was really building a structure that would allow us to celebrate, recognize, and reward our players, and that was our principal priority. What we've come to realize is there's a big commercial opportunity potentially as well. So we've got a great team assembled with people from places like ESPN, Fox Sports, the NFL, the NBA. We've been out meeting with prospective team owners, both endemic teams as well as professional sports team owners, and the reception has been terrific. We'll be announcing our key city sometime later this year and give a little bit more detail into what the play schedule will be. But not for another few months.

Operator

Let us now move to San Phan with Mizuho.

<Q - San Q. Phan>: Hi. This question is for Riccardo. Can you tell us a bit more about King engagement, what you're focused on at this point? And how you think by driving that business, you're growing engagement.

<A - Riccardo Zacconi>: Hi Phan. It is Riccardo. So engagement has always been and continues to be a key priority for the company. And as you've seen from what Thomas was saying earlier, we have very positive trends and we are very happy about these positive trends. The average time played per player in last quarter was around 35 minutes per day. And this has been an increase both towards the last quarter and also versus the same quarter of the previous year. So, great results. And it's also great result that create engagement, it translates into how you're monetization. And we have seen here that bookings per pay year have gone up for the seventh consecutive quarter. So we have reached a new record level.

Now what do we do to drive engagement? We do a few things. First of all, we release new fresh content in the live games, and we do – we call it live operations, which basically means this content is temporary, limited in time, and only available for a specific timeframe. And this makes it particularly attractive. And what we also do then, we also release features, which are permanent. So that they are impacting the gameplay for the long term. And both of those – the content releases are in the live games. What we also do is we then leverage the network of games we have by cross promoting players from one game to the next game. And by doing so, retaining and increasing the engagement, not only in the single game but at network level.

And then of course we release new games and we have released Bubble Witch Saga 3 in January of this year. And the launch went very well. We are very pleased with the results of the launch, and we're very pleased with the high quality of the game. And as you have heard earlier, Thomas, we have now – we're also entering a new genre of games with the partnership with PlayStudios, which will go live towards the ends of the year.

<Q - San Q. Phan>: Great. Thank you.

Operator

At this time, we'll take a question from Evan Wingren with Pacific Crest Securities.

<Q - Evan Wingren>: Thanks. So given Blizzard's slate this year, with less full games being released, just curious how you think about the content to help keep the community engaged throughout the year and how you think about the monetization of that engagement?

<A - Michael Morhaime>: Hi, Evan, this is Mike. So, yeah, this year for Blizzard represents a new type of pipeline, one that's not necessarily based on full game launches, but instead on delivering new content updates for our games. This quarter, we have meaningful new content for every franchise in our portfolio. In fact, a few weeks ago we set a new DAU record on the back of these new content updates. This reflects the evolution of our business from focusing primarily on full game releases to also providing a consistent stream of content for our players. Even without any full game launches this year, we're continuing to add to the depths of our games to serve a very highly engaged community with more content across our portfolio than we ever have before.

Operator

At this time we'll move to Michael Olson with Piper Jaffray.

<Q - Michael Olson>: Thanks, good afternoon. Looks like King has posted some developer job openings for Call of Duty mobile game. Can you provide us with any more detail on the game and your plans with that going forward?

<A - Eric Hirshberg>: Sure, I'll start. Riccardo, then maybe you can jump in. So, yeah, Thomas mentioned King and Activision are teaming up to build a Call of Duty mobile game from the ground up. And the goal is to take a brand that tens of millions of people know and love and reinterpret it in a way that is appealing to the mass mobile audience. And we think it's a big opportunity. With King's experience making massively accessible and engaging games for that platform, and Activision's experience building one of the most enduring and appealing and engaging gaming franchises ever, we think we have the right combination of skills to pull it off. But obviously it's very early days. But that's the goal. Riccardo?

<A - Riccardo Zacconi>: Hi, Mike. So I believe if I may I will add a couple things to what Eric just said. First of all, and most importantly, and I'm talking here for the entire King's team. I'm super excited about this incredible opportunity, and to work together with the incredible team at Activision Publishing. One of the things which really excited us when we joined the Activision Blizzard family was the strength of the team on one side and the incredible quality and depth of their portfolio of games. And now we have the opportunity to work together on one of the jewels in this portfolio. So, this is super exciting.

Of course, as Eric was saying, it's still early days. We are just at the beginning of this process and of the development, and it will take many iterations, as we know well, to create a game of incredible quality. But we are super focused on it. We put amazing people on this task. The target is to develop a game of broad appeal and to combine in doing it the experience of King of creating mobile games of broad appeal with the great experience in the genre and in the shooter genre of Activision Publishing and the experience of creating a franchise which has been around for a very long time. And so I believe that this is a really significant future opportunity, and I'm very excited to work together.

Operator

We'll now move to Doug Creutz with Cowen.

<Q - Doug Creutz>: Yeah, I wonder if you could give as much update as you can on when you expect to rollout advertising to the King user base, and maybe talk about what some of the gating items are to do that? Thank you.

<A - Riccardo Zacconi>: Hi, Doug. So advertising is still in beta. In Q1 of this year, we've been doing further testing. We've built the internal capabilities, and we've built the team and are continuing to build the team. Currently, we are testing in seven titles, including some of our largest titles, with Candy, Candy Soda, and Farm Heroes. And we're testing different ad formats to ensure that we have the best possible player experience and also to ensure that we have the best possible return for our advertisers. We're seeing that in the market there's incredible demand for high quality mobile video ad symmetry, and we continue to be very excited about this opportunity, because we think we are in a very strong position both because of the size of the network and as you've heard before, because of the engagement of our players. So as we said earlier this year in – at our last earnings call in February, we expect to become profitable with this business line, with advertising this year, and to scale up the business in 2018.

Operator

Our final question today will be from Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Great. Thanks. A question on Destiny. Can you just talk a little bit about your expectations for Destiny in the new guidance given the dual platform, console and PC release? And then talk a little more about the digital and the MTX innovation you see coming with the title and what type of contribution you expect in that? Thanks.

<A - Eric Hirshberg>: Thanks, Brian. Well, the community's reception to the reveal was obviously awesome. And after four weeks, Destiny 2 pre-orders are tracking amongst the top in Activision Publishing's history. So the most important thing for this franchise beyond delivering a great game, which Destiny 2 is definitely going to do, as we talked about in the past, is getting the content pipeline right. Destiny's engagement has been the best in Activision's history. And we now have a lot of confidence that we're going to be able to keep up with demand with that steady stream of great content to sort of keep pace with our player's engagement post the release of Destiny 2.

So as you know from our past comments on previous calls on – with Destiny 2's content, we're coupling Bungie's great visionary leadership with multiple AAA developers that have a proven track record here at Activision to help us make sure that we have just one great piece of new content after another to keep the community engaged. And that's the most important answer to the second part of your question. We've shown that when we have great engagement, great business follows. So with respect to PC, which you asked about, we're committed to delivering meaningful features that are bespoke for the PC community and I'm really excited about what we have to show for them. But I'm going to leave the details of those for our gameplay premiere event which is happening on May 18. And we'll have some additional, obviously, exciting announcements on the game overall at that time as well.

Robert A. Kotick

All right. Thanks, Brian, and thanks everyone for joining us today. We'll look forward to seeing many of you at E3 or on our earnings call this summer. So thank you.

Operator

And again, that does conclude today's conference call. Thank you all for your participation.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2017-02-09
Event Description: Q4 2016 Earnings Call

Market Cap: 57,112.03
Current PX: 74.91
YTD Change($): +11.59
YTD Change(%): +18.304

Bloomberg Estimates - EPS
Current Quarter: 0.492
Current Year: 2.616
Bloomberg Estimates - Sales
Current Quarter: 1666.333
Current Year: 7482.826

Q4 2016 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Eric Hirshberg
- Michael Morhaime
- Riccardo Zacconi

Other Participants

- Timothy L. O'Shea
- Drew Crum
- Mike J. Olson
- Brian Nowak
- Doug Creutz
- Christopher Merwin
- Eric J. Sheridan
- Colin Alan Sebastian
- Eric O. Handler

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard's Q4 2016 Earnings Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Amrita Ahuja, Senior Vice President of Investor Relations. Please go ahead.

Amrita Ahuja

Good afternoon. And thank you for joining us today for Activision Blizzard's fourth quarter 2016 conference call. With us are Bobby Kotick, CEO; Thomas Tippl, COO; Dennis Durkin, CFO. And for Q&A, Mike Morhaime, CEO of Blizzard; Eric Hirshberg, CEO of Activision; and Riccardo Zacconi, CEO of King will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation, and while we believe them to be true, they ultimately may prove to be incorrect. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factors section of our SEC filings, including our 2015 Annual Report on Form 10-K, which is on file with the SEC, and those indicated on the slide that is showing. The company undertakes no obligation to release publicly any revisions to any forward looking statements to reflect events or circumstances after today, February 9, 2017.

We will present both GAAP and non-GAAP financial measures during the call. However, as discussed on our July 29 conference call, due to updated compliance and disclosure interpretations issued by the SEC staff on May 2016, we are no longer able to present non-GAAP financial measures excluding the impact of [indiscernible] (1:46). On this call and in the future, we will continue to provide non-GAAP financial measures, which exclude the impact of expenses related to stock-based compensation, the amortization of, intangible assets, expenses including legal fees, costs, expenses and accruals related to acquisitions, including the acquisition of King Digital Entertainment, expenses related to debt financings and refinancings, restructuring charges and the associated tax benefits. These non-GAAP measures are not intended to be considered in isolation from, as a substitute for, or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision.

Please refer to our earnings release which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also a PowerPoint overview, which you can access through webcast and which will be posted to the website following the call. In addition, we will be posting a financial overview highlighting both GAAP and non-GAAP results in a one-page summary.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Amrita, and thank you all for joining us today. Our performance in 2016 further strengthened our position as the world's leading stand-alone interactive entertainment company. We achieved record results in 2016, delivering all-time high revenues of $6.6 billion, and record non-GAAP EPS of $2.18, up 42% and 68% respectively over last year. We also delivered record non-GAAP operating margins of 35%. We over-performed our plan for the quarter delivering record revenues of $2 billion and record non-GAAP earnings per share of $0.65, up 49%, and 160% respectively over last year. We also delivered our strongest annual operating cash flow in history at $2.2 billion, up 71% over last year.

Our success continues to be driven by our two greatest assets: our incredibly talented people, and the devoted community of gamers we serve. We have roughly 450 million players in 196 countries, and they spent over 40 billion hours playing our games in 2016, and they watched a record 3 billion hours as spectators of our games. We continued to see opportunities to expand audiences, deepen engagement and increased player investment. In fact, prioritization of opportunity remains our greatest challenge. But we remain vigilant in ensuring that the right resources are connected with the right priorities.

We had number of important successes in 2016 that we'd like to acknowledge. Blizzard's new franchise, Overwatch, has captured the imaginations of players all over the world, and we've only scratched the surface. The truly extraordinary Overwatch team launched the most successful new intellectual property in our company's history. We now have over 25 million registered players and engagement has continued to grow. The King team was very focused on continuously releasing fresh content with new levels and features as well as increasing live operations efforts with events and competitions. As a result, mobile bookings for the Candy Crush franchise grew in 2016.

King also made meaningful progress with its advertising initiatives. Last year's advertising tests had two primary goals: to design and build an outstanding ad platform that would actually enhance our users' in-game experience, and to deliver significant value to advertisers. We're encouraged with the early results. In most tests, our users play more game rounds, spend more time in the game, and have a self reported better game experience with advertising. Additionally, our platform delivers meaningful value to advertisers. We've partnered with some of the world's top advertisers, including Nestle, Fox Entertainment and Visa, and our viewability, verifiability and completion metrics are all encouraging.

Ads are perceived as more unique and interesting when shown on King inventory, and viewers are more likely to take action after seeing an ad in King games. The King team will continue to build on their efforts this year, and we believe advertising has the potential to be a growth driver in the years to come. We also nurtured emerging growth opportunities outside of our games, including e-sports, television and film, and consumer products, and we enhanced the organizations that will support these initiatives. These new opportunities are consistent with and organic to our company's missions, and they have the potential to become important standalone businesses in pursuit of our goal to become the leading 21st century entertainment company.

We accelerated our e-sports efforts with the integration of Major League Gaming, the formation of the Call of Duty World League, and the announcement of the Overwatch League. Our ambition is to create nothing less than the e-sports equivalent of the world's established major professional leagues. To this end, in 2017, we plan to start the process of selling teams and commercializing media rights for the Overwatch League. We look forward to welcoming team owners with the expertise, skills and investment required to build the professional league together.

We plan to invest in these long-term growth pillars further in 2017 and expect them to have even greater impact in 2018 and beyond. I couldn't be more excited about our prospects for the future, and our team's dedication and enthusiasm reinforces my confidence that we will continue to achieve our ambitious plans.

Thomas and Dennis will now share with you the results of our record quarter and our record year.

Thomas Tippl

Thank you, Bobby. Due to our portfolio strength and digital momentum, we far exceeded our plans in 2016. We surpassed our initial revenue guidance by $0.5 billion and our initial non-GAAP EPS guidance by more than $0.40. And we also outperformed expectations for the holiday quarter. In driving our record-setting year, and as we look ahead, we remain focused on our three strategic pillars: first, expanding our audiences; second, deepening engagement; and third, providing opportunities for more player investment.

Let's start with audience reach, which was 447 million monthly active users this quarter. Blizzard had record Q4 MAUs of 41 million. And for the year, Blizzard had its highest annual MAUs ever, up 37% from 2015, and up 87% since 2014. This is a remarkable achievement, demonstrating the strength of the Blizzard portfolio and capabilities. Overwatch, released in May, set the record for the strongest launch year financial performance of any game in Blizzard's 26-year history. The game is critically acclaimed, receiving 55 game of the year awards and reached 25 million registered players faster than any franchise in Blizzard history, beating Diablo III's launch year unit sales record set in 2012, which for a new IP is an extraordinary accomplishment.

In Q4, MAUs rose to a new franchise high, as existing players stayed engaged and new players joined the fun. Showcasing its continued global appeal, Overwatch has players all over the world, including great success in Korea and China. It's always difficult for Western companies to succeed there, and Overwatch's popularity is testament to Blizzard's unique ability to create globally appealing games.

World of Warcraft's Legion expansion, which launched in late August, continues to reenergize the community. For the year, MAUs were up 10%, and for the quarter, MAUs were up over 20% versus year ago.

Hearthstone players enjoyed a tremendous amount of new content in 2016, with one adventure and two expansions including Mean Streets of Gadgetzan in the fourth quarter. For the year, Hearthstone had record MAUs, up over 20% year-over-year, and for the quarter, MAUs were also up versus year ago.

Activision had Q4 MAUs of 51 million. On a full-year basis, Activision had its highest annual MAUs ever, up 3% from 2015, and up 23% since 2014. Black Ops III's digital season led to record MAUs for Call of Duty in the year, and Destiny showed steady engagement in its third year. Call of Duty was the number one franchise in North America for the eighth year in a row, and the number one console franchise globally, a mantle we've held for seven of the last eight years.

Activision's November release, Call of Duty: Infinite Warfare is a high quality, innovative game that paired with Modern Warfare Remastered offers a tremendous amount of value and gameplay variety. However, sales underperformed our expectations, and it's clear that for a portion of our audience, the space setting just didn't resonate. We had a passionate experienced studio deeply committed to this direction, and despite the risks we saw, we believe it is important to consider the passions of our game teams in deciding what content to create. While it wasn't the success we planned, it allows us to protect a core tenets of our culture that Bobby discussed, empowering our talented teams to have the chance to pursue opportunities that they are passionate about.

Providing an environment that recognizes passion is a critical component of our success, and the process to learn from our mistakes is what makes our company special, and it's why the most talented people in our industry are attracted to our company. In 2017, Activision will take Call of Duty back to its roots, and traditional combat will once again take center stage. This is what our dedicated community of Call of Duty players and Sledgehammer Games, who has been developing this year's title, are the most excited about. The Call of Duty community remains strong, and Call of Duty is the most successful video game franchise of the last 20 years. Overall franchise MAUs were stable in Q4 as players engaged on multiple titles. Life to date, on current gen consoles, Call of Duty alone has three of the top ten games. This demonstrates the value of year round engagement and live operations on both new releases and our highly engaging prior releases.

Activision also released Skylanders Imaginators during the fourth quarter, an innovative new game that allows players to create and play their very own Skylanders. The game has delighted kids around the world, and has grown the franchise to become the 11th biggest console franchise of all time with more than 300 million toys sold. Based on this franchise strength, our film and TV division launched its first initiative, Skylanders Academy on Netflix in October, which has been very well received. The second season will be delivered later this year, and Netflix has already ordered a third season. In 2017, rather than releasing a new console title, we will be supporting the award-winning Skylanders Imaginators with multiple adventure packs, new characters and new in-game content. We are also excited to bring Skylanders Imaginators to Nintendo Switch as a launch title next month, and we have a new Skylanders mobile game in development.

Now turning to our second strategic pillar, deepening engagement. Our compelling games, deep gameplay and consistent follow-on content drove not only large communities, but also strong engagement with over 10 billion hours of playtime in Q4. Our 43 billion hours of engagement in 2016 was on par with Netflix and 1.5 times Snapchat. And importantly, we own our content.

Blizzard's Q4 playtime sets a new record, breaking the previous record set in Q3. During the fourth quarter, Overwatch had its second and third seasonal events, Halloween Terror and Winter Wonderland, showcasing the successful year round event-based approach to content. Each successive event drove new engagement records, including the most recent Lunar New Year event. And Overwatch has more exciting content coming.

Blizzard's increased investment in World of Warcraft development resources is paying off through a more regular content cadence for players, with two patches released since Legion launched. This has resulted in higher engagement for the franchise, with an increase in total playtime for the quarter surpassing Legion's launch quarter, and all non-launch quarters in the last four years. More content is coming later this year, as the full Legion story unfolds.

King's player base continues to be highly engaged with time spent of 34 minutes per daily active user, an increase over last year, and last quarter. This was due in part to our increased focus on live operation efforts. King also released a new franchise sequel at the start of this year, Bubble Witch Saga 3, which is off to a great start. Playing our games is just one way our players engage with our franchises. We recently announced our new Consumer Products division, headed by Tim Kilpin, a veteran of Mattel and Disney. Elevating our nascent consumer products business to a more strategic level is a great opportunity to provide our communities with more high-quality products and collectibles based on our own intellectual properties. Our audiences also connect with our franchises by viewing our games. In fact, Activision Blizzard accounted for five of the top ten most viewed games on Twitch in 2016.

E-sports has become not only a catalyst for increased reach and engagement, but also a stand-alone opportunity. Our Major League Gaming division hit a number of milestones this year, including hosting tournaments for Call of Duty, Overwatch, and World of Warcraft, launching the enhanced viewing experience, integrating the MLG.tv player into Call of Duty, growing video viewers on social platforms like Facebook and Instagram by 50%, and increasing twice player engagement by over 60% year-over-year. Activision's launch of the Call of Duty World League sparked strong growth for Call of Duty e-sports. Activision doubled the 2016 prize pool to over $3.5 million across 16 hosted events.

Millions of fans were drawn to the action with the 2016 season delivering 120 million video views, and more than twice the time spent viewing compared to last year's season. We look forward to plenty more action in the months to come.

Last year, Blizzard held its tenth BlizzCon and celebrated its 25th anniversary. BlizzCon again sold out in minutes and drew a large global audience with over 25,000 in-person attendees, and 10 million people from around the world tuning in. Blizzard also sold a record number of DIRECTV pay-per-view tickets to fans wanting the full BlizzCon virtual experience.

Blizzard announced the formation of the Overwatch League at BlizzCon. For fans, it will offer city-based teams around the world competing in annual seasons, with standardized schedules creating a consistent experience to build passion and allegiance. For team owners, guaranteed slots and clear rights will enable stability and transparency that they can invest in. For players, contracts, including benefits and a combine for player selection will open up the sort of career opportunities associated with traditional sports.

The Overwatch League is being designed to bring a new era to e-sports with an epic entertainment experience for everyone involved. Blizzard feels it has the community passion in place and the required structure established to commence the process of selling teams and media rights for the Overwatch League later this year. We'll have more exciting news to share in the months ahead. In January, Blizzard kicked off its Heroes Global Championship and announced its upcoming third annual collegiate e-sports competition, Heroes of the Dorm, which will be streamed exclusively via Facebook Live, ensuring broader global accessibility to e-sports audiences.

Turning next to the third pillar of our strategy, providing opportunities for more player investments. In-game purchases were yet again close to $1 billion in the quarter, and a record $3.8 billion for the year, more than double last year's $1.7 billion. Even without the benefit of the addition of King to our portfolio, the company's in-game purchases would have grown 33% this year. World of Warcraft content and continued strength in Overwatch seasonal events delivered Blizzard's record levels of in-game revenues in the quarter and for the full year. Activision's record in-game revenues for 2016 were driven by a record-setting Call of Duty Black Ops III in-game content season where for the first time, add-on revenues were greater than DLC and Season Pass combined even with record Season Pass participation.

Over the past several years, Activision has methodically and creatively evolved the Call of Duty business model, and this performance illustrates the impact those strategies have had in a relatively short period of time. It also showcases the virtuous cycle created when engaging content leads to more player investment. And this year is the first time we have three player communities at scale concurrently in Infinite Warfare, Modern Warfare Remastered, and Black Ops III, and we will be supporting each of them with new content throughout the year.

Destiny continues to have a large and committed audience, which is eager for new content and adventures. Activision along with their partners at Bungie plan to answer the call with the release of a full Destiny sequel later this year, designed to thrill our existing loyal fan base and bring many new players into the fold. We plan to support the release of the sequel, with a great content plan post launch, setting the stage for growth with this year's sequel and the content season that will follow.

King continues to perform from a player investment perspective despite lower MAUs. Bookings per paying user has increased six quarters in a row to its highest level ever. Importantly, we saw stability in the Candy Crush franchise throughout the year, with fourth quarter and full-year mobile gross bookings increasing year-over-year for the franchise. We have also invested in a mobile incubation pipeline with multiple games for a number of our core franchises across the company. We will rely on our own talented teams and partners, and leverage King's mobile expertise. Some of these games has reached the prototype phase and we believe could drive growth in future years. We'll have more to share on our expanding mobile efforts down the road.

So in summary, despite many opportunities for improvement, 2016 was by far our best year ever from what we've accomplished and for the groundwork we laid to realize the significant growth opportunities that lie ahead. Dennis will now review the numbers in more detail.

Dennis M. Durkin

Great. Thanks, Thomas. Q4 was another great quarter, capping off a record setting year. For the full year for the first time, we had over $1.5 billion in revenues on three different interactive platforms: console, PC, and mobile. Nearly $1 billion in Asia Pacific revenues and more digital revenues for the year than our prior record for total company revenues, all of which helped contribute to record non-GAAP operating margin of 35%, year-over-year EPS growth of 68%, and nearly $2.2 billion of operating cash flow, up 71% year-over-year. These results highlight the powerful combination of owned IP, a direct and increasingly digital customer connection and global scale. We're obviously very encouraged by this and believe we're only in the early innings of realizing this multi-year opportunity.

Looking back, I'd like to first start with our segment results. As a reminder, our segment results unlike our consolidated results are still presented excluding the impact of deferrals as they always have been. Blizzard had its strongest financial performance in history including record revenue up more than 50% versus last year, a record $1 billion in segment operating income for the year, up 81% versus last year, and record Q4 revenue up 46% versus last year. This historic performance underscores the significant progress Blizzard has made towards transforming into a multi-franchise, multi-platform and multi-geography company.

In 2016, Blizzard had more than 60% of its revenues from non-World of Warcraft franchises, 20% of its revenues from non-PC platforms and more than 25% of its revenues in APAC. Activision's Q4 had strong catalog and digital performance from Call of Duty Black Ops III, which offset new release underperformance. Activision delivered record Q4 and full-year in-game revenues and the strong digital performance helped drive a record full-year segment operating margin of 35%. In 2016, King contributed more than the originally planned 30% accretion to our overall results. They continued to have two of the top ten grossing games in the U.S. for the 13th quarter in a row, and importantly, the Candy Crush franchise showed continued stability with an increase in mobile bookings year-over-year.

Now let's turn to our consolidated results. Unless otherwise indicated, I will be referencing non-GAAP as redefined figures which include the impact of deferrals. If you would like to calculate metrics as we used to report them, you would add the impact of deferrals to our non-GAAP as redefined figures. Please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter, we generated record Q4 GAAP revenues of $2.01 billion, $158 million above our November guidance, and $661 million or 49% above Q4 last year. The net effect of deferred revenue was $438 million for the quarter. We generated GAAP EPS of $0.33. We generated an all-quarter record non-GAAP EPS of $0.65, $0.25 above guidance. The impact of deferrals on non-GAAP EPS was $0.27. The over-performance in the quarter versus guidance was driven primarily by Overwatch and World of Warcraft as well as favorable adjustments to our tax rate versus guidance. In Q4, you saw the power of our diverse portfolio and year-round engagement model, where even with lower Call of Duty Frontline sales, we were able to deliver growth and record results.

Turning to the full year, we generated record GAAP revenues of $6.61 billion, up 42% year-over-year, an operating margin of 21% and EPS of $1.28. The impact of deferred revenue was negative $9 million for the year. On a non-GAAP basis, we generated record EPS of $2.18, up 68% year-over-year. The impact of deferrals on non-GAAP EPS was $0.02 in 2016. The digital transition continues to be a nice tailwind for our business, and digital revenues in Q4 were an all quarter record $1.5 billion, double last year's figure. For the year, we delivered record digital revenues of $4.9 billion, up 94% versus last year. The primary driver for our digital momentum is the continued growth of in-game content. As Thomas mentioned, in-game purchases were close to $1 billion for the quarter, and a record $3.8 billion for the year, more than double the $1.7 billion we had last year. We believe we still are in the early days of this important vector in our business with more opportunity ahead.

In terms of cash flow, our strong business performance has led to record cash flow generation. For the year, we delivered a record $2.2 billion of operating cash flow, up 71% year-over-year. For the quarter, we generated operating cash flow of $859 million.

From a balance sheet perspective, we had a number of positive developments in 2016. The durability of our underlying business has driven continued credit rating improvement. During the year, S&P upgraded us to investment grade, and

Moody's, who had upgraded us in 2015 concurrent with the King deal announcement, moved us up another notch. In August, we restructured our term loans, which allowed us to realize interest rate savings and in September, we issued new five-year and ten-year notes which replaced our prior 2021 notes at a more cost-effective rate. So, a very busy year on the capital structure front.

Regarding liquidity, we finished the year with approximately $3.3 billion in cash and investments on the balance sheet, with almost $1.4 billion held domestically. Our strong balance sheet and cash flow have allowed us to return significant capital to our various stakeholders. Since 2010, we have repurchased $7.8 billion of our shares and paid out over $1.3 billion in dividends. In addition, since 2013, of the $7.1 billion of gross debt we have borrowed to fund the Vivendi buyback and the King transaction, we've already repaid $2.1 billion as of the end of 2016. Continuing on this trend, our board has once again approved a balanced approach to capital allocation for 2017, increasing our dividend by 15% to $0.30 per share payable in May, authorizing debt pay down of $500 million this year, of which we've already paid down $139 million in February, and authorizing a $1 billion stock repurchase over the next two years.

Now, let's turn and look forward to our outlook for 2017. In 2017 as expected, we have a lighter slate of full-game releases. Given fewer major launches this year, we expect to build on our strong momentum on year-round engagement and in-game player investment across our portfolio. A few other things to call out. While strategically important, emerging new revenue streams like team sales for the Overwatch league and the associated media rights are not embedded in our current guidance. In addition, as we have said previously, we expect advertising to begin to contribute in 2017 and have a more substantial impact in 2018 and beyond.

In terms of segments, we expect a more evenly-weighted contribution from Activision, Blizzard, and King in 2017 than in 2016. We expect Blizzard to have a lower 2017 performance given a lighter release slate. However, Blizzard has lots of exciting plans for live ops and additional in-game content for every franchise, including Overwatch, Hearthstone and World of Warcraft. For Activision, we expect to have lower performance in the first half of the year, given a smaller Call of Duty digital season compared with the record performance of Black Ops III in the first half of 2016. That said, we do expect a larger back half of the year as we release the Destiny sequel and a new Call of Duty title. We are enthusiastic about this year's Call of Duty release going back to its roots, and as such we are guiding it up in Q4 versus last year's Q4 performance.

In addition, as Thomas mentioned, the Skylanders franchise will not have a full game console release this year, but we will continue to engage the community and drive player investment through new toys and digital content. For King, we expect to be modestly up year-over-year, mainly driven by a full-year contribution from the business, the introduction of advertising, and ongoing live ops across the portfolio.

Turning to the numbers, on a GAAP basis for 2017, we expect revenues of $6 billion, including GAAP deferrals of $300 million, with product costs of 22% and operating expenses of 64%. Our GAAP interest expense is expected to be $156 million and our GAAP tax rate is expected to be 21%. We expect 765 million fully diluted shares, both for GAAP and non-GAAP, and GAAP EPS is expected to be $0.72. Our GAAP numbers include a $0.03 net of taxes GAAP-only restructuring charge, which is related to our continued transition to digital.

For 2017 on a non-GAAP basis, we expect product costs of 22% and operating expenses of 47%. We expect non-GAAP interest expense of $149 million. We expect a return to the historical tax rate of 24% as 2016's tax rate was lower due to discrete items and stronger international mix due to Blizzard's over-performance. We expect non-GAAP EPS of $1.70, including a GAAP deferral of $0.15.

Please note that we expect more of a deferral impact in Q4 2017 than we had in Q4 2016 due to the larger expected launches of Destiny and Call of Duty in the second half of the year, part of which will be deferred into 2018. Also just to remind everyone, if you would like to calculate non-GAAP metrics as we used to report them, you would add the impact of deferrals, or $0.15, to our non-GAAP as redefined EPS of $1.70 to get to our full-year 2017 number.

Now let's turn to our Q1 outlook. On a GAAP basis for Q1, we expect revenues of $1.55 billion including GAAP deferrals of negative $500 million, product costs of 21%, and operating expenses of 60%. Our GAAP interest expense is expected to be $43 million, and our GAAP tax rate is expected to be 21%. We expect 760 million fully diluted shares, both for GAAP and non-GAAP, and GAAP EPS is expected to be $0.25. For Q1 on a non-GAAP basis, we expect product costs of 21% and operating expenses of 43%. We expect non-GAAP interest expense of $39 million, a tax rate of 24%, and non-GAAP EPS of $0.51, including a GAAP deferral of negative $0.33.

So in summary, 2016's strong performance highlights the tremendous opportunity and potential we have in front of us. The combination of leading owned IP, and franchises, a direct digital connection to our consumers, best-in-class content creation capabilities, and geographic platform and business model diversity provides an incredibly powerful engine for sustained financial performance. So while in 2017, as expected, we will have a lighter release slate, our strong business platform, combined with promising emerging opportunities like e-sports, advertising, and consumer products provides us with a compelling opportunity for growth in 2018 and beyond.

Now, I welcome our business leaders, Eric, Mike, and Riccardo as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] And we'll take our first question from Tim O'Shea with Jefferies. Please go ahead.

<Q - Timothy L. O'Shea>: Yes, hi. Thank you for taking my question. So looking at Call of Duty, I'm curious what the plan is for content this year, and whether for the Q4 release you intend to tweak anything based on the reaction to last year's version of the game. Thank you.

<A - Eric Hirshberg>: Hey, Tim. Thanks. It's Eric. So the first thing I'll say is just that I think the most important thing is remember, the Call of Duty ecosystem is strong, and we continue to see very strong MAUs, and that this is the first time we'll have three active games with three different player communities at scale with Infinite Warfare, Modern Warfare Remastered, and Black Ops III. And the plan is we're going to be driving engagement for all of those titles with great content throughout the year.

As far as the second part of your question, as I've said many times before, with any longstanding franchise like Call of Duty, there's a balancing act we need to strike between staying true to the things that people love about the franchise and also the need to never become complacent and to keep pushing for innovations to keep the franchise fresh and vital. I would argue, over a period of many years now, we've managed that balance on Call of Duty better than just about any longstanding franchise in any medium.

Last year I don't think we got that balance right. Infinite Warfare had a ton of great gameplay innovations that many of our fans appreciated and loved, but it also had a setting that didn't appeal to all of our fans. The good news is, is that I'm excited to say that in 2017 we think we have this balance in perfect harmony with a game that our teams are incredibly passionate about, with a lot of great innovations, but that also has the traditional combat that we know our fans are going to love.

The game is being made by Sledgehammer, as Thomas mentioned. They're a proven team that's passionate about this title. We green-lit it over two years ago now, and they've been hard at work at it ever since, and we can't wait to unveil it to the world soon. And without discussing too much about what else we've got in the Call of Duty pipeline, I can also tell you that we're confident our fans are going to love those games as well, and we've never be more excited either creatively or commercially about our three-year Call of Duty slate.

<Q - Timothy L. O'Shea>: Great. Thanks, Eric, and congrats on the quarter.

<A - Eric Hirshberg>: Thank you.

<A - Robert A. Kotick>: Thank you.

Operator

And we'll take our next question from Drew Crum with Stifel.

<Q - Drew Crum>: Okay, thanks. Good afternoon, everyone. So for Overwatch, would you be willing to provide any additional detail on plans for content in 2017 and beyond? You made reference to live ops, but any additional detail there? And as far as the Overwatch League, any additional color on what you have in store for that? Thanks.

<A - Michael Morhaime>: Sure. Thanks for the question. This is Mike. First, we're very pleased with the launch of Overwatch and the player response to the content. We've entered 2017 with strong momentum. The game passed the 25-million-player mark last month. And each seasonal event that we run has set a record for engagement.

Our plan is to continue evolving Overwatch with new hero and map content, new game modes, and additional events. We've seen very strong engagement in digital sales from these efforts last year. Looking into the future, we also see opportunities in areas like linear media and consumer product. We think that this will help deepen connections with the franchise and also expose Overwatch to new audiences.

In addition, we want to create new ways for players to engage with the franchise through the Overwatch League. Esports is growing, but the ecosystem isn't always easy to navigate for players, viewers, or teams. So with the Overwatch League, we're working very hard to address those challenges. Our focus is on creating stability and participation for teams and owners, and accessibility of the content for fans.

We'll have global city-based teams with a standardized annual schedule, creating professional, high quality content and guaranteed league slots for the teams. This is all built on a game that's easy to understand, with short matches, and great action. The core experience is very fun to watch, and there's already a sizable audience for it around the world. Based on this, we think that we'll see significant new business and engagement opportunities.

We're going to start identifying team owners soon. That's our next step. And we're looking forward to holding our first combine and kicking off the League later this year. So with all of that said, we're very excited about Overwatch's future.

<Q - Drew Crum>: Great. Thanks, Mike.

<A - Michael Morhaime>: Yeah.

Operator

And we'll take our next question from Mike Olson with Piper Jaffray.

<Q - Mike J. Olson>: Hey, good afternoon. For King advertising, can you fill in some detail on the testing so far and when we should expect that you get to a full rollout across the games and the player base? Thanks.

<A - Riccardo Zacconi>: Hi, Mike. Here's Riccardo.

<Q - Mike J. Olson>: Sure.

<A - Riccardo Zacconi>: So, first of all, we have a large user base, but more importantly, it's a very engaged user base. You've heard earlier Thomas saying that we have more than half an hour of gameplay per player per day, and we think this is an attractive opportunity, a very attractive opportunity for advertisers. It's a very engaged user base.

So at the last earnings call I said that we are very careful and protective of the user experience, and so we've been testing and we are testing several ad formats. We've been testing with very high quality consumer brands like Nestle or Fox in our key games. We've been testing in Candy and we've been testing in Candy Crush Soda Saga. And we are testing integrated ad formats, which are integrated in the gameplay and are supportive of the gameplay. And so far, the results have been very positive. They've been positive both for the players, with an increase in gameplay and an increase in ad spend, and they've been positive for advertisers.

So we have seen completion rates, which are above industry benchmarks, and we define completion rates as when the player really starts a video ad and finishes the video ad. And further on, we have engaged third parties through third-party research to analyze the impact on players, and the result was that our ads stand out more when they are presented and shown on our platform, on our games than when they are shown on other platforms. So we are very pleased with the results so far.

So we are continuing on our plan, and the plan for this year is, first of all, to continue to invest in building the technical infrastructure, and to continue building out the team. Secondly, we will continue to test various ad formats, and as we do so, we will also ramp up the inventory. So our expectation for this year is to have a positive contribution to the bottom line, and we expect to scale the impact on the bottom line in 2018.

<Q - Mike J. Olson>: Thank you.

Operator

And we'll take our next question from Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Thanks for taking my question. Appreciate all the color on the digital revenue strength. I guess I'd be curious to hear about where you finished on full game download mix for consoles for the year and what are you expecting for 2017? Thanks.

<A - Dennis M. Durkin>: Yeah, hey, Brian. Thanks. It's Dennis. Yeah, digital tailwinds have obviously been a huge and important factor across all of our businesses, and thankfully we have the diversity of being across multiple platforms. So having huge success on mobile, which is almost all digital, on PC which has over time become almost all digital, and then the last real holdout is really on console where full game download mix is still the minority of player purchases.

In general, it varies based on title and region and audience type. So for a game in big and mass market as Call of Duty, you see a slightly lower percentage mix of digital just because it is so mass market. But it's now in the low to mid 20s, and that's up from zero three or four years ago. But in games like Destiny and Overwatch, we see in the mid 30s. And that trend is continuing every year where we see 5-plus percentage points of mix moving every year in terms of overall business mix. So it should be a nice tailwind for us and for others in the industry over the next few years as well. Thanks.

<Q - Brian Nowak>: Great, thanks.

Operator

And we'll take our next question from Doug Creutz with Cowen.

<Q - Doug Creutz>: Hey, thanks. I think you got 300,000 Redditers to breathe a huge sigh of relief when you confirmed Destiny 2 for this year. Could you give any indication whether you expect that in Q3 or Q4? And then could you talk about what you and Bungie learned from Destiny 1 that's informing the design process for Destiny 2 and your plans for post-launch content? Thanks.

<A - Eric Hirshberg>: Hey, Doug, it's Eric. Yeah, I think the best thing we can say about Destiny is that the development is going great, and it is indeed on track for release this fall. As for the particulars, we've got a big reveal planned. I'm going to let the game do most of the talking, but I'll give you some broad strokes. I think that our team and our great partners at Bungie are doing a very nice job on two fronts. One is if you're one of the millions of players who really invested in Destiny 1 and have put a lot of hours and passion into that game, you're going to love this game, and there's a lot more of what you love here.

For anyone who either hasn't yet tried Destiny or hasn't played it in a while, we think we've made a game with the sequel that's going to have a lot for them to love, too. The cornerstone of that is a great cinematic story. That's been a real focus with a great cast of memorable, relatable characters, coupled with some very nice ways to make the game more accessible to a casual player, without losing anything that our core players love. We've made it more accessible to someone who just wants to have a great more casual first-person action experience.

We're also going to introduce Destiny to a number of new people by going to some international markets that we haven't been in before. So I'm going to leave the rest for the reveal, but we're very excited about the game, and it'll be coming this fall.

<Q - Doug Creutz>: As am I. Thanks.

Operator

And we'll take our next question from Chris Merwin with Barclays.

<Q - Christopher Merwin>: Okay, thank you. I just have one for Riccardo. If you don't mind just updating us on the game pipeline for King. I think you said in the past that you're mostly focused on developing King IP for the time being, but at some point does it make sense to take one of your established IPs from Blizzard or Activision Publishing and create a mobile version of that game that the King team can develop? Thanks.

<A - Riccardo Zacconi>: Hi, Chris. Here's Riccardo. So over the past year, we have taken a much more focused approach on what content we develop and release. So this is in line with our goal to continuously raise the bar on innovation. Innovation is a major word for us. It is a major focus point. So talking about the King team, first and foremost we're focusing on the existing King franchises. So we have proven last year that our focus on live games, creating new content in the forms of live ops and new features has paid off, and pays off, and we've seen this in the growth of the Candy Crush franchise year-on-year on mobile. So we are continuing to invest in live games.

Secondly, we are working on sister titles and sequels for our existing successful King franchises. We have launched recently, in mid-January, we have launched Bubble Witch 3, and we are extremely pleased not only with the quality of the game, but also with the response from the players and the acceptance from the players. And we are looking forward to scaling further this game in the year. We are also working on titles with much higher level of innovation for the long-term growth of the franchise, and we believe innovation is key for the long-term success.

We're also working for the future on additional IPs in new genres with franchise potential, and here it's great to be part of the Activision Blizzard family, and we are very excited about the opportunities coming from working together on bringing established Activision Blizzard IP to mobile. And we're currently working on this, and the work is at prototype stage. We're also working with the Activision Blizzard team on marketing existing Activision Blizzard mobile IP on mobile devices, and that's where we can leverage the experience we have made on mobile, and the technique and infrastructure. So in summary, our resources are more focused than ever, on the long-term growth of our business.

<Q - Christopher Merwin>: Okay. Thank you.

Operator

And next we have Eric Sheridan with UBS.

<Q - Eric J. Sheridan>: Thank you for taking the question. We saw the announcement of the consumer products division. We've certainly seen other companies like Disney turn large IP libraries into big consumer product businesses. Why now in terms of the consumer product launch? How should we think about that opportunity? And what should we be watching for over the next couple of years as that business rolls out? Thank you.

<A - Robert A. Kotick>: Great question, Eric. It's Bobby. I think Disney is a great example. They've figured out probably better than any entertainment company how to turn consumer products into a multi-billion dollar business, but also to increase the touch points for their franchises around the world. And so we've elevated consumer products to a new strategic pillar for the company. We hired Tim Kilpin who is a veteran of both Disney and Mattel, and we think that consumer products can accelerate growth by leveraging our IP and creating new ways for people to connect with our franchises, especially as we're launching our e-sports leagues. If you think about consumer products as they relate to the NFL or the NBA, these are billions of dollars of revenues for the leagues, and we think they'll be great opportunities for league and team merchandise. That'll be important components of what we do in the consumer products business.

Generally, we think creating more consumer touch points in a low capital investment, high-return way, adds tremendous value to the franchises. So we think this is a great opportunity for the company, and we're really looking forward to expanding what we do in consumer products with Tim Kilpin.

<Q - Eric J. Sheridan>: Great. Thank you.

Operator

We'll take our next question from Colin Sebastian with Robert W. Baird.

<Q - Colin Alan Sebastian>: Great, thanks. And this is a follow up question for Mike. I was hoping you could tell us a little bit more about the Blizzard pipeline as well, both in terms of full new releases and online expansions. And then any sense for the linearity of release timing would be helpful as well. Thanks.

<A - Dennis M. Durkin>: Hi, Colin, thanks for the question. Well, last year was a really epic and important year for us, in addition to celebrating our 25th anniversary, we posted record results and have more people playing Blizzard games than ever before. We're very grateful for the passion and support of our players, and our commitment to delivering awesome content to them has never been stronger. So with that in mind, we've put in a significant effort into being able to support the type of longer-term engagement that Blizzard games have always delivered, but doing so now across more games on more platforms and in more regions. So we've really had to scale up our organizational capabilities to do that.

This year, we'll have compelling new content across all of our franchises, as well as continuing to expand beyond the games with things like comics, animated shorts and more. In addition, we're always thinking about new game ideas, and we have several in the prototype phase, but not able to talk about those right now. As I mentioned before the Overwatch League also represents new business and engagement opportunities for us this year and beyond, and that's going to be a big focus for us as well.

<Q - Colin Alan Sebastian>: Great. Thanks.

Operator

We have time for one more question. We will now hear from Eric Handler with MKM Partners.

<Q - Eric O. Handler>: Yes. Thanks for taking my question. Bobby, question for you. With League of Legends recently signing a $50 million year streaming deal with BAMTech, I'm curious, how do you perceive the value for your e-sports properties?

<A - Robert A. Kotick>: Great question, Eric. I actually think it was a very important milestone for e-sports. It's a large-scale broadcast commitment, and I think it really demonstrates how valuable our content can be as spectator content. I think when we look at what the opportunity is for professionally-produced content, and as Mike pointed out, city-based competition around the world, which there really isn't an analog to, we think that if you look at where advertisers want to spend their capital, where sponsors want to spend their capital, it is very difficult to reach 18 to

35-year-old males today, and this programming is incredibly compelling. People are watching it largely as user generated content today. But we think the professionally produced content will have tremendous value, and we think this is going to be a big area of opportunity, again, to strengthen our franchises, but probably most importantly to really celebrate our players. Because if you think about the player investment that our players make, the time, the commitment, there's a great opportunity for us to showcase and celebrate our professional players, and we think there's going to be larger audiences and large numbers of advertisers willing to support those efforts.

<Q - Eric O. Handler>: Thanks, Bobby.

Dennis M. Durkin

All right. Thank you everyone for joining us today and we'll look forward to talking to you again in early May.

Operator

And that concludes today's presentation. We thank you all for your participation. And you may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2016-11-03
Event Description: Q3 2016 Earnings Call

Market Cap: 29,743.40
Current PX: 40.02
YTD Change($): +1.31
YTD Change(%): +3.384

Bloomberg Estimates - EPS
Current Quarter: 0.772
Current Year: 2.032
Bloomberg Estimates - Sales
Current Quarter: 2451.882
Current Year: 6579.474

Q3 2016 Earnings Call

Company Participants

- Colin Roussil
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Michael Morhaime
- Eric Hirshberg
- Riccardo Zacconi

Other Participants

- Michael J. Olson
- Brian Nowak
- Chris P. Hickey
- Brian P. Fitzgerald
- Colin Alan Sebastian
- Christopher David Merwin

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard Q3 2016 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Colin Roussil. Please go ahead, sir.

Colin Roussil

Good afternoon, and thank you for joining us today for Activision Blizzard's third quarter 2016 conference call. With us are Bobby Kotick, CEO; Thomas Tippl, COO; and Dennis Durkin, CFO. And for Q&A, Eric Hirshberg, CEO of Activision; Mike Morhaime, CEO of Blizzard; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call, we'll be making statements that are not historical facts. The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation. And while we believe them to be true, they also may prove to be incorrect. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factors section of our SEC filings including our 2015 Annual Report on Form 10-K, which is on file with the SEC and those indicated on the slides that is showing. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, November 3, 2016.

We will present both GAAP and non-GAAP financial measures during this call, however, as discussed on our July 29 conference call, due to updated compliance and disclosure interpretations issued by the SEC staff on May 17, 2016, we are no longer able to present non-GAAP financial measures excluding the impact of deferrals. On this call and in the future, we will continue to provide non-GAAP financial measures which exclude the impact of expenses, related stock-based compensation, the amortization of intangible assets, expenses, including legal fees, costs, expenses, and accruals related to acquisitions, including the acquisition of King Digital Entertainment, expenses related to debt financings and refinancings and the associated tax benefits.

These non-GAAP measures are not intended to be considered in isolation from as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation with respect to our non-GAAP measures. There's also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Colin. Many of you may notice that the voice reading you this safe harbor is a different voice than usual, and that's because Amrita is out on maternity leave and we're happy to say, she had a beautiful baby a few weeks ago and she's doing well, but we're looking forward to her being back to accompany Colin on the next call.

We delivered another record quarter, and we continue to focus on building enduring franchises for our nearly 500 million monthly players around the world. Continuous innovation within existing franchises and the creation of new franchises like Overwatch helps broaden our audiences, deepen engagement and increase player investment. We believe gaming is the most engaging form of media and players spend tens of billions of hours a year with our franchises.

In fact, this quarter alone, our players spent over 10 billion hours playing our games. This strong engagement and the social experiences that are such an important part of game-playing have been the catalyst for our new opportunities in enhanced game monetization, expansion of our franchises into linear media and consumer products, and greater involvement in advertising supported spectator gaming like we have with MLG.

It's estimated that as many as 225 million people are now watching organized gaming competitions. Competition between videogame players is becoming as thrilling to watch as traditional professional sports. With the launch of professional global leagues, we believe games spectating will grow significantly as an opportunity for us and for our players. The increased popularity of spectator gaming will enable us to celebrate and reward our players and recognize their accomplishments. Professional gamers will eventually be as celebrated, honored and recognized as professional athletes.

Professional gamers will be the role models and goodwill ambassadors of the digital generation and we believe great new business opportunities are emerging throughout the esports ecosystem which we helped pioneer more than a decade ago with games like StarCraft.

In May, Blizzard released Overwatch, which in about four months has already eclipsed 20 million registered players making it Blizzard's fastest, new intellectual property to reach that mark. And Overwatch was specifically designed to be the definitive competitive game.

We're uniquely positioned to realize the full potential of esports. We have some of the most successful iconic franchises in gaming and direct relationships with nearly 0.5 billion monthly active users, a powerful combination that distinguishes us from the rest of our competitors. And we have unmatched commercial capabilities that have served our shareholders extremely well over the last 25 years.

Before I hand off the call, I want to take this opportunity to thank the talented people who drive the success at our company every day. They are our greatest asset, inspiring play, competition and community by creating the most engaging entertainment in the world.

Thomas and Dennis will now share the details of our record quarter.

Thomas Tippl

Thank you, Bobby. Thanks to the efforts of our creative and commercial teams, 2016 has continued to be a record-setting year. We over-performed our plan delivering record third quarter revenues, up almost 60%, and EPS more than doubling year-over-year on a non-GAAP basis.

On the back of this strong momentum, we are raising our full-year guidance once again. As we've discussed before, our results are driven by focus and execution against our three strategic pillars. First, expanding our audiences; second, deepening engagement; and third, providing opportunities for more player investment.

Let's start with audience reach which was nearly 0.5 billion monthly active players this quarter. In Q3, Blizzard had its highest MAUs in history, up 50% year-over-year and 25% over the previous record in Q2. This increase was driven in particular by Overwatch and World of Warcraft. Blizzard's MAUs have more than doubled from two years ago, thanks to compelling new content and the broadening of the portfolio to new franchises and new platforms, including mobile.

World of Warcraft: Legion launched on August 30 and has reenergized players worldwide. The expansion sold through 3.3 million copies on launch day, matching the all-time record achieved by previous expansions and making it one of the fastest selling PC games ever. The exciting new Legion content led to an almost 30% quarter-over-quarter increase in MAUs, building on momentum established earlier in the year.

Overwatch's strong momentum carried into the third quarter and its player base continues to grow. In fact, Overwatch became Blizzard's fastest game ever to reach 20 million players. Overwatch also continues to have strong global appeal with a roughly even player split between East and West, and the number one position in Korean IGRs from launch all the way through Q3.

Hearthstone continues to add players and also had record MAUs this quarter, increasing by double-digit percentage year-over-year, thanks to great gameplay, regular content updates, and accessibility across platforms, including mobile.

Activision also had record Q3 MAUs, driven by continued strength of Call of Duty and strong re-engagement in Destiny. Activision has increased MAUs 18% over the last two years on the back of a more focused, yet broadly appealing slate of content.

Call of Duty: Black Ops III continues to be the best-selling current-gen game life-to-date, and its follow-on content has led to continued strength in the player base with record franchise MAUs for the third quarter. Destiny's new expansion, Rise of Iron, released on September 20, addressed a passionate community eager for new content and drove an increase in MAUs quarter-over-quarter. Activision and our talented partners at Bungie are hard at work on a sequel to Destiny which should energize both Destiny's passionate fan base and bring millions of new fans to the franchise next year.

Turning to our second strategic pillar; deepening engagement. Each time we offer our players an opportunity to engage with our franchises, whether in or outside of gameplay, they respond passionately. These opportunities include not only additional in-game content which drove over 10 billion hours of playtime in Q3 alone, but also out-of-game experiences, including esports and fan events like Call of Duty XP and BlizzCon.

An expanding player base and strong engagement across a number of franchises led to all-time Blizzard engagement records virtually across the board, including monthly, weekly and daily active users; unique users and playtime. This is a testament to the epic compelling content the Blizzard team has been creating.

For World of Warcraft Blizzard's priority with the recent Legion expansion was to provide meaningful content and features that supported stronger ongoing engagement. Blizzard has already released Legion's first Patch, Return to Karazhan, making it the fastest post-expansion content Patch in franchise history.

In addition, Blizzard has offered players a new way to interact with World of Warcraft by releasing a companion mobile app. For the first time, players can manage select in-game activities and continue their gameplay even when away from their PC. Millions of players have already used the app and are logging in an average of four to five times every day.

Esports overall continues to draw large and growing audiences, and our Major League Gaming division keeps innovating to celebrate the best players and most exciting game-playing. During the quarter, MLG held tournament events for Call of Duty: Gears of War, Destiny, and World of Warcraft, developing deep industry relationships. Our esports report and premium content recorded about 50 million video views on Facebook, growing 67% quarter-over-quarter and reached a record 11 million users in a single day. In our games, our proprietary video player and GameBattles will soon be integrated with Call of Duty: Infinite Warfare and will allow fans easy access to Call of Duty World League in professional play, as well as amateur competitions.

We're also looking forward to the MLG Las Vegas event held over three days in December which will feature the first Call of Duty World League event for Infinite Warfare and an Overwatch Invitational. Esports also features prominently at this weekend's BlizzCon, which again, sold out in minutes with millions more expected to join the action through live steaming or virtual tickets. Over 200 top players from around the world will compete in global finals across five Blizzard franchises. The participants started off match play last week and the unprecedented eight days of competition will culminate in what promises to be a weekend of epic sports action.

This year's event which marks the 10th BlizzCon and commemorates Blizzard's 25th anniversary will also feature community events and contests, hand-on play and – hand-on play with pre-released version of Blizzard games, discussion panels with developers and artist and more. It's going to be a very exciting weekend and we look forward to seeing some of you there.

Also during the quarter, Activision held Call of Duty XP, their largest fan event ever. The event showcased the passion and commitment of Call of Duty fans for the franchise broadly and for Call of Duty World League esports events as well. More than 1,000 teams participated in the Call of Duty World League during the 2016 season which recorded 121 million views.

We also launched our first TV show, Skylanders Academy on Netflix. It is the first initiative for our film and TV division and offers a brand new way for fans to interact with our franchises. We think the combination of the TV series and the opportunity to create your very own Skylanders is part of our recently-launched game, Skylanders: Imaginators is a compelling one for kids around the world.

And finally, we recently announced a new live-action game show based on the Candy Crush franchise to be distributed domestically by CBS and internationally by Lionsgate. This is just one more example of the strength of our IP and engagement with our franchises outside of core gameplay. These additional opportunities to engage also reinforce our franchises with our existing players and introduces them to potentially new players.

Turning next to the third pillar of our strategy, providing opportunities for more player investment. Our direct digital connection to our players, development of new analytical capabilities and new business models all support our efforts to offer great content to our players to invest in. Digital in-game content increased to another record this quarter. Actual in-game digital player purchases were a record at more than $1 billion this quarter and a record $2.8 billion year-to-date. This was driven by broad-based strength, including record participation in World of Warcraft value-added services.

In Overwatch, customization items continued to perform well, thanks to a consistent flow of new content including time-limited seasonal events. Summer Games, Overwatch's first seasonal event spanned several weeks in August and drove record engagement, as well as record participation in the event's unique in-game customization items. In October, Blizzard unveiled its Halloween Terror event which included Overwatch's first-ever player versus environment mode and players responded with even higher engagement and participation. Also, Hearthstone released a new adventure in the quarter, One Night in Karazhan, which performed even better than the last adventure.

Turning to King, whose top franchises continued to perform well despite slightly lower MAUs this quarter. The Candy Crush franchise continued its momentum of increased gross bookings year-over-year. Farm Heroes, King's second largest franchise, also increased mobile gross bookings year-over-year driven by the launch of Farm Heroes Super Saga. Strength in top titles led to growth in mobile overall with mobile gross bookings up year-over-year. Time spent per user and average revenue per paying user also increased year-over-year showing strong engagement from King's core players.

In fact, King continues to have three of the top 20 grossing games in the U.S. for now the 11th quarter in a row. King has also made progress against its advertising initiatives, a large opportunity given the size of King's player community and its strong engagement. We've now been testing advertising in Candy for close to three months and we are progressing well against our internal milestones. We continue to believe this can be a positive contributor to EPS starting in 2017 and scaling up into 2018.

For Activision, in-game revenue was driven by Destiny's expansion, as well as Call of Duty which continues to deliver record performance for the quarter and the year. Year-to-date, the number of purchasers of Call of Duty in-game content grew more than 100%, and along with robust participation in Season Pass and a-la-carte map packs drove an increase in average revenue per user as well. It also is an exciting time for Activision as Call of Duty: Infinite Warfare is set to release tomorrow. Its bold new setting has opened up numerous meaningful innovations for gameplay, paired with a classic feel that Call of Duty is known for. And with three modes, including Campaign, Multiplayer and Zombies, it is a complete package for every type of fan.

Also included in Call of Duty: Infinite Warfare's Legacy Edition is the ultimate bonus content, Modern Warfare Remastered. The game has been faithfully updated for current-gen to look better than ever. Based on the excitement around Modern Warfare Remastered and the pre-orders, we expect to sell a higher percentage of our higher value premium SKUs than ever before.

So in summary, our record performance year-to-date has confirmed that execution against our strategic pillars is paying off and will set us up for success in the holiday quarter and beyond.

And now I'll hand it over to Dennis.

Dennis M. Durkin

Thanks, Thomas. Q3 was another great quarter as we continue to see strong performance across our broad portfolio of leading franchises. Before we go into results, as we mentioned on our Q2 call, we've made changes to how we report non-GAAP financials. As a reminder, our non-GAAP results no longer exclude the impact of deferrals. If you would like to calculate metrics as we used to report them, you would add the impact of deferrals to our non-GAAP – our non-GAAP as redefined figures. Our segment results, however, are still presented excluding the impact of deferrals like they always have been. This aligns with how Bobby, our management team and our board continues to review the business and our overall performance.

With that backdrop, I'd like to first start with our segments, as they are the engine behind our consolidated financial results. Starting with Activision, on the back of strong Call of Duty engagement and the successful launch of Destiny's Rise of Iron in September, Activision delivered record Q3 operating income of $123 million and also achieved record year-to-date operating income of $309 million, up 27% versus last year.

Blizzard delivered Q3 segment revenues of $727 million, which were nearly double last year's Q3 performance. This also helped fuel record third quarter segment operating income of $321 million, which is up 2.5 times versus Q3 of last year. And year-to-date Blizzard segment revenue of $1.8 billion is up 59% versus last year, and operating income of $740 million is up 93% versus last year.

I wanted to pause here for a second and mention that just the Activision and Blizzard segments, so excluding King, also set a Q3 and year-to-date record for combined segment revenue and operating income. Notably, this performance drove year-over-year organic growth for Activision and Blizzard segments of 15% for the quarter and 22% year-to-date. Operating income grew even faster year-over-year, increasing 78% for the quarter and 67% year-to-date.

Turning to King, as expected, revenues were down slightly quarter-over-quarter and year-over-year, but as Thomas noted, importantly the Candy Crush franchise and mobile overall performed well with bookings growth year-over-year.

King's operating income was down this quarter, mainly due to marketing costs related to the launch of Farm Heroes Super Saga, as well as investments we are making in our promising Advertising business.

Let's now turn to our consolidated results and raised outlook for the full year of 2016. Unless otherwise indicated, I will be referencing non-GAAP as redefined measures. Please refer to our earnings release for a full GAAP to non-GAAP reconciliations.

For the quarter, we generated record Q3 GAAP revenues of $1.57 billion, $78 million above our August guidance and $578 million or 58% above Q3 last year. The net effective deferred revenue was $62 million for the quarter and also above guidance of $45 million. We generated GAAP EPS of $0.26. That is $0.20 above guidance, of which $0.10 is related to the timing of our call premium, which I will discuss in more detail later when I cover the balance sheet. We generated record Q3 non-GAAP as redefined EPS of $0.49, $0.10 above guidance and more than double the $0.20 we generated in Q3 of last year. The impact of deferrals on non-GAAP as redefined, EPS was $0.03 and above guidance of $0.01.

The over-performance in the quarter versus guidance was driven by multiple factors, including Overwatch full game sales and in-game content, the strong performance of the World of Warcraft: Legion expansion, as well as the continued strength in Call of Duty in-game content.

Turning to the specific P&L items, please note that all percentages are based on revenues except for the tax rate. For Q3, GAAP product costs were 22%. Operating expenses were 59%. Interest expense was $63 million, including a $10 million GAAP loss upon refinancing of our term loan. And our GAAP tax rate was 14%. Our GAAP and non-GAAP fully diluted weighted average share count was 758 million shares, including participating securities.

On a non-GAAP basis as redefined, product costs were 22%, operating expenses were 43%, interest expense was $52 million, and our non-GAAP tax rate was 24%.

For the year-to-date, on a GAAP basis, we generated record revenues of $4.59 billion, up 39% year-over-year, and operating margin of 21% and EPS of $0.94. On a non-GAAP basis, as redefined, we generated operating margin of 36% and record EPS of $1.52, up 45% year-over-year.

Digital momentum continued to be a strong business driver for yet another quarter, producing record Q3 digital revenues of $1.3 billion, growing 114% year-over-year and 18% quarter-over-quarter. As Thomas mentioned, nearly $1 billion of this came from in-game content sales alone. And year-to-date, digital player purchases were a record $2.8 billion.

Our strong overall digital performance drove non-GAAP operating margins to a Q3 record of 35%, up from 23% operating margin in Q3 of last year. The continued strength in digital provides not only a source of growth for our business, but also will continue to benefit future operating margins as well as cash flow performance.

In terms of cash flow, our strong business performance has led to record cash flow generation. In addition, our ability to directly engage our customers with continued content updates has helped further shift our business to more recurring and less seasonal revenue streams with Q3 and year-to-date records for EBITDA as well as operating and free cash flow. This quarter, we generated operating cash flow of $456 million and free cash flow of $428 million after capital expenditures.

Year-to-date, we delivered $1.3 billion of operating cash flow and $1.2 billion of free cash flow, both up dramatically year-over-year. Q3 non-GAAP, as redefined, adjusted EBITDA of $574 million was up 131% year-over-year.

Turning to the balance sheet, I'd like to start with a quick summary of the positive refinancing activity we completed this quarter. In August, we restructured our term loans which not only allowed us to realize interest rate savings, but moved us to a completely unsecured capital structure which is more consistent with our investment-grade rating. In addition, our positive credit rating trajectory continued to improve with yet another one notch upgrade from Moody's. This was our second upgrade from Moody's in less than 12 months on the back of our spring upgrade from S&P. All of this served as great tailwind as we headed into our debut investment-grade debt offering which we completed on September 19.

We issued new five and 10-year notes which will replace our existing 2021 notes. Subsequent to closing, we exercised our call right on our 2021 notes which had a 30-day notice period. Because of this, our Q3 balance sheet reflects a temporary increase in both cash and debt as the call notice to redeem our legacy 2021 notes straddled the quarter end. Subsequent to quarter end, on October 19, we redeemed our legacy 2021 notes inclusive of the call premium which reduced both our cash and debt positions by approximately $1.5 billion.

Also, please note that the call premium expense drove a $0.10 timing difference between Q3 and Q4 versus our guidance for GAAP EPS. This will not impact the full year and is merely a shift from Q3 to Q4 for GAAP only based on the settlement date.

We are very pleased with the reception of our new investment-grade notes and the overall progress we have made on our capital structure since we first issued debt as part of the Vivendi buyback transaction three years ago. To put that progress in perspective, our gross debt levels are nearly equivalent to when we first issued debt in 2013, but since then, we have paid down more than $2.1 billion of debt, added King to our portfolio, moved to a fully unsecured investment grade capital structure and decreased our blended cost of debt to under 3%, thanks to our strong performance and improved credit rating. So, a great progress on this front as well.

Regarding liquidity and cash, as adjusted for the subsequent $1.5 billion redemption of our legacy 2021 notes in October, we had approximately $2.5 billion in cash on the balance sheet with over $600 million held domestically.

Now, let's turn to look forward to our outlook for Q4 and full year 2016. For Q4, on a GAAP basis, we expect net revenues of $1.86 billion, including GAAP deferrals of $522 million, product costs of 27% and operating expenses of 61%. We expect GAAP interest expense of $129 million. GAAP and non-GAAP share count of $765 million and EPS of $0.05.

For Q4 on a non-GAAP basis, as redefined, we expect product costs of 27% and operating expenses of 47%. We expect a non-GAAP interest expense of $45 million, a tax rate of 30% and non-GAAP EPS of $0.40 including GAAP deferrals of $0.34.

Now, let's take a look at our full-year 2016 outlook. On a GAAP basis, we expect revenues of $6.45 billion, including GAAP deferrals of $75 million. Product costs of 24% and operating expenses of 57%. Our GAAP interest expense is expected to be $313 million.

Our GAAP tax rate is expected to be 17% including tax rate impacts resulting from the adoption of the new accounting standard for simplification for share-based compensation. We expect 762 million fully diluted shares, both for GAAP and non-GAAP redefined, and GAAP EPS is expected to be $0.98, up $0.11 versus our previous guidance.

As we said on prior earnings calls, our GAAP earnings are expected to be down in 2016 versus prior year, as our expected results will be impacted by additional accounting charges associated with the King transaction, which include among other things transaction-related costs and the amortization of intangibles resulting from purchase price accounting adjustments. The majority of these GAAP accounting charges will not impact the economics of our business or our cash flows, although they will have a material impact on our 2016 GAAP earnings results.

For 2016 on a non-GAAP basis, as redefined, we expect product costs of 24% and operating expenses of 43%. We expect non-GAAP interest expense of $213 million, a tax rate of 24% and non-GAAP EPS of $1.92, up $0.09 from our previous guidance, including a GAAP deferral of $0.10, which is $0.03 higher than our previous guidance. Again, if you would like to calculate non-GAAP as we previously defined it, revenues and EPS, you would simply add the impact of GAAP deferrals to GAAP revenues and to non-GAAP redefined EPS using the numbers I just quoted.

So on the back of our strong business momentum, from an EPS perspective, we're essentially passing through all of our Q3 over-performance for the full year in actuals and increased deferrals, whereas for revenue, we are passing through roughly half of the Q3 beat, largely due to small variations in FX rates versus our last guidance, particularly in Europe. Please see our press release for current FX assumptions.

In summary, as you can see, 2016 is shaping up to be a record year on the back of strong performance across our diverse franchise portfolio. Our underlying business fundamentals remain incredibly strong with our direct digital consumer connection powering deeper engagement and more opportunities for player investment in our franchises than ever before.

In addition, we have great call options on promising long-term opportunities like esports, advertising and consumer products. So it's a great time to be in our business with so much opportunity in front of us. As always, we will continue to attack each opportunity with an emphasis on world-class execution and business excellence across all aspects of our organization.

Now, I welcome our business leaders, Eric, Mike and Riccardo, as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] We'll take a first question for Mike Olson from Piper Jaffray.

<Q - Michael J. Olson>: All right. Good afternoon, and thanks for taking my question. Activision is obviously evolving. It appears to be positioned to add several incremental categories of revenue over the next few years, each of which you touched on a bit in your prepared remarks. Between esports, King Advertising and consumer products and content, which category would you say you're most excited about? And which could you have the most impact on your results in the next couple of years? Thanks.

<A - Dennis M. Durkin>: Yeah, thanks, Mike. Great question. You hit on one of the hardest things in our business right now, which is really the prioritization of all the great opportunities we have in front of us. And first, I'd probably add one thing to your list, which is probably the biggest near-term opportunity, which is additional in-game content. As you've seen in our numbers, we've seen incredible growth in this area over the past several years, but we really think we're still only in the early stages here. And if we can do it right and not only drive additional player investment, it can also drive additional engagement as you deliver content to fans more frequently and consistently, as we saw in Q3. So this is really an enormous opportunity just based on the current engagement that we have across our portfolio.

And we're also excited about many of the new opportunities that you mentioned. We are making good progress in our Advertising business with King. And as Thomas mentioned earlier, we expect it to contribute next year and scale up in 2018. We're off to a very good start with our first TV show, Skylanders Academy, which just launched last weekend on Netflix, extremely high-quality and it's nice progress in that initiative. And as you heard Bobby say at the beginning of the call, we're incredibly excited about esports and the opportunities we have in this space, given our strong and owned IP portfolio. You only have to look as far as BlizzCon this weekend to sort of see that in action, and this longer term is an enormous opportunity for the company.

So across all these areas, we'll continue to manage our investments with the same discipline and prudence that we do in all parts of our business, but undoubtedly more opportunity in front of us than we've ever had before.

<A - Robert A. Kotick>: Thanks for the question, Mike.

Operator

Thank you. We will now take our next question from Brian Nowak with Morgan Stanley.

<Q - Brian Nowak>: Thanks for taking my question. I have two. The first one on World of Warcraft: Legion, it sounds like you drove a nice uptick in users and paying subscribers. Any help at all on where you are now in global paying subscribers? Just talk about strategies you might have in place to keep retention high on those payers going forward, and I have one follow-up.

<A - Michael Morhaime>: Okay. Thanks for the question. This is Mike. First, we're very happy with the Legion launch. We worked very hard to make Legion our best expansion, and we're pleased and gratified by the player reaction so far. We no longer report subscribers, but as Thomas mentioned, our MAUs were up 30% quarter-over-quarter, and that built on the momentum we saw earlier in the year. In terms of Legion performance, it has matched or exceeded our prior expansions launch performance across metrics like sales, player base, and participation in value-added services. So we're very excited to see how players are reacting and engaging in the new content, including our new Legion mobile companion app.

We're seeing players spend their time across a whole variety of activities, and with all of the content that's available to them, we're hopeful they'll have a lot to do for a long time. It is a big priority for us to continue to provide new content to Legion players. Last week, we released our first content Patch for Legion less than two months after the launch. This is the fastest that we've added a new major Patch to a World of Warcraft expansion in the game's history, and it's also bigger than the initial content Patch that we released for the last few expansions.

Our players have reacted very positively so far, and we're looking forward to furthering the momentum that Legion has generated into BlizzCon, the holidays and beyond, and following up with more content next year.

<Q - Brian Nowak>: Great. Thanks. And I have one follow-up. 2017 [ph] ramp, (34:54) some would call it a tough compare. Destiny is obviously one of the bigger titles as we think about next year. Anything more you can talk about kind of on timing or digital aspects or innovation around the new Destiny, drive more user growth, engagement or monetization? Thanks.

<A - Eric Hirshberg>: Hey, Brian. Thanks for the question. So, as we mentioned, we're on track and really excited about what we think is going to be an awesome sequel for Destiny in 2017. No announcements today on timing just yet. But what I will say is, that sequel is designed to both excite our highly-engaged current players, but also to broaden the appeal even further, bringing in new fans and bringing back lapsed fans, as well. So that's our primary focus right now.

Beyond that, in the past, I've mentioned that the incredible demand for Destiny content has somewhat outpaced our ability to deliver upon that demand. And going forward, along with our partners at Bungie, we've put together what we believe is a very smart approach that will allow us to deliver that steady stream of great content to keep our players engaged and keep the universe live and growing in the wake of that sequel.

Operator

Thank you. We'll now move on to our next question from Chris Hickey with Atlantic Equities.

<Q - Chris P. Hickey>: Thank you, and congratulations on the quarter. I had a question about King. MAUs were down slightly this quarter, but you said that time spent per user was up and it's obviously good to hear the mobile business continues to grow. What are you seeing in terms of overall engagement there and how should we be thinking about MAUs from here?

<A - Riccardo Zacconi>: Hey, Chris, it's Riccardo. Well, first of all, I think in terms of strategy, I think that we see that our focus on the top franchises is really paying off. And as you noted, while we see that – we see a slight decline in MAUs quarter-over-quarter, the mobile gross bookings have grown or we managed to grow gross bookings year-on-year. And very importantly, the Candy Crush Saga franchise overall gross bookings also grew year-on-year. This is the result of hard work from the teams in the [ph] end of life (37:08) titles, focusing on creating fresh new content, both through live operations as we described in the past, and through launching new features. So this has resulted in, number one, in increased engagement and time spent per player has grown year-on-year, it's now over 30 minutes per day; and secondly, we have increased also the monetization per player. The average revenues per paying player had increased substantially year-on-year.

So looking forward, the plan is to continue the investment in the live games, creating more content both through live ops and features. So we expect to focus not only – and have an impact not only on retention of players, but also monetization. So both monetization and retention are key targets for those expansions. And secondly, we are also focusing on new games. We have a pipeline of new franchise titles to attract new and lapsed players and we have one game in final stages of polish. It's shaping up well and it's slated for a Q1 release.

Operator

Thank you. We'll now take our next question from Brian Fitzgerald with Jefferies.

<Q - Brian P. Fitzgerald>: Thanks, guys. We know it's very early, but how are Call of Duty sales trending this year relative to last? Overall, should we think about Call of Duty user levels, revenue and profitability in 2016 as up, flat or down? Thanks.

<A - Eric Hirshberg>: Hey, Brian. Well, let's see, how do I answer that? First of all, I think it's obviously too early to make any comments on our annual release, which hasn't released yet with Infinite Warfare. But I think that it is important that we think about Call of Duty as a year-round business, which is designed to have a steady stream of content throughout the year to keep our players engaged, and obviously our annual release is a huge part of that engagement-driving strategy. But when we do our jobs right on this franchise, we manage to keep people engaged year-round. And this year we definitely achieved that with record operating income, which Thomas mentioned, for the franchise year-to-date. And I think probably the best news is that's been accompanied with also a record in monthly active users, so in this case engagement and the business are going hand-in-hand and helping one another.

So on the annual release, as you know, we've modeled Infinite Warfare, which is a new sub-brand, down versus Black Ops III, which is our best established sub-brand, and that only makes sense given our historical patterns. But we think that we have delivered a great game that we think is going to do great over the holiday quarter. And it's got huge innovation for our fans, and as you know, keeping a franchise that's been on top for as long as Call of Duty has fresh every year is no easy task, and Infinity Ward has definitely done that with Infinite Warfare, which has a ton of new experiences and gameplay mechanics for our fans while also feeling – giving that classic Call of Duty feel that our fans love.

Second, Thomas mentioned we think it's the most complete entertainment package in the industry. It's got a full campaign. The multiplayer builds upon. One of the stickiest and most played multiplayer games in the world. And it's the first time that we've had a full Zombies mode on the disk of the main release in a [ph] Treyarch (40:41) title. We know there's a lot of fans who appreciate that. And of course we have Modern Warfare Remastered for those who – those of our fans who long for the classic Call of Duty gameplay with our best bonus content ever in our Collector's Edition. So overall, we feel really good about both the quality and the breadth and the variety of the content that we're putting in the marketplace. We think we're going to have a strong quarter.

Operator

Thank you. We'll now take our next question from Colin Sebastian with Robert W. Baird.

<Q - Colin Alan Sebastian>: Okay. Thanks, guys. And maybe just as a follow-up on King, I was hoping you could provide a little more detail on the ad testing, specifically how monetization and engagement is tracking with paying and non-paying users in those tests? And then at what point in the next year should we expect those ads to roll out more broadly and contribute to revenues? Thank you.

<A - Robert A. Kotick>: Hey, Colin.

<A - Riccardo Zacconi>: Let me give you an update on the ad business. So we have been testing various ad units over the past several months, and we have tested these ad units in two Candy Crush games. And our plan is to increase inventory by adding additional cohorts of players through the end of the year with these ad units.

As I said in the past, we believe that advertising is an attractive opportunity to monetize non-paying players, and we see that because of the size of the network, and also because the players are so engaged on our network, that the interest from high-quality brand advertisers is very strong. So we want to take this opportunity, and there's a lot to do to take this opportunity. And the teams are working hard as we speak; on one side, on building the inventory; and on the other side, we are building the team and the infrastructure required to take this opportunity.

So, regarding the second part of your question, we believe that advertising will begin to contribute to bottom line, as Dennis was saying before, in 2017 and that we will be able to scale it in 2018.

Operator

Thank you. We'll now take our final question from Chris Merwin with Barclays.

<Q - Christopher David Merwin>: All right. Thanks for taking my question. So for Overwatch, can you just talk a bit about what your plans are around new content next year just to keep your users engaged? Is your hope to have some sort of new content out every year whether it'd be an expansion or a full re-release of the game? Thanks.

<A - Michael Morhaime>: Thanks for the question. We're very pleased with the launch of Overwatch. As Thomas mentioned, it's our fastest IP in Blizzard's history to achieve 20 million players, and we're happy to see our players reacting favorably to the new content and new experiences that we've been adding to Overwatch so far. We think Overwatch will achieve record launch-year revenue for Blizzard game this year. We've already had several new content releases since launch and player participation continues to build momentum.

As Thomas said, engagement and participation in the Halloween event in October exceeded the one for the Summer Games event in August. So, so far we've released a new hero, new map, competitive play mode, and we have more content in development. We're very excited about player reaction to the Overwatch shorts and the plans we have for Overwatch in esports which we will discuss more at BlizzCon tomorrow.

It's too early for me to discuss our plans for 2017, but what I can say is that the two events that we've had so far have shown us we have a great model for follow-on content. We've found that it stimulates our audience and drives record engagement. So you should expect to see more events like Summer Games and Halloween, and additional content, which we'll discuss in more detail later. So as the community continues to grow and our player base continues to react positively to the content we're creating, we're very excited about the prospects for the future.

Dennis M. Durkin

All right. On that note, Mike, thanks for the BlizzCon tease for this weekend. We look forward to seeing you all – many of you this weekend at BlizzCon in Anaheim and we look forward to talking to you all next quarter on our conference call in early February. So thanks for your time today.

Operator

And that does conclude today's conference. Thank you all for your participation, and you may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2016-08-04
Event Description: Q2 2016 Earnings Call

Market Cap: 30,274.10
Current PX: 40.83
YTD Change($): +2.12
YTD Change(%): +5.477

Bloomberg Estimates - EPS
Current Quarter: 0.361
Current Year: 1.884
Bloomberg Estimates - Sales
Current Quarter: 1497.118
Current Year: 6388.278

Q2 2016 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Michael Morhaime
- Riccardo Zacconi
- Eric Hirshberg

Other Participants

- Mike J. Olson
- Brian J. Pitz
- Doug Creutz
- John G. Taylor
- Neil A. Doshi
- Christopher David Merwin
- Drew Crum
- Colin A. Sebastian

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Activision Blizzard's Q2 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. [Operator Instructions] As a reminder, this conference is being recorded today, Thursday, August 4, 2016.

I would now like to turn the conference over to Amrita Ahuja, Senior Vice President of Investor Relations. Please go ahead, ma'am.

Amrita Ahuja

Good afternoon, and thank you for joining us today for Activision Blizzard's second quarter 2016 conference call. With us are Bobby Kotick, CEO; Thomas Tippl, COO; and Dennis Durkin, CFO. And for Q&A, Eric Hirshberg, CEO of Activision; Michael Morhaime, CEO of Blizzard; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call, we'll be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements including the factors discussed in the risk factors section of our SEC filings including our 2015 Annual Report on Form 10-K, which is on file with the SEC and those indicated on the slides that is showing.

The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation and while we believe them to be true, they ultimately may prove to be incorrect. The company undertakes no obligation to release publicly any revisions to any forward-looking statement to reflect events or circumstances after today, August 4, 2016.

We will present both GAAP and non-GAAP financial measures during this call, however, as discussed on our July 29 conference call, due to updated compliance and disclosure interpretation issued by the SEC staff on May 17, 2016, in the future, we will no longer be able to present non-GAAP financial measures excluding the impact of deferrals. As a result, this will be the last call where we provide such information. On this call and in the future, we will continue to provide non-GAAP financial measures which exclude the impact of expenses, related stock-based compensation, the amortization of intangible assets, expenses, including legal fees, cost expenses, and accruals related to acquisitions, including the acquisition of King Digital Entertainment, expenses related to debt financings and refinancings and the associated tax benefits.

These non-GAAP measures are not intended to be considered in isolation from as a substitute for or superior to our GAAP results. We encourage investors to consider all measures before making an investment decision. Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanations. There's also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks, Amrita, and thank you all for joining us today. We delivered record second quarter performance with revenues up more than 100% and EPS up more than 300% year-over-year on a non-GAAP basis as previously defined. As a result, we're raising our full-year guidance. Our continued success comes from the efforts of our over 10,000 employees. Their passion, dedication and focus are the reasons we're able to entertain hundreds of millions of players around the world and deliver value to our stakeholders.

This quarter was a record quarter in large measure because of the unique capability we have as a company to create new franchises. The truly extraordinary team at Blizzard launched Overwatch to incredible audience success. Overwatch already has over 15 million players who have spent about 0.5 billion hours playing the game and it has achieved success throughout the world including in China and Korea, where Overwatch is now the number one game in terms of share of playtime.

We remain focused on the priorities that we have outlined to you before: building our audiences around the world, growing engagement by continuously investing in new content for our audiences, celebrating our players through initiatives like competitive gaming and making certain we continue to be a great place to work.

Thomas and Dennis will now share with you the results of our record quarter. Thomas?

Thomas Tippl

Thank you, Bobby. Our creative and commercial teams across our five operating divisions delivered a very strong first half of 2016 with broad-based record results. To expand on what Bobby mentioned, our results are driven by focus and execution against our three strategic pillars: first, expanding our audiences; second, deepening engagement; and third, providing opportunities for more player investment. Let's start with audience reach, which was nearly 0.5 billion monthly active players in what is typically a seasonally softer quarter. In Q2, Blizzard had its highest MAUs in history, up 13% year-over-year and 29% quarter over quarter, driven by increases in players from Overwatch, World of Warcraft and Hearthstone.

It's important to take a step back and review Blizzard's continued growth over the past few years. Blizzard has doubled its number of franchises, expanding into new genres, business models and platforms; and as a result, they have doubled the size of the audience over a relatively short period of time. This performance is due to the strength of the team at Blizzard and their strategic focus on building epic entertainment experiences that capture the imaginations of tens of millions of people globally.

Overwatch has had incredible momentum and has now reached over 15 million players globally, achieving this milestone more quickly than any game in Blizzard's history. In China, Overwatch broke Diablo III's record as the fastest selling PC game in the market's history. Additionally, Overwatch has claimed the number one position in Korean IGRs with over 30% share of playtime. This global success has led to roughly even player split between the East and West.

World of Warcraft momentum continues to build ahead of the August launch of Legion. MAUs have seen double-digit growth both quarter over quarter and year-over-year and Legion pre-purchases are tracking in line with the last expansion in 2014. In particular, we've had strong momentum in China following the launch of the Warcraft movie, which is now one of the highest grossing Hollywood releases ever in China and the biggest game-based movie release worldwide.

Activision MAUs were also a Q2 record and were up 11% year over year. This was largely driven by the continued strength of Call of Duty. Black Ops III continues to be the top-selling current-gen game life to date, and again, over performed the prior year's game across every key metric: MAUs, full game sales, in-game content and engagement.

Destiny also saw month on month growth in MAUs with the launch of our April update with the June announce of Destiny's next expansion, Rise of Iron. The continued hunger for great new content from this passionate community bodes well for the September launch of Rise of Iron. Digital pre-purchases so far are very strong and tracking ahead of last year's Taken King.

That leads me to our second strategic pillar. Once again, our compelling game worlds broke not only large communities but also deep engagement with nearly 10 billion hours of playtime during the second quarter. Blizzard franchises continued to display the best of gameplay that they are known for. As Bobby mentioned, players spent about 500 million hours playing Overwatch. Since launch, Blizzard added a competitive playbook to the game in June and new hero in mid-July and just introduced this week, Summer Games content, which includes an exciting new soccer-like game mode.

Both the new hero and Summer Games also added what was [indiscernible] (08:58) to loot boxes that players can earn or purchase. In just the first day, we saw record engagement with the new Summer Games mode and its customization items. Blizzard is pleased with the strong adoption across all these releases and plans to continue adding new content and improving existing features to deliver a great ongoing experience to Overwatch players.

Hearthstone had its highest MAUs and highest quarterly time spent in the game's history this quarter on the back of the launch of the Whispers of the Old Gods expansion. This deep engagement drove a double-digit revenue increase year-over-year. Just last weekend at [indiscernible] (09:39) Blizzard announced its fourth adventure set for release on August 11. One Night in Karazhan continues Hearthstone's tradition of bringing a charming and accessible approach to some of the most popular Warcraft settings. As with our other adventures, players will be able to experience a single player storyline and earn cards with their player versus player decks.

The strong engagement around our franchises also serves our initiatives outside of our games. Our esports and film and TV initiatives are not only a driver of audience expansion, but drive deeper engagement which will lead to longer franchise lives with greater profitability. First, on esports. Last year, BlizzCon had its highest livestream viewership ever with over 10 million people around the world tuning in, higher than the viewership for this year's NBA and MLB All Star games. This November, Blizzard will be hosting its tenth BlizzCon. One of the biggest attractions there will be the culmination of the Road to BlizzCon tournaments with global champions across a number of franchises being crowned, including the champion for the just-announced Overwatch World Cup.

We have also made a lot of progress in the launch of our esports network Major League Gaming. MLG presented to advertisers [indiscernible] (11:02) in New York in May where they showcased a significant new product innovation that provides an enhanced viewing experience offering real-time statistics, leader boards and insights based on the competition you're watching, making the viewing experience far more accessible and rich. MLG also announced a partnership with Facebook to broadcast live competitions as the weekly Esports Report, providing broad reach for our premium content. Since the acquisition in December, MLG's reach has increased by more than 700% on Facebook.

MLG is also working closely with our internal teams to build up our esports leagues and events for key franchises. MLG and the Call of Duty World League hosted the Anaheim Open in June and are preparing for the upcoming Orlando Open as well. With the growth of the Call of Duty World League, Call of Duty esports viewership has increased by more than five times year-over-year to 33 million views of our Stage 1 events this year. And there are still major events to come, including the championships at Call of Duty XP this September, which we anticipate will be our most viewed Call of Duty esports event in history by a wide margin.

Our film and TV unit announced that the first two seasons of their first initiative, Skylanders Academy, have been sold to Netflix for global distribution. Skylanders Academy is an extremely high-quality animated TV show coming on the heels of the release of our innovative new game this fall, Skylanders: Imaginators, which was developed by the inventors of the toys to life category, Toys For Bob.

Now turning to our third pillar of our strategy, providing increased opportunities for player investment. This quarter, excluding deferrals, we drove a record $1 billion in digital in-game content sales, a rapidly growing part of our business. A big driver of that performance was King, which continued to drive large audiences of over 400 million monthly active users who invest increasing amounts in our games because of the incredibly compelling content King continues to deliver.

As expected, due to seasonality and launch timing, King MAUs were down this quarter, but deeper engagement and player investment in part due to the new initiatives around ongoing live operations and events led again to Candy Crush franchise growth with gross bookings up quarter-over quarter and year-over-year. King's time spent per MAU and average revenue per paying user across the network were both up quarter-over-quarter and year-over-year. Mobile gross bookings for King also increased year-over-year. King has had at least three of the top 15 grossing games in the Apple App Store and Google Play Store in the U.S. for ten quarters in a row, showing the durability of top mobile franchises over time.

King has also continued with its in-network advertising tests, which we expect to expand to Candy Crush later this year. The tests are critical to ensuring that engagement in value-added offers can be a virtuous cycle as we've seen with new in-game content in our core games. We believe advertising is an attractive opportunity given the size and quality of King's network and thorough testing is critical to ensure we preserve a high quality play experience and player investment opportunities.

Turning to our core game experiences, we see continued evidence of this virtuous cycle. Strong engagement leads to strong player investment, which in turn fuels strong engagement. Blizzard is a testimony to that. Record engagement in Q2 led to Blizzard's biggest revenue quarter ever. This strong performance was driven by Overwatch successful launch, now with life-to-date franchise revenue excluding deferral at about $0.5 billion. World of Warcraft's strong pre-expansion momentum with Legion III purchases tracking in line with the previous expansion and Hearthstone's double-digit revenue growth behind the successful launch of the Old Gods expansion.

The teams at Activision and Bungie continued to successfully introduce new earned and purchased in-game content into Destiny. We've seen strong community response to this content with no reduction in engagement. Finally, Call of Duty has seen strong performance across the board. In-game content purchases including season pass, map packs, and micro-transactions continued to deliver at record levels for the franchise. In fact, on the back of the strength, as well as strong catalog sales, the first half of the year was the best in terms of both non-GAAP operating income and revenue in the franchise's history. Activision also doubled the number of in-game purchases in Call of Duty with no degradation to average revenue per user. Most importantly, this was accomplished while actually improving overall engagement.

The bold innovations in Call of Duty: Infinite Warfare got exceptionally positive media sentiment at E3, including being named best shooter by Game Informer and receiving 25 other awards and distinctions. Activision is taking a different approach to the Collector's Edition this year with the best bonus content we have ever offered. Call of Duty: Modern Warfare Remastered. The Legacy Edition and Digital Deluxe Edition offer an amazing value and incredible breadth and variety of gameplay. Infinite Warfare offers three full modes which will deliver bold, new innovations for the franchise and the beautiful remaster of Modern Warfare will return fans to the classic gameplay of one of the most beloved games in history.

It seems to be a winning combination since we are seeing a far higher percentage of our preorders in our higher value premium SKUs than ever before. While as expected overall preorders are down versus last year, Activision is taking a different approach to the marketing cadence this year which is more backloaded. This has allowed for increased focus on driving Black Ops III engagement, which given the record first half of the year for the franchise has been a fruitful strategy.

As a result, the majority of the assets for this year's launch including Infinite Warfare's multiplayer reveal and hands-on, Zombies reveal and hands-on, and Modern Warfare Remastered multiplayer and hands-on are all yet to be revealed. This sets the stage for next month's Call of Duty XP which will provide the perfect stage to showcase all of this incredible content to drive momentum as we enter the launch season and of course to celebrate Call of Duty's amazing fans.

In summary, our strong performance in the first half of the year confirmed that execution against our strategic pillars is paying off and we have a great schedule of content for the balance of the year. Dennis?

Dennis M. Durkin

Thanks, Thomas. It's been an incredible first half of the year and across nearly all parts of our business we saw strong performance in the quarter. This performance further validates many of the important growth themes we've discussed around opportunities in mobile, digital, fee-per-player investment and our ability to launch new world-class intellectual property.

Before we go into the results as a reminder, we hosted a quick call last week to discuss changes to our external non-GAAP reporting in response to the SEC staff's updated interpretations. And I'd encourage you to review those materials if you haven't done so already. These interpretations affect external reporting for numerous companies but do not affect our strong underlying business fundamentals or cash flows. As we explained, starting this quarter, we will be sharing some reporting metrics and we will continue to provide you with supplemental disclosure to help you calculate relevant metrics for year-over-year comparisons. Our disclosures can be found in the tables in our earnings press release and the Excel model posted to the IR website following this call.

Turning to our Q2 results in highlights, we will now for one last time refer to our non-GAAP results as we have previously defined them, excluding deferrals. We generated revenues of $1.61 billion in the quarter, $234 million above May guidance and $850 million or 112% above Q2 last year. We generated EPS of $0.54, $0.16 above guidance and $0.41 or 315% above Q2 last year. The over performance versus guidance was composed of $0.04 of cost timing and $0.12 of business over performance, with the key drivers being the successful launch of our newest franchise, Overwatch, which is obviously off to a resounding start, continued momentum of the Call of Duty digital business and continued growth of the Candy Crush franchise.

In addition, digital momentum continued to be a strong business driver in Q2, producing record quarterly digital revenues and operating margins for the company. Digital revenues were $1.4 billion, growing 129% year-over-year and 76% quarter over quarter, and as Thomas mentioned, a remarkable $1 billion of this came from in-game content sales. Excluding King, digital revenues were also up a record – up over 50% year-over-year. Our digital performance drove operating margins to a Q2 record of 37%, up from 28% operating margin last quarter and 23% in Q2 of last year. So we have continued strong tailwinds on the digital front which bodes well for the future across the business.

Now let's take a look at the business results for each of our three segments. Let's start with Blizzard. The launch of Overwatch drove engagement to record highs, leading to their biggest revenue quarter ever with quarterly operating income that was nearly triple Q2 of last year. Blizzard also had its biggest quarter in China with the meaningful increase in revenues versus the previous high last year. World of Warcraft, Hearthstone and Overwatch success in Asia shows the depth of Blizzard's resonance in important growth markets.

Overwatch was the fastest selling PC game ever in China, and the Warcraft film had the biggest Hollywood launch ever in China as well. On the Activision front, the team delivered record MAUs and operating income for both Q2 and the first half of the year, driven by the continued strength of Call of Duty and in particular, digital in-game content. Turning to King, the Candy Crush franchise continues to perform well showing growth year-over-year and quarter-over-quarter. King's Q2 segment operating income was also up quarter over quarter on a full quarter basis.

With all that as a backdrop, let's now turn to our detailed financial results and to our updated external reporting format. Please refer to our earnings release for full GAAP to non-GAAP reconciliations. Please note non-GAAP redefined includes deferrals. For the quarter on a GAAP basis, we generated revenues of $1.57 billion, up 50% year-over-year, an operating margin of 15% and EPS of $0.17. For the quarter, on a non-GAAP basis as redefined to include deferrals, we generated an operating margin of 31% and EPS of $0.45, up 45% year-over-year.

Turning to the specific P&L items, please note that all percentages are based on revenues except for the tax rate. For Q2, GAAP product costs were 25%, operating expenses were 60%, interest expense was $65 million and our GAAP tax rate was 24%. Our GAAP and non-GAAP fully diluted weighted average share count was 753 million shares including participating securities. On a non-GAAP basis as redefined, which includes deferrals, product costs were 25%, operating expenses were 45%, interest expense was $64 million and our non-GAAP tax rate was 18%. In terms of cash flow, in Q2 we generated strong cash flow with non-GAAP adjusted EBITDA of $511 million, up 37% year-over-year, operating cash flow of $479 million, up 255% year-over-year and free cash flow of $435 million after CapEx, up 307% year over year with continued strong cash conversion. For the first half of the year, we delivered $788 million of operating cash flow, up 129% year-over-year and $717 million of free cash flow, up 143% year-over-year.

Turning to the balance sheet, on the back of that strong cash flow performance, we ended June 30 with approximately $2.3 billion in cash and investments, of which roughly one-third was held domestically. We also paid down $816 million of our outstanding debt in the quarter, bringing the total pay down so far this year to $1.3 billion. We ended the quarter with $5.1 billion in aggregate debt outstanding. Please note that our $1.5 billion of 2021 notes become callable during the third quarter of 2016. In light of our recent upgrade to investment-grade, we believe it will be advantageous to call the bonds and refinance that debt during the quarter. As such we've included the call premium and estimated transaction costs in our GAAP guidance for Q3. On the dividend front, in Q2 we paid a $0.26 per share cash dividend, or approximately $195 million in aggregate to shareholders of record as of March 30, 2016.

So in summary, Q2 and our first half were an incredibly strong start of the year for the company and set us up well for the upcoming quarters and years ahead.

Now, let's turn to our slate and our outlook for Q3 and full year 2016. Blizzard is launching Hearthstone's next adventure, One Night in Karazhan next week, and launching World of Warcraft's next expansion, Legion, globally on August 30. Activision is launching Destiny's Rise of Iron expansion on September 20 at the $30 price point as well as a map pack for Call of Duty Black Ops III in Q3. We expect Skylanders Imaginators to launch on October 16, followed by Skylanders Academy, an animated show which is expected to debut on Netflix.

In Q4, Activision also plans to release the fourth map pack for Call of Duty: Black Ops III as well as Call of Duty: Infinite Warfare and Modern Warfare Remastered on November 4. King launched Farm Heroes Super Saga in the last few days of Q2 and has one more non-Candy Crush franchise release coming towards the end of the year, along with continued live operations across key games and franchises.

For Q3 on a GAAP basis, we expect net revenues of $1.49 billion, including GAAP deferrals of $45 million, product costs of 23% and operating expenses of 64%. We expect GAAP interest expense of $138 million, which includes the potential payment of a call premium and related debt refinancing costs, a GAAP tax rate of 18%, GAAP and non-GAAP share count of 760 million, and EPS of $0.06. For Q3 on a non-GAAP basis, as redefined, we expect product costs of 23% and operating expenses of 47%. We expect a non-GAAP interest expense of $53 million, a tax rate of 24% and non-GAAP EPS of $0.39, including a GAAP deferral of $0.01. Note that you can reference our company materials for the FX rates we use in our guidance.

Now, let's turn to our full year 2016 numbers. On a GAAP basis, we expect revenues of $6.4 billion, including GAAP deferrals of $75 million, product costs of 24% and operating expenses of 58%. Our GAAP interest expense is expected to be $311 million. Our GAAP tax rate is expected to be 18%, including tax rate impacts resulting from the adoption of the new accounting standard for simplification for share-based compensation. Please see our outlook tables in the earnings release for additional detail.

We expect 765 million fully diluted shares, both for GAAP and non-GAAP redefined, and GAAP EPS is expected to be $0.87, up $0.18 versus our previous guidance. As we said on our prior earnings calls, our GAAP earnings are expected to be down in 2016 versus prior year as our expected results will be impacted by additional accounting charges associated with the King transaction, which include, among other things, transaction-related adjustments, costs and amortization of intangibles resulting from purchase price accounting adjustments. The majority of these GAAP accounting charges will not impact the economics of our business or our cash flows, although they will have a material impact on our 2016 GAAP earnings results.

For 2016 on a non-GAAP basis as redefined, we expect product costs of 24%, operating expenses of 44%, operating margin of 32% and a tax rate of 24%. Our non-GAAP interest expense is expected to be $223 million. Based on the information we disclosed in May, our non-GAAP redefined outlook was $1.64, including $0.14 of deferrals. We are now raising our non-GAAP redefined EPS outlook to $1.83, which includes $0.07 of GAAP deferrals. If you would like to calculate non-GAAP as previously defined revenues and EPS, in order to do year-over-year comparisons, you would add the impact of GAAP deferrals to GAAP revenues into non-GAAP redefined EPS using the numbers I just quoted.

So in summary, our performance in Q2 and in the first half of the year once again proved our ability to achieve three important things: first, to launch new content that can appeal to millions of players around the world; second, to consistently keep our large audiences engaged as we offer them more frequent digital content and services to enhance their experiences; and third, to deliver solid financial results which further sets us up for long-term success. As such, as a team we are very pleased with our first-half momentum and couldn't be more excited as we head into the back half of the year.

Now I welcome our business leaders, Eric, Mike and Riccardo as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. Ladies and gentlemen, at this time, we now begin the question-and-answer session. [Operator Instructions] And our first question comes from the line of Mike Olson with Piper Jaffray. Please go ahead.

<Q - Mike J. Olson>: Hey, good afternoon and congrats on a strong quarter. I was wondering if you could provide some color on the monetization around Overwatch. Title seems to be a strong example of the change in the industry model from just kind of selling units to generating an ongoing digital ARPU from full-game downloads to cosmetic add-on content to other future DLCs. Thanks.

<A - Michael Morhaime>: Hi. This is Mike from Blizzard. Thanks for the question. First, we're very pleased with Overwatch's launch results. I want to take this opportunity to thank all of our 15 million players around the world who've joined Overwatch so far. We really appreciate all their support and their incredible enthusiasm for the game. We've seen great momentum with the game across all the different engagement models, including digital and box sales, Korean Internet Game Rooms, which are time based, and cosmetic content, which can be earned or purchased.

As Thomas mentioned, altogether, the game has generated about $0.5 billion life to date, excluding deferrals. But more importantly, in the past two months since launch, we've already provided some great content to the Overwatch community including a competitive play mode, a new hero, the recently launched Summer Games content, which drove record engagement yesterday as well as customization items. So, we're very excited about creating even more content for players moving forward.

I also want to point out that while we had a great start with the game release, we really view this as just the beginning. We think we've created a strong character driven universe with big opportunities beyond just the game. We think Overwatch has strong potential as an esport. The recently announced Overwatch World Cup, which will take place at BlizzCon this year is a good first taste of that, but we'll be talking more about our Overwatch esports plans later in the year. We also look forward to telling more stories about the characters in the world of Overwatch through other media. You've seen some of this through the animated shorts and comics, but there's still more to come.

Operator

Thank you. And our next question comes from the line of Brian Pitz with Jefferies. Please go ahead.

<Q - Brian J. Pitz>: Thanks for the question. Just wondering if Pokémon Go has had any impact on King games, and if you're seeing any learnings from its success out there. Thank you.

<A - Riccardo Zacconi>: Hi, Brian. It's Riccardo here. So in terms of impact on the King games, we have not seen any meaningful impact on the network to date. What we see is that the core audience continues to stay very engaged with over 30-minute plays per day in average. As Thomas was mentioning earlier, the Candy Crush franchise has grown not only quarter on quarter but also year on year. And it is really testimony to not only to the longevity but also to the strength of the brand.

In terms of learnings, Pokémon Go has been very successful in expanding the mobile games audience. They have brought the large Pokémon fan base to mobile. And I believe this is very good for the whole gaming industry. What it has also proven is that when you pair innovation to very strong branded IP, there is a huge potential. And so I think this is actually very good, and it's a great opportunity for Activision Blizzard on mobile.

Operator

Thank you. And our next question comes from the line of Doug Creutz with Cowen and Company. Please go ahead.

<Q - Doug Creutz>: Hey, thanks. I wonder as we go through the launching plan and the launch of Call of Duty, if you could give a little color on how those are coming along, both Infinite Warfare and the Remastered version. I think you mentioned that preorders of the higher ARPU SKUs are the best you've ever had. Could you maybe comment on the digital SKU factored into that? Thank you.

<A - Eric Hirshberg>: Yeah, hey, Doug. It's Eric. I'll take the question. So first of all, on the quality, both of the games, both Infinite Warfare and Modern Warfare Remastered are really looking amazing, and we're very excited that we found a way to deliver both the breakthrough innovation that has been such an important part of Call of Duty's success over the years as well as a return to the classic gameplay that people love so much in one amazing package at an incredible value, and that combination, that value has really led to the performance that we're seeing in the preorders for both the Legacy Edition and the Digital Deluxe Edition, both of which are kind of registering far higher percentages for our higher priced SKUs than we have ever seen before.

So the way we think about it is that Modern Warfare Remastered is the best bonus content we have ever offered in one of our Collector's Editions and we think that's driving that player performance for both the Legacy Edition and the Digital Deluxe Edition. On Infinite Warfare, specifically, the team at Infinity Ward is just tremendously passionate about the game and that passion is really showing through and how the game is closing. It's fresh, it's inventive, it looks great and it has a ton of new gameplay mechanics for the franchise. There's often initial skepticism when you push for bold innovations in the context of something that's so well-established as Call of Duty, but the good news is the more people are seeing at the game the more they're getting really excited about it.

We showed eight uninterrupted moments of gameplay at E3 and that generated the highest positive sentiment from the usually hard to please gamer press that we've ever seen on the franchise at E3 since we've been measuring it. And we showed another 12 minutes of gameplay at Comic-Con and again got the highest positive sentiment from the press we've ever seen for Call of Duty at that event. The reason that's particularly good news is because people actually haven't seen that much of this game yet relative to previous years.

As Thomas mentioned, we're taking a little bit of a different approach to the marketing this year centered around Call of Duty XP, and that's both allowed us to focus on Black Ops 3, which I'll just deliver that record first half of the year that Thomas mentioned, but it's also allowing us to put all eyes on our launch titles in September at XP, where we will have a pretty incredible list of reveals and first hands-on including things like multiplayer in Infinite Warfare, multiplayer in Modern Warfare Remastered, the first zombies mode in the main game that we've had in an entrée art title with Infinite Warfare as well as more reveals on Campaign as well. And for context, all of the modes had been revealed at this time last year. So we think we've got a winning combination, I think we've got a great game of Infinite Warfare and a second great game with Modern Warfare Remastered.

Operator

Thank you. And our next question comes from the line of John Taylor with Arcadia Investment Corporation. Please go ahead.

<Q - John G. Taylor>: Hi. Congrats on a great quarter. I had a question, I think we're all kind of hungry for some metrics on engagement or monetization trends with some of your big brands and I was just wondering maybe you could talk a little bit about Destiny specifically and talk about what you've been seeing lately with that audience and then give us an update on what's going on with Rise of Iron and what we should expect there? Thank you.

<A - Eric Hirshberg>: Sure. Hey. It's Eric again. So as I mentioned on the last call, our biggest challenge on Destiny has not been generating demand for more content from our communities. It's actually been our ability to keep up with that demand, and I'm happy to say that we've made real progress working together with Bungie on that front and as a result, in addition to the update that we've already had this year that drove increased engagement, we also have an awesome expansion coming on September 20 with Rise of Iron.

As I think Thomas mentioned, pre-purchases and preorders on Rise of Iron are actually ahead of last year's expansion The Taken King, which is evidence of the continued passionate engagement for this game and this universe from our community, and we'll also have more updates planned for this year to continue to keep people engaged. As for the future, the majority of the team at Bungie is actually focused entirely on creating Destiny 2, which is still on track for release next year and it's going to be awesome.

Operator

Thank you. And our next question comes from the line of Neil Doshi with Mizuho Securities. Please go ahead.

<Q - Neil A. Doshi>: Great. Thanks for taking my question. I think you guys talked about having record operating income on certain franchises. Wanted to know how we should think about overall core Activision Blizzard operating income moving from kind of the low to mid 30% range to kind of higher 30% or maybe even 40% range excluding King? What are some of the levers you can push on the revenue side as well as on the cost side to get there? Thanks.

<A - Dennis M. Durkin>: Yeah, hey, Neil. It's Dennis. Thanks for the question. On a consolidated basis, we had Q2 record 37% operating margin, which is non-GAAP as previously defined. And in fact, Activision Publishing and

Blizzard, those two segments combined were above that at 39% in terms of operating margin this past quarter. So you have and can see some of the sight lines to how we might get there and then try to sustain that over time.

I'd probably call out maybe three things that are really key for that, and that are going to be really important for us to get to those levels and to sustain them going forward. The first one is just scale. In our business, we have a large opportunity to drive upside once we recover the fixed spend that we have to bring our games and our content to market, being very focused on how we do that and all the costs enable us to really scale those incremental margins as we do that. And it's a combination of those that once you get past that fixed cost base, really drives margin accretion for every incremental sale that you have.

The second part beyond scale is just digital growth, which really has two aspects. The first is just the trend that we're going to continue to see around the shift from retail to digital on full game sales, and that will continue. But even more importantly and a bigger driver as you saw in Q2 is the deeper player investment that we see once we have players inside of our experience and new opportunities to add micro-transactions, advertising, other things into those experiences, which are all really contribution margin and accretive to the overall margin of the company.

And then lastly, I'd just say as a competitive point relative to others, obviously owning our own IP is a huge factor in scaling those margins. That gives us a huge structural margin advantage relative to others and really gives us the flexibility to respond quickly as business models evolve and it'll help us build long-term value around our margin structure. So I'd say those are probably the three things that are most important to driving that. Thanks for the question.

Operator

Thank you. And our next question comes from the line of Chris Merwin with Barclays. Please go ahead.

<Q - Christopher David Merwin>: All right. Great. Thank you. I just have one for Ricardo. So you guys have been testing some mobile ads on King, and maybe can you just talk about some of the learnings that you've seen there so far? And I believe also you're looking to sell King ads mostly on a direct basis with a sales force. So I guess maybe could you also talk about why the direct sales model makes the most sense rather than say programmatic, and where you are in the process of hiring a sales force to ramp up direct sales by next year? Thanks.

<A - Riccardo Zacconi>: Hi, Chris. Nice talking to you again, Christopher. And before I get to your questions, I just want to reiterate that because of the size of the network and the engagement of our players, we believe that advertising represents an attractive opportunity. So as you said, at the same time, as you know, we are extremely focused on providing a first and foremost a great user experience. And we will not compromise on this. So this is the key reason why we are testing extremely thoroughly and are taking time for testing in-depth. And currently we are testing in two games, and we expect to test also in Candy Crush later this year as Thomas was saying earlier.

Besides testing, we are also hiring and we are hiring as selectively as we are hiring in the company, and we are hiring to bring the right experience to build this business for the long term.

And in regards to the other question you had, the sales model, we are focusing not only on direct sales, but we will sell both programmatic and direct. So I hope I answered your questions.

Operator

Thank you. And our next question comes from the line of Drew Crum with Stifel, Nicolaus. Please go ahead.

<Q - Drew Crum>: Okay. Thanks. Good afternoon, everyone. I wonder if you'd be willing to expound on your commentary concerning presales activity for Legion. The impact you've seen from the movie release, has that been more short lived or more sustainable in terms of the sub base? Thanks.

<A - Michael Morhaime>: Thanks for the question. This is Mike. We've seen very positive trends with the game over the past month. That's a result of the excitement building up to the Legion launch and also as a result of the positive attention we've seen globally with the Warcraft movie. While we have good momentum everywhere, the uplift in China has been particularly strong. So we have double-digit growth in engagement compared to a year ago and last quarter. And while there's several weeks to go until the Legion launch, our presales have been tracking in line with the prior expansion. So we have good strong momentum heading into next week, where we're going to be releasing the Demon Hunter and then following that, the Expansion launch later in the month.

Operator

Thank you. Our last question comes from the line of Colin Sebastian with Robert W. Baird. Please go ahead.

<Q - Colin A. Sebastian>: Thanks. I'll add my congratulations on a great quarter. Obviously, we're hearing a lot more about esports this year from you as well as other publishers. I wonder if your expectations are changing in terms of what you've seen thus far, but on the timeframe to ramp esports to material revenue contributor and longer term, how much in terms of potential incremental revenue and profit you could expect from that. Thank you.

<A - Robert A. Kotick>: Sure. So I think the important thing, Colin, for us is that, all of our esports initiatives are in the service of celebrating our players. And you think about the investment and the commitment that our players make in our games, this is a great way for us to really recognize through organized competition being that investment.

When you look at all the opportunities that present themselves, they're very franchise specific. There's a lot of work that needs to be done to get to a place where you have broad appeal watching, where you have the ability to broadcast content in an effective and successful way. And we're investing again all of the various opportunities that we think esports could present. It's a longer-term vision for what we're trying to accomplish. There's a lot of investment that's still going to be required.

Having said that, more people are spectating on video games than ever before. There are more opportunities for spectators than ever before. The live event competitions are providing greater prize pools, greater recognition, greater opportunities for players. And we think that this is one of the areas that'll present great opportunities for us for the long-term.

Getting from here to a place that will allow our franchises to resemble the NFL, the NBA, Major League Baseball, is going to take some time, but I could tell you the best minds of the company, the people who are in this room are all committed to continuing the efforts that we've made. And I think we have a genuine belief that in all of these sports, we've been the most successful. I think most of what you see is organized competition started out with Blizzard games a long time ago. And so we have a lot of belief and a lot of expectation that the promise of esports will continue to be something that we will excel at.

Dennis M. Durkin

All right. Thanks, Bobby, and thanks, everyone, for joining us today. We look forward to talking to you again on our next call in early November.

Operator

Thank you. Ladies and gentlemen, this concludes the Activision Blizzard's Q2 2016 Earnings Conference Call. Thank you for your participation. You may now disconnect.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2016-05-05
Event Description: Q1 2016 Earnings Call

Market Cap: 25,766.25
Current PX: 34.91
YTD Change($): -3.80
YTD Change(%): -9.817

Bloomberg Estimates - EPS
Current Quarter: 0.336
Current Year: 1.793
Bloomberg Estimates - Sales
Current Quarter: 1328.895
Current Year: 6290.650

Q1 2016 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Riccardo Zacconi
- Eric Hirshberg
- Michael Morhaime

Other Participants

- Neil A. Doshi
- Christopher David Merwin
- Douglas L. Creutz
- Eric O. Handler
- Arvind Bhatia
- Brian J. Pitz
- Colin A. Sebastian

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Activision Blizzard Q1 2016 Earnings Call. Today's conference is being recorded.

At this time, for opening remarks and introductions I would like to turn today's call over to Amrita Ahuja, Senior Vice President of Investor Relations. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's First Quarter 2016 Conference Call. With us today are Bobby Kotick, CEO; Thomas Tippl, COO; and Dennis Durkin, CFO. And for Q&A, Eric Hirshberg, CEO of Activision; Mike Morhaime, CEO of Blizzard; and Riccardo Zacconi, CEO of King, will also join us.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factors section of our SEC filings, including our 2016 Annual Report on Form 10-K which is on file with the SEC and as indicated on the slide that is showing.

The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation, and while we believe them to be true, they ultimately may prove to be incorrect. The company undertakes no obligation to release publicly any revisions to any forward-looking statement to reflect events or circumstances after today, May 5, 2016.

Unless otherwise indicated, our speakers will be referencing non-GAAP measures, which exclude the impact of the change in deferred net revenues and related cost of sales with respect of certain of our online enabled games, expenses related to stock based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses and accruals related to acquisitions, including the acquisition of King Digital Entertainment, the related debt financings, and the associated tax benefit.

Please refer to our earnings release, which is posted on www.activisonblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation.

There's also a PowerPoint overview which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Amrita. And thank you all for joining us this afternoon. This year the global market for interactive entertainment is expected to reach $94 billion. With more than $6 billion of revenues forecasted for this year, Activision Blizzard is clearly the world's most successful standalone interactive entertainment company, yet we only have a 7% participation. These forecasts don't really contemplate the growth in eSports or the introduction of advertising into games and they certainly don't contemplate the introduction of prize and cash play into games, all of which are emerging and potentially significant opportunities for the company.

eSports has unique meaning to our audiences. Frank Pearce, one of the founders of Blizzard captured what makes our games and the organized competitions we host so special to our players. He said our players feel a unique sense of belonging from their engagement with our content. Their social experiences are shaped by the communities they're a part of, and the investments our players make in our games is rewarded by being part of a community that celebrates their play and recognizes their accomplishments.

Our audiences spent 42 billion hours playing and watching our games in the past 12 months, similar to the number of hours people spent watching Netflix, and greater than the number of hours people consumed video on Facebook. But because these are principally social and truly interactive experiences, the commitment to our franchises is deeper and much more personal than other forms of entertainment.

One special example is that of a high schooler whose father was deployed in Afghanistan. The son and the father stayed connected by regularly playing World of Warcraft throughout his deployment. The shared experiences and high engagement required to play our games creates a unique bond and a special sense of belonging for the players. A great multigenerational example is an 84-year-old grandfather who, for 10 years now, has played WoW with both his son and grandson.

And another example of a life-changing experience is our most recent Heroes of the Dorm competition. The result changed the lives of five players when they won the collegiate championships and had their college tuitions entirely paid for.

There isn't any other form of entertainment that generates the passion, engagement, and commitment that game players experience and we're at the very beginning stages of providing opportunities to celebrate and reward our audience commitment.

This year, our franchises will provide over $10 million in prize money for players and shout-casters and commentators are earning real revenues and yet we're barely in the first inning of opportunity for games as organized sport.

Today, collectively, eSports' viewer-ship is greater than the individual audiences for NHL, Major League Baseball or the NBA. In the future, Call of Duty, Hearthstone and Overwatch could each have audiences in excess of any of the most well-known sports leagues.

Advertising and subscription revenues for eSports events are dwarfed by major league sports and yet the passion of a Call of Duty player is no less than the passion of the most ardent NFL fan. My friend, Robert Kraft, the owner of the New England Patriots paid a little less than $180 million for the Patriots in the early 1990s and he told me it was the best investment he ever made. 15 to 20 years from now, pro-team owners of our major franchises will likely be sharing similar sentiments. Our network itself has over 0.5 billion users each month. Only Facebook, YouTube and WeChat have bigger audiences, and we continue to transform our business to franchise focused, frequent content delivered directly to our 0.5 billion audience members in 196 countries around the world.

Value is delivered through a variety of player investment models, all providing flexibility to our audiences, and as we introduce new player investment opportunities like advertising, and we start seeing our eSports events command their fair share of broadcasting revenues, our players will have their efforts recognized and their achievement rewarded and their sense of belonging to their communities will only deepen. Because of our uniquely talented 9,000 employees around the world, we're better positioned than any other entertainment company to take advantage of the sizable opportunities ahead.

Our challenge, the challenge of prosperity, is the prioritization of these many opportunities and our 25 years of disciplined careful execution is what will enable us to pursue these opportunities with success as we have for 25 years. Since I joined the company, I haven't felt more excitement for our prospects and now Thomas will discuss the key drivers of our overall performance at our operating units and Dennis will review our financial results.

Thomas?

Thomas Tippl

Thank you, Bobby, and good afternoon, everyone. 2016 is off to a great start. We over-performed our plan for the first quarter, delivered year-over-year growth, achieved record digital revenues and raised our full year guidance. These results are driven by focus and execution against our three strategic pillars. First, expanding our audiences; second, deepening engagement; and third, providing opportunities for more player investments. Let's start with our progress in growing our audience reach which grew to 544 million monthly active players this quarter. With the close of the King acquisition, we massively expanded our audience reach. King brought a diverse network of 463 million global players to the Activision Blizzard family.

The acquisition also provides us with significant audience expansion opportunities going forward, as mobile is the fastest-growing platform and has the greatest global reach. The team at King continues to execute with excellence, as they grew monthly active users 3% over a large base last quarter. King's growth was driven by the release of Candy Crush Jelly Saga, which became a top 10 grossing game on the iPhone in the U.S. and Google Play worldwide.

This, combined with continued strong performance of the first two Candy Crush games, which are regularly updated with new content, features and live ops, returned the Candy Crush franchise to sequential growth. This further demonstrates that continued investment in innovation of existing franchises drives longevity.

We have also seen strong organic audience expansion in the Activision and Blizzard businesses. Both divisions set new all-time records with quarterly MAUs up 10% year-over-year for Activision and 23% for Blizzard. Activision's audience expansion was driven by Call of Duty, which, on the back of high-quality DLC, set the new franchise record for MAUs in the quarter, impressively growing its MAUs to exceed that of the holiday quarter.

With the number-one title on both next-gen platforms live to-date and with two other titles in the top-10 list, Call of Duty is the preferred choice on next-gen. In fact, about 85% of all PS4 buyers in North America this quarter opted for the Black Ops III Bundle, an amazing statistic which bodes well for the franchises' engagement and in-game play investment continued to expand rapidly.

On top of the Black Ops III momentum, Activision plans to build upon the community with an innovative new release this holiday, Call of Duty: Infinite Warfare, expected to launch November 4. This is the first three-year development cycle for award-winning studio, Infinity Ward, and they have been taking full advantage. With Infinite Warfare, they're redefining and building upon a classic war story that takes place in a bold new setting, which includes what happens when space becomes militarized. We can't wait to share more with you, including a hands-on experience later this year.

Activision also revealed Infinite Warfare Legacy and Digital Deluxe Editions, which includes Call of Duty: Modern Warfare Remastered. Activision is thrilled to fulfill the Call of Duty community's passionate request by re-mastering with great care one of the most beloved games of all time for this console generation. Not only do these additions represent an incredible value, but they also represent the largest content offering we have ever provided, filled with both innovative new experiences and classic Call gameplay in one great package, which will appeal to a wide audience.

Blizzard's 23% MAU growth was driven by the continued success of Hearthstone, which recently surpassed the 50 million registered player milestone. This is a testament not only to how awesome the game is, but also to its accessibility on multiple platforms as well as Blizzard's ability to deliver a regular pace of content updates. Hearthstone has had six major releases since the game's launch just over two years ago.

And the next major initiative to expand Blizzard's audience is just around the corner with the upcoming launch of the highly anticipated new IP, Overwatch. On May 24, Blizzard will enter the [ph] largest drawn-in (12:17) gaming with this very compelling and innovative team-based shooter.

Overwatch will not only serve Blizzard's current loyal community, but also introduce Blizzard's signature high-quality experience to a whole new audience.

The open beta, which just started last night, is off to a terrific start with millions of people playing already and the player feedback has been exceptional. We expect Overwatch to be Blizzard's biggest launch since Diablo in 2012. We also believe Overwatch will resonate well in eSports, which provides yet another vector for audience expansion. In fact, eSports is not only a driver of audience expansion, but also importantly drives growth in terms of time spent with our franchises.

So let's talk about the progress we made on our second strategic pillar, deepening engagement. As a result of our creative teams providing outstanding gameplay and frequent content updates, we were rewarded with players spending more than 10 billion hours playing our games during the first quarter. Over the last 12 months, players spent about 42 billion hours playing and watching our games. This level of engagement is in line with Netflix 2015 viewership of 42.5 billion hours, higher than Facebook's video consumption of about 37 billion hours annually, and more than four times the national viewership of professional U.S. sports leagues, including the NFL, NBA, MLB, NHL, and MLS combined.

The secular trends we are seeing are going to further expand our advantage. Viewership of those traditional sports leagues increased only 2% last year, while player and viewer time spent with Activision and Blizzard games increased nearly 20% last year. We are confident that we can further build on this momentum as we expand our ability to deliver more frequent and meaningful content updates on our core franchises and provide new ways for our audiences to engage with our franchises.

On this note, last week's release of Hearthstone third expansion card set, Whispers of the Old Gods, is off to a great start with record daily active users and record hours played by daily active user. In addition to what I already mentioned, our content pipeline includes new expansions for World of Warcraft and for the Destiny Universe in the second half of the year which will drive reengagement across their vibrant communities.

With World of Warcraft's next expansion, Legion, which will release on August 30, players will not only be able to dive into the new zones, quests, dungeons and raids that they expect but will also gain access to features that deepen and expand engagement post launch of the expansion. There will be ongoing social interactions in order halls, customizationable Artifact weapons and new character class and a revamped player-versus-player system. Players that have been away from World of Warcraft will be able to jump right into Legion content with an included boost to level 100.

Before the expansion though, the whole world will get to experience the epic orcs versus humans conflict on big screens with the release of the Warcraft film produced by Legendary Pictures. It's an exciting time for players to dive even deeper into the game to come back to World of Warcraft or to try it for the first time. Destiny's loyal passionate community also remains highly engaged. Bungie has released over 40 updates since launch in an effort to continually improve the game which has helped attract new players and keeps them coming back.

The game now has nearly 30 million registered players who have averaged over 100 hours of game time each. In April, Bungie released an update to the game which was well received by players and drove strong reengagement. We also successfully introduced a new loot box future which had a double-digit attach rate. Later this year Activision and Bungie plan to launch a large new expansion for the Destiny Universe which you will hear more about in the coming months.

Beyond new content, we're also driving increased engagement with our eSports initiatives which are making great progress. Since the beginning of the year, we have delivered millions of hours of audience engagement with our marquee eSports events. Specifically on Call of Duty, Activision concluded the stage one finals of the Call of Duty World League and will host the Call of Duty championship presented by PlayStation 4 this fall where teams are competing for a $3 million prize pool. You will soon hear more about the Call of Duty championships this year and the amazing player celebrations we are putting together.

Also Call of Duty is partnering with MLG on a number of fronts. MLG's sanctioning systems now govern the Call of Duty World League. MLG will produce the first event this summer and we are making strides inside the game with MLG's live event video viewer now embedded.

Blizzard is also expanding engagement this year through its biggest eSports calendar ever including the second year of the Heroes of the Dorm collegiate tournament which ESPN again aired during prime time. The ESPN's audience was up 17% versus 2015. Additionally, BlizzCon 2016 was announced for November 4 and 5, and once again thousands of tickets sold out within minutes of going on sale. The annual celebration Anaheim will bring passionate players from around the world together to compete and to celebrate all things Blizzard. Finally, eSports is not only helping us grow our franchises but also developing as a business opportunity.

Our Media Networks division held an event for Valve's Counter-Strike: GO Major at the end of the quarter and delivered 45 million hours of viewership which ranks amongst the top eSports events ever. It's a six-day celebration of players and teams. It was notably a profitable event for MLG on a standalone P&L basis, including ticketing, merchandising, broadcast rights, advertising sponsorship and MTX revenues. We've extended our partnership with WoW based on the success of this event. Advertisers will hear more about the plans from Media Networks at next week's Digital NewFronts in New York.

Now turning to the third pillar of our strategy, providing increased opportunities for player investment. During the March quarter, revenues from in-game content reached over $620 million, an increase of 20% year-over-year from the base Activision and Blizzard businesses and up 80% with the inclusion of King's top quarter results.

Growth in this area has been broad based. King's metrics improved quarter-over-quarter in terms of the number of monthly unique payers and gross bookings per paying player, as well as overall gross bookings. King is doing a great job implementing live ops, as well as fresh content across their games. These updates serve to drive engagement and provide value-added services to the players.

On the Activision business, Call of Duty is setting new records for follow-on digital content sales. Season Pass attach rates are at all-time highs and the number of players who choose to purchase in-game content more than doubled while maintaining average revenue per paying user. Most importantly, engagement with the game is stronger than ever.

And within the Blizzard business, Hearthstone delivered 20% revenue growth year-over-year by growing audience reach engagement and providing more opportunities for players to invest in the game.

This performance across the businesses again shows that increased player investment and deeper engagement are a virtuous cycle when executed well. So in summary, Q1 was a great start to the year and confirmed that our execution against our strategic pillars is paying off.

And with that, I will now turn it over to Dennis to talk us through the details of the financials.

Dennis M. Durkin

Thanks, Thomas. Good afternoon, everyone. Today, I will review our better than expected Q1 financial results, our outlook for Q2 and our increased outlook for 2016.

Q1 was a great start to the year that included the close of the King transaction and strong trends in our year-round franchises. We over performed our non-GAAP February guidance by $108 million on revenue and $0.12 on EPS. Our results grew year-over-year by 29%, or $205 million on non-GAAP revenues, and by 44% or $0.07 on EPS. This increase is largely due to the inclusion of King in our results, since the closing date of the acquisition, February 23rd. Excluding King, non-GAAP revenues and EPS were relatively flat to Q1 of last year.

Reflecting on some highlights by segment, Activision exceeded plans and last year's results on revenues and profit, with record Q1 digital revenues that were up 54% year-over-year. Activision also continued its next-gen leadership with four of the top 10 titles on PS4 and Xbox One life-to-date, including the number one spot with Call of Duty: Black Ops III, which, as Thomas mentioned, accelerated user engagement in Q1. This outstanding Call of Duty performance was partially offset by continued weakness in the toy select market.

As expected, Blizzard's Q1 was relatively quiet and consistent with expectations as the team prepares for the onslaught of upcoming content for its fans. But starting this quarter, Blizzard entered into what may be the busiest stretch of releases in their history with activity across franchises, genres, platforms and linear media to appeal to Blizzard's current community while attracting new and lapsed players.

In Q1, we also completed the successful integration with King and the team did not skip a beat. They continued to stay focused and execute through the closing of the transaction and once again had at least three of the top 15 grossing games on both the Apple App Store and Google Play store in the U.S. for the ninth consecutive quarter. Importantly, the King business grew quarter-over-quarter in both engagement and gross bookings.

Turning to our financial results, please refer to our earnings release for a full non-GAAP to GAAP reconciliations. Also the numbers I'll be quoting are compared to the prior year, unless otherwise noted.

For the quarter on a GAAP basis, we generated revenues of $1.46 billion, up 14% year-over-year, an operating margin of 32% and EPS of $0.45. As we said on our February call, our GAAP earnings are expected to be down in 2016 versus prior year, as our expected results will be impacted by additional accounting charges associated with the King transaction which include, among other things, transaction-related costs and the amortization of intangibles resulting from purchase price accounting adjustments. The majority of these GAAP accounting charges will not impact the economics of our business or our cash flows, although they will have a material impact on our 2016 GAAP results.

For the quarter on a non-GAAP basis, we generated revenues of $908 million, an operating margin of 28% and EPS of $0.23. On a non-GAAP basis, digital revenues in Q1 grew 48% year-over-year to a quarterly record. These increases were due to the inclusion of King in our results in Q1 of 2016, as well as the higher performance of Activision's Call of Duty and Blizzard's Hearthstone year-over-year.

Of the $0.12 in non-GAAP EPS over performance versus guidance, about $0.07 was related to timing, about $0.03 was related to strong franchise momentum and the earlier King close, and about $0.02 was related to one-time tax benefit. Please note that when you look at the segment results, King's Q1 financials are not directly comparable with their previously reported quarters.

Among other things, we have adjusted King's compensation plan from an equity-based program to a cash-based profit-sharing plan and we've also allocated corporate overhead to the group, as we do with our other divisions. Both of these changes are value-neutral to the company. Controlling for those factors in comparing their full quarter results, in addition to gross bookings and engagement, King's overall revenues and operating income were up quarter-over-quarter.

Turning to the specific P&L items. Please note that all percentages are based on revenues except for the tax rate. For Q1, GAAP product costs were 21%, operating expenses were 47%, interest expense was $52 million and our GAAP tax rate was 18%. Our GAAP and non-GAAP fully diluted weighted average share count was 750 million, including participating securities.

On a non-GAAP basis for the quarter, product costs were 24%, operating expenses were 48% and our adjusted EBITDA margin was 31%. Interest expense was $51 million. Our non-GAAP tax rate was 14%. As mentioned, this tax rate was as a result of one-time discrete benefits. In terms of cash flow, in Q1 we generated strong cash flow, with non-GAAP adjusted EBITDA of $277 million, up 24% year-over-year, operating cash flow of $309 million, up 48% year-over-year and free cash flow of $282 million after CapEx, up 50% year-over-year.

Turning to the balance sheet. We closed the King transaction in February for approximately $5.8 billion, which was funded with $3.5 billion in cash held internationally and $2.3 billion of cash from new debt. The enterprise value was $4.7 billion after factoring in the $1.15 (sic) [$1.15 billion] (25:23) of cash that came along with King, or about 6 times King's 2015 EBITDA.

Directly following the transaction, we also paid down a net $500 million of our outstanding debt balance, which ended the quarter at $5.92 billion in aggregate. As mentioned on our last call, we are authorized to pay down an additional $1 billion of debt this year. As of March 31, we had approximately $2.91 billion in cash and investments, of which roughly half was held internationally.

On the dividend front, next week, on May 11, we plan to pay a $0.26 per share cash dividend, or approximately $192 million in aggregate, to shareholders of record as of March 30, 2016. So in summary, Q1 was a very strong start to the year for the company and sets us up well for the coming quarters ahead.

Now let's turn to our slate and our outlook for Q2 and the balance of 2016. Our Q2 slate includes Call of Duty second map pack and Hearthstone's latest expansion, Whispers of the Old Gods, which released last week. And on May 24, Blizzard plans to release its newest IP, Overwatch. We also plan to continue to release new content and updates across our portfolio to keep our players engaged while, at the same time, beginning the ramp in sales and marketing spending for our major releases later this year.

For Q2 on a GAAP basis, we expect net revenues of $1.425 billion, product costs of 24% and operating expenses of 65%. We expect GAAP interest expense of $62 million, a GAAP and non-GAAP tax rate of 23%, a GAAP and non-GAAP share count of 755 million and EPS of $0.10.

For Q2 on a non-GAAP basis, we expect revenues of $1.375 billion, product costs of 23% and operating expenses of 46%. We expect a non-GAAP interest expense of $60 million and non-GAAP EPS of $0.38.

In the back half of the year, Blizzard plans to release World of Warcraft's next highly anticipated expansion, Legion. Activision plans to release two more map packs for Call of Duty, a large expansion for Destiny and new releases in Q4 for Skylanders and Call of Duty. King plans to release two non-Candy Crush franchise games this year, one this summer and another later this year.

Now to our 2016 full year numbers. On a GAAP basis, we expect revenues of $6.13 billion, product costs of 25% and operating expenses of 60%. Our GAAP interest expense is expected to be $243 million. Our GAAP and non-GAAP tax rate is expected to be 24%, 1 point better than our February guidance. We expect 765 million fully diluted shares, both for GAAP and non-GAAP, and EPS for GAAP is expected to be $0.69.

For 2016 on a non-GAAP basis, we expect revenues of $6.275 billion, an increase of $25 million versus our February guidance, product costs of 24%, operating expenses of 44% and an operating margin of 32%. Our non-GAAP interest expense is expected to be $235 million. Though it's still early in the year and nearly all of our major launches are still in front of us, we are raising our full year outlook by $0.03 on EPS to $1.78 related to business performance and tax benefits.

In summary, Q1 was an incredibly productive quarter for the company and a great start for the year. With the closing of the King acquisition, we now have global leadership across major gaming platforms and one of the largest interactive entertainment networks on the planet. Our franchised focus has delivered growing audience reach, deepening player engagement, and more player investments than ever before.

In addition, the tailwind in emerging areas like eSports provides compelling option value going forward. As a team, we couldn't be more excited about the large opportunities for growth that we have ahead of us.

Now I will welcome our business leaders, Eric, Mike, and Riccardo, as they join us for the Q&A portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] We'll go first to Neil Doshi with Mizuho.

<Q - Neil A. Doshi>: Great. Thanks, guys. A quick question on Overwatch. It seems like the beta has been quite successful. Just wondering how we should think about units for the quarter when it's released and then as well as for the year. It seems like there's a much bigger audience than there is for Diablo, so any thoughts or color on that front would be very helpful. Thanks.

<A - Dennis M. Durkin>: Well, we're very excited about the open beta, so we're less than 24 hours in but the game is now live and freely accessible to players around the world including China. We've already seen millions of players try out the game in open beta. The feedback has been extremely positive. This is our first global simultaneous multiplatform launch and so we're on PS4, Xbox, PC across all of our regions.

We don't project out specific unit numbers but like Thomas mentioned, we do expect this to be our biggest launch since Diablo 3 which was heavily anticipated and the Diablo franchise was something that has been loved for many years. This is a brand-new IP. We're doing a ton to expose players to the richness of this world that we've created but it is a new IP in a very popular genre.

<Q - Neil A. Doshi>: Great. Thanks.

Operator

We'll go next to Chris Merwin with Barclays.

<Q - Christopher David Merwin>: Hi. Great. Thank you. So now that the King acquisition is closed, I was wondering if you could just update us on the strategic plans for King. At what point does King start to plan for the development of some of Activision's IP and maybe given the size of King's user base does it make sense to integrate some third-party advertising into the mix? And if so, what would the ramp look like there? Thanks.

<A - Riccardo Zacconi>: Hi, Chris. It's Riccardo here. First of all, it's nice to talk to you again and thank you for the question. So before I answer the first part of your question on the strategic plans, as part of Activision Blizzard, I would like to highlight that the integration went extremely smoothly and it's effectively complete. King has been part of the Activision business family as you know now for two months and we have retained our key talents and have remained focused on driving the business and executing on our existing plan.

As you have heard in Q1, we had delivered both top line and profit growth by growing our player and payer networks as well as the investment per player. We're first of all focused on executing on our strategy and we have a strong pipeline across our franchises and we're working on new titles within these franchises. We're also developing additional new IPs within our studios. In addition to developing the new titles, we're also continuing to invest in our existing franchise games with new content, new features, and with live ops. Live ops as a brief reminder are the time-limited events. And all of this content is driving engagement, retention, and investment per player.

Now as part of the Activision business family, beyond existing plans, we have now new opportunities to create even greater games for our massive player network by combining Activision Blizzard's top-performing IPs on console and PC with our mobile expertise. The deal, as you know, closed two months ago and we have started conversations with both Activision and Blizzard to explore those opportunities.

In regard to the second part of your question regarding advertising, I want to say that first and foremost we are focused on retaining our players and we are focused on providing a great player experience and we will not compromise on this point.

That said, given our massive network, we do believe that advertising could be a meaningful revenue stream for King in the long term. We have 463 million monthly active users, and with that it's one of the largest untapped audiences for advertisers in the world. But it's early days and we've just begun experimenting with that in two of our games, so we do not expect any impact to this year's results from ad sales.

<Q - Christopher David Merwin>: Thanks, Riccardo.

Operator

We'll go next to Doug Creutz with Cowen and Company.

<Q - Douglas L. Creutz>: Thanks. You mentioned on the call that you got some good re-engagement at Destiny around the April update, I just wonder if you could maybe kind of size how engagement is trending relative to the peak you hit back in September around The Taken King launch? Thanks.

<A - Eric Hirshberg>: Hey, Doug. It's Eric. So Destiny has nearly 30 million registered players now and our April content successfully reengaged the community and was very well received. We think engagement has remained remarkably strong, even after the release of some competitive games in this genre. But it's clear that our fans are hungry for more content than we've been able to create and that passion and loyalty from our fans is something that we don't take for granted, which is why we're working side-by-side with Bungie to make sure that in the future, we're able to deliver a more consistent stream of great content and drive even more engagement.

<Q - Douglas L. Creutz>: Great. Thanks.

Operator

We'll go next to Eric Handler with MKM Partners.

<Q - Eric O. Handler>: Thank you very much. A question for Mike regarding Hearthstone. Mike, so users are now, you said, they are at 50 million. I think it's up from about 40 million players in November, so big increase there. Can you talk about user monetization trends for the game, and are the newest players spending as much, less or more than those that have been playing longer?

<A - Michael Morhaime>: We don't publicly discuss specific monetization trends, but we're very happy with the continued strong performance we're seeing from Hearthstone. As Thomas mentioned, we are very excited that engagement both in terms of daily players and hours per player rose with the Old Gods' launch. Hearthstone revenues were also up 20% year-over-year in the first quarter, so in general we're very pleased.

<Q - Eric O. Handler>: Thanks.

Operator

We'll go next to Arvind Bhatia with CRT Capital.

<Q - Arvind Bhatia>: Great. Thank you. Congratulations on another good quarter. I've got a two part question, first, if you could maybe touch a little bit more on the Call of Duty: Black Ops III expansion pack's performance year-over-year? And also maybe talk about the Infinite Warfare, the trailer and some of the YouTube dislike that it's getting. What do you make of that?

<A - Eric Hirshberg>: Thanks, Arvind. It's Eric. Black Ops III is performing very well, but before I address our digital performance specifically, I think it's important to take a step back and first talk about overall engagement.

We've made a great game that our fans love and that's demonstrated by the fact that our monthly active users are at all-time highs. And as a result of that, our digital business is also operating at Q1 all-time highs and is up significantly year-over-year. Season Pass is at an all-time high and, in fact, we expect to deliver the most map packs ever to players with Black Ops III. So the most important thing for us is that we're delivering all this performance, while seeing record engagement with the game.

On the second part of your question related to Infinite Warfare, first of all you got to love the passion of gamers, this is an industry like no other, and a fan base like no other and we love that our fans treat this franchise like it's their own and have such strong points of view about it. There just aren't many entertainment franchises on Earth that can generate the kind of passion that Call of Duty can and that's a good thing.

Secondly, of course we know that there are people in our community who are nostalgic for the boots on the ground style gameplay, and that's why we made Modern Warfare Remastered. But we also have millions of people in our community who want to have new innovative experiences in the game each year and Infinite Warfare is going to deliver that. And the good news is this year we found a way to deliver both in one package while keeping our community together.

And while of course we see the passionate opinions online, we also look at other measurements. And the fact is, while it's very early, preorders are off to a very strong start. Views of the reveal trailer that you referred to are up and, in fact, the number of likes per view on the Infinite Warfare reveal trailer are also the highest we've ever seen. We've seen this in the franchise before. The reveal trailer for Black Ops II, which took the franchise into the future for the first time, had the most dislikes of any reveal trailer we had ever made at that time. And that, of course, went on to become our most successful game ever.

And right now, the franchise has never been stronger. We have more people playing Black Ops III, a game that takes place in the future with boost jumps and fictitious weapons and all the rest, than any game in our history. So what we know for sure is that if we always just did what worked in the past and never took any creative risks, we wouldn't have a franchise. The day to worry is the day we stop trying new things.

<Q - Arvind Bhatia>: Very helpful. Thank you.

Operator

We'll go next to Brian Pitz with Jefferies.

<Q - Brian J. Pitz>: Thanks. A question on Overwatch marketing. Maybe you could discuss how you build Overwatch into a true trans-media franchise including the types of media, such as eSports, movies, cartoons, comic books, et cetera, as well as merchandising opportunities we might see over time if the game is successful. And basically is it fair to compare it to, say, you're building essentially your own version of the Marvel Universe here? Thanks.

<A - Michael Morhaime>: Thanks for the question. I think it's a great question. We see a ton of opportunity here. We put a lot of work into creating a game universe with awesome characters and a deep backstory. We think there's a big opportunity for Overwatch to thrive across all sorts of media. The game itself is vibrant and rich with personality. We've seen an overwhelming positive response to our animated shorts and comics and we're working on more of those. We think that there's a lot of potential to go even further in the future.

When it comes to eSports, we feel Overwatch has huge potential. We put a lot of focus on the viewing experience and making sure the action is fun to watch. We designed the game with eSports in mind and we have big plans in this area, which we'll talk more about later this year.

<Q - Brian J. Pitz>: Thanks, Mike.

Operator

We'll go next to Colin Sebastian with Robert Baird.

<Q - Colin A. Sebastian>: Thanks. I guess as a follow-up to an earlier question on the mobile business in King, hope you can talk in a little more detail about Jelly Saga's performance since launch in terms of usage and monetization and then also how you view the prospects for the performance of the Candy Crush franchise as a whole through the balance of the year, especially as we consider promotion across the network. Thank you.

<A - Riccardo Zacconi>: Hi, Colin. It's Riccardo. Thanks for the question, first of all. The overall Candy Crush franchise is very healthy. It continues to produce strong performance, growing sequentially in Q1, as you have seen. And this validates our franchise-focused strategy.

We continue to execute on our four-pronged approach to creating enduring franchises by, number one, adding new content, implementing live ops, delivering extensions in our existing games as well as offering players new sister or sequel titles. This approach has led to continued strong performance by the Candy Crush franchise. In fact, the original game, the Candy Crush Saga, is already four years old and it continues to lead the casual game category and was the number three top grossing game in the U.S. in Q1.

In regards to your question on Candy Crush Jelly Saga, we launched the game in January of this year and it's a sister title to Candy Crush Saga. It has the same star ratings as Candy Crush Saga and our players are clearly enjoying the game. It's our third largest title and a top 10 grossing game in the U.S. on iPhone and it's also a worldwide top 10 grossing game on Google Play. The game brought new players to King's network in Q1 and has returned the franchise to growth.

When you look across the entire franchise, all three Candy Crush titles were top 15 grossing games in the U.S. in Q1, which demonstrates the longevity and strength of the brand. So we believe we have an enduring franchise with Candy Crush and we are executing to keep innovating for our players.

<Q - Colin A. Sebastian>: Great. Thanks. And maybe I could sneak in another follow-up around eSports, more specifically around monetization in eSports longer-term beyond the loyalty and improving the brand Halo around certain titles. Thank you.

<A - Robert A. Kotick>: Our first priority has been the opportunity to celebrate our players. And when you think about the commitment that our players make to our games, by providing them with the recognition, the organized competitive experiences, highlighting their accomplishments, being able to provide higher levels of prize play than we ever have, these are all in the service of enhancing engagement and building value in the equity of our properties.

I think when you look at the untapped opportunities though that enable you to do a lot of those things, we have this very virtuous cycle. People pay to participate, sponsors are willing to finance events, those events then become the content that is broadcast on our network or on other networks, those events then lead to having the ability to have regional events, national events, international events; all of these things have the opportunity for us to expand broadcast rights, licensing and merchandising, ticket sales, local sponsorships, national sponsorships, and these are all things that we're very actively engaged in, not to mention all the opportunities to sell our professional teams for our professional leagues. And so over the long term, we view this as a tremendous opportunity to both celebrate our players and to create a lot of value for our shareholders.

<Q - Colin A. Sebastian>: Thanks, Bobby.

Operator

That was our final question. So at this time, I'll turn the call over to Dennis Durkin for any additional or closing remarks.

Dennis M. Durkin

All right. Thank you, everyone. We appreciate your dialing in and participating on this call and we look forward to seeing you on next quarter's call in early August. Thank you.

Operator

That does conclude today's conference. We thank you for your participation.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2016-02-11
Event Description: Q4 2015 Earnings Call

Market Cap: 22,315.73
Current PX: 30.52
YTD Change($): -8.19
YTD Change(%): -21.157

Bloomberg Estimates - EPS
Current Quarter: 0.178
Current Year: 2.050
Bloomberg Estimates - Sales
Current Quarter: 762.500
Current Year: 6511.800

Q4 2015 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Eric Hirshberg
- Michael Morhaime

Other Participants

- Douglas L. Creutz
- Brian J. Pitz
- Neil A. Doshi
- Arvind Bhatia
- Colin A. Sebastian
- Eric O. Handler
- Chris Merwin

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard Fourth Quarter 2015 Earnings Call. Today's conference is being recorded.

At this time for opening remarks and introductions, I would like to turn today's call over to Amrita Ahuja. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's fourth quarter 2015 conference call. Speaking on the call today will be Bobby Kotick, CEO of Activision Blizzard; Thomas Tippl, COO of Activision Blizzard; Dennis Durkin, CFO of Activison Blizzard; Eric Hirshberg, CEO of Activision; and Mike Morhaime, CEO of Blizzard.

I would like to remind everyone that during this call, we will be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factor section of our SEC filings, including our 2015 Annual Report on Form 10-K and subsequent Quarterly Reports on Form 10-Q, which are on file with the SEC, and those indicated on the slide that is showing.

The forward-looking statements in this presentation are based on information available to the company as of the date of this presentation, including information provided to the company by King Digital Entertainment and our preliminary assessment on the impact to our financial information of purchase price accounting, and while we believe them to be true, they may ultimately prove to be incorrect. The company undertakes no obligation to release publically any revisions to any forward-looking statements to reflect events or circumstances after today, February 11, 2016.

Unless otherwise indicated, our speakers will be referencing non-GAAP measures which include the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games. Expenses related to stock-based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses, and accruals, related to acquisitions, including the acquisition of King Digital Entertainment, the related debt financings and the associated tax benefit.

Please refer to our earnings release, which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation. There's also a PowerPoint overview, which you can access with the webcast and which will be posted to the website following the call. In addition, we'll also be posting a financial overview, highlighting both GAAP and non-GAAP results in a one page summary sheet.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Amrita, and thank you all for joining us this afternoon. This month, Mike Morhaime and I are celebrating our 25th anniversaries with the company, and I wanted to take this opportunity to thank Mike and the incredibly talented team at Blizzard for 25 years of creating some of the world's most inspired, enduring and entertaining franchises. They have one of the best track records of any game company in the creation of franchises, and this year with Overwatch, Blizzard will launch its first entirely new franchise in 17 years. From the reaction so far, Overwatch is on track to become a fantastic success. Mike, thank you for 25 extraordinary years, and I'm looking forward to many more together.

We ended our 2015, our 25th year, with $4.6 billion of revenues, $1.5 billion of operating income and $1.2 billion of operating cash flow. Upon the expected close of our acquisition of King later this month, we'll have over a 0.5 billion monthly active users in 196 countries, which as an entertainment network, ranks only behind Facebook, YouTube and WeChat in monthly active users. We'll have seven times the audience members of Netflix and have a larger audience than Snapchat and Twitter combined. We'll be the world's leading standalone interactive entertainment company and we expect 2016 to be a record year for the company, with $6.25 billion of revenues and more than $2 billion of operating income.

In the past 25 years, based on yesterday's stock price, our compound rate of return was over 1,000% and we outperformed the S&P 500 by almost 300%. In our Annual Report last year, we shared our plans to enhance engagements in our franchises and celebrate our players through initiatives like esports. And we're really beginning to better realize these plans.

Last year, our Activision Blizzard games were played for over 14 billion hours and spectators watched over 1.5 billion hours of video content based on our games. In the 2014-2015 season, fans of the NFL watched about 7 billion hours of nationally-televised games, which is less than half the time spent engaged with our franchises. Those televised games generated approximately $7 billion of broadcast rights fees for the NFL and another $4 billion in other revenues including sponsorships, merchandise and ticket sales.

When we think about our franchises, we view our responsibilities to our fans and the associated business opportunity through the lens of these leagues like the NFL, the Premier League, the NBA, Major League Baseball or NHL. Our franchises today generate revenues principally from the sale of interactive content but not meaningful revenues from tournament play, advertising, broadcasting and pay-per-view, licensing or merchandising, all of which are great future financial opportunities we are pursuing.

We think competitive gaming and the spectator opportunities connected to organized gaming competitions could provide sizeable opportunities for shareholders and great rewards and recognition for our hundreds of millions of players. We continue to believe that esports is another long-term growth pillar for the company, and our recent acquisition of Major League Gaming has accelerated our strategic plans. esports helps fuel one of the underlying drivers of our strong financial performance, which is a deepening engagement with our fans.

As I begin my 25th year at the company, I couldn't be more excited about the many, many opportunities we see ahead. Prioritization of opportunity remains a great challenge but our well-defined strategy and focused execution have enabled us to make great content, satisfy large audiences and generate superior shareholder returns for 25 years. Our talented teams around the world are committed to our future success, and for their effort and commitment to excellence, we are very grateful.

Now, Thomas will discuss the key drivers of our overall performance, Dennis will review our financial results and 2016 outlook in detail and Mike and Eric will discuss the results of their respective operating units. Thomas?

Thomas Tippl

Thank you, Bobby, and good afternoon, everyone. Activision Blizzard had another successful year in 2015. We achieved record digital revenues up 20% year-over-year, and for the first time in 2015, our digital revenues were larger than our retail revenues. At constant currency, we achieved 4% revenue growth and 13% EPS growth above 2014's record levels. These results are driven by our strategic focus and execution on growing our audiences, deepening engagement and providing opportunities for more player investment. Let's briefly go through each of these key business drivers.

First, we broadened our audience reach with successful new content launches and expanded onto new platforms and geographies. In the fourth quarter, our monthly active users grew to our highest level ever at over 80 million users. For the full year, MAUs grew 25% over 2014. And in key markets like China where we launched three new games in 2015, our revenue growth accelerated to 87% year-over-year, faster than ever before.

Second, we drove deeper engagement by providing outstanding game play and frequent content updates. Players spent 3.5 billion hours playing our games in the fourth quarter alone. For the full year, engagement was up 16% to a record 14 billion hours, and this doesn't include rapidly growing hours spent spectating which we estimate for Activision Blizzard alone is now 1.5 billion hours. Third, we progressed in something that is very hard to do, but is critical for our business. We shifted to a year-round player investment model, while growing engagement at the same time. And as a result, we grew our revenues from in-game content and services to over $1.6 billion. That's up 57% year-over-year at constant FX.

When executed well, increased player investment and deeper engagement are not a tradeoff but instead can reinforce each other, and we are pleased that our results are proving out this important element of our business strategy. As we look ahead to 2016, in our core business, we expect continued growth from these strategic initiatives against a backdrop of an increasing installed base of devices capable of delivering games around the world. We will continue to see the shift towards a digital distribution network, and most importantly, we will deliver another year of the very best interactive entertainment in the world.

In addition to the organic progress we made in 2015, we also created opportunities for growth ahead through new corporate initiatives focused on the fastest-growing parts of our industry. Let's start with King, which we expect to add to our portfolio later this month. King operates in the large and rapidly growing mobile segment with a world-class management team, exceptional game development talent, and great commercial instincts. In addition to being significantly accretive this year, we expect the transaction will solidify Activision Blizzard's position as a world leader in interactive entertainment, positioning the combined company for growth across platforms, audiences, geographies and business models.

Second, our recent acquisition of Major League Gaming will accelerate our opportunities in esports. Major League Gaming provides us with a superb streaming platform, league management expertise with MLG Pro Circuit and online competition and prize play through the GameBattles platform. We believe our investments in esports fit perfectly with our strategy to deepen audience engagement by celebrating our players, delivering high production values to our communities and providing greater opportunities for player investment.

By the end of February, we'll have one of the largest entertainment networks in the world with over 0.5 billion monthly active users in some of the strongest franchises in all of entertainment with meaningful new long-term growth opportunities for future value creation. We couldn't be more excited to welcome the incredibly talented teams at King and MLG into the Activision Blizzard family.

So now, I'll hand it over to Dennis who will take you through our results in detail.

Dennis M. Durkin

Thanks, Thomas. Good afternoon, everyone. Today I will review our Q4 and full year 2015 financial results, and then I will review our outlook for 2016.

Twelve months ago, our original non-GAAP outlook included revenues of $4.4 billion, 30% operating margin, and EPS of $1.15. Today we are announcing that we delivered revenues of $4.62 billion, a 32% operating margin, and EPS of $1.32; once again exceeding our initial guidance, this year by $221 million on revenues and by $0.17 on EPS.

Importantly, digital revenues achieved a quarterly record in Q4, and for the year, grew 20% or 29% at constant FX versus last year to an all-time annual record of $2.63 billion. This represented a 57% share of our total revenues, up from 46% last year. This strong growth in digital revenue was driven by new and emerging high-margin opportunities including in-game content and services, which grew 57% at constant FX. These in-game content and services now account for about a third of our total revenues. In addition, console full-game downloads grew 56% year-over-year or at 65% at constant FX.

From a capital perspective, we delivered more than $1 billion of operating cash flow for the sixth year out of the past seven years. Further, we strengthened our balance sheet and we were upgraded to investment-grade by Moody's. We paid a record dividend to shareholders, repaid $250 million of our debt and continued to invest in a strong pipeline of new opportunities with high margin potential and announced agreements to acquire King Digital and Major League Gaming. So, it was a busy year on many fronts for the company.

Now, let's take a moment to review our operational performance for 2015. Activision grew in 2015 on its path to becoming an increasingly digital business with digital revenues up nearly 70% this year, driven by strong growth from full-game digital downloads and in-game content and services. We still have considerable opportunity in digital because even with this strong growth, less than 50% of Activision revenues were digital last year.

In Q4, Call of Duty: Black Ops exceeded our plan in prior year in practically every key commercial and engagement metric delivering upside for the year. And more importantly, the Call of Duty franchise had its largest player community ever at yearend. Destiny's Q3 release, The Taken King, continued to perform strongly as well. We did however experience lower than expected performance on Skylanders and Guitar Hero, which Eric will discuss in more detail in a few moments.

2015 was an important year for Blizzard with expansion across more platforms, business models and regions than ever before. It was the first year since our merger that more than 50% of Blizzard's revenue was derived from content in games other than World of Warcraft. Blizzard has also exhibited strong growth in new territories with China revenues reaching new highs. Blizzard's large online community is growing and is stronger than ever.

Now let's turn to our financial results. For the quarter on a GAAP basis, we generated revenues of $1.35 billion, up $135 million versus our November guidance, an operating margin of 18% and GAAP EPS of $0.21, up $0.12 versus our November guidance. For the quarter on a non-GAAP basis, we generated revenues of $2.12 billion, an operating margin of 40% and EPS of $0.83. We outperformed November guidance by $0.01 on EPS. We came in slightly below our revenue expectations largely due to foreign exchange and underperformance on our casual franchises on console.

In terms of EBITDA, in Q4, we generated non-GAAP adjusted EBITDA of $862 million and $1.55 billion for the year. Operating cash flow for the year was $1.19 billion and free cash flow was $1.08 billion. We had no share repurchases during the year. On a non-GAAP basis for the year, revenues were $4.62 billion, down slightly year-over-year and up 4% at constant FX. Our non-GAAP operating income was $1.47 billion, reflecting an operating margin of 32% or 34% at constant FX, and an adjusted EBITDA margin of 34%. Our tax rate was 22% and our EPS was $1.32. At constant currency, our EPS grew 13% year-over-year above 2014's record EPS levels.

Turning to FX, please note that as discussed on prior calls, the strong dollar continued to be a headwind as our international revenues were translated at lower rates than in 2014. In the quarter, the year-over-year FX impact was $125 million on revenue and $0.11 on EPS. For the year, there was a significant FX impact of $364 million on revenue and $0.28 on EPS.

Turning to the balance sheet, as of December 31, we had approximately $5.4 billion in cash and investments, of which approximately $1.35 billion was held domestically. Approximately, $3.6 billion of this cash was held in escrow and combined with the incremental $2.3 billion term loan we have committed from our banking syndicate, we'll provide funding for the closing of our pending King transaction.

Now let's turn to our plans for 2016. For the first time, as we shift to a year-round engagement model in our business, we expect more than 50% of our earnings to be realized in the first three quarters of the calendar year. For our Activision business, we expect Call of Duty to continue its strong momentum by the delivery of fantastic new game content including multiple map packs, in-game content and an innovative new Call of Duty game in Q4.

For planning purposes, as we have assumed in past years, we have modeled Q4 new release sales to be down from last year's Black Ops III levels. We do expect overall Call of Duty franchise revenues, however, to be up for the year given strong engagement trends leading into the digital season for Black Ops in the first half of 2016. On Destiny, we expect to deliver a new expansion in 2016 but note that we no longer expect a full game Destiny release during the year. We do however expect a full game Destiny sequel to now come in 2017. For Skylanders in Q4, we expect to release an innovative new game, which for guidance purposes we plan to be down year-over-year given the challenging competitive environment in the toys to life category.

Turning to Blizzard, we have a lot of exciting plans this year that Mike will cover in more detail later in the call. Blizzard plans to release the highly-anticipated Overwatch in the spring, as well as the Legion expansion for World of Warcraft in the summer. In addition, Hearthstone and Heroes of the Storm will have ongoing content updates throughout the year.

Our 2016 guidance today also includes King, as we expect to close the transaction later this month. Note that there are few key closing conditions still outstanding, including Irish High Court approval and EU regulatory approval, both of which are expected shortly. King has already launched Candy Crush Jelly Saga, the first of three new franchise games that are expected in 2016. We are excited about their plan and look forward to closing of the transaction soon. On capital allocation, our board has once again increased our dividend, this year by 13% to $0.26 per share payable in May. Additionally, once we've closed the King transaction, our primary focus for the near-term will be on debt reduction and we plan to repay up to $1.5 billion of debt in 2016.

With that context, now let's review the numbers. For 2016, we expect GAAP revenues of $6.1 billion, product costs of 23% and operating expenses of 65%. We expect GAAP net interest expense of $245 million. For both GAAP and non-GAAP, we expect a fully-diluted weighted average share count of 767 million and a tax rate of 25%. GAAP EPS is expected to be $0.45. Our GAAP earnings are expected to be down versus prior year as the expected results will be impacted by additional accounting charges associated with the King transaction, which include, among other things, transaction-related costs and the amortization of intangibles resulting from purchase price accounting adjustments. The majority of these GAAP accounting charges will not impact the economics of our business or our cash flows, although they will have a material impact on our 2016 GAAP results.

I want to highlight that there could be significant movement in our GAAP outlook as it will be impacted by estimates and assumptions, which may be materially different when the King transaction actually closes. These estimates and assumptions are inherently difficult to predict. Please refer to our GAAP to non-GAAP outlook reconciliation tables in our earnings release for more details.

On a non-GAAP basis, we expect revenues of $6.25 billion, product cost of 23% and operating expense of 44%. We expect a non-GAAP operating margin of 32% and an adjusted EBITDA margin of 35%. We expect non-GAAP net interest expense of $235 million. Non-GAAP EPS is expected to be $1.75, which as we indicated when we announced the transaction in November, contemplates 30% accretion from King.

A few things to call out to help you understand the non-GAAP EPS numbers here. First of all, please note that as was mentioned earlier, we do not expect a full-game Destiny release this year, which has an approximately $0.15 impact on our guidance. A full-game Destiny sequel is now expected in 2017. Also note that we plan to transition King's current compensation plan from an equity-based compensation program to a cash-based profit-sharing plan more similar to what is used today at Blizzard and in Activision studio organization. Overall this is value-neutral as it moves equity expense into compensation expense. However, it will negatively affect non-GAAP EPS by approximately $0.06 this year. We believe that this incentive structure has proven successful in our existing business and we're confident that it will also drive business results with King. Note that both the Destiny timing and the King compensation impact are included in our $1.75 non-GAAP EPS guidance for the year.

Now let's turn to our quarterly outlook, which assumes King closes later this month. On a GAAP basis for the March quarter, we expect net revenues of $1.26 billion, product costs of 21% and operating expenses of 58%. We expect GAAP and non-GAAP interest expense of $55 million, a tax rate of 25% and share count of 756 million shares. We expect GAAP EPS of $0.21. On a non-GAAP basis for the March quarter, we expect revenues of $800 million, product cost of 23% and operating expenses of 57%. We expect non-GAAP EPS of $0.11.

In summary, 2015 was an important year for Activision Blizzard and we again delivered strong financial results during a truly transformational year for the company, which set a strong foundation for future growth. With the largest interactive entertainment network, some of the most important wholly-owned franchises in all of entertainment, solid execution skill and continued business discipline, we are poised for continued success in driving shareholder value creation over the long-term.

Now I will turn the call over to Eric to discuss Activision.

Eric Hirshberg

Thanks, Dennis. 2015 was an important growth year for Activision. Our digital revenues grew by 68% year-over-year. At constant currency our total revenues grew 7% and our operating income grew 30% year-over-year with more than 600 basis points of margin expansion.

We're providing great year-round content that our fans love and as a result our monthly active users were up 20% in 2015 year-over-year with a double-digit increase in Q4 as well, reaching our highest level ever. We grew our leadership on next-gen and we now have four of the top 10 titles on PS4 and Xbox One live to date, including the number-one spot with Call of Duty: Black Ops III. And our partnership with Sony is off to a great start on both Call of Duty and Destiny.

This year we saw our largest franchise, Call of Duty, ascend to new heights with performance above our plan. OI and margin growth for Call of Duty continues to expand, and we also saw phenomenal reception to in-game content and services. This is a virtuous cycle. Engagement creates the opportunity for us to earn additional player investment by providing more great content, which in turn leads to more engagement.

Along with our partners at Bungie, we continued to grow Destiny's incredibly loyal audience base and introduce new ways to excite the community throughout the year, culminating in the release of The Taken King, which achieved record digital attach rates in Q3. And the Destiny community responded well to the new content we made available for purchase in-game in Q4, which allowed players to customize their experience.

Our games for core audiences did extremely well, but our games for casual audiences performed below expectations, largely due to greater competition in the toys-to-life genre and we believe because of the casual audience's shift to mobile devices, which will benefit the company overall in the future. We want to be where our casual audience is. In light of the pending King transaction, we're exploring new opportunities on mobile.

While Skylanders performed below our expectations, we believe in its future and remain committed to the franchise. We will do what we always do, which is to make sure that we have right-sized the investment on our efforts in the category while continuing to introduce breakthrough innovations that our fans will love. We're excited about the innovations in the next Skylanders game launching this fall from the creators of the franchise and the genre, Toys for Bob. More on that in the coming months.

We expect to launch Skylanders Academy, a new animated TV series later this year, which will help extend the reach and the popularity of the franchise and introduce our characters and their adventures to new audiences. Next, Guitar Hero Live is a fun, high-quality game that introduced innovative new game play to fans, including the GHTV platform, which keeps our community engaged and will allow us to cost-effectively deliver new content and build our installed base. We plan to release new content, but not another full Guitar Hero console game this cycle.

Turning to Destiny, the Destiny community is one of the most passionate, loyal audiences for a game that we have ever seen. Our audience has logged nearly three billion hours in the game. We're excited to announce that we will be bringing a large new expansion to Destiny this year that players are going to love. We will also be delivering other content and events throughout the year to keep the community engaged. We are also working with Bungie on the sequel to Destiny, which will be coming in 2017, and we look forward to sharing more with you on this in the future.

Finally, Call of Duty, which continues to gain momentum and set new records. In quarters one through three, Call of Duty: Advanced Warfare over-performed our plan and the prior year with very strong performance on our digital season of content. In Q4, Call of Duty: Black Ops III exceeded our plan and the prior year in practically every key area: retail sell-in and sell-through, digital full game sales, digital in-game sales and season pass sales.

Black Ops III delivered the biggest entertainment launch of 2015, even beating Star Wars: The Force Awakens in its opening weekend. Black Ops III was the top-selling console game globally by a wide margin in both units and dollars sold through. In fact, according to NPD and GfK, we sold through more copies of Black Ops III than the two closest competitors in the genre combined.

On a franchise basis, Call of Duty was number one in North America for an incredible seventh year in a row and has now surpassed 250 million units sold life-to-date worldwide with over $15 billion in sell-in on full game and in-game content. Importantly, engagement on Call of Duty exceeded both our plan and the prior year. Call of Duty franchise monthly active users grew by 20% year-over-year in December and time spent grew by 30%. In fact, in November and December, we had the highest monthly active users in franchise history.

This reach and engagement is a promising sign as we look ahead to Black Ops III's upcoming 2016 season of content. Season pass sales for Black Ops III have increased significantly year-over-year, setting a franchise record for total sales.

We're seeing that players are deeply invested in personalizing their game play experience in the game. We launched Supply Drops for Advanced Warfare well after the launch of the game itself, driving significant player investment and strong engagement. We have already launched an early version of Supply Drops in Black Ops III and we plan to create more fun, new content for our fans to enjoy in the months ahead.

This Q4 we will have a new innovative Call of Duty game from our award-winning studio, Infinity Ward, the makers of the Modern Warfare series. And, of course, our esports initiatives on Call of Duty are transforming the experience for pro players and fans alike. Interesting Call of Duty esports continues to rise with a third more people watching the prequalifying matches for Call of Duty World League than watched the championship matches last year. The top teams in the world are competing each week in live broadcast competition to see who will qualify for the Call of Duty World Championships later this year. We'll broadcast 750 hours of competitive Call of Duty programming, but more importantly we'll inspire millions of Call of Duty fans to celebrate the game in a whole new way.

And now I'll turn the call over to Mike to talk about Blizzard.

Michael Morhaime

Thank you, Eric. 2015 was another strong year for Blizzard. We achieved an all-time high in active players and ended Q4 up nearly 25% in average MAUs year-over-year. On a constant currency basis we achieved even higher revenues in 2015 than 2014, which was a record year for us. These results reflect our careful and long held approach to growing our community and deepening their engagement with high-quality content.

In 2015 we expanded to new platforms and new regions, bringing our games to more players than ever before. In addition, we broke new ground with the first live telecast of a collegiate esports tournament on ESPN. And our ninth BlizzCon highlighted the amount of diversity and diversity of upcoming content in our pipeline. BlizzCon also showed the strong connection we have with our global community. More than 25,000 Blizzard gamers attended the show from all 50 states and nearly 60 countries. We had our highest live stream viewership ever with over 10 million people around the world tuning in, and we had record audience on pay-per-view as well. Our specific franchise highlights further demonstrate the value we see in delivering and supporting high-quality game experiences globally.

Hearthstone had a great quarter and a great year. For those who might not be familiar with Hearthstone, it's our free-to-play collectable card game on PC, Mac, tablet and mobile. It has very strong global appeal and it brought Blizzard to a new genre on new platforms with a new business model. Ahead of BlizzCon, Hearthstone surpassed 40 million registered players and it closed out December with record global engagement in multiple categories including MAUs. The introduction of Hearthstone on mobile last year was a big contributor to that.

We announced our new adventure, The League of Explorers at BlizzCon and launched it the following week. League of Explorers brings new cards, new game mechanics and a lot of personality. Despite the shorter window to launch and no presales as we'd had with our previous adventure, League of Explorers sold over 20% more units as of six weeks post launch. We also expanded Hearthstone into a new region. In October we released the Japanese version providing easier access for new and existing Japanese players.

Moving onto World of Warcraft, we saw quarter-over-quarter growth in Q4 as we kicked off presales at BlizzCon for our new expansion, Legion, which is coming out in the summer, and we released a new content patch. With Legion we're taking care to build off the best aspects of Warlords of Draenor to create an experience that appeals to an even wider audience and which offers more opportunities for sustained engagement.

Legion adds a new hero class, customizable weapons, class order hauls, which strengthen the social elements of the game and more. This will give players more compelling options for extending their experience. With this expansion we are again offering a character level boost immediately with pre-purchase. And for the first time, we're also offering early access to the new character class, which will be activated for everyone who pre-purchases the expansion once it's ready.

Before I move on, I want to thank our community for the generosity they showed with the World of Warcraft charity pet that we offered on behalf of Make-A-Wish. With our player support we achieved a new record for the donation we'll be making to Make-A-Wish, over $1.7 million. That reflects the passion and power of a very strong and very engaged community.

Next, Overwatch, our new IP, which will be a big step into a new genre for us as well as our first simultaneous release across multiple platforms. As with other Blizzard franchises, we have long-term plans to support this new IP with more content and also with external world-building efforts and a robust esports program. Overwatch made a lot of news in the quarter and continued to build momentum. We announced the remainder of the 21 hero launch lineup at BlizzCon and revealed the console versions of the game. We also began closed beta testing reaching top-viewed status on Twitch. In addition, we shared our plans to patch in more heroes after launch, which received a very positive response. We are excited about Overwatch's potential and we look forward to sharing more details as we get closer to its spring release.

One of our big highlights for the quarter was the launch of StarCraft II: Legacy of the Void. The new features and content make StarCraft II easier to get into than ever before, and we saw a lot of excitement with the launch. As of its first 24 hours, Legacy of the Void had sold through more than 1 million copies. In addition it received multiple awards for best strategy game of 2015.

At BlizzCon we announced a series of standalone digital mission packs featuring Nova, a popular character in StarCraft II and Heroes of the Storm. This content will give players exciting new options for continuing their StarCraft II experience, and it will be a great entry point for anyone new to StarCraft. We've been very pleased to see a very positive player response and look forward to releasing the first mission pack in the spring.

Q4 was also a busy one for Heroes of the Storm, our free-to-play team brawler that features iconic characters from across our bestselling franchises. With Heroes of the Storm, we've worked hard to push the boundaries of the genre, while keeping the game engaging and accessible for the widest possible audience. For example, at BlizzCon we announced a new game mode, The Arena, which will mix up gameplay with fun parameters, smaller maps and shorter sessions when it's released later this year. We also revealed our tenth Battleground and three new heroes at the show, including Cho'gall, a hero controlled by two players. Players around the world have responded with enthusiasm for unique heroes like Cho'gall, and with support for the experience that Heroes of the Storm delivers. Heroes of the Storm had a great close to the year, taking home multiple awards, including Best Competitive Multiplayer and Best MOBA from Game Informer.

I also want to touch on the Diablo III, which has a strong and active community nearly four years after launch. The game performed very well throughout 2015, in part due to our launch in China, which broke sales records there. Players and the media have been enthusiastic about the content we've added over time and our recent patch in January is no exception. There are new zones, legendary weapons, set dungeons and more. In addition we periodically restart seasons, refreshing the challenge for players. Diablo III continues to thrive in all regions and we appreciate all the support from players around the world.

We are also supporting community engagement and franchise growth outside of our games, particularly with world-class esports that represent the diversity of our portfolio and our audiences' interests. At BlizzCon we had our strongest esports lineup to date and crowned champions in Hearthstone, World of Warcraft Arena, StarCraft II and Heroes of the Storm, four very different but equally exciting esports experiences for attendees and spectators online.

Looking forward, 2016 will be our biggest Blizzard esports program ever. It will be Heroes of the Storm's first full year of global competition. In addition, Heroes of the Dorm collegiate tournament is return and we've added another evening of primetime coverage this time. With the final matches – The Heroic Four – playing out over two nights on ESPN 2. We also made changes to the StarCraft II World Championship Series and Hearthstone's Championship Tour to give local heroes even more opportunities to shine. And we're excited about our esports plans for Overwatch and look forward to sharing more details about that in the future.

With strength across all franchises and broader reach than ever, we're very enthusiastic about 2016. We are especially excited about the spring launch of Overwatch and look forward to releasing World of Warcraft Legion in the summer on the heels of the June release of the Warcraft movie. With all the content and activities we have planned, we expect another year of solid growth of the Blizzard community and we're very excited about the future.

As Bobby mentioned, Monday was Blizzard's 25th anniversary. We've poured our hearts into making great games for 25 years. We're very proud of the worlds that we've created and the great moments we've shared with our players. We are extremely grateful for the support of our players, and we look forward to many more adventures in the next 25 years and beyond.

Thank you, and I'll turn the call back over to Amrita.

Amrita Ahuja

Operator, we're ready for some questions.

Q&A

Operator

Thank you. [Operator Instructions] And we'll first go to Doug Creutz from Cowen and Company.

<**Q - Douglas L. Creutz**>: Hey. Thanks. Just on King just briefly, you can confirm that I can do math. With a $1.75 guide and 30% accretion, it sounds like you're expecting $1.35 from the existing business and $0.40 from King. And then the longer question is with King, most of King's peers advertise in their games and King does not. And I know King had some reasons why they made that decision, but I'm just wondering if you look at that, do you think that's a significant opportunity for King going forward? Thank you.

<**A - Thomas Tippl**>: Hey, Doug. So the way we think about advertising, we think of it as a proven part of large network entertainment businesses like Facebook, YouTube and even Twitch. And therefore we believe it could also be a huge opportunity for the network that we're building, particularly the parts that are accessible for free. Now all that said, we have and always will prioritize a great user experience above all else, and therefore this is an opportunity that we will approach with great care and is also the reason why none of it is factored into the plan and the numbers that we just shared with you today. But when you think about the future, we think there's a significant opportunity and with that significant option value there.

<**Q - Douglas L. Creutz**>: Great. And then just the question about guidance?

<**A - Dennis M. Durkin**>: Yes, Doug, it's Dennis. On that, due to the ongoing King transaction and the Irish regulatory restrictions until we get that approval, we're actually not able to unpack the specifics of the pieces. So we'll have to cover that as we get into our next quarterly call.

<**Q - Douglas L. Creutz**>: Okay, fair enough.

Operator

And we'll now move to Brian Pitz from Jefferies.

<**Q - Brian J. Pitz**>: Thanks for the question. A question on Destiny. Lots of change obviously going on at Bungie right now. Maybe you could comment on what it all means? And then any commentary maybe on micro transaction plans for the driving of ongoing engagement? Thanks so much.

<**A - Eric Hirshberg**>: Sure. Thanks, Brian. So, first of all, it's important for us to keep it in context and acknowledge that we have incredible success on our hands with Destiny that we've created with Bungie, the partnership between Activision and Bungie has proven to be a potent one and we don't see that changing. I think Bungie's proven themselves to be a capable team over many years and many games and combinations of leadership. So while the decisions that they made recently related to their organization are up to them, we're confident that our interests remain 100% aligned and that we're going to continue together to deliver amazing content for our shared fans.

On the second part of your question, Destiny is one of the most engaging games of all time and our first job is to make sure that it stays that way. So all the content that we're providing is designed to make sure that we not only capitalize on that engagement, but also continue to make the game better and better for our fans, and that's why we're planning on delivering a large expansion this year and more incremental content along the way to keep fans engaged. And of course we're looking forward to Destiny 2 in 2017.

<**Q - Brian J. Pitz**>: Great. Thanks.

Operator

And we'll now go to Neil Doshi from Mizuho.

<Q - Neil A. Doshi>: Great. Thanks, guys. Mike, can you maybe help us think about the units built into the guide for Overwatch? I know you guys don't really guide to units, but maybe help us think about other games in the past as a potential comp and how we should be thinking about Overwatch's contribution? And then what drove the solid growth in China revenue, and how much of that came from Call of Duty in China? Thanks.

<A - Michael Morhaime>: So you're right, we don't typically provide sales guidance. But what I can say is we're extremely excited about Overwatch. It's an important step for us into a new genre that we think has a ton of potential. We have seen a very positive response from players, over 8 million players have signed up for the beta test. Since beta we have been very happy with viewership interest on Twitch.

Overwatch is every bit a Blizzard game in terms of I think it exemplifies the design values that we have. It's a ton of fun, it's excellent gameplay, art style, interface. And so I think we're bringing a Blizzard take to an already very fun genre. We're looking forward to launching on PC and consoles on a simultaneous launch this spring. And like other Blizzard franchises, we have long-term plans to support Overwatch through ongoing content, world-building efforts outside of the game to build the franchise, the IP and a robust esports program. So we have a lot of reasons to be very optimistic that Overwatch will be an important long-term addition to our collection of franchises.

<A - Dennis M. Durkin>: Right. And then to the second – I guess maybe the first part of your question about China and sort of how China revenues have moved. A lot of the growth came over the course of the year by having – we obviously have more games in in-market than we've had in the past. But it was really broad-based performance across the portfolio. Diablo obviously had a very strong year, Hearthstone as well caught online, and the rest of the portfolio. So it was really the breadth of the portfolio, but it was really broad-based performance across the portfolio.

<Q - Neil A. Doshi>: Thanks, Mike. Thanks, Dennis.

Operator

And we'll now go to Arvind Bhatia from Sterne Agee.

<Q - Arvind Bhatia>: Good. Thanks for taking my question. I was wondering if just going back to the Call of Duty online China question, just how that's been trending throughout the year and as you exit 2015, now that you've had a little bit of time to see it ramp up, how is it performing relative to what you might have expected? And does your 2016 guidance contemplate meaningful contribution from that? Thank you.

<A - Eric Hirshberg>: Thanks, Arvind. The game has been growing revenues month-over-month for the last six months in a row and we believe that the updates we have planned for 2016 will further improve the game play and the performance. The updates to come this year are going include enhancements to the user interface, to onboarding, the addition of supply drops inspired by the success we've seen with that in our western products, esports features and social systems that will make our communities' engagement even stronger and additional modes and maps and characters as well. We also continue to work closely with Tencent to bring more people into the game, which is critical. So we remain optimistic about the game's opportunities and as we said when we launched the game into beta, it will take time to build the ramp.

<A - Dennis M. Durkin>: Relative to the second part of your question what's in the guidance, we have a very prudent I'd say ramp forward even though we have great aspirations for the opportunity that we have inside the game.

<Q - Arvind Bhatia>: Okay. Thank you.

<A - Eric Hirshberg>: Thanks.

Operator

And our next question comes from Colin Sebastian from Robert W. Baird.

<Q - Colin A. Sebastian>: Great. Thanks. Hoping you could add a little detail on the investment required to support both esports as well as the broader multimedia initiatives? And more specifically, how much upfront and ongoing investment or risk do you take on versus the media partners?

And then secondly, obviously you mentioned competition intensifying with some of the casual games, but just to confirm is there any macro related pressure either we're seeing through price discounting or sell through that you can identify? Thank you.

<A - Robert A. Kotick>: So I'll take the first one, Colin. So as we said there isn't a significant investment in the esports individual operating unit initiative or in the other broader media areas. But what we step back and look at is ESPN. And when you look at ESPN with 80 million subscribers and you see the flight of some of the subscribers, and the opportunities that we see there is roughly $5 billion of operating profit there, $4 billion of league payments for the broadcast rights, and we have 80 million of our own players.

And over a long period of time we think that watching a video game competition is going to be a tremendous opportunity. It doesn't require a very big investment today, it just requires us to have and in fact most of the efforts we have are funded by things like organized competition ticket fees, but when you look at what the opportunity is for the future to enhance engagement, to build and strengthen our franchises, to celebrate our players, to provide rewards and recognition for our players; these initiatives are really important for the building of engagement and enhancing the value of our franchises.

<A - Robert A. Kotick>: And I guess just to build on that from the investment side, all of our investments start with great people, we now have great leaders in those businesses to prudently invest behind, but as we always are, we're being very choiceful in how we invest and disciplined about the gated investments in those areas. This year it's really less than a couple pennies of investment that will go into our new divisions from an overall company EPS perspective. And most of that is against the media networks which is our esports division that Bobby was referencing there.

We do have additional esports investments in some of our business and franchise level details like Mike and Eric alluded to, but we think those are more around demand generation than anything and help support the franchises that they cover.

On your other question, Colin, around macro environment and sort of competitive aspects, it is, yeah, you hit on the obviously Skylanders and Guitar Hero points where in the casual segment on console there was more competition, that feels more category specific. When we look more across the broad base of our business, we feel we haven't really felt many of the macro trends that are sort of – and volatility we've seen in the overall market really affecting our business. And in fact, many of the digital trends when you look at our biggest franchises are stronger than ever. And in fact, in many new regions, even regions that are experiencing some turmoil like China, we've had great growth in the past year. So for us, it's more about delivering great content on cadence that will be the most important thing for us.

<Q - Colin A. Sebastian>: All right. Thanks, guys.

<A - Robert A. Kotick>: Thanks, Colin.

Operator

And we'll now go to Eric Handler from MKM Partners.

<Q - Eric O. Handler>: Yes. Thanks for taking my question. Interested – what do you think is going to be the planned cadence of releases for Hearthstone this year? And maybe how should we think about the key drivers of growth there in terms of users, specifically like what markets are showing the best growth, and is there still growth drivers among the digital platforms? And also, when you think about higher spending per user, what's going to be the key driver of that?

<A - Michael Morhaime>: Okay. Regarding cadence, we definitely have plans for some great new content this year, but we're not quite ready to discuss the timing. I can confirm that our next expansion will be out in the spring.

As for growth drivers, we've consistently seen strong engagement pretty much universally globally, and we plan to continue supporting that with new content for the foreseeable future. Bringing Hearthstone to mobile last year drove a lot of growth, as did releasing a good amount of new content. We also plan to support the community around social events for the game such as fireside gatherings and high-profile esports experiences. This also drives engagement. In addition, we'll be looking at geographical expansion opportunities like we did last year with Japan. In general, spending does increase around new content, so we're focusing on providing great experiences with new content and making careful design decisions to make sure we protect the long-term health of the game.

<Q - Eric O. Handler>: Great. Thanks, Mike.

Operator

And our last question will come from Chris Merwin from Barclays.

<Q - Chris Merwin>: Great. Thank you. I just had one. For all of your titles, what percentage of unit sales were digital downloads in the fourth quarter? And as it relates to your 2016 guidance, what are you implicitly factoring in for digital downloads, and what would that imply for gross margins? Thanks.

<A - Robert A. Kotick>: Hey, Chris. Thanks. Obviously, the digital transition has been a very nice tailwind for us over the past several years. And really, front-line console games are the final part of that transition, but it's only really part of the equation. As we mentioned in the call in Thomas's remarks and my remarks, the add on content in services which is purchases effectively after the initial sale are really increasingly more important or as important and are growing incredibly fast and is one of the fastest parts of our digital portfolio.

To your question, though, on front-line titles, it really varies by title. So for games like Destiny, it had, in the high-20%s in terms of digital downloads. In terms of overall volume for Call of Duty just based on the size of the player base, full game downloads were a lower share than that, although on an absolute basis, full game downloads were up over 80% year-over-year, so very nice progress there. And we know when we look at the Blizzard side of our portfolio on the PC, the vast majority of those front-line games are delivered digitally.

Obviously that brings margin benefits for us as each new game gets delivered through digital channels, brings us gross margin benefits, and you'll see that in our overall corporate margin. We were at 32% this year, and with currency effects or excluding the currency effects, it would have been north of 34%. So overall, we think that trend is going to continue on the console side, particularly on the front side, and it will be a nice tailwind for us for 2016 and beyond.

<A - Thomas Tippl>: Chris, the vast majority of what we create are zeroes and ones, and when you look out over 500 million people in the network, you're going to see for the first time we really have the opportunity to sell our products in virtually every country in the world on every type of device, whether it's a mobile device, a desktop device or a console. And so the most important thing for us is engagements across our communities and then the opportunities for delivering player investment follow from there.

<Q - Chris Merwin>: Great. Thank you.

Dennis M. Durkin

All right. Thank you. Well, we appreciate the time today, and we look forward to talking to you on our Q1 conference call in the spring.

Operator

This concludes today's presentation. Thank you for your participation.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2015-11-03
Event Description: Q3 2015 Earnings Call

Market Cap: 27,309.72
Current PX: 37.35
YTD Change($): +17.20
YTD Change(%): +85.360

Bloomberg Estimates - EPS
Current Quarter: 0.863
Current Year: 1.362
Bloomberg Estimates - Sales
Current Quarter: 2198.733
Current Year: 4717.389

Q3 2015 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Riccardo Zacconi
- Dennis M. Durkin
- Eric Hirshberg
- Michael Morhaime

Other Participants

- Chris Merwin
- Douglas L. Creutz
- Neil A. Doshi
- Arvind Bhatia
- Eric J. Sheridan
- Ben Schachter
- Brian J. Pitz
- Drew E. Crum

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to the conference. Today's presentation is being recorded. I would now like to turn the call over to Amrita Ahuja, Senior VP of Relations.

Amrita Ahuja

Good morning and thank you for joining today's call. We have a lot of exciting news to share with you. First, our proposed acquisition of King. Then Activision Blizzard Third Quarter Earnings Results, followed by Q&A.

I'd like to remind everyone that during this call, we will be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. These forward-looking statements include comments about our plans and expectations regarding Activision Blizzard's pending acquisition of King Digital Entertainment as well as our comments about our outlook and other future plans and expectations that we'll provide during the earnings report portion of this call.

A number of important factors could cause actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors indicated on the slide that is showing and those discussed in the Risk Factors section of Activision Blizzard's and King Digital Entertainment's SEC filings.

In particular, all of our statements with respect to the expected impact of the acquisition are subject to the risk that the acquisition may not be completed, or may not be completed on the expected timeline. The forward-looking statements in this presentation are based on information available to Activision Blizzard and King Digital Entertainment as of the date of this presentation. And while we believe them to be true, they may ultimately prove to be incorrect.

The companies undertake no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, November 3, 2015, or to reflect the occurrence of unanticipated events.

I would like to note that Activision Blizzard prepares its financial information in accordance with U.S. GAAP and King Digital Entertainment prepares its financial information in accordance with IFRS as issued by the IASB. Certain numbers we will be presenting today will be made on a non-GAAP basis for Activision Blizzard and on a non-IFRS basis for King Digital Entertainment. We refer to these measures as non-GAAP measures. Please refer to our Rule 2.5 announcement which is available at Activisionblizzard.acquisitionoffer.com and Activision Blizzard's Earning Release which is posted on Activisionblizzard.com for the applicable reconciliations of these non-GAAP measures and further explanation.

There are also two PowerPoint overviews, one with respect to the deal and one with respect to Activision Blizzard's Q3 results which you can access with the webcast and which will be posted to the websites following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results in a one-page summary.

Please note because this an Irish public company deal, there are certain limits on what we can say, specifically our statements must be limited to matters disclosed in the Rule 2.5 announcement which was released last night, and we won't be able to go beyond what is presented in that document. Irish law also places certain limitations on what are deemed to be profit forecasts, so we are more limited in what we can say about future prospects.

Now speaking on the call today will be Bobby Kotick, our CEO; Thomas Tippl, our COO; Dennis Durkin, our CFO; and Riccardo Zacconi, CEO and Co-Founder of King Digital Entertainment. Later we will be joined by Eric Hirshberg and Mike Morhaime to review Activision Blizzard's quarterly overperformance. And now, I would like to introduce our CEO Bobby Kotick.

Robert A. Kotick

Thanks, Amrita. Over the last 25 years, we've demonstrated a consistent ability to identify opportunities to serve and support our audiences and deliver superior value to our shareholders. We're disciplined, deliberate and methodical whether in the development of new franchises, entering new segments and geographies and, perhaps most importantly, identifying transactions with great opportunity for shareholder value creation.

With respect to the latter, we've had very positive results and track records over the last 25 years because we care deeply about how we allocate our capital and prioritize our opportunities. The way we considered King is consistent with our proven history of evaluating acquisition opportunities. King operates in a rapidly-growing segment. They have a truly world-class management team, exceptional game development talent and great commercial instincts. The transaction is accretive, brings new audiences, and the King Corporate DNA is oriented towards great game making with commercial potential.

When we merged with Blizzard Entertainment, we found the right partner with extraordinary leadership. And when others dismissed the sustainability of Blizzard's incredible capacity for innovation, we were certain patience would be rewarded. And it has. We see a lot of the same characteristics today in King. We think now is the right time to enter mobile gaming in a meaningful way. Widespread mobile access around the world has opened up significant demand for engaging, fun content that players can enjoy anytime, anywhere.

By acquiring King, which has a proven ability to turn its games into iconic franchises, we will be a participant in the fastest-growing segment in gaming, a category that today is estimated to be $36 billion. It's still extremely fragmented and we believe has great promise for the future. We also believe King's management team, including Riccardo, Sebastian and Stephane, are some of the most talented executives in the game industry.

We've long admired their talents and after spending a lot of time over the last three years getting to know the King team, we realized how truly special their company is. They have over 1,600 incredibly talented people committed to a community of more than 450 million monthly active users. Acquiring King will solidify Activision Blizzard's position as the world leader in interactive entertainment, positioning the combined company for growth across platforms, audiences, genres and business models.

Combining Activision Blizzard's portfolio of some of the very best interactive entertainment franchises on the console and PC with King's leading mobile titles will create a world-class portfolio of games with strong endearing appeal to a wide range of demographics and audiences along with leadership positions across key platforms. The number one console franchise was Call of Duty, the number one PC franchise was World of Warcraft, and now two of the top five highest-grossing mobile games.

We'll have one of the largest entertainment networks in the world, with over 0.5 billion monthly active users, immediately opening up meaningful opportunities to grow and cross-promote content to provide enhanced offerings to our collective players while expanding into untapped geographies. The combined company will have diversified capabilities across business models, like subscription, up-front purchase, free-to-play and micro transaction.

Through our world-class properties and enhanced capabilities across segments and business models, we'll be able to diversify our revenue streams, enhancing our position as the most profitable interactive entertainment company in the world. The result is a transaction that will be accretive to estimated 2016 non-GAAP EPS estimates by approximately 30%. I couldn't be more excited to welcome King into the Activision Blizzard family.

And now Thomas will share with you the specifics of the transaction.

Thomas Tippl

Thanks, Bobby. Under the proposed transaction, Activision Blizzard will acquire all of the outstanding shares of King for $18 in cash per share for a total equity value of $5.9 billion or an enterprise value of $5 billion, representing a multiple of approximately 6.4 times King's estimated 2015 adjusted EBITDA. This transaction will be financed through a mix of offshore cash and fully committed debt financing. This will enable us to maintain a strong balance sheet and conservative leverage.

Following today's announcement, our path to completion is subject to approval by the Irish High Court, the U.S., EU and other antitrust regulators as well as other customary closing conditions. In addition, the transaction is subject to a vote by King's shareholders. Apax and key management shareholders have committed to voting their shares in favor of the transaction. All in all, we expect the transaction to close by spring 2016.

Once the transaction closes, King will operate as an independent operating unit of Activision Blizzard, similar to how Blizzard Entertainment operates. We have an excellent track record of integrating with minimal disruption and in a way that maintains the organization's culture, creative independence and ability to really thrive. As Bobby said earlier, King's management team has been integral to their success. Riccardo, Sebastian and Stephane will continue to lead the business and they've all signed long-term contractual commitments.

We think this acquisition is an exciting opportunity for everyone connected to Activision Blizzard and to King. This is a very compelling transaction from a financial perspective. Together, we'll have more diversified and recurring revenues, a strong balance sheet and strong liquidity. King's shareholders will also be getting a 20% plus premium to the recent share price and liquidity. And we'll be able to speed up our ability to capitalize on meaningful long-term growth opportunities. We'll reach more players across more audiences and expand our presence in fast-growing regions, such as Asia.

One of the most exciting things about this deal is what it means for our communities of players. By putting these two companies together, we'll have greater capabilities and expertise to enrich the player experience, an expanded network to reach players in virtually every country across the world and more resources to amaze and delight our players. We want to be wherever our players are, whether they are at home on consoles or PCs or out on their smartphones and tablets, and this deal enhances our ability to do just that.

I also want to talk to you about employee culture. It's something that's incredibly important at Activision Blizzard and something we really think sets us apart. We have a track record of attracting and retaining top talent. This is incredibly important in the entertainment and technology industries. And one of the reasons we are able to do this is because we have deep respect for the creative process. We are the destination for the best talent in the business. Activision Blizzard's commitment to innovation, talent development and the creative process is 100% mirrored in King's culture.

For Activision Blizzard debt holders, this transaction accelerates the promising path we are already on to build out our diverse portfolio, grow our predicable recurring revenue streams and generate strong cash flows while maintaining strong liquidity. This financial profile puts us on the path for near-term deleveraging and further supports our already investment grade financial profile. In fact, last night Moody's upgraded the company's debt ratings to investment grade upon announcement of the deal. King and Activision Blizzard are a great fit for all stakeholders and we're excited about what we'll be able to accomplish together.

As Bobby mentioned earlier, our long-term strategy has been focused on innovating on new high-growth platforms, expanding our franchise portfolio with captivating and original new intellectual property and building our capabilities to create compelling offerings to our diverse player base across genres, platforms, business models and geographies. You will hear more during the second half of this call about our strong results, which are further evidence that our strategy is working.

And this transaction meaningfully accelerates that growth strategy by providing Activision Blizzard with a leadership position in mobile gaming, the largest and fastest-growing segment of interactive entertainment, which is expected to grow by more than 50% from $36 billion in 2015 to $55 billion by 2019. Mobile franchises are now reaching results similar to established console franchises. King in particular has shown repeat success with multiple titles, and the leading franchises demonstrate a track record of continued success.

The combined company will have a world-class portfolio with some of the world's most iconic franchises in the entertainment industry across key platforms. Activision Blizzard knows how to create, develop and sustain a portfolio of titles and turn them into iconic franchises with long-lasting appeal and deep engagement. The names you see on this slide are some of the most successful interactive entertainment franchises in the world.

What attracted us to King is that, in similar ways to us, they have a proven ability to extend the success of their core titles, developing them into proven franchises. Together we'll be able to apply our highly complementary strengths, assets and operational expertise to drive deep year-round engagement and digital revenue streams and build upon our proven development models to bring new content to more audiences across genres.

Our combined audience will have more than half a billion monthly active users, making it one of the largest entertainment networks in the world. Our audience includes a broad diversity of demographics in almost every country around the globe. The ability to cross-promote our industry-leading franchises across this highly engaged network is incredibly exciting.

As part of our growth strategy, not only do we have some of the leading owned intellectual property in interactive entertainment, but we've been building capabilities across platforms, genres, business models and geographies.

It is clear that our acquisition of King provides important, highly complementary capabilities in key areas: in mobile, free-to-play and the ability to reach casual gamers in emerging geographies. Our capabilities in infrastructure have never been better, and we've never been in such a great position to deliver content to any audience on any platform. That is an exciting prospect for not only our fans, but for our employees and for our shareholders as well.

Now let me introduce Riccardo, who will walk you through King's business.

Riccardo Zacconi

Thank you, Thomas. I would like to share a little about King, especially for those who are [audio gap] (15:14) company. King is a leader in mobile gaming and has been developing games since 2003. We have created a strong organization with 12 studios in Europe, Asia and the U.S. that are driven by dedicated world-class talent. King has a portfolio of best-in-class franchises that include the top grossing games within their sub-genres. Our four franchises, Candy Crush, Farm Heroes, Pet Rescue and Bubble Witch, are category-leading brands. We operate them as a live service and continually give our players new, highly-engaging content by adding new levels, time-based live ops and extensions with innovative modes of play.

We also launched new games within our existing franchises. Candy Crush Soda Saga is our highly successful sister title to the original hit, Candy Crush Saga. We have seen that these efforts have transformed our games into true game franchises. In third quarter 2015, more than three years after the original launch of Candy Crush Saga, an average of 92 million people played Candy Crush games every day.

The popularity of our games and success of our monetization and franchise strategy have translated to a leading position in the mobile gaming business. We have had two of the top five grossing games on the Apple App Store and Google Play Store in the U.S. for three consecutive quarters, and at least three of the top 15 grossing games for seven consecutive quarters.

We have built one of the largest networks of mobile game players, with 474 million monthly active users in Q3 who played 1.4 billion games per day. Our network is a key asset for launching new games through cross-promotion.

We are excited about what we bring to the combined company. We have a strong pipeline which includes new franchise games and other new games to diversify our portfolio into new genres, which we have just begun with our first non-casual game launch.

Since our company already has a strong presence globally, we see meaningful opportunities in key Asian markets. Our strength as a company is reflected in our robust financial profile, with significant scale and profitability. In the 12 months ended September 30, we generated $2.2 billion of gross bookings and $875 million of adjusted EBITDA for a 42% adjusted EBITDA margin. We have a highly cash-generative business with $920 million of cash on our balance sheet.

We think we can have the combined company win in mobile. We have one of the largest networks, not just for a gaming company, but across the mobile sector with 474 million monthly active users and 133 million daily active users in Q3. We have a portfolio of best-in-class game franchises on mobile, which are top-grossing in their respective sub-genres, and a multi-year plan to operate our franchises with three new games planned for launch by the end of 2016.

In addition to our focus on our franchise business, our strategy is to leverage our reach and capabilities to answer new genres. We recently launched our first resource management game and expect to release our first mid-core title in 2016. Through this transaction, I think that both King and Activision Blizzard will be able to better serve our players by leveraging our complementary strengths, assets and operational expertise.

We also will have the ability to cross-promote games, providing our players more opportunities to engage with our content. Activision Blizzard has a long history of building, maintaining and growing what I think are iconic and successful franchises, and I believe we can benefit from their experience.

Our third quarter performance reflects the continued strength of our business. Our preliminary third quarter 2015 results include gross bookings of $502 million, which exceeded the high end of our guidance range. Adjusted EBITDA for the period was $180 million for a 38% adjusted EBITDA margin.

Our player metrics for the quarter, 474 million monthly active users, 330 million monthly unique users, and 133 million daily active users underscore our massive player network. Built on the timing of game releases and recent trends, King expects gross bookings in the fourth quarter to be between $475 million and $500 million. We look forward to sharing more with you about our third quarter performance during our earnings call tomorrow.

In closing, I think this deal makes sense because it makes us stronger in the industry, it brings together two world-class teams, and it gives our shareholders an attractive liquidity event. And we look forward to working together with Activision Blizzard and I'm very excited.

Dennis M. Durkin

Thanks, Riccardo. As Bobby, Thomas and Riccardo have mentioned, we're incredibly excited to be combining the capabilities and portfolios of our companies together. This transaction enhances Activision Blizzard's current position as the most profitable standalone interactive entertainment company.

We expect accretion to 2016 estimated non-GAAP revenues and earnings per share of approximately 30% based on IBES Consensus estimates. The transaction is also significantly accretive to 2016 estimated free cash flow per share.

We'll be combining Activision Blizzard's trailing 12-month non-GAAP revenues of $4.7 billion with King's trailing 12-month adjusted revenues of $2.1 billion, and combining Activision Blizzard's adjusted EBITDA of $1.6 billion with King's $0.9 billion over the same period. Importantly, the accretion figures detailed in this presentation do not include potential synergies that could come from cross-promotion and shared capabilities for the combined company.

Activision Blizzard's business today generates the bulk of its revenues from its high-performing Console and PC businesses, which, as we will discuss during our Q3 earnings report, continue to perform very well and are increasingly shifting to higher margin digital channels with increasingly long tails of player engagement and monetization.

King generates virtually all of its revenue from high-margin digital platforms, with the vast majority of it on mobile. The industrial logic of combining these businesses, bringing leadership in gaming across PCs, consoles and mobile platforms, is highlighted by the balanced post-deal revenue mix of roughly one-third coming from each of these platforms. In addition, the combined company will be an online services business with roughly two-thirds of the combined revenue being delivered digitally.

One of the things we've learned from our Blizzard merger is that a broader IP portfolio across more platforms creates a diversified and highly profitable financial profile, which in turn provides us with more capital to reinvest in innovation and to deliver the great content that our fans expect. And with the acquisition of King, we will now have some of the world's leading interactive entertainment franchises, not only on PC and console, but mobile as well.

Now let's turn to balance sheet and look at the sources and uses of capital as well as the combined capitalization of the company. As mentioned earlier, the acquisition of King is an accretive use of Activision Blizzard's offshore cash. The transaction will be funded with $3.4 billion in offshore cash from our balance sheet along with $2.3 billion coming from a fully-committed term loan financing led by Bank of America Meryl Lynch and Goldman Sachs and around $200 million of rollover unvested equity awards. The combined company's capitalization will also maintain a conservative balance sheet with strong liquidity.

Having a strong balance sheet with deep capital resources is very important to us, and the transaction further diversifies and reinforces our financial profile. And as Thomas mentioned, just last night, Moody's upgraded all of our debt rating to investment grade upon announcement of the deal, which is obviously great recognition for the progress we have made in the past two years since we raised debt for the first time.

So in summary, Activision Blizzard's acquisition of King solidifies us as a world leader in interactive entertainment and positions us well for future growth opportunities. The transaction accelerates our current growth strategy as it provides us with a leadership position in mobile gaming, the largest and fastest-growing gaming segment, and it adds to our portfolio of iconic interactive entertainment franchises. It is also highly accretive to earnings and free cash flow per share while still providing King's shareholders with the premium and liquidity. And most importantly for the long-term growth prospects of our business, our acquisition of King brings with it a committed management team with a proven track record and talented employees with aligned objectives to drive innovation to better serve our player communities. So we couldn't be more excited than we are now to have Riccardo, Sebastien, Stephan and the entire King team as part of the Activision Blizzard family.

I will now turn the call back to Thomas to kick off our Q3 results discussion.

Thomas Tippl

Thank you, Dennis. I will now turn to Activision Blizzard's earnings results for the third quarter of 2015. Our strong results reflect our strategic focus on expanding our franchise portfolio with innovative new intellectual property, broadening our reach by expanding out to new platforms and geographies and driving deeper engagement through regular content updates that delight our audiences.

We outperformed our Q3 targets on revenues, digital growth and earnings per share and we are raising our full-year outlook yet again. We project year-over-year revenue and EPS growth at constant FX. We will continue to invest in our franchises through the holidays to build our install base, given the increasing opportunity of back-end revenues. This investment sets us up for continued organic growth in 2016 and beyond. And of course the addition of King to our portfolio presents additional opportunities for growth ahead.

As we successfully transition from a launch to a year-round engagement model, our audience base and the total amount of time people spend with our franchises continue to grow. In the third quarter, our monthly active users grew by 27% year over year, and the amount of time our communities spent playing Activision Blizzard games grew by 23% year-over-year. Our audiences yet again logged nearly 3.5 billion hours of game play in the quarter, not including rapidly growing hours spent spectating. You will hear more about our strategic initiatives at Investor Day later this week at BlizzCon, where you will also get to see some of the industry's most exciting eSports Championships. We look forward to seeing you there.

And now I will turn the call over to Eric to discuss Activision Publishing results.

Eric Hirshberg

Thanks, Thomas. Activision Publishing delivered another record quarter with record non-GAAP operating income, which at constant FX was up by over 50% versus last year's Q3 performance. We also drove monthly active users up by 17% year-over-year, continued to have three of the top-five next generation games life to-date and had the largest digital revenues in our history both in Q3 and year-to-date. Our results are due to our proven ability to turn great games into long-term franchises with large passionate communities. We strategically and methodically expanded our portfolio to include three such industry-leading franchises, each of which gamers enjoy playing year-round.

We've also just relaunched what we hope could become our fourth major franchise with Guitar Hero Live. We are only two weeks in, but early reception from fans and critics has been very positive. While sell-through comparisons to prior games from five years ago aren't exactly apples-to-apples, our current sell-through is significantly up versus each of the prior two Guitar Hero titles. As you know, unlike past games, we also designed Guitar Hero Live to be a living platform to keep players engaged, and so far, people are responding well, with average engagement per player reaching nearly two hours per day. The game has also been featured in a wide array of the most influential must-have holiday toy lists. All that said, it's still very early and we anticipate that this title will ramp towards the holiday, which is why we have over half of our marketing investment this year still yet to come.

Moving onto Destiny, we launched The Taken King in September with our partners at Bungie to an extremely positive reception from fans and critics. Day one downloads broke Sony PS4 records, day one engagements saw the highest number of active players in Destiny's history. Daily player engagement is now well north of three hours per day, and the Destiny community has now over 20 million registered players – 25 million registered players.

For new players, The Taken King Legendary Edition gives new players the original Destiny game, both expansion packs and The Taken King all for the same price as a regular console game. We've also successfully introduced great new content into the game which allows our players to express themselves and personalize their experience, which is available via in-game purchases and has caused a number of Thriller dances in-game to increase dramatically.

On to Skylanders, which launched at the end of September with Skylanders Superchargers, our first game featuring both vehicle and character toys. I said in our last call that we expect the competition to continue to increase in the toy select category which we invented. And it has. I also said we will continue to lead because we deliver the best games and the biggest innovations. And we are, with Skylanders remaining the biggest franchise in the toy select category year-to-date.

Superchargers and the addition of vehicles into Skylanders have been positively received by both critics and fans. It's also one of our most engaging Skylanders games ever, with more choice per player than last year. But even though Supercharger sell-through is down year-on-year due to increased competition, we are investing in the holiday to maintain our leadership position, and we're optimistic that we'll see category expansion in the holiday. The full game will once again be available on tablet and for the first time on iPhone and Apple TV as well.

As I mentioned on our last call, we are in development on a major new mobile initiative called Skylanders Battlecast which brings cards to life in a free-to-play card battle game. The game is looking great and we expect it to launch in 2016.

Last, but not least, Call of Duty. The year so far has been phenomenal for the franchise, with revenues up double-digit percentages both this quarter and year-to-date. The over-performance has been driven by: 1) higher advanced warfare selling; 2) deeper engagement from our community, driving up performance on season pass, DLC and the new consumable micro-transaction feature Supply Drops; and 3) strong catalogue sales of Black Ops which have ramped with consumer anticipation for Black Ops III.

In fact, monthly active users for Black Ops II grew quarter-over-quarter again to a new record of nearly 12 million monthly active users. And on today's level of engagement for a game, that is now three years old, and only available on Old Gen.

This brings me to our most anticipated launch of the year, Call of Duty Black Ops III. We couldn't be more excited about the launch this Friday. We have strong momentum indicated by a number of factors, but just to name a few, the growing engagement around the past Black Ops titles, the significantly year-on-year lift in pre-orders, consumer sentiment around our marketing assets which is more positive for Black Ops III than any Call of Duty title on record, a great partnership with Sony across consumer, trade and custom PS4 bundles, and our ranking as Neilson's Number One Most Anticipated Title of the Year.

Even more importantly, we've got the game. It is simply awesome. With innovations across single-player, multi-player and of course, zombies, Black Ops III has more content and more surprises packed inside than any game we've made to-date.

So in closing, we've had a great first three quarters built on innovative games that engage our passionate fans and the stage is set for a strong Q4. I look forward to seeing you and sharing more at Investor Day this Friday.

And now, I'll turn the call over to my good friend, Mike, to discuss Blizzard.

Michael Morhaime

Thank you, Eric. Q3 was another strong quarter for Blizzard. We had significant activity across our franchises and our MAUs for the quarter were up 50% year-over-year. Blizzard continues to be well positioned for growth. We're operating more franchises on more platforms and in more regions than ever before. We have an exciting upcoming content of late. And we're continuing to foster powerful connections with our community, online, through our pro and amateur eSports programs and at live events like BlizzCon.

Hearthstone in particular had another great quarter, driven by the launch of The Grand Tournament expansion. Along with continued strength on mobile and continued strong performance in all markets, the new expansion helped push engagement for Hearthstone even higher in Q3 than in Q2. Year-over-year engagement was up 77%, leading to Hearthstone's highest ever quarterly revenue. In addition, we recently launched a fully localized version of Hearthstone in Japan. The game already had an established audience in Japan, but we were pleased to provide them, as well as new players, with a version that makes access even easier.

Activity around Hearthstone eSports is also continuing to grow and drive excitement. Over the past few months, we concluded several tournaments feeding into the World Championship at BlizzCon. For World of Warcraft this quarter, we released a key update, which helped maintain stability in the subscriber base, and we're currently at work on the next update. We also had very exciting news at Gamescom, with the announcement of World of Warcraft Legion, our next expansion. Players responded very positively, not only to the new features coming with the expansion, but to the care we're putting into the content. In addition to hosting the World of Warcraft Arena Championship, we'll have more to share on Legion at BlizzCon this week.

On the StarCraft II front, excitement for Legacy of the Void, which will be sold as a standalone product launching on November 10, remains strong. In fact, pre-purchases for Legacy of the Void have continued to outpace those for the previous release, Heart of the Swarm. At the professional level, the StarCraft II World Championship Series competition has been intense and extremely fun to follow. I encourage everyone to tune in at BlizzCon or online for the final round. It's amazing to see some of the most skilled pro gamers in the world in action.

As for Diablo III, we were pleased that it continued to bring in new players in Q3. And in China, it passed the 2 million sales milestone. We released a huge well-received content update in the quarter. All together, we've added a ton of post-launch content to Diablo III, and this reflects our strong commitment to the game and to the community.

Heroes of the Storm also brought in more players in Q3, driven in part by our Diablo-themed content series. While we are still in the early days for the game, it's been great to see the ongoing enthusiasm and support from players as the community continues to come together. We held the regional championships for our Road to BlizzCon series, including the Americas Championship in Las Vegas and the European Championship in Prague over the past few months. These events featured teams with international followings across multiple games, which is exciting for the Heroes of the Storm community and for eSports as a whole. We're looking forward to seeing the winners of the regional championships face off at BlizzCon for the World Championship title.

There is also a lot of ongoing excitement around Overwatch, which just started its beta test last week. We've already had more than seven million players sign up to participate, and that's not including China. We're keeping access limited in order to focus feedback, but we plan to periodically run stress test weekends around the world that will allow many more players to join in. We'll be sharing the latest Overwatch news at BlizzCon, so I hope you will tune in.

As you can tell, we're very excited about BlizzCon and all the eSports action taking place there this week. BlizzCon represents the depth and breadth of our portfolio and the height of eSports competition in our games. It's a massive undertaking and it wouldn't exist without the super-passionate, highly-engaged audience of Blizzard gamers around the world. Tickets again sold out very quickly and we're using more of the Anaheim Convention Center than ever before to host the 25,000-plus live attendees.

The BlizzCon Virtual Ticket is again available this year and viewers will have multiple channels for catching as much of the show as possible. We'll be broadcasting the opening ceremony and all the eSports events for free globally and we're expecting the total audience to again number in the millions. You can tune in via BlizzCon.com.

Duncan Jones will be there to talk about the Warcraft movie and he'll debut the commercial trailer during our opening ceremony. We're also happy to have Wil Wheaton hosting our community contests, and Linkin Park will help close out the show on Saturday night. I look forward to seeing those of you who will be attending, and I encourage everyone else to follow the action online.

Thanks. And I'll turn the call back over to Dennis.

Dennis M. Durkin

Thanks, Mike. I will now review our better-than-expected Q3 financial results and our raised outlook for Q4 and the full year 2015. Unless otherwise indicated, I will be referencing non-GAAP measures, so please refer to our earnings release for full non-GAAP to GAAP reconciliations.

For the quarter, on a GAAP basis we generated revenues of $990 million, up 31% year-over-year, and operating margin of 20% and GAAP EPS of $0.17, up $0.09 versus our August guidance. For the quarter, on a non-GAAP basis we generated revenues of $1.04 billion and operating margin of 24%, up 190 basis points year-over-year, and EPS of $0.21. We outperformed our August guidance by $110 million on revenue and $0.07 on EPS. At constant FX, our year-to-date revenues are up 5% ahead of last year and EPS is 35% ahead of last year despite the tougher comp with last year's Diablo III expansion and Destiny's full game launch.

Importantly, total digital revenues grew 38% year-over-year or 50% at constant FX to an all-time quarterly record of $697 million. A significant driver of that growth was sales from digital add-on content, which grew 60% year-over-year or 75% at constant FX. Our digital full-game downloads also grew 39% year-over-year or 48% at constant FX, largely driven by the Destiny expansion launch.

There are a few key franchise drivers worth highlighting. Hearthstone had its highest revenue quarter yet with the launch of its expansion, The Grand Tournament, in August. Destiny's operating income grew by a double-digit percentage year-to-date on the back of the launch of The Taken King in September. Skylanders SuperChargers launched to great fan and critical reception, though into a more competitive landscape. Activision's Call of Duty and Blizzard's Diablo III and Heroes of the Storm continued to perform well and attract new players. And World of Warcraft subscribers stabilized at 5.5 million subs in the quarter. And note that this is the last quarter that we plan to provide the subscriber number as there are other metrics that are better indicators of the overall Blizzard business performance.

In terms of EBITDA, in Q3, we generated non-GAAP adjusted EBITDA of $275 million and $1.63 billion on a trailing 12-month basis. Operating cash flow on a trailing 12-month basis was $1.36 billion, up 39% year-over-year, and free cash flow was $1.25 billion, up 43% year-over-year.

Turning to the balance sheet. As of September 30, we had approximately $4.5 billion in cash and investments, of which approximately $870 million was held domestically. We had total debt of $4.12 billion and net cash of approximately $400 million. We had no share repurchases in the quarter.

Turning to FX, please note that as discussed on our prior earnings calls, the strong dollar has and will continue to be a headwind this year as our international revenues are translated at lower rates than last year. In Q3, the year-over-year impact of the strengthening of the dollar was $85 million on revenue and $0.05 on EPS. Year-to-date, the year-over-year FX impact was $239 million on revenue and $0.16 on EPS.

Now let's turn to our outlook for Q4 and full-year 2015. First for Q4, on a GAAP basis we expect net revenues of $1.22 billion, product costs of 30% and operating expenses of 57%. We expect GAAP and non-GAAP interest expense of $51 million, a GAAP tax rate of 39%, a GAAP and non-GAAP share count of 753 million and EPS of $0.09.

For Q4 on a non-GAAP basis, we expect revenues of $2.15 billion, product costs of 25% and operating expenses of 35%. We expect a non-GAAP tax rate of approximately 24% and non-GAAP EPS of $0.82. Note that our guidance is at FX spot rates, as laid out in the accompanying slides on our IR website.

Now to our full-year 2015 numbers. For 2015 on a GAAP basis, we expect revenues of $4.53 billion, product costs of 24%, operating expenses of 49% and GAAP and non-GAAP interest expense of $201 million. Our GAAP tax rate is expected to be 22%. We expect GAAP and non-GAAP fully diluted shares of 750 million and GAAP EPS is expected to be $1.07. For 2015, on a non-GAAP basis, we expect revenues of $4.65 billion, $50 million higher than our August guidance, product costs of 24%, operating expenses of 44% and an operating margin of 32%. Our non-GAAP tax rate is expected to be 24%.

Once again, we are raising our full-year EPS guidance now to $1.31. We are not fully passing through the entire $0.07 Q3 over-performance largely due to three factors: the first, revenue pull-forward on Destiny and Skylanders from Q4 to Q3 which had an impact of approximately $0.02, cost saving and timing of expenses which pushed into Q4 from Q3, which also was worth $0.02 and additional investments we will be making in Q4 to build the installed base of players across our portfolio, which accounts for the other $0.02.

With the strong back-end monetization we are seeing across our portfolio, we think these investments set us up well heading into next year. Importantly, we expect to end the year with more than half of our revenues coming from digital channels, up double-digit percentage points in aggregate from last year. So in summary, strong engagement and recurring digital monetization trends continue to drive our financial results.

Along with these positive digital tailwinds, our strategic investments in new franchises, platforms and geographies are paying off as shown by our year-to-date results. And going forward, with King's franchises in our portfolio, we feel that our strategic growth opportunities across platforms, genres, business models, audience demographics and geographies are more promising than ever. We couldn't be more excited to welcome King and their talented employees into the fold and look forward to taking advantage of the great mutual opportunities we have in front of us.

Lastly, we look forward to seeing many of you in person this Friday at Investor Day at the start of BlizzCon to tell you more about the exciting times ahead. And for those of you who can't attend in person, you can watch the livestream from our IR website.

Thanks again, and now we'll open up the call for questions.

Amrita Ahuja

Operator?

Q&A

Operator

Thank you. [Operator instructions] And we'll go to our first question from Chris Merwin of Barclays.

<Q - Chris Merwin>: Hi, great. Thank you. And congrats to everyone on the deal. In the last couple years, the revenue mix for Activision has been evolving more towards a predictable model with free-to-play games and we've seen very good improvements in engagements for console and PC games. And then mobile as a category historically has had different characteristics in terms of the life of games and engagement.

So can you talk about the plan for creating even more predictable revenue streams on mobile and how you can drive consistent engagement and monetization with those mobile games, much as you've done very successfully on other platforms? Thanks.

<A - Dennis M. Durkin>: Well, I think I'll let Riccardo get into more details, but I think you've got to recognize King has already a fantastic track record of continuing engagement. Riccardo mentioned some of the incredible number of games people play every day, almost 100 million people coming to King to play their games every day.

I think they have a tremendous track record, and we really only got full appreciation of that as we spent a lot of time over the last few months going with Riccardo and his team through their business, the analytics that they built and the sophistication that their game developments have built in order to make the games fun to play, engaging, rewarding for players, and that is why you see the strong performance that they have put on. And we don't see any reason for that to change. If anything, we think there's opportunity for that to continue to grow and expand, as the teams get stronger and as we will be able to share our very complementary expertise that we have built over decades of being in this business.

<A - Robert A. Kotick>: I think one of the things you realize from the combination is that with now over 0.5 billion players in our network, there's an insatiable demand for great content. And so, now the model is going to start to shift across all of the categories to be able to deliver continuous content, and that should be helpful for more consistent monetization.

<Q - Chris Merwin>: Thank you.

Operator

And we'll go to our next question from Doug Creutz of Cowen & Company.

<Q - Douglas L. Creutz>: Hey, thanks and congratulations, everybody involved. In your comments, you said you're not assuming any synergies from the deal, but maybe could you talk about what opportunities you think there might be for synergies? Thanks. Especially on the cost side.

<A - Dennis M. Durkin>: Yeah. So I think from a financial perspective, obviously the deal is already very attractive, but without the assumption of any synergies delivering 30% accretion, and that was an assumption of the deal, only closing by spring. So on a full-year basis, that would be even better.

Now we do think there are obviously opportunities. We talked a lot about already how complementary our relative skill sets are and Bobby just mentioned the incredibly large size of the network overall and, therefore, we're broadening our audience reach, which I think will give all of our franchises a broader access to more people in more geographies, particularly in some of the fastest geographies like Asia.

And I think the same is true vice versa. I think we have a lot of experience in how to build franchises and grow franchises over time and I think some of those skills will be helpful as King continues to grow and mature as a leader in mobile gaming.

<A - Robert A. Kotick>: I think one of the other things that we obviously are not reflecting in our discussions today, but is an important point, if you look at the history of Activision Blizzard, we go back to our founding in 1979, whether it's Infocom, Dynamix, Sierra, Activision, Imagic, we have the largest library of intellectual property in games that exists from any company. And a lot of that intellectual property, you look back in its history, there are tens of millions of players who have experienced those franchises.

With mobile, we now have the opportunity to reach new players in 196 countries around the world and take a lot of that great content that we've built over 35 years and create new content or leverage that content against this new opportunity.

<Q - Douglas L. Creutz>: Okay. Thank you.

Operator

And we'll hear next from Neil Doshi of Mizuho.

<Q - Neil A. Doshi>: Great. Thank you very much, guys, and congrats. Bobby, will you guys be investing in King or will King be primarily responsible for funding its own initiatives?

And then, Mike, can you provide any update on Overwatch? It looks like the game will lend itself well for eSports. So if you can provide any color on the eSports front for Overwatch and then how we should be thinking about the distribution strategy going forward, that'd be great.

<A - Robert A. Kotick>: From an investment perspective, King will, like Activision and Blizzard, operate as an independent unit. And so they'll generate their own capital, that capital will be available to them to invest against their business opportunities.

One of the big benefits I think they'll get is plugging into the great framework that we've created for long-term strategic planning, and that includes capital allocation. Remember, King generates a lot of operating profit, in fact, more operating profit than virtually any other gaming company that has ever existed. And so they'll be able to continue to generate that operating profit and invest that cash flow in new opportunities.

<A - Michael Morhaime>: Okay. And on the Overwatch questions, we just entered beta. Feedback from the beta has been extremely positive. On the eSports question, I think that Overwatch has a lot of potential with eSports. We've done some experimenting internally at Blizzard with our own show matches internally at the company. It's very fun to watch. But in terms of announcements about business model or distribution, we're not ready to talk about that today. We'll have more information about Overwatch at BlizzCon.

<Q - Neil A. Doshi>: Great. Thanks, Bobby. Thanks, Mike.

Operator

And moving on, we will go to a question from Arvind Bhatia of Sterne, Agee.

<Q - Arvind Bhatia>: Thank you very much. And I'd like to add my congratulations as well. My question is on Guitar Hero. I appreciate the color and the comparison to the first two franchises in the game's history. If you could maybe refresh our memory on the size of the performance of the original game in the first few years and then just maybe any quantification if possible at retail for Guitar Hero, the new one that's just come out? Thank you.

<A - Robert A. Kotick>: Obviously, the prior games were the first to reach $1 billion of any video game franchise, so the performance was very strong commercially at its apex. And as I said, the new game's sell-through in week one is up significantly versus the last two games. But as I mentioned, those are five-year old comparisons so not exactly apples-to-apples.

I think the more relevant factors right now are the fact that we've designed this game, the first time for a Guitar Hero game to really have a long tail of engagement with Guitar Hero TV, the world's first playable music video network. We're seeing two hours per day engagement from players who've already purchased the game. And it's going to be a holiday-centric title and we expect to see it ramp during the holiday. And we've got over half of our marketing budget yet to go for the year because of that.

<Q - Arvind Bhatia>: Great. And good luck.

<A - Robert A. Kotick>: Thanks, Arvind.

Operator

And we will hear next from Eric Sheridan of UBS.

<Q - Eric J. Sheridan>: Thanks for taking the question. Maybe a bigger picture question for Bobby and the team around capital allocation going forward. With so many choices now between the various divisions as well as the debt holder and equity holder desire to get capital back with deleveraging, maybe just think bigger picture about where capital incrementally is going to get allocated 2016 and beyond and just rank order those opportunities.

<A - Dennis M. Durkin>: Sure. Thanks, Eric. Obviously having a strong balance sheet and having access to capital has been a critical and important part of our strategic plan and our process. We've always tried to be very balanced regarding capital allocation. We have significant capital to be able to invest in our business and invest in new opportunities, whether that be inside the Activision business, the Blizzard business or in the future in the King business. And really the greatest governor in that investment is usually related to great development talent and great ideas. And then we try and be disciplined about how we put that investment against those ideas internally.

As it relates to other capital allocation, now obviously taking on a little bit more debt, our near-term priority will be on deleveraging in line with our investment grade profile. Our dividend payout is expected to be largely consistent with our historical approach. And in the short term, the $750 million share buyback authorization will likely not be utilized under current plans. So we feel like we have significant capital resources to be able to invest in our business and still return capital and balance the needs of our various stakeholders.

<A - Amrita Ahuja>: Operator?

Operator

And did you have anything further, Mr. Sheridan?

<Q - Eric J. Sheridan>: No. Thank you very much for that color.

<A - Amrita Ahuja>: Thank you.

<A - Dennis M. Durkin>: Thanks, Eric.

Operator

And so, we'll go to our next question from Ben Schachter of Macquarie.

<Q - Ben Schachter>: Congrats. A few questions, one, are there particular new franchises in the King pipeline that you think are important drivers? Or just more about the long-term value of the current franchises? And then, Bobby, can you just talk about how the success of Hearthstone on mobile may have influenced this deal and your overall thinking of mobile gaming? Thanks.

<A - Riccardo Zacconi>: Sure. So it's both. We're having our earnings call tomorrow, so we'll give more details tomorrow, but fundamentally, what we have announced in the past is that we are working on all the key franchises we have, with basically sequels and sister titles. And we announced that by the end of 2016, we will see at least three new titles coming out. And of course at the same time, most of our people are working on new things. So, the target is also to over time crystallize new franchises.

<A - Robert A. Kotick>: So, I think the thing that always drives us, Ben, is can we really creatively and in an inspired way figure out new opportunities to delight and engage our audiences? And mobile is allowing us to do that. I think certainly Hearthstone's success, which has been extraordinary, was a catalyst for us to think about the opportunities differently.

And when you look at 196 countries being served by King's footprint and a network of over 400 million players, our intellectual property that goes back to 1980, we really thought that there was a great opportunity. And you're now seeing mobile as a $36 billion market that's growing faster than almost any category. I think the most important thing, though, was that we thought that creatively, we could see sustained franchises that would have perpetual value, where we could continuously put our best creative foot forward.

Operator

And did you have anything further, Mr. Schachter? At this time, we'll go to our next question from Brian Pitz of Jefferies.

<Q - Brian J. Pitz>: Great. Thanks for the questions. In the prepared remarks, you mentioned the cross-promotional opportunity. Any additional color on that point? What games might be candidates near term to promote into King's network? And then separately, any comments on the need to acquire versus build a mobile studio? Clearly, you guys have a great development team, but just want to hear your thoughts on thinking through that decision longer term. Thanks.

<A - Robert A. Kotick>: Riccardo will take the second part of the question, they've built the best mobile company in the world. And with that network, with hundreds of millions of people, the incredible expertise with inspired, creative talent in all of their studios, as much as we could invest on our own, we couldn't, as quickly or probably in that quality, get to the place that Riccardo and his team have gotten to. So it's a perfect complement to what we do already so well in the categories that we operate in.

<A - Riccardo Zacconi>: And it's something in terms of the network composition, if you look at the composition of our network on the free playing side, it's about 60% female, 40% male. But if you then look at the paying side, it's much more accentuated towards a female audience, and this is where one of the big opportunities here is to not only retain better, but in particular market better to our audience, and continue to build out further our network with games which have more focus on males, and that's where I think the opportunities are to tap into the amazing IP portfolio of the Activision business.

<A - Robert A. Kotick>: And, with 0.5 billion players now in our network, or audience members as we like to think of them, there's a lot of opportunity to distribute content to that 0.5 billion player network. And we haven't really announced a lot of the future plans, but some of the things that we've announced recently, you'll see tied very well into what the opportunity is to look at that network and continuously deliver new content to players around the world.

<A - Dennis M. Durkin>: Thanks, Brian.

<A - Amrita Ahuja>: Operator?

Operator

And we will go to our last question from Drew Crum of Stifel.

<Q - Drew E. Crum>: Okay. Thanks. Good morning, everyone. So, want to follow up on an earlier question on King. Just can you talk about plans to accelerate the rate of content or game output going forward? And then separately, I think there's been some discussion around Destiny favoring micro transactions going forward. Based on the experience you had with The Taken King, can you talk about the strategy with DLC going forward? And can it, along with micro transactions, coexist with this franchise? Thanks.

<A - Riccardo Zacconi>: In terms of – as I said, I think tomorrow you will hear more details, but overall, I think we have a big pipeline of games lined up. A large focus of this pipeline is focused on our franchises with sequels and sister titles for our franchises, and this is a multiyear plan. And then at the same time, we announced in our last earnings call that we are focusing on leveraging the massive network we have to enter new genres.

So we have launched our first title in resource management, Paradise Bay, and you will hear more details tomorrow on its performance. And we have also announced that next year, we're going to launch our first mid-core title. And then beyond that in terms of what can we do with the new portfolio of ideas, I think that the work we started on the deal is closed with the team sitting together and going through the opportunities which this presents.

<A - Robert A. Kotick>: And on Destiny, Drew, I think they're already coexisting. We had a full year of expansions to the game that have been very well received and sold quite well. And more recently, you've seen us introduce smaller in-game purchases that allow people to customize their experience and express themselves. And those have been very well received and have sold well also. So I think we've already shown in those things that micro-transactions can exist and that our community is hungry for more great content.

As far as any shifts in strategy, I don't have any announcements today, but I think we have a lot of options at our disposal. And the reason for that of course is that we have such great engagement with this game. As I said, we're seeing average player times of three hours per day, which is really an astounding figure. And beyond that, we're also bringing in new players. And I think our Legendary Edition going into the holiday gives players the best time ever to jump into the Destiny universe, because you've got the original Destiny game, both the expansion packs and The Taken King for the price of a regular console game. So this has already brought a lot of new players in, and we hope to see even more as we head into the holiday.

Dennis M. Durkin

Great. So thanks, Drew, and thanks, everyone, for joining us this morning. We're obviously very excited about the new announcements today, and welcome the whole King organization inside of Activision Blizzard, and we look forward to seeing many of you and hopefully speaking to many of you online this Friday at our Investor Day, which will be Friday morning Pacific Time, right before the opening ceremony of BlizzCon. So thanks, everyone, for joining us today.

Operator

And that does conclude this call. We would like to thank everyone for their participation today.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2015-08-04
Event Description: Q2 2015 Earnings Call

Market Cap: 20,944.76
Current PX: 28.73
YTD Change($): +8.58
YTD Change(%): +42.581

Bloomberg Estimates - EPS
Current Quarter: 0.136
Current Year: 1.254
Bloomberg Estimates - Sales
Current Quarter: 864.526
Current Year: 4502.571

Q2 2015 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Thomas Tippl
- Dennis M. Durkin
- Eric Hirshberg
- Michael Morhaime

Other Participants

- Drew E. Crum
- Chris Merwin
- Michael J. Olson
- Justin Post
- Douglas L. Creutz
- Brian J. Pitz
- Eric O. Handler
- Colin A. Sebastian

MANAGEMENT DISCUSSION SECTION

Operator

Well, good day ladies and gentlemen and welcome to the Activision Blizzard Q2 2015 earnings conference call. Today's conference is being recorded.

I will now turn today's call over to Ms. Amrita Ahuja. Please go ahead.

Amrita Ahuja

Good afternoon and thank you for joining us today for Activision Blizzard's second quarter 2015 conference call. Speaking on the call today will be Bobby Kotick, CEO of Activision Blizzard; Thomas Tippl, COO of Activision Blizzard; Dennis Durkin, CFO of Activision Blizzard; Eric Hirshberg, CEO of Activision Publishing; and Mike Morhaime CEO of Blizzard Entertainment.

I would like to remind everyone that during this call we will be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the risk factor sections of our SEC filings including our 2014 annual report on Form 10-K which is on the file with the SEC and those indicated on the slide that is showing.

The forward-looking statements in the presentation are based on information available to the company as of the date of this presentation, and while we believe them to be true, they ultimately may prove to be incorrect. The company undertakes no obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after today, August 4, 2015, or to reflect the occurrence of unanticipated events.

I would like to note that certain numbers we will be presenting today will be made on a non-GAAP basis, excluding the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, expenses related to stock-based compensation, the amortization of intangible assets, expenses including legal fees, costs, expenses and accruals related to the purchase transaction and related debt financing, and the associated tax benefits. Please refer to our earnings release which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation. There's also a PowerPoint overview which you can access with the webcast and which will be posted to the website following the call. In addition, we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now, I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thanks very much, Amrita, and thank you all for joining us this afternoon. Q2 was another strong quarter and we have a lot of momentum going into the back half of this year. Our teams around the world continued to deliver the very best interactive entertainment and our franchises continue to be among the strongest in all of entertainment. On today's call, Thomas will discuss the key drivers of our over-performance, Dennis will review our financial results in detail, and then Mike and Eric will discuss the positive results in their respective operating units. Thomas.

Thomas Tippl

Thanks, Bobby. Our strategic focus on expanding our franchise portfolio with captivating and original new intellectual property, innovating on new platforms, and expanding into new geographies is reflected in our results. We outperformed our Q2 targets and last year's results on revenues, digital growth, and earnings per share. These strong results and the excitement for upcoming launches have driven us to raise our full year outlook yet again. As we're successfully transitioning from a launch to a year-round engagement model, our audience base and the total amount of time people spend with our franchises continue to grow. In the second quarter, our monthly active users grew at 35% year-over-year. And in a world with so many entertainment choices from television to movies to social media and beyond, we are grateful that people are choosing to spend more and more of their time with us.

In the second quarter, the amount of time our community spent playing Activision Blizzard games grew by 25% year-over-year. In fact, this past quarter, our player communities logged nearly 3.5 billion hours of game play with our key franchises, Heroes of the Storm, Hearthstone, World of Warcraft, Diablo, StarCraft, Skylanders, Destiny, and Call of Duty. And these numbers do not even include the rapidly increasing amount of time expected to spend watching content based on our games on channels like Twitch and YouTube.

Our strategic investment in new franchises, platforms and geographies continue to pay off, and along with growing engagement and better monetization, set the stage for more growth ahead. We're well underway to expanding our franchise portfolio from 5 to over 10, with four new intellectual properties already launched and performing well. In addition, the beloved Guitar Hero franchise will return this fall with product innovation that we couldn't be more excited about, and Overwatch is on the horizon with a beta this fall.

We have an increasing focus on mobile and tablet. Hearthstone's release on iOS and Android smartphones in April through the player base has been a key driver of our performance in Q2 and should benefit us for the foreseeable future. Guitar Hero Live fall release will also include mobile and tablet at launch, and we're redoubling our efforts to provide a great mobile experience for our Skylanders franchise, in addition to making the full game available on tablets.

Finally, we are positioned for growth in new geographies, and in particular in large and fast-growing China. We now have six franchises in market in China up from two at the start of last year and we're already seeing strong results with our teams and partners in China delivering record revenues in MAUs in Q2. Before I hand it over to Dennis, I want to thank our talented teams who continue to execute very well. Our employees are extraordinarily committed and they create the most engaging entertainment experiences for our players and it shows in our results, which Dennis is now going to take you through in detail.

Dennis M. Durkin

Thanks, Thomas. Good afternoon, everyone. Today I will review our better than expected Q2 financial results, our outlook for Q3, and our increased outlook for 2015. Unless otherwise indicated, I will be referencing non-GAAP measures, so please refer to our earnings release for full GAAP to non-GAAP reconciliations.

For the quarter on a GAAP basis, we generated revenues of $1.04 billion, up 8% year-over-year and operating margin of 32% and GAAP EPS of $0.29 up $0.08 versus our May guidance. For the quarter on a non-GAAP basis we generated revenues of $759 million and operating margin of 23%, up more than 550 basis points year-over-year and EPS of $0.13. We outperformed last year's revenue and EPS by $101 million and $0.07 respectively. At constant FX for Q2, we outperformed last year's revenue by $188 million or 29%, operating income by $116 million or 103%, and EPS by $0.13. In addition, we outperformed our May guidance by $109 million on revenue and $0.06 on EPS. Revenue and EPS outperformance was primarily due to strong growth in recurring revenue from digital content across our broad franchise portfolio. Importantly, total digital revenues grew 27% year-over-year to a Q2 record of $611 million.

The main franchise drivers of the quarter's performance were: Hearthstone, with the launch of their newest adventure, Blackrock Mountain, as well as the release of Hearthstone onto new Android and iOS smartphones; Destiny, with the launch of their second expansion, House of Wolves; Call of Duty with sales of Seasons Pass, DLC and microtransactions like Supply Drops for Advanced Warfare; Blizzard's Diablo III which launched and outperformed in China, helping drive record revenues in China for the company this quarter; and finally, Blizzard launched Heroes of the Storm globally on June 2. Note that this quarter was an important inflection point for Blizzard. In spite of World of Warcraft subscriber declines, which were more concentrated in the east, and partly affected by the success of Diablo III in China, Blizzard grew its Q2 revenues 29% year-over-year at constant FX. This performance was driven by the strong performances of Diablo, Hearthstone and Heroes of the Storm, which in Q2 made up the majority of Blizzard revenues.

The franchise diversification inside Blizzard is happening rapidly and even more importantly the aggregate Blizzard community is healthy and growing and in Q2 reached the highest levels in Blizzard history on the back of strong engagement across the expanded portfolio. And the community will have even more to enjoy with an incredible lineup of new content for these franchises that is yet to come. You'll hear more details from Mike on Blizzard's engagement and pipeline later in the call.

In terms of EBITDA and cash flow, in Q2 we generated strong non-GAAP adjusted EBITDA of $193 million, up $47 million year-over-year, operating cash flow of $135 million and up 27% year-over-year and free cash flow of $107 million up 32% year-over-year. In Q2 we also paid our previously announced $0.23 per share cash dividend, a 15% increase year-over-year and had no share repurchases in the quarter.

Turning to the balance sheet as of June 30, we had approximately $4.5 billion in cash and investments of which approximately $800 million was held domestically. We had total debt of $4.12 billion and net cash of approximately $400 million.

Turning to FX, please note, as discussed on our February and May calls, the strong dollar has had and will continue to be a headwind this year as our international revenues are translated at lower rates than last year. In Q2, the year-over-year impact of the strengthening of a dollar was $87 million on revenue and $0.06 on EPS. Year-to-date, the year-over-year FX impact was $154 million on revenue and $0.11 on EPS.

Now let's turn to our slate and our outlook for Q3 and for the balance of 2015. We are planning one of the best content pipelines in our history for the back half of the year and the games are all progressing very well. You will hear more about our Q3 and Q4 slate from Eric and Mike. New releases include Destiny's mega expansion, The Taken King, Skylanders SuperChargers, Guitar Hero Live, Call of Duty: Black Ops III and Hearthstone's expansion, The Grand

Tournament. One important addition is we are now confirming that the much anticipated final chapter for StarCraft II: Legacy of the Void is expected to be released in 2015 and will now be included in our guidance for the full year.

Looking forward to Q3, on a GAAP basis we expect net revenues of $875 million, product costs of 26% and operating expenses of 59%. We expect GAAP and non-GAAP interest expense of $51 million, a GAAP tax rate of 23%, a GAAP and non-GAAP share count of $748 million, and EPS of $0.08. For Q3 on a non-GAAP basis we expect revenues of $930 million, product costs of 25% and operating expenses of 55%. We expect a non-GAAP tax rate of approximately 25% and non-GAAP EPS of $0.14. Note that our guidance is at FX spot rates as laid out in the accompanying slides on our IR website.

Now to our 2015 full year numbers. For 2015 on a GAAP basis, we expect revenues of $4.425 billion, product costs of 24%, operating expenses of 48%, and GAAP interest income expense of $202 million. Our GAAP tax rate is expected to be 22%. We expect $750 million fully diluted shares, both for GAAP and non-GAAP, and GAAP EPS is expected to be $1.06 up $0.08 from our May guidance.

For 2015 on a non-GAAP basis, we expect revenues of $4.6 billion, $175 million higher than our May guidance, product costs of 23%, operating expenses of 45%, and an operating margin of 32%, 100 basis points better than our May guidance. We expect non-GAAP interest expense of $201 million and our non-GAAP tax rate is expected to be 24%.

For the second time this year, we are raising our EPS outlook. Our new outlook has increased by $0.10 to $1.30 based on strong franchise momentum coming out of Q2 and now including the StarCraft: Legacy of the Void in our full year numbers. At constant FX, we now project year-over-year growth on the top line and bottom line including record EPS for the year.

In summary, strong engagement and recurring digital monetization trends are driving our financial results so far this year and give us great momentum heading into the back half of the year. Along with these digital trends, our strategic investments in new franchises, platforms and geographies are paying off. This backdrop sets the stage for growth as we take advantage of the best content pipeline in our history.

Now I will turn the call over to Eric to discuss Activision Publishing.

Eric Hirshberg

Thanks, Dennis. Activision Publishing significantly outperformed last year's result and delivered meaningfully higher digital revenues and operating income for the quarter and the first half of the year. Our Q2 and year-to-date revenues were each up 35% at a constant FX rate. We also continue to have 2 of the top 5 console franchises year-to-date in Skylanders and Call of Duty, and 3 of the top 5 next-gen games, life-to-date, including the number one slot.

This revenue performance is due to our proven ability to create great games that turn into beloved long-term franchises. In recent years we have methodically and effectively expanded our portfolio to now include three innovative and industry-leading franchises, each of which gamers enjoy playing year-round. As a result, our monthly active users are up by more than 25% in Q2 year-over-year and each of these franchises contributed significantly to our overperformance year-to-date.

Let me share some specifics by franchise, starting with Call of Duty. In Q2, revenue was up by double-digit percentage year-over-year due to strong sell-through on Advanced Warfare, strong momentum in digital monetization as well as strong sell-through on catalog titles. I want to highlight Advanced Warfare's strong season of digital content in particular. Season pass, DLC, microtransaction, and average revenue per user have all grown year-over-year.

As we said on our last call, we introduced a new digital consumable mechanic called supply drops to which players have responded very positively. We maintained our already high engagement levels while monetization of that engagement significantly grew. We believe this approach will allow our average revenue per user to continue to grow in future years driving higher margins as more revenue is delivered digitally.

Which brings me to Call of Duty: Black Ops III, the November release from our award winning studio, Treyarch. In June, we provided the public with hands-on multiplayer at E3 for the first time in Call of Duty's history, and the response is overwhelmingly positive. In fact, since E3, the number of Black Ops II monthly active users has risen to over 11 million players, which is unprecedented in a game that's nearly three-years-old and particularly one that is only available on old generation systems.

We're also attracting new consumers into the Black Ops universe, with catalog sales of both Black Ops I and Black Ops II up significantly in North America for the first half of the year. Then at Comic-Con in July, we unveiled the Black Ops III Zombies mode, and again the fan reception was great. Their excitement was driven not only by the Zombies mode itself, but also by fans' realization of just how deep this game is going to be. Black Ops III will have three incredible play modes: campaign, multiplayer, and zombies inside one game. Each mode has its own sticky progression system, and we will offer a full season of follow on content to keep players engaged.

We couldn't be more excited for Call of Duty fans to experience Black Ops III multiplayer and that's why for anyone who pre-orders we're holding our first public beta in years starting in August. We can't wait for fans to play the game and provide feedback to help us make it even better at launch in November. We're also planning our most robust and expansive season of eSports for Call of Duty ever, and we'll have more details on that in the future.

On to Call of Duty Online, which is in open beta in China. As I've said before, this is a game that will take time to ramp and early signs on core player engagement are encouraging. In the last week of July, we launched a significant content and feature update and Tencent kicked off a marketing campaign to support new player acquisition. While it's too early to know, initial engagement trends after the update are positive, and we'll have more to share in future quarters.

Turning now to Destiny. In May, we along with our partners at Bungie released the highly acclaimed second expansion pack, House of Wolves. The percentage of Destiny players who have bought both expansion packs is the highest we have ever seen for any Activision Publishing game. Moreover, engagement of the game's millions of active users actually increased after we released House of Wolves, which is impressive for a game 10 months after its launch.

Destiny now has over 20 million registered players with an average of about 100 hours of gameplay each, showing great momentum as we head into our fall release. On September 15 comes the largest update to the Destiny universe yet, a mega expansion called The Taken King. We revealed The Taken King at E3, highlighting the all new campaign, subclasses, and brand new destination, and gaming reception was incredible.

For those who already own Destiny and both expansion packs, they can buy The Taken King for a suggested retail price of $40. For those who are new to the Destiny universe, we'll offer The Legendary Edition, which includes the original Destiny game, both expansion packs thus far, and all of the content in The Taken King for a suggested retail price of just $60. This obviously provides new players with a great value, but it's also the right thing to do for our community, as it will help us keep as many players as possible playing together in the same universe of content.

Onto Skylanders, the industry's top performing console franchise and title for the year so far. Despite the increasingly competitive toys-to-life category, we've maintained our leadership position, grown user engagement, and average revenue per user, and outsold all other action figure lines year-to-date.

Before we get to this year's release for Skylanders, let's take a step back and look at the toys-for-life category overall. As you know, this is a genre we created and had led ever since, transforming the way kids interact with toys in the process. Despite an ever increasing list of competitors and with strong characters from other mediums, we feel we are best positioned to continue to lead this category for one reason. We've delivered and will continue to deliver the best games with the biggest innovations. Games are at the heart of what we do and games are also at the heart of this genre since compelling gameplay is the way to drive toy sales.

This year's fall release, Skylanders SuperChargers, which we plan to launch on September 20 in North America and September 25 in Europe, will bring both action figures and vehicles to life for the first time, allowing our fans to drive, fly, and captain their way across land, air, and sea. This innovation increases the size of the pie, which will now include both action figures where consumers spent about $2.5 billion each year, and vehicle toys where consumers spend about $3.3 billion each year in North America and Europe alone.

Our proven ability to create great games in this space is what led to our unprecedented partnership with Nintendo to bring Donkey Kong and Bowser into Skylanders SuperChargers. As we had last year, the full game will be available on tablet, one of the world's fastest growing gaming platforms. We're also in development on a new mobile initiative for the Skylanders franchise and look forward to telling you more about it next week.

Finally Guitar Hero. As I said on our last call, Guitar Hero's brand affinity and name recognition are amongst the highest in our industry which gives us a strong platform from which to re-launch the brand. But neither we nor our fans would be content if we had simply repackaged an upgraded version of an old game. Guitar Hero Live is entirely new and the result of many years of meaningful creative innovation. It is one game with two ways to play: GH Live, which lets fans rock real crowds with real reactions, making you feel more like a rock star than ever before, and GHTV, which is the world's first playable music video network with hundreds of songs and a continual stream of new content to keep our players engaged. At E3, we gave the media a chance to play GHTV for the first time, and the response could not have been better. Our partners are equally excited, and retailers are allocating shelf space to us at multiples to what they are allocating to our competitors. And we'll have more music and promotional partnerships to announce as we get closer to launch, which we plan for October 20.

So, to close, Activision Publishing has had a great first half of the year built on innovative games that engage our passionate fans. The stage is set for a great second half as well, with major innovations across the portfolio, including Call of Duty: Black Ops III, Destiny, The Taken King, Skylanders SuperChargers, and Guitar Hero Live. We look forward to sharing more details with you at gamescom later this week.

Now I'll turn over the call to Mike to talk about Blizzard.

Michael Morhaime

Thank you, Eric. Blizzard had another strong quarter in Q2, with multiple releases and more activity on more platforms than in any previous quarter. This new content led to incredible engagement across our player base. Monthly active users, the number of players who log into a game each month in the quarter, summed across our entire portfolio is a good indicator of the health of the Blizzard community.

In Q2 the average MAU across Blizzard games was up more than 50% year-over-year, achieving its highest level ever. Moreover Battle.net ended the quarter at an all-time high for active accounts. Again, up double digits percentage-wise year-over-year. These important metrics reflect the strength of our portfolio with many more people around the world playing more Blizzard games than ever before.

On the World of Warcraft front, in late June we launched one of our biggest non-expansion content updates ever, Patch 6.2, Fury of Hellfire. It added a new zone for players to explore, a new raid, and much more. This helped stabilize the subscriber base in the last part of the quarter. We're currently at work on a much anticipated update for the game that will bring flying to Draenor, add a new player versus player matchmaking feature and more. In addition, we're going to have exciting news at gamescom this week. We'll be announcing the next expansion for World of Warcraft.

We've been listening closely to our players about their experience with Warlords of Draenor, and we think they'll be really excited when they hear our plans. You can tune into the announcement through the Battle.net desktop app or the World of Warcraft website.

Hearthstone had a very good quarter, with multiple releases in quick succession. We launched the Blackrock Mountain adventure at the beginning of the quarter followed by the release of Hearthstone on mobile phones. We also added a popular new game mode called Tavern Brawl, which gives players a different way to play each week, for example, playing as a legendary monster from the game complete with a customized deck.

As a result of the new platform and all the new content, engagement for Hearthstone which was already very strong, nearly doubled year-over-year in terms of active players and time spent. The game continues to perform well in all major regions and remains a top viewed title on Twitch. We recently announced our new card expansion, The Grand

Tournament. Like our first expansion, Goblins vs Gnomes, The Grand Tournament will add new game mechanics and a ton of new cards that will have an impact on how Hearthstone is played, which ultimately supports longer-term engagement. The Grand Tournament is due out this month, and we're already seeing a lot of excitement about it from the community. In addition, like other Blizzard games, Hearthstone has developed into a premier fixture in the competitive gaming scene. That includes our formal tournaments as well as community-driven events. A big example of the latter are fireside gatherings where members of the community post local Hearthstone get-togethers. This year alone the community has already held more than 1,300 fireside gatherings globally. Many of these offer participants a chance to secure a spot in the Hearthstone World Championship competition culminating at BlizzCon. We look forward to seeing which of these players rise up and make a name for themselves and how they fare against the established pro players who have advanced through our official tournaments.

Heroes of the Storm also had an exciting quarter with the team making solid progress in driving engagement. Following the June 2 game launch, the critical reception has been enthusiastic with many outlets giving Heroes of the Storm high marks for its innovations, accessibility, and depth. We've also seen consistently positive commentary from players and that's only increased as more try the game. One of the strengths of Heroes of the Storm is the fact that it draws on content from all of our franchises, giving our players familiar touch points in the game regardless of their familiarity with the genre. At the end of June, we started a series of updates that brought popular characters from Diablo, such as The Butcher and King Leoric, and the new Diablo-themed battleground, the Battlefield of Eternity to the game. Players have really enjoyed this event, which we're calling the Eternal Conflict, and it's still going on, so there is more to come.

We plan to continue a rapid cadence of Heroes of the Storm updates for the foreseeable future. This will constantly give players new character and strategy options which will support the game's long-term appeal. Heroes of the Storm eSports is another avenue for engagement and growth of our audience. We kicked off the collegiate scene in April with Heroes of the Dorm, a March Madness style tournament which culminated in a live finals event on ESPN2 and resulted in a lot of excitement across the Blizzard community. On the professional side, the game has been added to our Road to BlizzCon program and major tournaments are underway globally.

With the total prize pool of $1.2 million in cash and prizes and an opportunity to be crowned world champion at BlizzCon, the stakes are high and the competition has already been amazing. Q2 was also a very good quarter for Diablo III. We launched the game with a free model in China while offering two premium versions at $32 and $64. Despite the availability of the free option, the premium versions achieved record sell-through in China out the gate and it's continuing to perform well there. The take-up of Diablo III in China played a large part in driving Blizzard's record MAU globally, as well as in China specifically, for the quarter. In fact, Blizzard's total revenue in China this quarter reached a record high, driven in large part by the success of Diablo III there, as well as Hearthstone and Heroes of the Storm.

I'm pleased to report that Diablo III as a whole has now sold through over 30 million copies globally. Players around the world are looking forward to the upcoming content patch, which will add the Ruins of the Barbarian City of Secheron for them to explore. It also adds a powerful item called Kanai's Cube which provides endless options for transmitting and upgrading their items. Blizzard gamers have always expected an outstanding level of entertainment from our games, and content updates such as this reflect our commitment to that standard.

Moving on to StarCraft II, the Legacy of the Void beta test continues to go well and we're excited to get the game into players' hands later this year. We recently started offering pre-purchases and as part of that, we're providing beta access along with advanced access to a set of campaign missions, titled Whispers of Oblivion, to anyone who pre-purchases the game. We've seen a lot of anticipation for this final chapter of the trilogy and even higher demand at this point in pre-sales compared to Heart of the Storm.

The Whispers of Oblivion content plus the multiplayer changes have been received very positively. This is gratifying because we're working hard to deliver a worthy finale to an epic story that's now been over 17 years in the making. One of the reasons we feel we can continue to expand our StarCraft II audience is that players no longer need to have the previous entries in the series in order to play Heart of the Storm or Legacy of the Void. This provides a great opportunity for players who might have missed one of the chapters in the trilogy to come back and jump right into the latest content.

We are also excited to bring StarCraft II multiplayer into a whole new era with new play modes and other changes that increase accessibility. One of the new modes, Archon Mode allows two players to team up and share control of an army, making the game even more fun to play with a friend.

We've seen a very enthusiastic response to this mode as well as a lot of anticipation about our other new co-op mode Allied Commanders, which we will be providing more detail about at gamescom.

Looking back at the amount of content we delivered this quarter, and the player response, we're really pleased with the performance and engagement overall. For the second half of the year, we're driving towards the milestones I mentioned in addition to the global beta test for Overwatch. We're particularly excited to carry the momentum from the first half of the year forward to BlizzCon in November, where we will have more to share with our community.

One of the biggest attractions there will be the culmination of this year's Road to BlizzCon eSports tournament, with the global champion for World of Warcraft, StarCraft II, Hearthstone, and Heroes of the Storm being crowned. This will be the most Blizzard eSports competitions ever contained under one roof, and we're really excited to see which of the world's top players make it to the main event and walk away with the grand prizes.

The global Blizzard community is now as big and as vibrant as it's ever been, and we're thrilled to be able to serve players across a wider range of genres and platforms than ever before. Looking across our entire portfolio and all the upcoming content in our pipeline, it's a great time to be a Blizzard gamer. Thank you. And I'll turn the call back to Amrita.

Amrita Ahuja

Thanks, Mike. Operator, we'll now take a few questions.

Q&A

Operator

Certainly. [Operator instructions] And we'll hear first from Drew Crum with Stifel.

<Q - Drew E. Crum>: Okay. Thanks. Good afternoon, everyone. So on Hearthstone, can you guys discuss the revenue mix you're seeing for the game and what you've observed in terms of monetization on smartphones and whether or not that's led to any cannibalization against PC revenue? Thanks.

<A - Michael Morhaime>: Thanks for the question. So we don't provide per-platform breakouts, but the launch on phones and the new content that we've recently released combined have led to a step change in Hearthstone's results. We're very pleased to see substantial growth across the board. We saw almost double the amount of active players in time spent year-over-year, and an increase in more than 50% quarter-over-quarter. Revenue on the new platforms appear to be incremental to PC.

<A - Amrita Ahuja>: Operator?

Operator

And we'll now hear from Chris Merwin, Barclays.

<Q - Chris Merwin>: Great. Thank you. So I just had a question about eSports. I know this has been an area of focus for you, most recently with some of the new free-to-play titles like Heroes of the Storm, which, Mike, I think you mentioned in your prepared remarks. So could you please just talk about how eSports have helped in terms of driving player engagement and maybe what types of opportunities you see there over time? Thanks.

<A - Robert A. Kotick>: Yeah, that's a great question. We've said over the last few years that we see competitive gaming as [indiscernible] (32:30) opportunity for the company, and obviously a great way to celebrate our players. The franchises like Hearthstone and Heroes of the Storm and Call of Duty, and then future franchises like Overwatch, are going to be among the most important of all eSports franchises.

From our perspective, if you look at just spectating hours on our franchises, over the last 12 months, spectator hours have jumped to roughly 1.5 billion hours. And we expect that we're really in the first inning of eSports opportunities. So this is an area of great focus and attention and investment across the company and we expect that we'll continue to lead in eSports as we have since the beginning of eSports initiatives.

<Q - Chris Merwin>: Great. Thank you.

Operator

Our next question will come from Mike Olson with Piper Jaffray.

<Q - Michael J. Olson>: All right, thanks very much. So Activision pioneered the toys-to-life genre, but since then this space has become a bit more crowded with competitors, particularly with bigger brand IP, Disney, Star Wars, Marvel, et cetera, now LEGOs. Just curious about how you're thinking about Skylanders and how it can compete over the next couple of years and beyond to maintain the lead?

<A - Eric Hirshberg>: Sure, I understand the question. It's inarguable that the category has become much more crowded since we invented it a few years ago, but to be fair, we've been being asked some form of this question, how can you hold onto your lead versus competitors that have much better established characters from other mediums, since the – before the launch of the first Disney game. We're now several games past that and we've managed to retain our sizable lead at every step of the way.

We've already shown I think that established characters from other mediums are not the shortcut to leading this category. We believe we will continue to lead the category because we make the best games in the category, we consistently delivered the best innovations in the category, and our characters are built for interactive entertainment. And our creators have no constraints surrounding what those characters can and can't do in a video game. And we believe that's a key competitive advantage as well.

On the category itself, we think that the toys-to-life genre will continue to grow, and more broadly that the idea of physical toys that have digital lives is definitely here to stay. Also thus far, we've only brought one form of toys-to-life with action figures. As I mentioned, with SuperChargers, we bring vehicles to life as well, and vehicle toys are an even bigger category than action figures are. So we're actually expanding the pie and the audience further. So we think the category is going to continue to grow and we're confident that we uniquely have the right strategy and capabilities to continue to lead it.

<Q - Michael J. Olson>: All right. Thank you.

Operator

Moving on to Justin Post with Merrill Lynch.

<Q - Justin Post>: Thank you. I'd like to talk a little bit about World of Warcraft. Can you talk more about the kind of subscribers by geography? What's going on in the western markets? Any metrics you can share on players or player hours with that? And I guess you're going to have an expansion pack, but what's your kind of outlook for that franchise? Can you get expansion packs to kind of not ebb and flow or kind of sustain the subscriber levels going forward? Thank you.

<A - Michael Morhaime>: Hi. Thanks for the question. So we don't disclose that level of detail on subscriber engagement. But, I mean, as with all of our franchises, we think great content is what draws players in, keeps them engaged, and brings them back. That's why we've been continuing to invest in growing the World of Warcraft development team. We have now more developers working on World of Warcraft than ever before. And that's so we can continue to release high-quality content for our community and hopefully increase the pace of which we're releasing that.

The upcoming expansion announcement, I think is a great example, which we're planning to announce later this week at gamescom. Looking back at Warlords of Draenor, we were able to bring back more players than any previous expansion, taking the game back over to 10 million subscribers. So we definitely believe that there's potential to re-engage lapsed players with good new content. We also think that the Warcraft movie is a key inflection point. It's coming out next June. It's a chance to expose the Warcraft franchise's rich lore to new audiences and hopefully increase interest in World of Warcraft overall.

<Q - Justin Post>: Thank you.

Operator

Cowen & Company's Doug Creutz has the next question.

<Q - Douglas L. Creutz>: Hey, thanks. I was wondering if you could talk a little about what you're seeing in terms of pre-order interest for Call of Duty. Thanks.

<A - Eric Hirshberg>: Sure. First I want to reiterate what we've said a couple of times now in the past which is that, as the world moves more to digital, obviously pre-orders become really just one of the many metrics that we look at to determine momentum. So with that as a backdrop, I'll tell you that year-to-date, we're in fact significantly up on pre-orders with Black Ops III, and we expect Call of Duty to lead the industry in pre-orders again.

But more important to us than that is the wide range of other metrics that we use to look at. And from trailer views to positive sentiment to social media engagements to unaided title awareness to purchase intent, these metrics are all also up year-on-year as well. Also, as I said, we now have over 11 million monthly active users playing Black Ops II, which is unprecedented three years past the release date of one of our titles, and it shows I think a lot of momentum and a lot of hunger for – as we head into the launch of Black Ops III. So we're optimistic.

<Q - Douglas L. Creutz>: Great. Thanks, Eric.

Operator

We'll now hear from Brian Pitz with Jefferies.

<Q - Brian J. Pitz>: On Guitar Hero Live, in terms of sales expectations, is there any perspective you could provide for how we should think about this title? And looking at it from a profitability standpoint, how would you expect the game to compare to the overall corporate margin profile? Thanks.

<A - Eric Hirshberg>: Sure, Brian. As I think you know, we don't provide specific forecasts, franchise-by-franchise, but I'll still try to answer the spirit of your question. We know we have a great game that has meaningful innovations, and everyone who's put their hands on it including both critics and fans, loves it.

Guitar Hero Live makes you feel like more like a rock star than ever before, which is a big marketable innovation. But equally important is Guitar Hero TV, which gives us a real long-term engagement strategy on this franchise for the first time. We've learned a lot of lessons here from games like Call of Duty and Destiny, which are that fans appreciate a constant stream of new content, the ability to compete with their friends online, and for the game to constantly reward them for their engagement. So we've designed GHTV with all that in mind. So it's really about more than just how many units we sell. It's also about us driving that long-term engagement. And you know how powerful that can be for our business when we achieve that.

And also we're expanding the addressable audience by making the game available on mobile. And we've made a significant investment in both the product development to make sure we have a great game. And we're making a significant investment in the marketing to make sure that we have a great launch. So those should be two good indicators for you. We believe that this can be a significant contributor to our business in the coming years.

<Q - Brian J. Pitz>: Great. Thanks.

Operator

Moving on to Eric Handler with MKM Partners.

<Q - Eric O. Handler>: Yes. Thanks for taking my question. So recognizing what's still early in the launch, I was hoping you could discuss where you are with the players, and more specifically, the paying players for Heroes of the Storm. Also are there any regions of the world where player engagement is more significant than others and maybe you could draw any similarities, if possible, to what you saw in the early days of the release of Hearthstone?

<A - Michael Morhaime>: Okay. It's tough to draw any meaningful comparison to Hearthstone just because the pricing model and game players are different. I think I would say that looking at the game's reception performance globally, we're very happy with the reaction and reception around the world. We did just launch the game in June, so you're right, it is still very early. I think if you look at other games in the genre, they all had more gradual growth of their player base so that is what we would expect to see with Heroes of the Storm. We think that, in this genre eSports is a big driver, and we've already started with our major eSports initiatives underway with our Road to BlizzCon, and so we would expect that eSports will continue to be a driver for us in terms of engagement and growth of the game.

So right out the gate, we're very pleased with the positive reception from players and press. We're going to continue evolving the game, adding content on a frequent cadence, and we think we're well on the way towards Heroes becoming another key pillar in the portfolio.

<Q - Eric O. Handler>: Thanks a lot.

Operator

Ladies and gentlemen, we have time for one additional question from Colin Sebastian with Robert Baird.

<Q - Colin A. Sebastian>: Hi. Thanks for taking the question and congrats on the quarter. Eric, on Destiny, you mentioned the engagement being very high with the game and pre-orders for the expansion seem to be quite strong as well. Can you help us, by putting into perspective how large this expansion could be relative to a typical games expansion pack and if you can compare the amount of content that comes in a certain game versus other packs? Thank you.

<A - Eric Hirshberg>: Sure, Colin. It's hard to compare to other games expansion packs with Destiny in such an unusual game, but the short answer is compared to our own past expansion packs, it's significantly bigger than the other expansion packs we've had, but still smaller than an entirely new game. We're calling it a mega expansion for a reason. But that's just The Taken King and I want to emphasize that equally significant to our plans for Q4 is the legendary edition, which includes the original game, both the expansion packs thus far and The Taken King, and it's just $60. So this probably represents the most game play you can get for $60 anywhere in the industry this holiday and we're doing that very deliberately because – both because we want to bring in new fans and it's a great value for them, but it's also the right thing to do for the community, because it's a shared world game and we want to keep the largest number of players possible playing together with the same content, so both strategies are equally important to our launch this Q4.

<Q - Colin A. Sebastian>: Okay. And then maybe as a quick follow-up, obviously, a nice beat on digital revenue side. Can you talk a little bit more about trends on the digital side of the business and how we should expect that to track over the remainder of the year? Thanks.

<A - Michael Morhaime>: Sure. Thanks, Colin. Thanks for the question. Yeah, obviously digital was a great – we had great momentum on digital in the first half of the year and we expect, obviously when you look forward for the first time, more than 50% of the company's sales will come through digital channels this year which is an important milestone and obviously with a great digital growth of 27% in Q2. We're well on our way of achieving that. There's a couple of buckets in terms of that that are really important. The first is obviously full game downloads, where on the Blizzard side of the business we already see most of – the majority of that volume being digital. Now we are starting to see on the console side more of our AAA share moving digitally. We've seen high teens in the past and that can sometimes spike in weeks depending upon how deep a title is in its catalog lifespan. So that's growing very, very nicely and we expect that to continue to grow this holiday.

But, another important area for us, in that you really see reflected in our results so far this year is digital add-on content sales. So think of that as content and services that we sell to our players once they're already playing one of our games. And these are things like advanced supply drops or map packs in Call of Duty, or card packs in – or tokens in Hearthstone or paid character boost in World of Warcraft. And our teams are getting more and more creative about finding ways to use these tools to drive further engagement. And this is actually the largest and fastest growing segment of our digital business, which had sales in this area growing at over 56% year-over-year or 73% at constant currency, so very, very strong momentum there. And we think that these add-on content sales are super important, because they provide not only opportunities for ARPU expansion and nice margins, but can expand and deepen gameplay and engagement with all player base, so overall strong trends of momentum for this and heading into the back half of the year.

<Q - Colin A. Sebastian>: Great. Thank you.

<A - Michael Morhaime>: Thanks, Colin.

Operator

And, again...

<A - Amrita Ahuja>: Operator...?

Operator

I turn it back to the speakers for closing or additional remarks.

Amrita Ahuja

Thank you very much, everyone for joining the call.

Robert A. Kotick

Thank you.

Operator

And, again, ladies and gentlemen that does conclude our conference for today. We thank you all for your participation.

Company Name: Activision Blizzard
Company Ticker: ATVI US
Date: 2015-05-06
Event Description: Q1 2015 Earnings Call

Market Cap: 17,820.61
Current PX: 24.54
YTD Change($): +4.39
YTD Change(%): +21.787

Bloomberg Estimates - EPS
Current Quarter: 0.080
Current Year: 1.235
Bloomberg Estimates - Sales
Current Quarter: 666.611
Current Year: 4471.250

Q1 2015 Earnings Call

Company Participants

- Amrita Ahuja
- Robert A. Kotick
- Dennis M. Durkin
- Eric Hirshberg
- Michael Morhaime
- Thomas Tippl

Other Participants

- Eric O. Handler
- Colin A. Sebastian
- Arvind Bhatia
- Doug L. Creutz
- Drew E. Crum
- Brian J. Pitz
- Yung Rok Kim

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Activision Blizzard Quarter 1 2015 Earnings Conference Call. Today's conference is being recorded. At this time for opening remarks and introductions, I would like to turn today's call over to Amrita Ahuja. Please go ahead, ma'am.

Amrita Ahuja

Good afternoon, and thank you for joining us today for Activision Blizzard's First Quarter 2015 Conference Call. Speaking on the call today will be Bobby Kotick, CEO of Activision Blizzard; Dennis Durkin, CFO of Activision Blizzard; Eric Hirshberg, CEO of Activision Publishing; Mike Morhaime, CEO of Blizzard Entertainment; and Thomas Tippl, COO of Activision Blizzard.

I would like to remind everyone that during this call we will be making statements that are not historical facts. These are forward-looking statements that are based on current expectations and assumptions that are subject to risks and uncertainties. A number of important factors could cause the company's actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements, including the factors discussed in the Risk Factor sections of our SEC filings, including our 2013 Annual Report on Form 10-K, which is on file with the SEC, and those indicated on the slide that is showing.

The forward-looking statements in the presentation are based on information available to the company as of the date of this presentation, and while we believe them to be true, they ultimately may prove to be incorrect. The company undertakes no obligation to release publicly any revisions to any forward-looking statement to reflect events or circumstances after today, May 6, 2015, or to reflect the occurrence of unanticipated events.

I would like to note that certain numbers we will be presenting today will be made on a non-GAAP basis, excluding the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, expenses related to stock-based compensation, the amortization of intangible assets, expenses, including legal fees, costs, expenses and accruals related to the purchase transaction, and related debt financing and the associated tax benefits.

Please refer to our earnings release which is posted on www.activisionblizzard.com for a full GAAP to non-GAAP reconciliation and further explanation. There's also a PowerPoint overview which you can access with the webcast and which will be posted to the website following the call. In addition we will also be posting a financial overview highlighting both GAAP and non-GAAP results and a one-page summary sheet.

And now I'd like to introduce our CEO, Bobby Kotick.

Robert A. Kotick

Thank you, Amrita. Usually I end my remarks by thanking our incredibly talented, extraordinarily committed employees around the world, but today I'm leading with it because they are, in fact, the reason we remain one of the world's most successful game companies. And also, during this quarter, for the first time we were recognized by Fortune as one of the 100 best companies to work for.

Inclusion on this list is largely determined by employee survey results and to be recognized as a great place to work by a respected institution like Fortune is gratifying and rewarding, but being acknowledged as a great institution by our own people means more to me than just about anything. And I'd like to thank our wildly talented, inspired, driven, and hard-working teams for everything they do to capture the imagination of tens of millions of people day after day.

Our talented teams around the world continue to create experiences that inspire our players, drive deeper levels of engagement in our games by our massive and growing global [ph] community's events (3:36). In the last 12 months we had over 150 million active users around the world playing our games for more than 12 billion hours and spectators watching over 1 billion hours of linear content based on our games.

In the hour we'll spend on this conference call, we expect over 1 million people to interact with Activision Blizzard franchises alone. And in the past year our communities grew by more than 25%. This deepening level of engagement with a widening base of players across our franchises is what drove another successful quarter.

We delivered better than expected Q1 results, increased our 2015 non-GAAP revenue outlook to $4.425 billion, and our earnings per share outlook to $1.20 per share. On a non-GAAP basis we delivered record higher margin digital revenues of over $0.5 billion dollars, a first quarter record on an absolute basis and an all-time high on a percentage basis.

As we celebrate our 35th anniversary, we continue to create extraordinary entertainment for our fans. We couldn't be more excited to continue to do so for another 35 years. Our greatest achievement continues to be our ability to attract and retain the most talented employees around the world. And because of that I have never been more excited or confident about our future. And now I'll turn the call over to Dennis.

Dennis M. Durkin

Thanks, Bobby. Good afternoon, everyone. Today I will review our better than expected Q1 financial results, our outlook for Q2, and our increased outlook for 2015.

Q1 was a great quarter that displayed strong trends on our year-round monetizing franchises. We overperformed our non-GAAP February guidance by over $60 million on revenue, $100 million on operating income, and $0.11 on EPS. Even though we had a relatively lighter slate in Q1 this year, non-GAAP revenue and EPS were flat to Q1 last year on a constant FX basis given strong digital trends. Non-GAAP digital revenues comprised a record percentage of overall revenues, up 800 basis points year-over-year.

Turning to our financial results. Please refer to our earnings release for full non-GAAP to GAAP reconciliation. Also the numbers I'll be quoting are compared to the prior year unless otherwise noted.

For the quarter, on a GAAP basis, we generated revenues of $1.3 billion, up 15% year-over-year, an operating margin of 43% up from 37% last year, and a record quarterly GAAP EPS of $0.53, up 33% year-over-year and up $0.16 versus our February guidance.

For the quarter on a non-GAAP basis, we generated revenues of $703 million, an operating margin of 29% and EPS of $0.16. Of the $0.11 in non-GAAP EPS overperformance versus guidance, about $0.05 was related to timing for costs that shifted out of the quarter, and about $0.06 was related to strong franchise momentum including digital sales and engagement trends with our large community of fans. Activision Publishing had a strong season pass, downloadable content, and expansion attach rates on both Call of Duty and Destiny. Console full game downloads represent a high teen share of total units and continue to increase year-over-year.

Blizzard Entertainment had steady and strong performance on Hearthstone with ongoing engagement on the Q4 expansion Goblins vs Gnomes. As mentioned during our February earnings call and consistent with our experience following prior expansions, we saw a decline in World of Warcraft subscribers. Subscribers ended the quarter at 7.1 million.

World of Warcraft's revenue performance at constant FX has been more stable driven by continued strong uptake on value-added services and price increases in select regions, which partially offset the subscriber declines particularly in the east. Moreover, Blizzard has successfully expanded their portfolio over the recent past and continues to do so. Growth from franchises like Hearthstone and Diablo have boosted Blizzard's top line and have pushed Blizzard's non-World of Warcraft revenue stream from 30% of total revenue in 2013 to 40% of total revenue in 2014, even while the World of Warcraft revenues also increased in that period. And new franchises like Hearthstone and Heroes of the Storm are expected to further expand non-World of Warcraft revenue to more than 50% share of the Blizzard business in 2015.

So strong recurring franchise diversification is in process inside the Blizzard portfolio, which sets us up for a bright 2016 and beyond.

Turning to specific P&L items, please note that all percentages are based on revenues except for the tax rate. For Q1 GAAP product costs were 20%, operating expenses were 37%, and operating margin was 43%. GAAP and non-GAAP interest expense was $50 million and our GAAP tax rate was 20%. Our GAAP and non-GAAP fully diluted weighted share count was 741 million including participating securities. On a non-GAAP basis for the quarter, product costs were 21%, operating expenses were 50%, and operating margin was 29%. Our adjusted EBITDA margin was 32%. Our non-GAAP tax rate was 24%.

In terms of cash flow in Q1, we generated strong cash flow with non-GAAP adjusted EBITDA of $223 million, operating cash flow of $209 million, and free cash flow of $188 million after CapEx. We also repaid $250 million of our term loan in February, and next week, on May 13th, we plan to pay a $0.23 per share cash dividend or approximately $167 million in aggregate to shareholders of record as of March 30.

Turning to the balance sheet, as of March, 31, we had approximately $4.5 billion in cash and investments of which over $1 billion was held domestically. We had total debt of $4.12 billion and net cash of $360 million.

Turning to FX. Please note that as discussed on our February call, currency fluctuations continue to be a headwind that we will monitor. In Q1 the year-over-year impact of the strengthening dollar was $68 million on revenue and $0.03 on EPS. As mentioned, both revenue and EPS would have been flat year-over-year at constant FX. In summary, Q1 was a very strong start to the year for Activision Blizzard.

So, now let's turn to our slate and our outlook for Q2 and for the balance of 2015. Our expected Q2 slate from Activision Publishing includes additional downloadable content releases from Call of Duty and Destiny and continued live operations during the open beta for Call of Duty Online in China.

Blizzard Entertainment's Q2 slate is a robust offering across the portfolio including Hearthstone's new adventure, Blackrock Mountain, Hearthstone's important iOS and Android smartphone releases, Diablo III's launch in China, StarCraft: Legacy of the Void's closed beta, and Heroes of the Storm's launch in June. In Q2 we also expect to begin the ramp in sales and marketing spending for our major releases in the back half of the year.

Now to the numbers. For Q2 on a GAAP basis we expect net revenues of $930 million, product costs of 20% and operating expenses of 52%. We expect a GAAP and non-GAAP interest expense of $50 million, a GAAP tax rate of 25%, a GAAP and non-GAAP share count of 745 million, and EPS of $0.21. For Q2 on a non-GAAP basis, we expect revenues of $650 million, product costs of 19%, and operating expenses of 63%. We expect a non-GAAP tax rate of approximately 26% and non-GAAP EPS of $0.07.

Our expected Q3 and Q4 slate from Activision Publishing is one of the strongest we've ever had, including the biggest addition to the Destiny universe yet, Call of Duty: Black Ops III, which we are very excited about, a new innovative release for Skylanders, and the return of one of our most beloved IPs with Guitar Hero Live, as well as further ramp up of our audience playing Call of Duty Online in China. Blizzard Entertainment will bring additional content and live service updates to World of Warcraft, Hearthstone and Heroes of the Storm, as well as bring Overwatch into closed beta.

Now to our 2015 full-year numbers. For 2015 on a GAAP basis we expect revenues of $4.25 billion, an increase of $110 million versus our guidance in February, product costs of 23% and operating expenses of 50%. For both GAAP and non-GAAP we expect interest expense of $202 million. Our GAAP tax rate is expected to be 22%. We expect 750 million fully diluted shares both for GAAP and non-GAAP, and GAAP EPS is expected to be $0.98, up $0.09 from the February guidance.

For 2015 on a non-GAAP basis, we expect revenues of $4.425 billion, $25 million higher than our February guidance, product costs of 24%, operating expenses of 45%, and an operating margin of 31%, 100 basis points better than the February guidance. Our non-GAAP tax rate is expected to be 24%.

For the year we are raising our full year outlook by $0.05 to $1.20. As I mentioned earlier, strong business momentum in Q1 amounted to $0.06 of EPS favorability, which is partially offset by $0.01 of FX headwind, given the further strengthening of the dollar since we last gave guidance in February. See our accompanying earning materials for FX assumptions.

So in summary the transition to digital continues inside of our business, helping to further drive our year-round engagement and monetization model, where our community can play and invest in their experiences throughout the entire year. Along with these digital trends, our strategic investments in new franchises, platforms, and geographies are paying off and set the stage for growth ahead.

Now I will turn the call over to Eric to discuss Activision Publishing.

Eric Hirshberg

Thanks, Dennis. Activision Publishing is off to a great start, and in Q1 we significantly outperformed last year's results with revenues up 28% year-on-year. We have two of the top five video game franchises globally year-to-date. We continue to have three of the top five next-gen games life to date, with Call of Duty: Advanced Warfare remaining the number one title on next-gen, as it has since its launch six months ago. Including toys, Skylanders is also the number one console franchise and title globally in Q1, outsold the number one action figure line globally and of course was the number one kids console franchise and title globally.

Over the past few years we have methodically and effectively expanded our portfolio which now includes three industry-leading franchises, each one of which keeps players engaged all year-round. This engagement creates a virtuous cycle, great content leading to large engaged communities, leading to our ability to monetize those communities by providing more great content. This is why we had the biggest Q1 online player community in our history, up double-digit percentages year-over-year and it is also why, based on our current trajectory, Activision Publishing will likely deliver our biggest year yet of digital revenues.

So let me share a few more specifics by franchise starting with Call of Duty. In the first quarter revenue was up by a double-digit percentage year-over-year, due to the strong sell through of Advanced Warfare and growing online revenues per user across our recent Call of Duty titles. Sales of season pass and map packs were up significantly, and we introduced a new consumable digital mechanic in Advanced Warfare which drove engagement and allowed our players to invest more deeply in their online experience.

We recently revealed Call of Duty: Black Ops III from award winning studio, Treyarch. Nearly 100 million players have played Black Ops and Black Ops II, making Black Ops the most played series in Call of Duty history. In fact, Call of Duty: Black Ops II originally released in 2012, continues to exhibit record-setting engagement this long after release with millions of actively engaged players who are now eager for the next installment of the series.

Black Ops II is Treyarch's first three-year development cycle, and they've been making the most of it with unparalleled depth of content across three modes of play. The campaign can be played as a full single player game or as a co-op game with up to four players. The multi-player experience is the deepest we've ever offered in Call of Duty, and the mind blowing third mode, Call of Duty: Zombies experience features its own XP progression system for the first time.

Another benefit of the three-year cycle is that we've been able to get the press hands-on with the game earlier than ever before, and the response has been phenomenal. In fact, positive media sentiment is double what it was last year, and mind you, last year was our previous high water mark.

We're confident that anyone who gets their hands on the game will agree, which is why we're going to have hands-on multiplayer at E3, as well as this year our first beta in years. Fans who pre-order the game now on Xbox One or PlayStation 4 or PC will have access to the beta.

On to Call of Duty Online which commenced open beta in January in China, the largest gaming market in the world. We're seeing good early trend, especially with high engagement from core first person action players. As we said on our last call, this is a game and a business model that will take time to ramp, and we're now working with our partner Tencent to expand our audience base. We continue to be enthusiastic, both about the opportunity in China, and about the long-term prospects for our game.

Turning now to Destiny, which continues to have incredible online engagements from millions of active players. In fact, these players are still playing on average about three hours a day, as they have been since launch, with strong digital sales and expansion attach rates. In all, Destiny has now received 299 awards, including 31 wins for Game of the Year, most recently adding Action Game of the Year from DICE and Game of the Year at the BAFTAs. And every day, our great partner at Bungie continues to make the game and online experience better.

Later this month we plan to launch Destiny's second major expansion pack, House of Wolves, yet another great piece of content to keep our fans engaged. And in the fall, we'll have a major release, which will be the biggest content addition yet to the Destiny universe, and you'll hear more about that soon.

On to Skylanders, the industry's top console franchise and title of year so far. Skylanders has its own unique engagement and monetization loop, real world toy purchases that enable new and different play experiences in the game, and which roll out in waves for our fans throughout the year. As with our other franchises, Skylanders' average revenue per user has grown year-over-year. And while the toys to life category that we created is increasingly competitive, we believe it remains highly attractive, and one that we will continue to lead with industry-best innovation and gameplay. We'll have more details to share soon about the next installment in the Skylanders franchise, which will once again bring fresh innovation to the category and expand the audience even further.

Finally, Guitar Hero: in April, we announced a fall 2015 return for the beloved franchise, which has been played by over 40 million gamers. Consumers' affinity for the brand remains incredibly strong, and we've spent years developing meaningful, creative innovation. The new Guitar Hero game is one game with two ways to play. Guitar Hero Live lets fans rock real crowds with real reactions, and Guitar Hero TV is the world's first playable music video network, which offers hundreds of songs and additional content to constantly engage our players. The game will be available across console, smartphone and tablet devices. The fan and media response to our reveal has been overwhelmingly positive and we couldn't be more excited to share additional details later this summer.

Overall, we had a great start to 2015 across our portfolio of titles and we look forward to sharing more news with you at E3. So thanks. And I'll now turn the call over to Mike to talk about Blizzard.

Michael Morhaime

Thanks, Eric. Compared to last year's launch of Hearthstone, Diablo III: Reaper of Souls, and presales for Warlords of Draenor, this year's Q1 was relatively quiet for Blizzard Entertainment. Despite this, we continue to have strong performance in terms of engagement. Without any major launches, Battle.net still ended the quarter with the largest Q1 player community in our history, up double digits percentage-wise year-over-year. This reflects ongoing strength across our portfolio of games.

On the World of Warcraft front, we launched the first Warlords of Draenor update in Q1, adding new content, Twitter integration and more. This update increased stability in the last few weeks of the quarter. Warlords of Draenor brought more players back than any previous expansion, and showed that even long time lapsed players will return when the right content is offered.

On that note, we recently revealed the next major update for the game, which will add a ton of new content that will appeal to players across a range of play styles. That's currently on our public test realm and we're looking forward to getting it into players' hands as quickly as possible.

We also announced the WoW Token System. Players who purchase a WoW Token priced at $20 can exchange that token with another player for gold. The player who received the token can then redeem it for one month's game time, or a set amount of play time in China. This provides two benefits: It enables players to pay for their subscriptions with their gold, and it provides players with a secure method for purchasing gold in game. We just launched World of Warcraft Tokens in April, so it's too early to see the long-term impact, but many players welcome the service and have been using it actively.

This was also a big quarter for Heroes of the Storm, our highly anticipated online team brawler. More than 11 million people have signed up for the closed beta test, which went live in January. We're seeing a lot of anticipation in the gaming community and we're continuing to collect great feedback from our beta testers as we drive toward the launch on June 2.

To showcase the action and depth that the game offers, we recently sponsored a collegiate eSports tournament, which we dubbed Heroes of the Dorm. Thousands of players formed teams at over 460 schools across the U.S. and Canada. And similar to March Madness, we created a 64-team bracket after a few qualifying rounds. Those teams then battled their way to the finals, which were televised live by ESPN.

This was the network's first ever live telecast of a collegiate eSports event. The competition was intense throughout the tournament and we saw the formation of many potential Heroes of the Storm college rivalries. I'd like to congratulate the Cal Berkeley Golden Bears on their championship victory. We also saw widespread positive commentary across a range of online communities about the event. This is a testament to the fact that Heroes of the Storm is not only fun to play, it's fun to watch. We think it has great potential as a spectator sport.

Q1 was also an important quarter for Hearthstone. Despite no new content releases, engagement and revenues were steady quarter-over-quarter and in fact have remained relatively stable since launch. The performance for the quarter was driven by a sustained pick-up of Goblins vs Gnomes. Players have really enjoyed the mechanics of the new cards, and we've seen some incredibly creative deck strategies.

During the last two weeks of March, we held presales for our second adventure, Blackrock Mountain. We were pleased to see that enthusiasm for the new content was even stronger than it was with Curse of Naxxramas last August, with

40% more sales in the same timeframe. That enthusiasm continued with the launch of Blackrock Mountain in April which was followed by the iPhone and Android phone versions of Hearthstone a few weeks later.

The mobile phone versions pushed Hearthstone to the number one spot for game downloads in over 25 countries across North America, Europe and Asia, and quickly drove the game to a new milestone of more than 30 million players. Hearthstone continues to be very popular with players worldwide and we're already hard at work on our next release for the game.

We also recently started beta testing the Chinese version of Diablo III together with NetEase in March. There has been a lot of anticipation for the game in China with about 3 million players signing up for the closed beta test. Two weeks ago we launched the open beta test, opening up the game to everyone else in China. Chinese players are able to access the base experience for free and can buy much of the content from Reaper of Souls via an add-on, which is already available for purchase across two offerings priced at $32 and $64. In fact, we just announced with NetEase that Diablo III has already achieved over 1 million unit sales in China, which is a fantastic reception from the community. We look forward to building on that momentum as we drive towards the commercial launch.

Lastly, at the end of the quarter we kicked off the closed beta test for Legacy of the Void, the final chapter of StarCraft II. We know the StarCraft community is eager to play through the conclusion of the story and we've already seen great positive feedback about the game's new multi-player features.

Archon Mode, which allows two players to team up and share control of an army has gotten a very enthusiastic response. We're excited about this feature in particular because it greatly increases accessibility for the game. As I mentioned previously, Legacy of the Void will be a stand-alone expansion that doesn't require either of the first two releases. So, it will be easier than ever for players to get into the game and experience all of the latest content.

On the eSports side, Season 1 of the StarCraft II World Championship Series came to an exciting conclusion with our finals event in France at the beginning of April. Season 2 is now underway and the finals are set to take place at the Metro Convention Center in Toronto at the end of June. It's a thrill to see the top StarCraft II players in the world compete for a spot in the global finals, so I hope you'll tune in online if you can't make it in person.

To recap, we had a great start to the year. With more games in more genres and on more platforms than ever before, it doesn't look like things will be slowing down any time soon. We announced that BlizzCon 2015 will take place at the Anaheim Convention Center on November 6 and November 7, and tickets for the event sold out quickly once again. We're going to have a lot to talk about at the show as well as in the months ahead. So now I will turn the call over to Thomas.

Thomas Tippl

Thanks, Mike. Before we open the call to Q&A, I'll take a moment to summarize the key takeaways from today's call. First, 2015 is off to a great start. We over-delivered the plan for Q1 and raised our full year guidance, which now projects year-over-year EPS growth from operations. And even more important for the long-term prospects of our business, we saw a 25% increase in the size of the player community that engages with our games.

That leads me to the second key takeaway from today's call. We are successfully transitioning our business to a digital year-round engagement model, where our community can play and invests in their experiences not just at launch but throughout the year. This is important because it allows us to improve the player experience by delivering fresh content on a frequent basis while at a time creating value for our shareholders through deeper and higher margin monetization of the audiences we serve.

Lastly, our strategic investments in new franchises, platforms, and geographies continue to pay off, and along with growing engagement and better monetization sets the stage for growth ahead. We are well underway to expanding our franchise portfolio from five to over ten, with four new intellectual properties already in market. The two IPs we launched last year, Destiny and Hearthstone, combined now have over 50 million registered players and nearly $1 billion in non-GAAP revenues to life to date.

We have two new free-to-play franchises if beta, Call of Duty Online and Heroes of the Storm. We also recently announced that this fall, the beloved Guitar Hero franchise will return, with product innovation that we couldn't be more excited about. And Overwatch is on the horizon with a beta this fall. We have an increasing focus on mobile and tablet, with Hearthstone's release on iOS and Android smartphones, and Guitar Hero Live's planned release to also include mobile and tablet at launch.

Finally, we are positioned for growth in new geographies and in particular in the large and fast-growing China market. We now have six franchises in the market in China, World of Warcraft, StarCraft, Hearthstone, Heroes of the Storm, Diablo, and Call of Duty Online, up from two at the beginning of last year.

So now let's take a few questions.

Amrita Ahuja

Operator?

Q&A

Operator

Thank you, sir. [Operator Instructions] And we will take our first question from Eric Handler at MKM Partners. Please go ahead.

<Q - Eric O. Handler>: Yes, thanks for taking my question. First for Mike, with regards to Hearthstone, I think you touched on this briefly, but with the addition of the smartphone SKUs, how is that increased player engagement as well as impacted on monetization? And then I wonder if you have a data about how many players are actually playing on multiple devices?

<A - Michael Morhaime>: Okay, thanks for the question. The response to the phone version has really been very positive globally. We've seen an increase in new players. As I said, it's pushed us past the 30 million player mark. We're very excited about that. Overall engagement and revenue levels have increased meaningfully with the release of the phone version, and they continue to be strong. So we're not breaking down usage across platforms, but I think it is important to note that Hearthstone is a little bit unique, and that is a shared ecosystem. So many of our players do choose to play across multiple platforms and they have access to the same cards regardless of which platform they're playing on.

<Q - Eric O. Handler>: Great. Thank you.

Operator

And we'll go next to Collin Sebastian at Robert Baird.

<Q - Colin A. Sebastian>: Thanks. And congrats on another good quarter. It sounds like the initial reception for Black Ops III has been quite positive, and wondering if you could add a little more specific color on how the three-year development cycle is benefiting the game. And then how it will be differentiated from prior versions of Black Ops and even from Advanced Warfare. I think on the surface at least there appear to be some similarities between the titles. Thanks.

<A - Eric Hirshberg>: Thanks, Colin. Well, the first and I think most obvious advantage of the three-year cycle is just pure creative quality. That third year allows us more time to innovate and iterate and more time to polish and this is Treyarch's first Call of Duty game with that time period to develop.

So, the first answer is it's just going to be a great game. Secondly, you've heard a lot of talk today about driving engagement being key to our business strategy, and as I mentioned Black Ops is the most played series in Call of Duty's history. But beyond just that pedigree of both Treyarch and the Black Ops series, the three-year cycle has also allowed us to put a deeper offering on the disk.

The MP, the multi-player game is going to be the deepest and we think the stickiest we've ever made. The Zombies is going to be deeper than ever and it's going to have our first XP progression system, which we think will also drive engagement. And, of course, the campaign has big innovations in it as well. As I mentioned, you can play it as a single player game or as a co-op game with up to four friends. So, that drives not only increased engagement but replayability because there's more variability in the experience.

In terms of the differences with past Black Ops games and Advanced Warfare, the answer is honestly we're building on the successes of all of those games, but we're also bringing a lot of fresh ideas. I understand what you mean when you say you see similarities with Advanced Warfare, I think the movement system in Black Ops III picks up where Advanced Warfare left off, but improves it and makes it more athletic and intuitive and smoother than ever before, and that's been a big theme we've heard from the press who got hands on with the game at Reveal, which we've never been able to do before, which is another good advantage of the three-year cycle.

So, I think anyone who gets their hands on the game is going to agree, which is why we're doing hands on at E3 for the first time in MP in a long while as well as our first beta in years. So, we're really bullish on the content and think it's going to be a great experience.

<Q - Colin A. Sebastian>: Great. Thanks, Eric.

Operator

We'll go next to Arvind Bhatia at Sterne Agee.

<Q - Arvind Bhatia>: Thank you very much and like to add my congratulations as well. Quick question on Heroes of the Storm. Just wondering – we appreciate all the commentary, Mike. Just wondering if you can maybe talk about the monetization opportunity here this year and then just the ramp you're expecting over the coming years and maybe how you differentiate versus your competition? Thank you.

<A - Michael Morhaime>: Thanks. Well, first, we're really excited that the launch is just a few weeks away occurring on June 2nd. The team has really worked hard in fine-tuning the experience to make it fast, fun and easy to get into. And I do think that relative to some of the other options in the genre, it is easier to get into Heroes, and I think judging by the response that we've gotten from our recent Heroes of the Dorm tournament, I think it's easier to watch as well. The feedback that we've been getting from the closed beta tests has been very positive. There's a lot of great buzz around the game.

We've had, like I said, over 11 million people signing up for the beta test, so there's a lot of anticipation there. As you know, it's a very popular genre. I think the fact that this is a digital game with long-term content, opportunities we're very optimistic about Heroes of the Storm and how it can grow to become another key game in our portfolio. And I think in terms of how the monetization curve will look, we expect to get started strong on June 2 and we are hoping that that will grow over time.

<Q - Arvind Bhatia>: Great. Thank you.

Operator

And we'll go next to Doug Creutz at Cowen & Company.

<Q - Doug L. Creutz>: Thanks. Yeah, you guys only invest in projects if you believe there's a meaningful needle-moving opportunity. And obviously Guitar Hero was a property that moved the needle for you several years ago. But since then the market has changed a lot particularly relating to what casual gamers are doing these days. So, what do you see in the market now that leads you to believe that this can be a profitable investment for you? Thank you.

<A - Eric Hirshberg>: Thanks, Doug. Well, yeah, a lot has changed in the market in that time, and we think for the better in terms of our prospects with Guitar Hero. The first thing is that we think we have a great game innovation and that the franchise needs that. And we said when we put it on ice five years ago, that we wouldn't bring it back unless we really had a breakthrough creative way to bring it back and we think that we have that.

In terms of the way the market itself has changed, first of all online social play has transformed gaming over the past five years, and GHTV is going to be constantly updated with new content to keep the game fresh and to keep people engaged and it also allows people to compete online with their friends in a highly social way. We think this has the potential to have the kind of sticky long tail engagement that defines the rest of our portfolio and our major franchises.

Second, the game's been out of market for five years and during that time, we've had a console transition. We now have powerful new consoles in the marketplace that give us the opportunity to deliver that rock star fantasy in a more vivid and visceral way than ever before, which is what the live mode is really going to do.

Third is mobile has had explosive growth over the last five years with casual players. And one of the breakthrough innovations is that you'll be able to have the entire experience on mobile, and this is a great experience both on the go, on the glass, or with the full experience with the guitar and your big screen TV. So we think that's a big innovation for us and a big opportunity for us as well.

And finally, as I mentioned at the Reveal, we've improved and innovated on the guitar itself, managing to make it both easier and more accessible to a casual player, while also managing to make it more challenging than ever for an advanced player.

So we think we're going to widen the appeal of the game in that score as well. And also we mentioned that guitar is going to be forward compatible with any additional games that come out. That's going to be a better consumer experience we think this time around. It's going to focus us on innovating on the software and keeping the game more engaging as opposed to the hardware like last time around.

<Q - Doug L. Creutz>: Terrific. Thanks Eric.

Operator

Thank you. And we'll go next to Drew Crum with Stifel.

<Q - Drew E. Crum>: Okay, thanks. Good afternoon everyone. So as it relates to Destiny, Eric, can you talk about in more detail the plans around the more expansive DLC coming in the fall you that you alluded to and to the extent you're willing to discuss any updates on future console titles for this franchise? Thanks.

<A - Eric Hirshberg>: Yeah, of course I would love to, Drew, but we don't have any new announcements today. But obviously, a constant stream of robust content is integral to our plans on Destiny. And I would say both the expansiveness of the universe as well as the innovation that Bungie has established with bringing together the best of both first person action games with MMORG (sic) [MMORPG] (37:25) has led Destiny to become already I think one of the most engaging games ever.

As I said, the active Destiny player is still playing for about three hours a day, which is just remarkable amounts of engagement from a large and passionate player base. So this points to exactly the kind of model that I spoke about for all of our games, great content leading to large audiences, leading to our ability to monetize those communities by providing more great content.

So the answer is we have a very robust content plan for Destiny starting with our second major expansion pack, House of Wolves, which has already been announced. And then, you'll also see content being dropped throughout the summer, and then in the fall we'll have a major release, which will be the biggest addition to the Destiny universe yet across all modes of play. Unfortunately, I don't have more details than that today, but we're confident it's going to be incredibly appealing not just to our current fans, but also to people who haven't yet joined the Destiny universe. It's going to be that big of an expansion.

<Q - Drew E. Crum>: Okay, thanks, Eric.

Operator

And we'll go next to Brian Pitz with Jefferies.

<Q - Brian J. Pitz>: Thank you. A quick question on digital. What was your mix of digital business in the quarter? And can you provide any commentary on how this is trending? Thanks.

<A - Dennis M. Durkin>: Hey, thanks Brian. It's Dennis here. Just regards to the digital mix, it's obviously the highest we've ever had on a quarterly percentage. It was at 76% for the quarter. And you look back a couple of years ago, our digital mix was in the mid-30%s for the full year 2013. In full year 2014 it got into the mid-40%s, and obviously we're out of the blocks really strong in the beginning of this year. It's really driven by the full game download on the console, which is obviously transitioning over time. We're now seeing in the high teens in terms of percentage mix of revenue. And then across the business and really across all of our franchises is the add-on digital content and services that we're seeing to drive ongoing player engagement that all of the guys have talked about today. So all of this is really driving that mix up, and we'll see that continue to grow north of 50% across this year. It will be a nice tailwind for the business in the coming years.

<Q - Brian J. Pitz>: Great. Thanks, Dennis.

Operator

Thank you. And we'll take our final question today from Michael Olson at Piper Jaffray.

<Q - Yung Rok Kim>: Hi. Thank you for taking the call. This is Yung Kim in for Mike. Activision's made a significant push into eSports between Call of Duty, World of Warcraft, Hearthstone, and Heroes of the Dorm. How should we think about the opportunity there? Is it more marketing or is it directly monetizable?

<A - Robert A. Kotick>: That's a great question. This is Bobby. For starters, what we've always found eSports has been a great way for us to celebrate our players, and that's really been the principal focus of the company's initiatives.

There may be commercial opportunities in the future. In fact, we expect there will be more commercial opportunities in the future, but right now you have so many players around the world who dedicate so much of their time and their energy and their passion playing our games that we never really want to take that for granted, and this is a way to celebrate them.

You've seen a lot of value created so far with star players. We have players who are earning over $1 million a year between endorsements and winnings. Then you've seen opportunities for shoutcasters at professional events who are also earning meaningful revenues. And then for our players themselves who are narrating their own game play and are now starting to develop millions of fans.

And then we have gamers who are competing in prize events like Blizzard's Heroes of the Dorm that we just hosted last weekend. We gave away college scholarships to Berkeley, the winning team. And we recently also had the Call of Duty championships where we paid out $1 million dollars in prize money.

So if you look at the numbers of spectators that are now watching gameplay, you're probably looking at just for our content alone last year somewhere around 1 billion hours of spectating of linear play. And so from a lot of perspectives it's something that when we look out into the future, we are incredibly excited about, both as a way to really recognize our player's investment and commitment but also from a commercial perspective.

<Q - Yung Rok Kim>: Great. Thank you.

Amrita Ahuja

Operator?

Operator

And that does conclude today's conference. We thank you for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2020-05-20
Event Description: Q1 2020 Earnings Call

Market Cap: 51099.9031909
Current PX:
YTD Change($):
YTD Change(%):

Bloomberg Estimates - EPS
Current Quarter: 30.121
Current Year: 117.603
Bloomberg Estimates - Sales
Current Quarter: 16403.1
Current Year: 68123.828

Q1 2020 Earnings Call

Company Participants

- Margaret Shi, Investor Relations Director
- Charles Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Alex Poon, Analyst
- Alicia Yap, Analyst
- Natalie Wu, Analyst
- Jialong Shi, Analyst
- Eddie Leung, Analyst
- Alex Liu, Analyst
- Binnie Wong, Analyst
- Thomas Chong, Analyst

Presentation

Operator

Good day and welcome to the NetEase First Quarter 2020 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Margaret Shi, Investor Relations for NetEase. Please go ahead ma'am.

Margaret Shi, Investor Relations Director

Thank you, operator. Please note, the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2020 third quarter earnings news release issued earlier today.

As a reminder, this conference is being is being recorded. In addition the presentation and a webcast replay of this conference call will be available on NetEase's corporate website at ir.netease.com.

Joining us today on the call from NetEase's senior management is Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer; and Mr. Hilton Huang, Co-President of NetEase Games. I will now turn the call over to Charles, who will read the prepared remarks on behalf of William.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Margaret, and thank you everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi.

Like every company around the globe, we started the year with a great deal of uncertainty amidst one of the world's worst health crisis. I am pleased to say that we have worked very hard to address the effects of the pandemic, providing help where we can and making the appropriate adjustments to our businesses to ensure the safety of our NetEase family. We believe many companies, inside and outside of China, will overcome this pandemic and come out strong.

We had a good quarter, increasing our net revenues by 18% to RMB17.1 billion, and our net income from continuing operations, attributable to our shareholders was up by 30% to RMB3.6 billion, both on a year-over-year basis. For our online games, net revenues reached RMB13.5 billion in the first quarter on the back of our existing titles' stellar performances, growing 14% year-over-year, even though 1Q, 2019 was itself a very strong quarter for our games services a year ago.

Our legacy PC titles, such as the Fantasy Westward Journey and New Westward Journey Online II continued their strong performances in the first quarter with new expansion packs launched for the Chinese New Year holidays, introducing a series of new content. Quarterly revenues for these games broke new record, hitting another all-time high since their debut almost two decades ago.

Momentum for legacy mobile games was also strong, as we continued to supply this large and sustainable user base with continual content updates. Take our Fantasy Westward Journey mobile game as an example, where we introduced a brand new character, which quickly gained popularity and was a strong driver for gross billings. While we continue to dominate the MMO genre, many of our recent titles in categories that are relatively new for us have also shown remarkable success and sustainability, providing us with steady revenue streams in what is now a very diverse game portfolio. Invincible, Onmyoji, Identity V and Life-After launched in 2015, 2016, and 2018 [ph] respectively serve as good examples of our superior game longevity within different game genres.

Invincible, our 2015 launch, hit another record quarter high gross billings and active users. We are pleased to see the game's strong traction in the SLG markets. After more than five years of successful operations with Invincible, we have accumulated a solid SLG fan base and extensive expertise in this field. We look forward to developing more innovative games to delight our users in this engaging and thought-provoking genre.

Onmyoji continues to show remarkable longevity as we consistently introduced new characters. These additions are resonating well with new game players further solidifying the reach of Onmyoji as a leading ACG game. At the first of our younger IPs that we have created in-house, our goal for Onmyoji is to have an even larger and deeper impact on the vibrant community of young users. In addition to Onmyoji, The Card Game, the Collectable Card Game we launched last year and the upcoming simulation game, Onmyoji: Yokai Koya planned for later this year, we have more exciting new games in store, based on the Onmyoji IP. Later today, this evening Beijing time, at our May 20 Game Day Event, we will introduce two new Onmyoji Spin-Off games in brand new genres.

Launched in 2018, Identity V and Life-After are also a fuel of our newer titles attracting a large base of young fans and starting to demonstrate sustained longevity. Celebrating its second anniversary in April with a series of content updates, Identity V reached a milestone of 200 million registered users, attracting players with its characteristic art style and innovative gameplay. With Life-After since its initial phase of stabilization, gross billings have been picking up steadily over the past few months as we launched a couple of highly popular expansion packs, introducing a series of new themes and innovative gameplay. We believe that Life-After will be another one of our titles that resonates with fans for many years to come.

In terms of new titles, Fantasy Westward Journey 3D was launched at the end of 2019 and it's delivered a stable performance in the first quarter, further expanding the reach of the FWJ franchise as a whole and captivating both returning fans as well as a new audience. In April, we launched Dawn of Isles in China, previously known as Age of isles [ph] as our newest MMORPG, featuring Sandbox gameplay. The game topped the iOS downloads chart soon after its launch and was featured by the iOS app store.

In overseas markets, we continue to gain market share in Japan. Knives Out and Identity V remain as default brands of Japan's top grossing games chart and the user basis for both games are growing at a strong pace. The success of these games has helped us to gain a much better understanding of Japanese users and their preferences, allowing us to better tailor our games for the Japanese market. We have integrated this successful experience and knowhow into the design of other NetEase Games, enhancing our ability to deliver popular titles to global audience. At the end of 2019, we began operating Invincible in Japan ourselves. With our proficiency in operating this game domestically, along with our newly acquired understanding of Japanese user preferences, we saw a steady increase in Invincible's revenues in the first quarter.

Now turning to our game pipelines, many of the games under development have the potential to achieve mass audience appeal, transcending geographies and spanning multiple genres. We have a number of these exciting new releases planned for 2020, which we expect to help us gain more brand recognition in the broader global markets, particularly in the US and European market. As announced two days ago, EVE Echoes is ready for its global launch in August. Additionally, other exciting upcoming titles include Fantasy Westward Journey H5 version, King of Hunters, PES Club Manager, Onmyoji: Yokai Koya, Ghost World Chronicle, Revelation mobile game, Harry Potter: Magic Awakened, Diablo Immortal, Pokemon Quest and MARVEL Duel. Now for our education business. Youdao started the year off on a strong note with healthy gains across many of its primary financial metrics. Total net revenues accelerated by 140% year-over-year to RMB541 million and operating cash flow turned positive for the first time. We are seeing an increasing adoption rate of online education do in large part to the structural effect of the pandemic. Online classes generated gross billings of RMB519 million, up 287% year-over-year, primarily due to continued enhancements to our cost, content and product. To match the needs of newly enrolled students during the pandemic, Youdao quickly developed and refined new products, helping students receive the most effective teaching online, especially for those taking entrance exams this year. In line with the growing enrollments, we carefully crafted a few more products, including junior high school math, high school English courses, which received wide popularity. We also expanded our education team to over 1,000 instructors and teaching assistants who are well trained and incentivized to give our students the most tailored and personal support they need. During the quarter, we further enhanced our technology offering with the launch of AI assay assessment in our dictionary app, a feature that automatically grades and offers suggestions to improve English writing. Going forward, Youdao will continue to build up its largely scalable business model and provide users with effective educational experiences empowered by great content and technology. For our Cloud Music business, we are also growing and proud to have celebrated NetEase Cloud Music's 7th anniversary in April. Revenue from our Cloud Music platform continues to accelerate with high speed, achieving triple-digit growth year-over-year in the first quarter and record high membership revenue. Live streaming revenue is also growing at a rapid pace. In the first quarter, we released several online live events that were particularly poignant [ph] during the pandemic outbreak and helps to support our independent musicians and their ability to distribute. These include the Bedroom Live Music Festival (foreign language) where well-known musicians performed at home via live streaming and In The Live [ph], a high quality broadcast of independent brands and live shows. While we maintain a competitive edge in our original music, with now over 160,000 independent musicians on our platform, we are also looking to provide music from all over the globe to expand our music library. In March, we added popular Japanese music to our platform through our distribution agreement with Studio Ghibli, one of the most acclaimed animation studios in the world. Further adding to our catalog of songs, we recently signed a strategic partnership with Rock Record, one of the largest record labels in China. As with all of our businesses, innovation is key. Along these lines, our music platform's largest progression includes a newly launched karaoke offering for our young people. Moving ahead, we will continue to make sensible investments in content and innovation to remain relevant and competitive in the exciting world of music. Turning our focus to Yanxuan, after a short four years we have developed a distinct and recognizable brand with a number of notable self-developed products that appeal to a wide range of consumers. In particular, Yanxuan has made a name for itself with distinctive offerings in housing, personal care and food categories. During the first quarter, we upgraded our membership offering to a pro membership, to include more benefits, attracting a considerable new constituency. New memberships rose by 138% year-over-year, owing to our innovative marketing approaches, such as collaborating with top livestreaming celebrities. Meanwhile, our inventory has been managed to a healthy level as we continuously optimize our procurement and reduce obsolete inventory. Overall, we had a strong start to 2020. Our primary business lines grew during the first quarter and we are pleased to have advanced our mission to bring inspiring, leading products and services to our growing community of followers. We will press forward, as we have done for the past two decades, with our eyes on the long term and plans to reach incremental gains along the way. This concludes William's prepared remarks. I will now provide a brief review of our 2020 first quarter financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details. Total net revenues for the first quarter were RMB17.1 billion or $2.4 billion, representing an 18% increase year-over-year. Net revenue from online game services were RMB13.5 billion, up 14% year-over-year. This increase was primarily driven by the strong performance of our flagship titles in FWJ franchises, New Westward Journey II, as well as Blizzard's World of Warcraft. Mobile games accounted for approximately 70% of net revenues from our online games in the first quarter. Net revenues from Youdao also increased 140% year-over-year in the first quarter, reaching RMB541 million, primarily due to the increased net revenues from online courses with a rapid increase in K12 paid enrollments and sales of intelligent learning devices. Net revenues from innovative businesses and others were RMB 3 billion for the first quarter, up 28% year-over-year, mainly due to increased contribution from NetEase Cloud Music and CC live streaming. Overall gross margin was 55% in the first quarter. GP margin for our online games services for the first quarter was 64.1%. Our gross margin for online games is generally stable, fluctuating quarter-to-quarter within a narrow bandwidth based on the revenue mix of mobile and PC, as well as self-developed and licensed games. Youdao's gross margin expanded sharply to 43.5% in the first quarter, a vast improvement from 29.8% in the last quarter. This was primarily driven by the achievement of economies of scale and better faculty compensation structure. Gross margin for innovative businesses and others for the first quarter was 15.8%, up from 5.7% year-over-year. The improvement comes primarily from significantly increased revenue from our NetEase Cloud Music business. For the first quarter, total operating expenses were RMB4.9 billion. Our selling and marketing expenses as a percentage of net revenue was 10.9% compared with 13.7% in the prior quarter. The quarter-over-quarter decrease was a result of less spending in online game promotion and Cloud Music during this quarter. R&D expenses were RMB2.1 billion, up 5% year-over-year. We remain committed to investing in innovative content creation and product development, which is what's defining us as a technology company. The effective tax rate was 22% for the first quarter, relatively flat with the prior period and down from 31% in the first quarter of 2019. Non-GAAP net income from continuing operations attributable to our shareholders for the first quarter was RMB4.2 billion or $595 million, representing an increase of 15% [ph] quarter-over-quarter and nearly 26% year-over-year. Our non-GAAP diluted earnings per ADS from continuing operations were RMB32.17 or $4.54 for the first quarter of 2020. Our cash position remains strong. As of 31st -- as of March 31, 2020, our total cash and cash equivalents, current and non-current time deposits and short-term investment balance totaled RMB 79.3 billion compared with RMB74.4 billion as of the end of last year. In accordance with our dividend policy, we are pleased to report that our Board of Directors has approved a dividend of $1.16 per ADS for this quarter. This represents a regular dividend paying stream since 2013. On February 26, 2020, we announced the Board approval for a new share repurchase program for up to $1 billion of our outstanding ADS and we announced an amendment to such program earlier today to increase the total authorized repurchase amount from the original $1 billion to $2 billion. As of March 31, 2020, approximately 1.1 billion ADS has been repurchased for a total consideration of $342 million. Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead with Q&A.

Questions And Answers

Operator

Thank you. (Operator Instructions) We will take our first question from the line of Alex Poon from Morgan Stanley. (Multiple Speakers)

Alex Poon, Analyst

(Foreign Language) I'll translate my questions. First question is regarding the lessons learned from COVID-19. Regarding the game business, managed game genres have become very popular during this period, no matter it is mobile or shooting games and also casual games as well. So in terms of user acquisition, retention, game genre development strategy, do we have some new -- sourced new ideas after this COVID-19? And my second question is regarding the Music business. Top-line growth is very strong. How should we think about the product development and margin trend in 2020? Thanks very much.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Alex. (Foreign Language).

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Alex, I will provide a brief translation of William's remarks. Firstly, on games, during the pandemic, we have seen games becoming an essential [ph] event for family members staying together in-house, so they have more time to spend together as a family, as a whole, to get joy and excitement and some relief from game as a broad entertainment. It is also a boost to new game users during the past quarter. These will be obviously translated into our thinking of how to focus more on R&D, sales development of games that can create a bonding opportunity for family members as a whole going forward.

For the Music, and William emphasized, in fact re-emphasized from his prior remarks that the ambition -- the mission of NetEase Cloud Music platform is we want to create a best environment to support development of China's independent musicians, people with talent who can express themselves and distribute their product to a group of music enthusiasts with passion, with exploration of new, diversified, different genres of songs. And I think for the foreseeable future that is our key focus of development.

You also asked about the margin trend. I think that as we continue to grow the scale and diversification of our Music revenue stream possibilities, we will naturally benefit a lot from economies of scale with the enhancement of margin trend. And I think on the margin trend, we are also quite optimistic. Hope that answers your question Alex?

Alex Poon, Analyst

Thank you very much.

Operator

We will take our next question from Alicia Yap from Citigroup. Alicia Yap, your line is open. Please go ahead.

Alicia Yap, Analyst

Okay. Hi, thank you. Good morning, William and Charles. Congrats on the results. Thanks for taking my questions. My question is on your gaming business. As many other companies are seeing the normalizing trend of the gamers' traffic and activity post the lockdown default [ph], how does that trend looking for NetEase Games and how should we think about the offsetting factor with your deferred revenue for the second quarter and also the lockdown in overseas that might benefit the overseas gaming grossing? Thank you.

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Alicia, do you want to translate your question yourself?

Alicia Yap, Analyst

Sure. (Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language).

Charles Zhaoxuan Yang, Chief Financial Officer

I will provide a brief translation of William's remarks. So he commented, Alicia, I think your observation is right. However, that is a short-term volatility, I think, across the board, as you mentioned, other game companies and us might be seeing. However, William emphasized that the growth engine of NetEase Games is our ability to continuously, long, produce in-house and launch new game titles, as well as our ambition of becoming a more globalized game company with more exciting titles launched into overseas markets, such as Japan and hopefully very soon in the mainstream Western market. We saw that we are not overly concerned about these short-term volatilities and we are very, very optimistic about the outlook of NetEase Games growth, driven by the diversification of new titles, as well as diversification of new geographies.

Alicia Yap, Analyst

Thank you.

Operator

We will take our next question from the line of Natalie Wu from China International Capital Corporation. Natalie [ph], proceed further.

Natalie Wu, Analyst

Hi, good morning. Thanks for taking my question and congratulations on a very solid quarter. (Foreign language) I will translate myself. So I have two questions, first one is regarding the PC games. So your PC games outperformed the industry despite holdup [ph] operation of the Net Cafe, which is quite encouraging. It would be great if management can share with us some thoughts of the future outlook for that segment.

And the second one is regarding Harry Potter. So just wondering if the game is ready, but still need time to get approval in domestic China market. Will you decide to wait for the license or will you launch it firstly in overseas regions? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Yeah. Natalie, I will translate William's comments for everyone's broader benefit, for the first question and I'll answer the question on Harry Potter. So firstly, what we observed is that during the global pandemic, PC and console games in general has seen the increasing trend as more people are spending time at home. And it is not so much correlated to the Internet cafes operation, as you can see from our game results, because our PC games are legacy titles running for over a decade. In case of FWJ, we see a record quarter since it debuted almost 17 years ago, and we are very confident about the sustained gross billing popularity of our flagship PC games. For the time being, our main concentration -- focus, of new game development is tilted towards mobile games. So launch of new PC games will be opportunistic. We do not have a regular agenda, like we regularly launch new mobile games. So that's to your first question.

Second question, Harry Potter. We are very excited about Harry Potter. It is a strong IP globally and we are confident in our R&D ability to convert this IP into an exciting game title. And I think it's too early to predict about the situation on regulatory approvals in China. And when it comes to the stage when the game is ready for launch, whether we will do a global simultaneous launch or whether we will do overseas launch first, followed by domestic, upon the approval, both are possibilities and we will decide that later when the game is more advanced.

Natalie Wu, Analyst

Got it. Thank you.

Operator

We will take our next question from Shi Jialong from Nomura. Your line is open. Please go ahead.

Jialong Shi, Analyst

Yes, good morning management. Thanks for taking my questions. First of all, congratulations on a very solid quarter. (Foreign Language) I have two questions. First question is about NetEase online gaming business, just wondering how much of NetEase online gaming revenue was contributed by overseas market in 1Q?

My second question is about NetEase Music business. According to various media reports, it seems to me NetEase Music has accelerated the purchase of license to contents since this year, including the recent license agreement with top global record labels, as well as the exclusive purchase of some of the highly rated music shows. I was just wondering why -- it seems NetEase Music has become more aggressive on content purchase. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Jialong's first question, overseas, first quarter, our overseas revenue accounts for slightly more than 10% of our total game revenue, consistent with our level of last year, but we are very confident to continue to grow and even very strongly to grow this revenue contribution from the overseas game market in the next three to five years. (Foreign

Language)

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

I'll provide a quick translation of William's remarks. So, first of all, our dedication to support and promote independent musicians and native IPs are not mutually exclusive with our deep respect and open-minded strong collaboration with music label companies. In fact, in the past, there are obstacles in the industry preventing us from purchasing music content and music IPs directly from label companies. We are very, very active and indeed have collaboration with all these highly regarded label companies in an effort to acquire music IPs, content, copyright and utilize our efficiency and our massive user scale of the NetEase Cloud Music to distribute their music content to a group of music enthusiasts, lovers. And we also want to reiterate that we hope that the whole industry in China and all the players in China can spend more focus, effort and resources into promoting native IPs, organic music from independent musicians, because I think it is going to be a much bigger ambition for the entire industry to see the rising of Chinese music, Chinese musicians as a whole, to play a much bigger role on the global audience, on the global stage.

Operator

Okay. We will take our next question from the line of Eddie Leung from Bank of America Merrill Lynch.

Eddie Leung, Analyst

Good morning. (Foreign Language) Good morning. So my question is about the new game launch. Historically, when we have a year of a lot of new games to be launched, typically, the marketing spending ratio would go up. So just wondering what could be the pattern this year and whether there would be different ways to promote these games. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Eddie, your question is on our outlook of marketing expenses. I wanted to re-emphasize one point. NetEase Games focuses a lot on self-developed, in-house developed games. As such, we are always excited about our lineups of new games. Whenever we consider promoting a new game, it is always a return-driven exercise internally, depending on our projections of the game's performance and expectations of the gross billings. Then we allocate marketing resources in a very sensible way. That is why I think in the prior year quarters I also made remarks that try not to look too much into the quarter-over-quarter fluctuations of the marketing spending dollars. In fact, if you look at my marketing dollars as a percentage of the overall revenue on the full year trend, last year we controlled it at around 10%, a significant decrease from the prior two years. However, absolute dollars is not shrinking. That is because we are more sensible. We are more conscious about the return generation on, like, marketing dollars with more new game titles. Yes, we are going to spend more marketing dollars, but we are even more optimistic that with effective promotion, the new games are going to generate even faster return for us at the top line. So on the financial planning aspect, NetEase remains prudent and sensible.

Eddie Leung, Analyst

Got it. Thank you Charles.

Operator

We will take our next question from the line of Alex Liu from China Renaissance. Your line is open, please go ahead.

Alex Liu, Analyst

(Foreign Language) I'll translate myself. My first question is on the cash allocation. We have very good cash flow on our core business and also very solid cash balance. I was just wondering, should we think about a large stock repurchase program and perhaps further stock repurchase program as more occurring practice down the road? And the second question is on the deferred revenue. Deferred revenue balance was very strong this quarter and I was wondering if the management could give some color on this growth and whether it is due to the mix change between PC and mobile games? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Alex, for your first question, our treasury policy is always very prudent. We are one of the very, very few tech companies globally that pays a regular dividend. In fact, we've been paying a regular dividend since 2013 and we will continue to do so, returning value to our shareholders, especially long-term shareholders who have been supporting us in the journey of the growth over the last two decades. The stock buyback programs is also a regular exercise for a couple of years, and when the situation requires and then within our ability, we can go back to the Board, just like this time, seeking for their authorization of enhanced dollar amount for the overall stock buyback. So that is on the treasury cash management aspect.

For your deferred revenue, we don't further break down exactly on the composition, but I think you are right, in Q1, if I remember correctly, it is probably another record quarter for both my recognized revenue, as well as deferred revenue, and again, largely is underpinned by the gross billing and the growth of both my PC lines as well as mobile lines of games, largely consistent with what you are seeing in the year-over-year growth for the recognized revenue. Youdao also contributed to a certain extent, of course, but then you can refer to the Youdao's public filing for the deferred revenue incremental portion.

Alex Liu, Analyst

Understood. Thank you very much.

Operator

We will take our next question from the line of Binnie Wong from HSBC.

Binnie Wong, Analyst

Hi. (Multiple Speakers) Thank you. Good morning. William, Charles and Margaret. (Foreign Language) I'll quickly translate myself. Post the COVID-19, do you think that actually changes in terms of how we view our overseas games expansion plan? What are the new opportunities we also see and how do we see our target in the next three to five years? Does that change or that remain the same? And then in terms of your upcoming game launches, which one do you think -- because these are all very highly anticipated, which one do you think that we probably will see launches soon, and then in terms how you see the significance of those. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

So, I will provide a brief translation of William's remarks. So firstly, how the pandemic situation globally would affect our thinking of game promotions, particularly in the overseas market. William's comment is that generally speaking the pandemic situation requires people to spend more time in-house. So it is a structural tailwind for overall activities that happen at home, playing video games, watching drama, et cetera and that we think is going to also benefit in our game promotions, because this content is having more user time, so to speak, on a global scale and we are not particularly concerned about the pandemic situation disrupting our plan -- our original plan of game launches, especially for these mature overseas market. Users are more attracted and emphasizing a lot on game quality. I think that is our biggest selling point, it is the quality of the NetEase Games.

And second you asked on the approval process and our expectation on the overseas games. It's really difficult for us to do a forced ranking, which one is number one, which one is number two, because for all these projects, since the inception of the project business planning, we think they are all great products, representing highest quality in the respective genre, to target -- attract to a very different segment of target users. So we are very excited. Some of the games can be launched as early as the middle of this year and some might have to wait and until the second half, later part of this year. And William chose [ph] also a closing remark that he himself personally, throughout, and given the pandemic situation, he is actually being thinking giving a lot of more thoughts in terms of how game content can be designed and developed and how game content can be distributed to fulfill a better social responsibility and value to families, to people around the globe.

Binnie Wong, Analyst

Thank you. Thank you, William and Charles. That's very helpful.

Operator

We will take our next question from the line of Thomas Chong from Jefferies. Your line is open. Please go ahead.

Thomas Chong, Analyst

Hi, good morning. Thanks William, Charles and Margaret for taking the question. I have a question back to the Music business. Given the fact that we have been also monetizing for the live streaming business model, can you comment about how we should think about the competition in the live streaming space, as well as the competition for short-form video? (Foreign Language).

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

So in the interest of time, I'll provide a brief translation of William's remarks just now. So broadcasting is just one way of us thinking how we can monetize on our NetEase Cloud Music platform. It is not the only way and we will continue to explore different and innovative and diversified ways of monetization in a sensible and user-appealing way. But the essence of us, the biggest ambition and the mission of us doing the NetEase Cloud Music platform is that we want to contribute, whenever we can, within our ability, to help, promote and better enhance the Chinese music industry as a whole. It might look very different from mature market in the Western world, but we think Chinese music market is huge with huge upside potential, and it could allow multiple players to develop its respective, differentiated, competitiveness, advantage and edge in collectively making China's online music industry a better and a more promising industry.

Thomas Chong, Analyst

Thank you.

Operator

Due to time limit, that concludes today's question-and-answer session. At this time, I will turn the conference back to Margaret Shi for any additional closing remarks.

Margaret Shi, Investor Relations Director

Thank you once again for joining us today. If you have any further questions, please feel free to contact us directly or TPG Investor Relations. Have a great day. Thank you.

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, everyone.

Operator

That's concludes today's conference. Thank you everyone for your participation, you may now disconnect.

Company Name: Netease
Company Ticker: NTES US
Date: 2020-02-27
Event Description: Q4 2019 Earnings Call

Market Cap: 44255.2205456
Current PX:
YTD Change($):
YTD Change(%):

Bloomberg Estimates - EPS
Current Quarter: 27.522
Current Year: 115.466
Bloomberg Estimates - Sales
Current Quarter: 15604.25
Current Year: 67324.97

Q4 2019 Earnings Call

Company Participants

- Margaret Shi, Media and Investors
- Charles Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Alex Poon
- Hillman Chan
- Alex Yao
- Natalie Wu
- Jialong Shi

Presentation

Operator

Good day, and welcome to the NetEase 2019 Fourth Quarter and Fiscal Year Earnings Conference Call. (Operator Instructions)

At this time, I would like to turn the conference over to Margaret Shi, IR Director of NetEase. Please go ahead.

Margaret Shi, Media and Investors

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for Safe Harbor from liability as established by the US Private Securities Litigation Reform Act.

Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its annual report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2019 fourth quarter and fiscal year financial statement news release issued earlier today.

And with respect to non-GAAP financial measures related to the results of our consolidated subsidiary Youdao, please visit the Investor Relations website of NetEase at ir.netease.com. As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on NetEase IR website.

Joining us today on the call from NetEase senior management is Mr.William Ding, our Chief Executive Officer; and Mr.Charles Yang, Chief Financial Officer.

I will now turn the call over to Charles, who will read the prepared remarks on behalf of William.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Margaret and thank you, everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are now based upon renminbi. 2019 was a eventful year for NetEase. We expanded the reach of our online games, grew our international presence, IPOed our online learning Youdao, advanced our music platform, and refined our operations in e-commerce.

For the full year, we grew our total net revenues by 16% to RMB59.2 billion, and increased our GAAP net income from continuing operations attributable to our shareholders by 60% to RMB13.3 billion. Online games segment is the cornerstone of our business. Despite having launched fewer games throughout the yea, we continued to grow our online games business at a healthy range in 2019 with 16% year-over-year increased in net revenues.

Driven by the steady performance of our long-standing titles, we once again exceeded RMB10 billion this quarter for the past seven consecutive quarters. Our flagship titles continue to provide solid support for our online games business with increasing longevity and user loyalty.

In 2019, revenues from Fantasy Westward Journey online and Fantasy Westward Journey mobile both grew at double-digit rate, remaining prevalent after years of operations. Westward Journey online and its mobile version also grew steadily in 2019.

After over 15 years of operation, our FWJ and WWJ franchises have been instilled in the collective memory of a generation of Chinese players.We further expanded the reach of these IPs through the introduction of FWJ 3D in mid-December last year, captivating both returning fans, as well as new audience.

As another iteration of the FWJ franchising mobile, this 3D version game reserves the classic game play and social system, while bringing brand new experiences to mobile users in a real-time 3D world. We are still working on new updates and expansion packs to further optimize the experience for FWJ 3D, and we are confident that over the long-term, the 3D version will show similar longevity and popularity as our other titles in this franchise.

In addition to growing and strengthening our existing franchise, we are also good at incubating new ones. Our corporate DNA in content innovation, marketing expertise and long-term operations have allowed us to consistently deliver new and long-lasting game titles to our users.

Onmyoji is the first of these relatively younger franchises that we have built in-house. We are pleased to see that as we introduce more innovative new story lines, new characters and other new content, the influence of Onmyoji's IP is growing and resonating well with game players. In 2019, Onmyoji topped the iOS grossing chart four times, stabilizing at a new run-rate after more than three years of operation.

In December, we launched our Onmyoji: The Card Game, its second spin-off game living up to expectations. The new Onmyoji card game carried on the tradition of impressing the market with its exquisite artwork. With this iteration, we also introduced more competitive and strategic game play, winning over a large group of hard core collectible card players.

We are now also currently working on several new Onmyoji games, including Onmyoji: Yokai Koya, a simulation game, which we plan to launch in the first half of this year. Identity V is another young IP where we see the potential to be building to a successful NetEase franchise.

With this goal in mind, we are continually enriching this IP through a variety of initiatives, including e-sport, IP collaborations and offline activities. We have hosted a number of high-profile event featuring Identity V, including both international and regional series tournaments. Most notably, our global championship, Call of the Abyss, has attracted over 800,000 players from around the world since December.

We also collaborated with Happy Valley, a popular national theme park right in China, bringing some of the in-game characters to life. We are pleased to see the early success of Identity V as it becomes another powerful IP franchise, establishing a broad and vibrant community of young players in China and abroad.

Invincible, our 2015 launch that has been growing steadily year-over-year in terms of the revenue and active users, is now one of China's biggest SLG titles. Like with many of our games, we invented a brand new in-game mechanism that reset gamers' scores every season, creating a much more balanced game experience and setting a new standard for the younger.

Given the reason of the increasing popularity of SLGs in China, we are optimistic about our prospects and are working to bring more exciting content to the promising SLG category. The prerequisite to build a successful franchise is the ability to create popular game IPs in-house, which is propelled by our world-class R&D infrastructure.

Over the past two decade, we have built one of the largest in-house R&D teams with China's most talented and passionate game creators supported by one of the most unique and comprehensive R&D infrastructures in the world.

We empower each of our talent with our game enthusiastic corporate culture and second-to-none training mechanism in the industry. Our training program at NetEase Games Academy are widely recognized in China as the premium online games training institution for the creative minds. Most recently, pool of our training programs were awarded the 2019 ATD Excellence in Practice Award by the Association for Talent Development, one of the most authoritative international award in the global talent development industry. As we move ahead, we will continue to foster talent and stimulate new ideas that propels the development the our games.

2019 is also a fruitful year for our licensed games, especially for our joint venture with Blizzard Entertainment. World of Warcraft Classic was launched in August as a inventive re-creation of WoW (Technical Difficulty) six, and it was very well received by a generation of returning players and newcomers alike. We are very pleased to see the continued popularity of WoW in China, achieving a record number of total monthly subscribers in the fourth quarter with increased revenue quarter-over-quarter.

In 2019, we continued to advance our games and made ingrowth that expand our reach in overseas market. Knives Out remained a household name in Japan, topping the iOS grossing chart multiple times during the year, leveraging our knowledge of building game brands. We further strengthened Knives Out brand presence by engaging in a series of successful collaborations and our first ever e-sports championship tournament in Japan.

Identity V also exemplifies our ability to operate games in the overseas market over the long-term, leading Japan's iOS topping chart for the first time in September. With the success of these titles, we have accumulated a better and deeper understanding of our users in terms of their interests, social behaviors, and preferences in style, esthetics, and game play. We have integrated this successful experience and know-how into the design of our other games, enhancing our ability to deliver popular titles to Japanese users.

In addition to our success in Japan, we've also expanded our footprint across more regions. In December, we launched Marvel Super War in several Southeast Asian market where it topped many of the iOS download charts. Building on our existing success at home and abroad, we have many exciting games in our pipeline including Harry Potter: Magic Awakened, EVE Echoes, Onmyoji: Yokai Koya, Ghost World Chronicle, Revelation mobile game, Diablo Immortal, and Pokemon Quest.

Turning to our online learning business, Youdao made solid progress in 2019, significantly growing its online course businesses. Youdao enhanced several course products, including high school Chinese and physics, practical English for adults, and coding courses for kids. We are also seeing excellent adoption and a rapid increase in sales of Youdao's intelligence learning devices driven by the successful launch of our second generation Dictionary Pen.

We also expanded our tutoring and sales team, and substantially improved our tutoring and operating systems to support them. These efforts have been rewarded by robust growth in gross billings of Youdao's online courses by 125% in 2019 and over 200% in the fourth quarter. More importantly, we have accumulated experience that we can replicate across our highly scalable online course model and are beginning to benefit from economies of scale. In 2020, NetEase will continue to support Youdao's mission to bring users more effective and technology-driven education experiences.

Our Cloud Music revenue hit a record high in the fourth quarter with membership revenue more than doubled year-over-year. Revenues from digital albums and live streaming also grew rapidly. Sales of digital albums have proven to be particularly effective on our platform. For example, sales from 22 year old Chinese pop Star, Wang Yibo's digital single, No Sense, exceeded RMB10 million within just 11 hours. Similarly, sales of Chinese singer, song writer, Hua Chenyu's digital single, How I'd like to love this world [ph], exceeded RMB15 million after 45 days online, marking the highest digital single sales record online in China according to a third-party data source.

NetEase Cloud Music is a home to a large number of independent musicians. More than 100,000 independent artist feature their music on our platform, and their songs were played back more than 270 billion times in the year. This makes NetEase Cloud Music, the most recognized platform for our regional music by Chinese artists.

In 2019, we plan to use the platform's distribution capability and its broad influence to create more viral content across the Chinese music industry. And finally, our focus with Yanxuan in 2019 remained on improving supply chain management and operating efficiency. We effectively reduced our inventory compared to a year ago and consistently improved our positive feedback range from users in the quarter.

We made adjustments to our pricing management, which resulted in increased revenue and better gross margins from the business. Our participation in product design has resulted in the creation of many hit products by providing valuable research and market analysis gained from the customer end to our manufacturers. At the same time, we have significantly improved our membership system and are seeing the benefits of increased member repurchase rate.

As for our manufacturer and factory initiatives, we have helped to build tailored online data systems that has further improved their manufacturing process and quality. In 2020, we will continue to enhance our brand influence and reach in China by bringing even more high quality and personalized products to a growing number of consumers.

We are excited for the new year. As our existing game titles continue to impress the market with their phenomenal longevity, 2020 will also see more game launches in China and globally from NetEase. 2020 also marks the 20th anniversary of NetEase being a publicly traded company. As an internet factory [ph] in China, NetEase has remained relevant and continues to be a forerunner in the evolving market. With our long track record of success, our goal is to inspire our ever-growing community, while bringing increasing value to each of our stakeholders.

Before I pass the call over to Charles, I'd like to share some updates on the evolving situation with the coronavirus outbreak in China. Right after the corona outbreak, we reacted instantly and rolled out a series of initiatives to support the affected regions. We set up a special fund of RMB100 million. The fund will be used to purchase medical equipment and medicines from home and abroad, and deliver to places where the outbreak is the most severe and helping most needed. At the same time, Yanxuan immediately delivered over 200,000 free masks, and other protective supplies to our customers and set up special funds for the supply of (inaudible).

For Youdao, we were among the first ones in the industry to offer free courses to K-12 students in affected areas, which was later expanded to other regions of China. For the college students, Chinese University MOOC connected with 800 universities, covering 4,000 professors lectures. We also provide our technology support to help other offline educational institutions to move courses to online through Youdao intelligent cloud.

Our company took every effort to protect the health and safety of our employees and the doctors multiple measures to maintain our operation efficiency, such as flexible work policy and remote office collaboration using our proprietary technology. Overall, with respect to the outbreak, we currently expect to see some impact to our business lines in the near-term. However, the situation is evolving. NetEase is committed to providing support to our employees, users and communities and working together as we together move through this challenging time.

This now concludes William's comments. I will provide a brief overview and review of our fourth quarter and full-year 2019 financial results. Given the limited time on the call, I will be only presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

Total net revenues for 2019 were RMB59.2 billion or $8.5 billion, representing 16% increase year-over-year. Net revenue for the fourth quarter came in at RMB15.7 billion or $2.3 billion, representing 9% increase year-over-year.

For 2019, our net revenues from online game services grew 16% year-over-year to RMB46.4 billion and, in the fourth quarter, it was also up 5% year-over-year to RMB11.6 billion. Mobile games accounted for approximately 70% of net revenues from our online game services in the fourth quarter. For 2019, net revenues from Youdao were up 78% to RMB1.3 billion, and, in the fourth quarter, net revenue from Youdao was up 78% to RMB410 million, primarily due to increased net revenues from its online courses and sales of the intelligent learning devices.

For 2019, net revenues from innovative businesses and others were up 12% to reach RMB11.5 billion. In the fourth quarter, it was up 18% year-over-year to reach RMB3.7 billion, mainly due to the increased revenue contribution from Cloud Music and CC live-streaming. Our gross margin was 52.2% in the fourth quarter. Gross margin for our online games remained relatively stable. It fluctuates quarter-to-quarter within a narrow bandwidth based on the revenue mix of mobile and PC, as well as self-developed and licensed games.

Youdao's gross margin improved to 29.8%. In the fourth quarter, this was primarily driven by the improvement of the sales and better economies of scales. Gross margin for innovative businesses and others was 20.6% in this quarter. Margin improvement both year-over-year and quarter-over-quarter was primarily due to the increased revenue from Cloud Music.

For the fourth quarter, total operating expenses were RMB5.2 billion. Our selling and marketing expense as a percentage of total revenue was 13.7% in this quarter. On the full year basis, selling and marketing expense as a percentage of full year net revenue was at 10.5% compared with 13.5% in 2018. R&D expenses were RMB2.3 billion, up 5% from the previous quarter. We remain committed to investing in content creation and product development, which is what defines us as a technology company.

On a full year basis, R&D expenses represent 14.2% of full year net revenue comparing to 14.4% in 2018. The effective tax rate was 22% for Q4 and 18% for the full-year 2019. The lower effective tax rate for the fourth quarter and for the full year compared to the 2018 period were mainly due to reduced losses from certain loss-making subsidiaries of the company. Non-GAAP net income from continuing operations attributable to our shareholders for the fourth quarter, totaled RMB3.7 billion or $526.1 million, representing a decrease of 23% quarter-over-quarter and a increase of 15% year-over-year.

Our non-GAAP diluted earnings per ADS from continuing operations were RMB28.03 or $4.03 for the fourth quarter of 2019. Our cash position remains strong. As of December 31, 2019, our total cash and cash equivalents, current and non-current time deposits, and short-term investment balance totaled RMB74.4 billion compared with RMB49.7 billion as of the year end of 2018.

In accordance with our dividend policy, we are pleased to report that our Board of Directors have approved a dividend of $1.02 per ADS. On February 26, our Board also announced and approved a new share repurchase program for up to $1 billion of our outstanding ADS for the next 12 months beginning on March 2.

Thank you for your attention. We would like now to open the call to your questions. Operator, let's go to Q&A, please.

Questions And Answers

Operator

(Question And Answer)

Operator

Thank you. (Operator Instructions) We will take our first question from the line of Alex Poon from Morgan Stanley. Your line is open. Go ahead.

Alex Poon

(Foreign Language) I translate my questions. First is regarding music. So we are hearing the agreements between Tencent Music and the top three labels are ending this year, and next year. And how will this change the competition landscape, revenue growth and cost structure of NetEase Cloud Music in the next two years?

And my second question is regarding the overall company Kaola, it has been loss making but it has been sold. And music already raised enough funds and overall company margin is improving. So what's your thoughts on balance sheet, cash flow in the next two, three years? Thank you very much.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Alex. For your first question, let me provide a brief translation of William's response. So, firstly, label companies exclusivity arrangement in the past years have said, China's overall online music industry and the fact all sorts of players along the value chain, not only just the platform like us, but also app stores, hardware manufacturers, upstream and downstream players along the chain.

We hope that all label companies, not just the big three, going forward, can all comply with the regulatory frameworks set in China, with a aim to provide a healthy environment to the overall industry as a whole. Financially, it's definitely going to make the cost structure of the cloud music of the whole industry to return to a more healthy and normalized level, because in the past we -- the whole industry has been overpaying for the content cost twice, three times or ever more to the label companies in this unfair set up.

Once the cost structure can normalize then players like NetEase Cloud Music can focus more resources in promoting innovative music content, and encourage native Chinese musicians with our mission to create a vibrant, healthy and successful music culture and community in China. So that's the response to your first question.

On your second question, on the cash. So first of all, let me make a comment that with a conscious effort of being more focused on our core businesses, starting from the end of 2018, and you see a series of fruitful actions throughout 2019. We are benefiting from the economies of scale. As a result, our balance sheet has been growing strong, our cash position is being very, very strong. Along the way, we've been also very disciplined in paying dividend, increase the dividend payout ratio and have a regular stock buyback programs. All-in-all, we've acted in a responsible way to our shareholders. And especially in a relatively more volatile market, we think by having a strong cash flow position together with a disciplined and responsible treasury policy to our shareholders, that will make NetEase even stronger and more defensive company throughout this macro turmoil.

Operator, next question, please.

Operator

We will take our take our next question from Hillman Chan from Citigroup.

Hillman Chan

Hello, William, Charles and Margaret. (Foreign Language) So my first question is on the Coronavirus impact on our various business lines, positive and negative, and how long the impact would last in your point of view? And my second question is on the overseas game expansion, could management update on the timeline with the major IPs like the Apple, Marvel, and Harry Potter? Thank you very much.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you. Let me provide a brief translation for your two questions. The first question on the Coronavirus impact to our different business lines. Firstly, William commented that the situation definitely affects the economy as a whole. It also affects us, different views to different extents. In particular, advertising segment will be more affected by the situation. Whereas our online games and online education businesses are relatively less impacted by the situation for now, especially for online education given the physical restrictions of people going out and moving around, it helps to raise the awareness and the adoption rate of online education, which propels the trend of the growth of this new format of learning.

For your second question, on our general strategy and pipeline about overseas games. Firstly, William commented that we are very serious and very focused on overseas expansion as a major business strategy of our games BU. We've achieved first step achievement in the sense with couple of games has been well established. And we are hoping to further leverage this experience and expanding to mainstream Western market by offering -- bringing more high-quality products to the users in those geographies. In the past couple of years, we've been consciously moving up the learning curves, and we think we are more prepared, more ready to reap some fruits in this year and in the coming two, three years.

Operator next question, please.

Operator

(Operator Instructions) We will take our next question from the line of Alex Yao from JP Morgan. Your line is open. Please go ahead.

Alex Yao

(Foreign Language) So, I would like to follow-up with question regarding the impact of Coronavirus breakouts, on the gaming side of the business. So, from consumers perspective, are you guys are seeing increase in usage and a better monetization during the Coronavirus breakouts? And then, secondly, from content development perspective is, is the current situation making internal content development more difficult, would that potentially affect new game launched China this year? Thank you.

Charles Zhaoxuan Yang, Chief Financial Officer

(Foreign Language) Thank you, Alex. I'll provide a brief translation for everyone's benefit on the call. So, in terms of the user matrix, William commented that Chinese New Year period is always a high season for online entertainment as a whole for our games. This new year period is obviously being affected by the Coronavirus situation. So it is a longer Chinese New Year period. User matrix has been stronger than the previous similar process in Chinese New Year.

And for your question on the R&D impact, so now we do not see any significant delays or impact to our R&D development progress as well as the planned pipeline launch schedule. Obviously, the virus situation is evolving, and we will continually to assess the impact on the game development, if any.

And William also further supplemented the question -- the virus impact on the online learnings. In particular, we are a firm believer that online learning actually offers a better user experience overall vis-a-vis the traditional offline learning. I think with the virus situation, more and more people are now more receptive and have adapted to the online learning model. And for a lot of learners it is also an opportunity for them to be more outreaching to a more variety of knowledge that is only available and offered in a convenient way online. So all-in-all, we think this virus situation is probably a catalyst to propel the overall online learning industry as a whole.

Operator next question, please.

Operator

We will take our next question from the line of Natalie Wu from CICC. Your line is open, please proceed.

Natalie Wu

(Foreign Language) I'll translate myself quite briefly. My question is regarding the Cloud Music. Just wondering, despite that you've launched several features last year, including the Cloud Village, so you emphasized on the live broadcasting features on the Cloud Music app. But according to past model, the daily time spent per user dropped by around 20% in the second half of last year. Just wondering what -- is this the hike, or it's just simply because the customer data is not tracking right? Can you give us some color on the Cloud Village business contribution for the Cloud Music? And also what kind of the new features you should we be anticipating this year? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Natalie, for your question. Let me briefly translate William's comment. So Cloud Village as well as the other features such as live streaming et cetera, this is overall -- this is our way of thinking how as a music platform we try to enhance value-add to our users, most of them are very vibrant music enthusiasts. We want to provide an integrated experience, not only just listening but from listening to also spending more time on watching the strings as well as interactions. So many of the initiatives and strategies are around building a more vibrant community on our NetEase Cloud Music platform. But the mission of us tapping into the online music segment is really to provide the most conducive channel of promoting native songs, native IPs for the Chinese independent musician artist.

With regards to your second part of the question on the customer mobile data. Again, I think you are referring to the average daily user time spent on the app. Again, we do not know how external third-party data channels track these number. But based on what we are seeing, in the second half there is no decline in the user activity and the user time spent on our platform as a whole. So that's probably something you can further verify and double-check with the external channel. Operator, next question, please.

Operator

We will take our next question from the line of Shi Jialong from Nomura. Your line is open. Please go ahead.

Jialong Shi

Hi. Good morning, William, Charles and Margaret. Thanks for taking my question. (Foreign Language) I have two questions. My first question is a follow-up on the overseas expansion. I'm just wondering how much of NetEase's mobile gaming revenue is currently generated across overseas market? And management mentioned earlier on the call, this year will be a harvest year for NetEase online gaming business in the overseas market. So, I just wonder what is the growth potential for the revenue contribution from the overseas market going forward?

My second question is about regulation, I just wonder how management think of the regulatory environment for this year -- for China's online gaming industry. Last year the authorities suspended new games approvals for certain number of miles. So I just wonder what management thinks of the regulatory trend this year for China's game market? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Jailong, for your questions. Let me provide a brief translation and further supplement to some of the number related questions -- answers. Firstly, William commented that, I think as all of us have noticed that over Chinese New Year period, Apple iOS app store has also implemented more stringent requirement, requiring developers who upload their content onto Apple iOS store would need to provide evidence of approvals, which is inline with the regulators, more emphasis and regulation IP protection. In a way we think that this is going to be more beneficial to first-year players, big players, like NetEase.

We have over 50 game studios, over 10,000 in-house developers working in a very compliant way of creating premium content. So, when the whole environment, whether it's the iOS app store, whether it's the regulators that's putting more emphasis in protecting IP and also encouraging regulated content to only regulated content to be uploaded, and also having more punishment on the IP violations that is a longer-term beneficial for the whole industry, in particular towards upstream content providers.

On top of the -- on top of our emphasis in-house development, we are also putting more focus on collaborating with global developers. Joining hands, strong hands together, hopefully in making a joint effort to provide some exciting content to the global audience that naturally brings to your first part of the question. For 2019, on the full-year basis, this is the very first time that NetEase overseas gaming revenue has accounted for more than 10% of the overall game revenue first time in NetEase history, as bringing us closer to a global premium game operator. Like William commented earlier on, I think this year and the next couple of years, we are going to see more fruit -- we are going to bear more fruit in our international expansion. Operator?

Operator

Thank you. Due to time limit, that concludes today's question-and-answer session. At this time, I would turn the conference over to Margaret Shi, for any additional or closing remarks.

Margaret Shi, Media and Investors

Thank you once again for joining us today. If you have any further questions, please feel free to contact us directly or TPG Investor Relations. Have a great day.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, everyone.

Operator

That concludes today conference. Thank you everyone for your participation.You may now disconnect.

Q3 2019 Earnings Call

Company Participants

- Margaret Shi, Investor Relations Director
- Charles Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Natalie Wu, Analyst
- Alex Poon, Analyst
- Hillman Chan, Analyst
- Kenneth Fong, Analyst
- Jialong Shi, Analyst
- Daniel Chen, Analyst
- Thomas Chong, Analyst

Presentation

Operator

Good day, and welcome to the NetEase 2019 Third Quarter Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Margaret Shi, IR Director of NetEase. Please go ahead.

Margaret Shi, Investor Relations Director

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to the future performance of the Company and are intended to qualify for the Safe Harbor from liability as established by the US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the Company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the Company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The Company does not undertake any obligation to update this forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2019 third quarter financial results' news release issued earlier today.

As a reminder, this conference is being recorded.

In addition, an investor presentation and a webcast replay of this conference call will be available on the NetEase corporate website, at ir.netease.com.

Joining us today on the call from NetEase's senior management is Mr. William Ding, Chief Executive Officer; and Mr. Charles Yang, Chief Financial Officer.

I will now turn the call over to Mr. Charles, who will read the prepared remarks on behalf of William.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Margaret; and thank you, everyone, for participating in today's call.

Before we begin, I would like to remind everyone that all percentages are based on renminbi. Firstly, to assist better understanding and analysis of our quarterly results, I would like to remind everyone that based on the changes in this quarter, including the sale of Kaola and the NYSE listing of Youdao, we will now be reporting segment report as online games, Youdao, and interactive businesses and others, which includes now Yanxuan, NetEase Cloud Music, Internet media, CC live streaming and others.

Kaola's financial results has been deconsolidated and listed as discontinued operations. This applies to the current quarter, as well as the historical comparative periods. This quarter, our total net revenue represents both year-over-year and quarter-over-quarter growth. You can also refer to Youdao's earnings release for more details about its quarterly results.

I will now read the prepared remarks on behalf of William. We have had quite an eventful third quarter with a number of strategic moves made across our business lines. Those moves allow us to realign our resources and sharpen our strengths in areas where we see the most potential for our sustainable long-term growth.

During this quarter, we continued to grow our online games business with steady performances from existing titles and further expanded our overseas presence. We are pleased to have achieved another quarter of strong financial performance with total net revenues increasing by 11% and non-GAAP net income from continuing operations increased by 74% year-over-year.

For games, our online games revenue continues to exceed RMB10 billion for the sixth consecutive quarter, driven primarily by the steady performance of the long-running titles in our games portfolio. Our flagship, Fantasy Westward Journey series and Westward Journey series, continue to perform strongly, as two of the longest and largest running game IPs in China. Those games continue to attract a loyal crowd.

Fantasy Westward Journey Online achieved another record high quarter of gross billings, since its debut in 2003, 16 years ago, while the mobile version also reached its highest quarter of gross billings in the last two years. While the Westward Journey series, we introduced a brand new dragon character in conjunction with an expansion pack in August, for both the PC and mobile games, which quickly gained popularity within fans. Westward Journey Online also peaked in gross billings this quarter, reaching the highest level we've seen since 2015.

Other games launched in more recent years are also enjoying an impressive popularity with highly active core user bases. Invincible had another quarter of record revenue with continued growth in active users. In October, with its fourth year anniversary, Invincible reached number two on China's iOS top grossing chart. Onmyoji also celebrated its third anniversary this quarter and topped China's iOS grossing chart for the third time this year since September.

In addition, other games in our portfolio, including our new ghost series, Identity V, all about (Foreign Language), which previously known as COX [ph] and Life-After are also enjoying a sizable and steady run rate with their respective large basis of royal fans. Two weeks ago, we launched an updated version of Life-After. The update came with an overhaul of the game, introducing a series of new themes and innovative gameplay, leading to a strong growth in the number of active users and gross billings. These games span different genres, target different user profiles and last a long time horizon. This is how we achieve sustainable revenue base for our existing portfolio of games and the continuously add more and more game titles to this expanding game portfolio. The fans that these games have accumulated over the years and reach of their influence have turned each of them into valuable IP, giving rise to the possibility of more renditions of these popular characters and story lines.

Most recently, in October, we launched Xuan Yuan Sword: Dragon Upon the Cloud, a Chinese style term-based MMORPG, which topped the iOS downloads chart soon after its launch. And for Bloom & Blade, a new MMORPG we just launched last Friday, is also trending well. This game is designed to target female game players and was featured by the iOS App Store.

Our joint venture with Blizzard Entertainment has also had a good quarter. In line with our successful 10-year partnership operating Blizzard's World of Warcraft in Mainland China, the popular franchise continues to provide new thrilling game experiences to players across the world. August 27th marks the official launch in China of Blizzard's World of Warcraft Classic, an inventive revitalization of WoW as a world renowned MMORPG, calling on the nostalgia of a generation of old players and intriguing new players alike. This latest release increased both revenue contribution and total number of subscribers for the game.

In terms of overseas revenues, we delivered a record quarter. We now have two blockbuster games in Japan, Knives Out and Identity V, both of which gained top positions on Japan's iOS grossing chart. Life-After, our newer release, is also ramping up well in Japan.

With the success of Knives Out, we gained a better and deeper understanding of users in Japan in terms of their interest, social behavior and preferences in style, aesthetics and gameplay. We passed the successful experience and knowledge on to the design of other NetEase games, enhancing our ability to deliver popular titles to Japanese users.

Identity V topped Japan's iOS top grossing chart for the first time in September, while Knives Out remains a household name in Japan amongst the gamers. To further support our games growth in Japan and stimulate player enthusiasm, we hosted Knives Out Championship, our first ever e-sports championship tournament in Japan from May to August with more than 500,000 players participating.

In terms of our pipeline of games, we are pleased to have received license for FWJ 3D, which is currently undergoing the final round of beta testing and is scheduled for launch in December. In addition, we are excited to announce plans to release Harry Potter: Magic Awakened, a card game featuring a blend of strategic roleplay elements that invites players to experience the magical wizarding world.

Other games included in our lineup include Onmyoji: The Card Game, Marvel Super War, Onmyoji: Yokai Koya, EVE Echoes, Ghost World Chronicle, Diablo Immortal and Pokemon Quest. While our existing games are expected to sustain our online games revenue at a high-level, the abundant pipeline titles represent opportunities to further fuel the revenue growth for our online games.

Now, turning to our education business. We have completed Youdao's public listing on the New York Stock Exchange in October. This marks our first ever carve out IPO under the NetEase umbrella and the beginning of a new journey for Youdao to lead our efforts in revolutionizing the way that people learn and receive education.

Following the IPO, NetEase remains Youdao's majority shareholder and will continue to support Youdao's future growth that propels their mission to empower the people of China on their lifelong learning journey. Over the past 13 years, Youdao has become a strong contender in the online education space with clear advantages in Internet-native pack-driven [ph] content offerings. The Internet has disrupted many industries in the world. But so far it has had a minimum impact on the education space in China. This offers tremendous opportunity for Youdao.

Led by Dr. Zhou, Youdao's senior management team is comprised mostly of computer science graduates and doctorates from top universities, who are best suited to lead the transformation in the online learning space, enabled by the application of technologies. Both Youdao and NetEase are fully committed to investing in technology and content creation in order to bring to our users more effective and technology-driven education experience.

Moving on to innovative businesses and others. For NetEase Cloud Music, we continue to deliver a highly differentiated music product with the mission to help tens of thousands of talented Chinese independent musicians, create indigenous content that resonates with Chinese listeners. We strive to provide our users with the most intimate, interactive and high-quality music experience as we continue to amass more and more of what we call Cloud Villagers. We know we are on track.

NetEase Cloud Music continues to ramp up its monetization efforts, reaching new record high revenues in the third quarter. Revenue growth has been strong across the board in subscription, advertising and live streaming, leading to continued improvement in our financials. We entered into a definitive agreement with Alibaba and Yunfeng for approximately $700 million in September. With our new strategic partners, we are able to explore more innovative forms of monetization for this highly engaging music platform.

For Yanxuan, the focus continues to be about operating efficiency. During the third quarter, we continued to optimize our supply chain management to reduce our inventory and to deepen our relationships with choice manufacturing partners. We help our manufacturing partners better understand the consumer metrics and provide them with better visibility and ultimately better sales figures. Forging ahead, Yanxuan will continue to focus more on quality control and bring high-quality products to our consumers.

In September, we completed the sale of our cross-border e-commerce business, Kaola, and we are pleased to have found a strategic fit for Kaola within Alibaba's extensive ecosystem.

In summary, we had a busy quarter, being more focused and realizing value for each of our core business areas. We are very confident in the future prospect of the sectors we choose to be in, and we have developed and will continue to strengthen our distinct product offerings in each of these markets. We will persist in our pursuit of excellence across all of our business lines and the needs of our users always remain at the heart of our business strategy. As we advance each of our businesses and create value, we are always looking for ways to increase returns to our shareholders. This quarter, in addition to our regular dividend, representing a 30% payout ratio, we will also be distributing a special dividend of $3.45 per ADS this quarter in consideration of the sale of Kaola business. As always, we appreciate and value the long-term support from our shareholders, and we are always devoted to maximizing the interest of our shareholders.

This concludes William's comments.

I will now provide a brief review of our third quarter 2019 financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

Our total net revenues for the third quarter were RMB14.6 billion, or $2 billion, representing a year-over-year increase of approximately 11%. And, again, let me remind everyone that the revenue has taken into the consideration that we have deconsolidated Kaola results in the current quarter, as well as the historical comparative period.

Net revenues from online game services were RMB11.5 billion, up 11% year-over-year. The year-over-year increase was primarily driven by Life-After, which was launched at the end of last year, as well as continued strong performances from Invincible and Identity V. Mobile games accounted for approximately 71% of net revenues from our online games in the third quarter.

Net revenues from Youdao nearly doubled year-over-year to RMB346 million, primarily due to increased net revenues from Youdao Premium Courses driven by higher paid student enrollments and average selling price.

Net revenues from innovative businesses and others were RMB2.8 billion, up 4% year-over-year due to mainly the increased monetization from Cloud Music, partially offset by decreased revenue from online advertising businesses due to macro environment.

Overall, gross margin was 53.8% in the third quarter. Gross margin for our online games services for this quarter was 63.8%. Our gross margin for online games is generally stable, fluctuating quarter-to-quarter within a narrowband based on the revenue mix of mobile, PC, as well as self-developed and licensed games. Youdao's gross margin was 25.8%, an improvement from 23.3% in the prior-year period due to increased net revenues from Youdao Premium Courses and down from 32.9% in the previous quarter. Gross margin for innovative businesses and others, for the quarter, was 15.2% compared to 15.5% and 17% for the previous quarter and prior-year period, respectively. The year-over-year decrease was primarily due to decreased net revenues from advertising services.

For the third quarter, total operating expenses were RMB4.5 billion.

Our selling and marketing expenses as a percentage of our net revenue were 11.1% compared with 8.9% in the second quarter. The quarter-over-quarter increase was mainly due to increased marketing expenditures related to online game services, as well as the summer promotion of Youdao, which is typical in the online education space.

R&D expenses remained steady at around RMB2.2 billion. We remain committed to investing in content creation and product development, which is what defines us as a technology company.

Non-GAAP net income from continuing operations attributable to our shareholders for the third quarter of 2019 totaled RMB4.7 billion, or $661 million, representing an increase of 21% quarter-over-quarter and 74% year-over-year. Our non-GAAP diluted earnings per ADS from continuing operations were RMB36.31, or $5.08, for the third quarter.

Our cash position remains strong. As of September 30th, our total cash and cash equivalents, current and non-current time deposits and short-term investment balance totaled RMB61.4 billion compared with RMB49.7 billion as of the year-end last year.

As William mentioned in his remarks, we are pleased to report that our Board of Directors has approved a dividend of $7.59 per ADS. This includes a regular quarterly dividend of $4.14 per ADS, equivalent to approximately 30% of our net income attributable to the shareholders, plus a special dividend of $3.45 per ADS.

Thank you for your attention. We would like, now, to open the call to your questions. Operator, please go ahead to the Q&A.

Questions And Answers

Operator

Thank you. (Operator Instructions) For the benefit of all participants on today's call, if you wish to ask your question in Chinese, please immediately repeat your question in English. Please ask one question each time. If you have more questions, please join the queue again. We will take our first question from Natalie Wu from CICC. Your line is open. Please go ahead.

Natalie Wu, Analyst

Hi, good morning. Thanks for taking my question. I have a question on the upcoming FWJ 3D. Just wondering if management can give us some color on your expectation for that game. And do we need to worry that game could have the possibility of cannibalizing your current FWJ mobile grossing, if that FWJ 3D could be the next IP game? Thank you.

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Natalie. I'll translate that question for William.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. I'll provide a brief translation of William's response. FWJ 3D is currently scheduled to launch in the first half of December and we are quite excited about this game, because this game represents accumulation of over a decade long of RMB experience both from the PC version, as well as the mobile version of FWJ. And we can assure to the users and the investor community that you're going to see a lot of innovative -- innovation in this game. So this game is -- we are hoping that this game can attract many enthusiastic fans about the Westward Journey franchise and we -- given all these games are in-house developed by NetEase, we are not overly concerned about any internal cannibalization to our existing FWJ PC and FWJ mobile.

Operator

Next up, we have Alex Poon from Morgan Stanley. Your line is open. Please go ahead.

Alex Poon, Analyst

(Foreign Language)

William Ding, Chief Executive Officer

Okay. (Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Alex. I'll provide a brief translation of William's comments for the audience.

Firstly, on Music. So in short, yes, we are very actively exploring different opportunities in terms of monetization, that will be reflected in the upcoming quarters as we continue to explore, strengthening existing monetization channels, as well as to apply some innovative brainstorming new features, for instance, social aspects, et cetera, that we mentioned previously.

In terms of our cost control, NetEase as a whole, not only as NetEase Music, we are very prudent and practical in terms of cost control. We think that in order to differentiate our Music business from the competition, we are going to further strengthen sales production, UGC, independent musicians as a differentiated content. As a result, we do not see any material increase in terms of music content acquisition cost. Overall, we are very confident about the prospect of monetization, which will lead the path to profitability. We do not have any definitive timetable for breaking even or IPO. But I think as long as we progress on track towards the mission and those are -- those growth will come just naturally.

To your second question on the overseas games strategy, so, as you had mentioned, we've been also quite active in exploring overseas opportunities. The various overseas investments that we made in those studios are mostly valuing their R&D expertise, which we think can supplement to our in-house R&D capability. Equally, our NetEase R&D expertise is something that attracts those business partners to collaborate with us. Today, we have achieved a small milestone in Japanese market and we are hopeful that with more new game launches on the global stage, step by step we are also going to have a more promising future in terms of the US and European, Western market.

Operator

Next up, we have Hillman Chan from Citi. Your line is open. Please go ahead.

Hillman Chan, Analyst

Hello, William, Charles and Margaret. (Foreign Language) Thank you very much for taking my question. My first question is to follow up on the FWJ 3D mobile. During the final beta testing for Android, do we have a sense of the percentage of participants coming from those currently playing mobile FWJ? And, also, could you share more observation from the beta testing as well?

And then my -- another question is on the Marvel Super War. Could you share more on the development status and launch timetable? And what other game genres for the Marvel IP under development and the status, please? Thank you very much.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Hillman. For your first question on FWJ 3D, as you know, we've started beta testing as early as in the summer. So far, the testing results has been very promising, which leads to our confidence in launching this game in the first half of next month.

And for your second question on Marvel IP, as we have reviewed the overall partnership with Marvel on our May 20th Game Day, there will be multiple games that's going to be developed by NetEase for Marvel IP and Marvel Super War is one of them. I think Marvel Super War is well on track from a development perspective, so this game could be expected in the near-term. Obviously, for Chinese market, this is after all subject to the license approval. But several of these Marvel games are targeting both the Chinese market as well as international markets.

Hillman Chan, Analyst

(Foreign Language)

Operator

Next up, we have Kenneth Fong from Credit Suisse. Your line is open. Please go ahead.

Kenneth Fong, Analyst

(Foreign Language) I have a couple of questions related to the overseas business. First, what is the overseas game revenue as a percentage of our total game revenue?

Second about our game pipeline, which one of you you see great potential for the overseas market next year?

Third is, how do you see the competitive landscapes for the overseas game development, especially I noticed that there is a lot of Chinese game developers also very active in publishing overseas? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

So, Kenneth, to translate William's response and also to add a few more color. In terms of the overseas game revenue, (technical difficulty) above [ph] 10% of our overall game revenues and we see great potential in terms of further enhancing both the absolute dollar by overseas game revenue, as well as this percentage ratio.

To your second question, in terms of game-specific product line-ups for the various international markets, apologies for your understanding that we would not be able to elaborate the details here, but there is a solid plan where we say that we are confident to increase the overseas game revenue, as well as the percentage. It is actually bottom-up, it is supported by a very extensive study of the overseas market, as well as our product line-ups.

For your third part of the question, in terms of the competitive landscape of the overseas market, I think that's a good question, because when we are launching our products to the overseas market, we realize that, in more developed markets like Japan and US, users are actually a lot more sophisticated. The only way to impress, to retain, to attract these users is through product innovation and game quality, that is something that NetEase is proud of our competitiveness. And with that confidence, I think it represents actually a very, very optimistic upside of the overall NetEase games in the markets beyond China.

Kenneth Fong, Analyst

(Foreign Language) Thank you.

Operator

Up next, we have Jialong Shi from Nomura. Your line is open. Please go ahead.

Jialong Shi, Analyst

Good morning, management. Thanks for taking my call, and congratulations on the solid quarter. Let me first ask my questions in Chinese.

(Foreign Language) I had two questions. The first question is about the online gaming business. So I was just wondering when Company will officially launch the upcoming new mobile game, Harry Potter? And, also, I was wondering, what Company did to -- in Q3 to have helped the two legacy titles, FWJ and WWJ2, to achieve record high growth in Q3, respectively?

And my second question is about the online music business. We heard from some media that China's regulator is likely launching investigation into the license in practice hitting [ph] record levels and music streaming companies. So, I was wondering, if management can provide some colors on this ongoing investigation and -- or specifically what potential changes this investigation may bring to the music streaming industry? And related to that, what potential impacts these changes may have on NetEase Cloud Music business? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Jialong. I'll translate William's response for the audience. Firstly, given that we have abundant line-ups for the game pipeline, William is actually encouraging people try not to focus too much on individual titles, whether it is existing FWJ, WWJ or the upcoming FWJ 3D or Harry Potter, all of these are high-quality games that we self-develop and we are very confident about their performance, longevity and we have a lot more than just those couple of names that we quoted.

For the past summer, yes, FWJ and WWJ, both have delivered a record quarter, stimulated mostly by expansion packs in the summer. Harry Potter is also scheduled for launch. We don't have a concrete timetable yet, but it should be planned for next year.

On your second question, Jialong, on the Music, we've also learned from the media about potential regulatory investigations and queries into that. Our general attitude is that, for any sort of industry growth, a conducive environment from the players and from the regulators are ultimately longer-term beneficial to serious and long-term players. Our mission ultimately is to ensure that the industry, as well as the passionate Chinese online music users, benefit from a healthy and diversified growth of the industry. Overall, we think an appropriate and conducive environment is going to be long-term beneficial to all the players in this sector.

Jialong Shi, Analyst

(Foreign Language)

Operator

Next up, we have Daniel Chen from J.P. Morgan. Your line is open. Please go ahead.

Daniel Chen, Analyst

(Foreign Language) I will translate myself. I'm asking on behalf of Alex Yao. So my question is, first one is related to PC games. We noticed some of our top PC games such as, World of Warcraft Classic and Fantasy Westward Journey, actually performance is very resilient. So could management talk about the PC game market outlook in next few years? And what are the key growth areas?

Second question is related to some of the new innovative trends. Could management talk about NetEase strategy in this new innovative trends, such as 5G and cloud gaming? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Daniel. I will translate William's response and also add on to your first question. Your second question, William commented, that's a great question, that the industry has been noticing these new features. First of all, William thinks that the user recognition of game titles, so any sort of content is ultimately attracted to the content, less so on the different screens or media. So, ultimately, it is the best quality content for the different sector of users that dictates who is the winner. Cloud gaming, as well as 5G, all these are great features to supplement to this content creation industry, whether they are going to be a mainstream feature or whether that's going to be disruptive to the overall user experiences, those are all good questions to ponder and to be further observed. Overall, we think as long as it's content industry, whether it's education, whether it's music, whether it's games, ultimately content is the King, the one who has the capability of developing the highest quality content would always be the ultimate winner.

For your first question on the PC games, we have recorded a great quarter in terms of PC games of our portfolio. We've seen both FWJ, WWJPC, as well as WoW Classic delivering quite strong quarterly results. Overall, we think -- obviously, we can't speak for the entire industry, but, as for us, we are fairly confident about the steady performance of our PC games into 2020.

Daniel Chen, Analyst

Thank you.

Operator

Next up, we have Thomas Chong from Jefferies. Your line is open. Please go ahead.

Thomas Chong, Analyst

Thanks, management, for taking my questions. I have two questions. The first question is about our Cloud Music business, given that we are going to include more features, such as live streaming to the music side, how should we think about the impact of our short-form video to live streaming?

And my second question is about the OpEx trend. Given the fact that we are innovating a lot of new business, as well as we are also expanding to overseas, how should we think about our R&D headcounts going forward? Are we going to expand our headcounts in overseas? Thank you.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Okay. Thank you, Thomas. I'll translate William's remarks. Firstly, he thinks that the short video industry, in general, is actually a positive catalyst to China's online music industry, because, as you can see, all the presentation of short format video, as well as live streaming require some sort of a music element, which actually helps to promote music popularity.

For NetEase Cloud Music, specifically, we now have over 80,000 Chinese independent musicians that's been nurturing on our platform and this figure is growing. We think short-format video is a very conducive way to promote good music. Based on our data and user statistics, we are not seeing short-format video as a distraction or a competition for users screen time and others. We think ultimately user traffic is attracted by good music, Chinese and global alike. Currently, on Cloud Music, we now have almost all the good music of the last couple of decades, those are the core assets that attracts users.

And quickly before we wrap up this call, for your second question, on the OpEx trend, our R&D headcount is steadily increasing. In fact, overall, by the end of the third quarter, especially after the summer recruiting season, our headcount has represented a slight increase comparing to last quarter, as well as to the last year-end. I think this is a strong factual evidence (technical difficulty) dismiss many ungrounded market rumors of so-called massive layoffs about NetEase.

Thomas Chong, Analyst

Thank you.

Operator

Thank you. I would now like to turn back the conference to our management for any additional or closing remarks.

Margaret Shi, Investor Relations Director

Thank you, once again, for joining us today. If you have any further questions, please feel free to contact us directly or TPG Investor Relations. Have a great day.

Operator

That concludes today's conference. Thank you, everyone, for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2019-08-08
Event Description: Q2 2019 Earnings Call

Market Cap: 29781.5823995
Current PX: 232.740005493
YTD Change($): -2.62999450684
YTD Change(%): -1.117

Bloomberg Estimates - EPS
Current Quarter: 18.368
Current Year: 78.555
Bloomberg Estimates - Sales
Current Quarter: 19573.929
Current Year: 79731

Q2 2019 Earnings Call

Company Participants

- Margaret Shi, Director, Investor Relations
- Charles Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Hillman Chan, Analyst
- Alex Poon, Analyst
- Natalie Wu, Analyst
- Thomas Chong, Analyst
- Bill Liu, Analyst
- Eddie Leung, Analyst
- Jialong Shi, Analyst

Presentation

Operator

Good day and welcome to the NetEase Second Quarter 2019 Earnings Conference Call. The conference is being recorded.

At this time, I would like to turn the conference over to Margaret Shi, the IR Director of NetEase. Please go ahead ma'am.

Margaret Shi, Director, Investor Relations

Thank you, operator. Please note the discussion today will contain forward-looking statements, relating to future performance of the company and are intended to qualify for the safe harbor from liability as established by US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors.

Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could cause NetEase's business and the financial results is included in certain filings of the company with Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update it's forward-looking information, except as required by law.

During today's call management will discuss certain non-GAAP financial measures, for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2019 second quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and the webcast replay of this conference call will be available on NetEase's corporate website at ir.netease.com.

Joining us today on the call from NetEase senior management is Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer and Mr. Hilton Hui, Co-President of NetEase Games.

I will now turn the call over to Mr. Yang who will read the prepared remarks on behalf of Mr. Ding.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Margaret. And thank you everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi. We are very pleased to report another quarter of financial and operational growth across our businesses with a 15% increasing revenue and 46% growth in our net income on a year-over-year basis. Online games remained a cornerstone of our business. Despite a seasonally slower period in the second quarter, the steady performance of our game portfolio marks the fifth consecutive quarter that we have exceeded RMB10 billion in online game revenues. Our flagship titles continue to provide solid support to our online games business. Throughout the year, these titles have remained relevant to each generation of users, as we diligently explore and create innovative new elements to our games, keeping our content fresh.

Take Fantasy Westward Journey online, as an example, over the course of the last 15 years, since its initial launch, we have introduced close to 30 major expansion packs, averaging approximately two major expansion packs per year, with many smaller scale updates along the way. For FWJ's mobile version, we have made even more frequent updates with nearly 40 major updates, since its initial launch four years ago. Beyond substantial game overhauls and additions, we consistently look for various ways to keep our users engaged.

During the quarter, we held a number of FWJ E-Sports tournaments, which helped boost our user stickiness and drive continued revenue contribution for future periods. The expertise we have gained from operating these flagship titles over the long-term has been deployed in developing our newer games, providing us with more steady revenue streams in what is now a very diverse game portfolio. Invincible, Onmyoji and Identity V launched in 2015, '16 and '18 respectively, serve as good examples of our superior game longevity with different game genres.

Invincible continues to grow steadily in terms of revenue and number of active users, achieving new record in the second quarter. Onmyoji topped the iOS grossing chart in China, twice in the second quarter, as we launched our hit expansion pack in Q2 that featured a rich and captivating story line. Identity V is also growing steadily after more than a year of operation.

During the quarter, we also launched an updated version of Chu Liu Xiang and renamed this MMO Sensation into All About Xuan Yuan. The update came with a full-fledged overhaul of the game, including improved graphics, new characters and new social systems. As a ground breaking game in the MMORPG genre, the original CLX impressed the market at its initial launch over a year ago, with its best-in-class graphics and high degree of freedom for users to customize and design their own characters and story lines. The game quickly accumulated a large and loyal community of users, particularly among the younger generation. Now with the relaunch, we are thrilled to delight players even without the game's original IP. Our strong content and an amazing team of designers captured the spirit of the game, while breathing new life into this market favorite. As a result, All About Xuan Yuan is attracting a growing user base and generating increased revenue contribution quarter-over-quarter.

Our growing portfolio of games has generated a solid fan base. Our goal is to have an even larger and deeper impact on the vibrant community of game users. Onmyoji is the first of these younger IPs that we are cultivating. In order to expand the reach of Onmyoji's IP, we are currently working on four new Onmyoji games. These include the Japanese Collectible Card Game called, Onmyoji: The Card Game. A simulation game called Onmyoji: Yokai Koya and two other Spin-Off games.

In July, we also launched the Onmyoji, cafe and shop in Guangzhou, featuring popular Onmyoji characters. This location has become a must see destination for many young fans. We are confident that these initiatives will further strengthen our increasingly valuable game IP and further enhance our recognition among younger generation. In terms of newer titles, we most recently launched BuildTopia and Sky in China, and a few other games overseas. BuildTopia is a real-time creative shooting game, topping the iOS download chart within a day of its launch. And Sky is an adventure game bringing users a heart warming experience and receiving multiple recommendations from the Apple store. We also launched an updated version of Tom and Jerry, which prove instantly popular among younger players, taking the game to the top of the iOS download chart, shortly after its launch and continues to trend well with a growing user base.

Globally, we continue to advance our games and make inroads that expand our reach. Knives Out remains popular in Japan and topped the country's highest grossing games charts multiple times in May and June. Additionally, Identity V was ranked for the first time on Japan's iOS top three grossing chart in July, following our collaboration with famous Japanese comics. The success of these games has helped us to gain a much better understanding of Japanese users and their preferences allowing us to better tailor our games for the Japanese market. Some of the titles, we recently introduced in Japan also show promising signs of popularity. We now have three more titles in Japan, which are live after previously known as Night Falls: Survival. Cyber Hunter as well as Super Mecha Champions, a Mecha anime shooting game which we just released in July. All three of these games topped Japan's iOS download chart shortly after their launches.

In the second quarter our overseas games revenue accounted for more than 10% of our total games net revenue. Having the right products is the key to global expansion and we will continue to invest in game content that will resonate with global players. In terms of R&D, we are looking for talent and teams that complement our R&D skills on a global scale. In July, we announced our minority investment in behavior interactive, an online games pioneer in Canada and the leader of the Asymmetrical Battle Arena genre. In addition, we also launched a new video game studio in Montreal, Quebec in Canada with an aim to hire local and international resources to broaden our R&D capabilities in North America.

Our extensive pipeline also holds a number of exciting new titles for the upcoming quarters. These include Fantasy Westward Journey 3D, Xuan Yuan Sword: Dragon Upon the Cloud, Pokemon Quest and Bloom & Blade.

Moving on to our e-commerce business. During the second quarter we made additional progress to improve our operating efficiency. We further optimized our internal structure, enhanced our warehouse and logistics operations and upgraded our supply chain management. For Kaola, our self-build bonded warehousing Ningbo began trial operation in June. This warehouse is capable of handling millions of orders every year, which we believe will help us to improve operating efficiencies even further.

During the quarter, we also signed strategic partnerships agreement with additional international brands such as L'Oreal and Maybelline, enabling our customers to more conveniently access these world-renowned beauty brands.

For Yanxuan, we continue to promote supply chain upgrade by helping manufacturers improve their design, reduce production cost and enhance efficiencies. We are further deepening our collaborations with top-performing partners, which will allow us to renegotiate better commercial terms, implement better controls over quality and optimize product creativity.

On the product side, we are even more selective with new product offerings, enabling us to focus on and dedicate our resources to top products with the highest repurchase rate and customer satisfaction rating, by offering customers greater value for their money with better product quality and pricing, we hope to further improve customer satisfaction.

Turning on to our online music business. We continue to innovate and create a highly differentiated product with an unparalleled social experience on our NetEase Cloud Music app. At the end of July, we added a new highly popular community module known as the Cloud Village. This is a music community that fosters discussion, creation and sharing and personalized expression around music. It is presented in the format of waterfall containing music video blog, music micro blog and many other exciting features that allow music lovers to follow and express themselves interactively. This brand new module changes the way that users experience music from just listening to also watching and interacting. At this moment we have over 800 million users on our music app, which is 50% up year-over-year. Subscriber numbers are also growing very strongly at 135% year-over-year increase.

For online education, Youdao continues to deliver solid growth and we see significant opportunities in the online learning industry. Over the course of the last 13 years, Youdao has built a robust suite of technology driven learning products and services. With its leading AI technology, strong content and predictive development capabilities Youdao has steadily build a large engaged and diverse user base with over 100 million average total MAUs in the second quarter of 2019. We do not take the responsibility of education lightly and we encourage innovation within each content studio at the Youdao.

Our courses are regularly evaluated and their success is measured by user satisfaction ratings, which we believe is pivotal to the long-term sustainable growth of any online learning company. Youdao most recently hosted its Annual Product Launch Conference in Beijing. At the event we announced five different products for children including Youdao Children's English mobile app, Youdao Mathematics Online Course and Youdao Chinese Reading Online Course. All designed to improve children's learning habits as well as Youdao sell tooling and kata [ph] to online courses teaching coding to children between the age of 3 to 18.

Additionally, we also announced our second-generation Youdao Dictionary Pen supported by more advanced optical character recognition (inaudible) technology, allowing more accurate and effective scanning translation. In an evolving Internet market, content is king and NetEase is best known for our content creation capabilities. This rings true across our different business segments. We continue to emphasize product enhancement, craftsmanship and innovation, and better user experiences to thrill our ever-growing user community of different segments. Through our industry knowledge, deep IP, diversification strategy within our core competencies and our international growth initiatives, we believe we can continue to bring relevant exciting new products and services to NetEase players, fans and users around the world.

As we continue to grow and evolve, we are always very appreciative of the long-term support from our shareholders. With that in mind, our Board of Directors have approved a dividend payout ratio of 30% this quarter. We are delighted to be returning value to our investors as our business continues to boast healthy and growing profits.

This concludes William's comments. I will now provide a very brief overview of our second quarter 2019 financial results. Given the limited time on the call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

For the second quarter, our total net revenue were RMB18.8 billion or $2.7 billion representing approximately 15% increase year-over-year. Net revenues from online game services were RMB11.4 billion, down 4% quarter-over-quarter, but up 14% year-over-year. The sequential decrease was due to the second quarter, typically being a slower quarter seasonally. Year-over-year increase was primarily driven by increased revenue contribution from flagship titles, such as FWJ and new games such as Justice and Life-After. Mobile games accounted for approximately 72% of net revenue from our online games in the second quarter.

Net revenue from e-commerce, were RMB5.2 billion and net revenues from advertising services were RMB582 million. Net revenues from our innovative businesses and others were RMB1.5 billion up 18% quarter-over-quarter and 23% year-over-year, both due to increased contribution from Cloud Music, CC live streaming and Youdao.

Our overall gross margin was 43.3% in the second quarter, compared with 44.1% in the preceding quarter and 44.5% for the prior year's period. Gross margin for our online game services for the second quarter was 63.1%. By and large, our gross margin for games is generally stable fluctuating quarter-to-quarter within a narrow bandwidth based on the revenue mix of mobile, PC, self developed and licensed games.

For e-commerce our gross margin was 10.9% in the second quarter. We achieved a positive gross margin for our innovative businesses and others business of 1.4% in the second quarter versus losses of 13.1% and 7.3% in the prior quarter and second quarter of last year respectively. The significant improvements came from increased revenue contribution from some of our business lines within this segment, as mentioned a moment ago, as well as better cost controls.

For the second quarter, total operating expenses were RMB4.6 billion. Our selling and marketing expenses as a percentage of net revenue were 9.4% in the second quarter, largely stable from the previous quarter. We continue to see operating leverage, as we benefit from economies of scale and improve operational efficiency.

E-commerce related shipping and handling expenses, included in selling and marketing expenses as a percentage of e-commerce revenue was 7.4% in the second quarter, significantly improved from 8.4% in the previous quarter. R&D expenses were maintained at around $2 billion level reflecting our commitment to investing in content creation and product development, which is what defines us as a technology company. Operating income for the second quarter of 2019 increased by 2% quarter-over-quarter and 50% year-over-year to RMB3.5 billion. The effective tax rate for the second quarter was 18%. The lower effective tax rate in the second quarter was mainly due to reduced losses from certain subsidiaries, as well as certain tax credits being recognized for certain subsidiaries of the company during the quarter.

Non-GAAP net income attributable to our shareholders for the second quarter totaled RMB4 billion or $531 million representing an increase of 21% quarter-over-quarter and 34% year-over-year. Our non-GAAP diluted earnings per ADS were RMB28.06 or $4.09 for the second quarter of 2019. Our cash position remains strong. As of June 30, 2019, our total cash and cash equivalent, current and non-current time deposits and short-term investments balance totaled RMB55.6 billion compared with RMB50.1 billion as of year end last year.

For the second quarter, we are pleased to report that our Board has approved a dividend of $1.04 per ADS representing a 30% dividend payout ratio. As we mentioned earlier in William's remarks, we are thankful for the long-term support from our shareholders and we are always looking for ways to return value to our shareholders. As a result, this quarter's higher dividend payout ratio reflect this commitment as we continue to both healthy and growing profit.

Thank you for everyone's attention. We would like now to open the call to your questions. Operator, please go to Q&A.

Questions And Answers

Operator

Thank you. (Operator Instructions) We will take our first question from Hillman Chan from Citi.

Hillman Chan, Analyst

Hi, good morning management. Hi, good morning, Management. Thank you for taking my question. I have a question regarding the overseas expansion strategy for our games. So as we noticed, we recently launched new game studio in Montreal and acquired stake in behavior, interactive and our games are doing well in Japan and in some overseas market. So going forward in the future could management share more on the strategies in particular what are the key focus markets by geography, the target game genres and the steps you will take to achieve the overseas growth either from organic growth or M&A and also some of the update on the latest partnership synergy with overseas studio would be helpful? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Hi, thank you Hillman. I will provide a brief translation of William's comments for everyone's benefit. So, as you can see that we have been very active and open-minded for deeper collaboration with global premium game studios, this is because for ourselves, NetEase, we have been cultivating in game content development, R&D with almost two decades of expertise and experiences. So, we are very, very open-minded and we'll continue to explore deeper collaboration with peers, the best-in-class studios globally.

In terms of the overseas expansion strategy, William has summarized from a few different aspects. First is about our games launch, NetEase games into global stage. Currently, we have achieved certain milestones in Japan and we are hopeful and we are working hard to make also our popular content, popular games into a popular hit into mainstream western market in North America and Europe.

In terms of collaboration, with global peers, we've always been focusing on joint R&D development as a priority, because that is our know-how and that is where we see a lot of supplementary capabilities that we can provide to each other. The goal is to jointly develop by leveraging each other's competitive strengths to develop premium content for global gamers.

As to the genres, there is no fixed rigid framework. We are very open-minded to be more explorative in nature, because as everyone can witness in the most recent years game genre has been evolving very fast and we are very glad that NetEase is always a pioneer in the forefront of keeping innovation in terms of game plays and genre.

Hillman Chan, Analyst

Thank you so much William and Charles.

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you.

Operator

We would take our next question from Alex Poon from Morgan Stanley. Your line is open. Please go ahead.

Alex Poon, Analyst

Hi, good morning. Thank you for taking my question. I have a question regarding the music business. It is very glad to see the new module Cloud Village launched recently. Can you also talk about in the second half, how your monetization strategy will change? And I also have seen some news regarding the timetable of profitability. Can you also share with us how are you going to control the costs and achieve the profitability?

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language) Okay. Alex also for everyone's benefit, let me quickly translate William's remarks. So, we are glad to see that you've noticed in our most recent version update of Cloud Music. There is a prominent music community feature called Cloud Village. So everyone, a true music lover is now official Villager of our app. As we've mentioned previously, a key focus of Cloud Music is to dedicate our platform and our user outreach to promote independent musicians and independent music, here in China. And with this community features, I think this is more productive in us achieving this mission.

In terms of your question on monetization by and large, I think it can be categorized into one being the user subscription, which we now seeing a very robust growth in both the overall users as well as subscriber growth more than 135% year-over-year. Second is act from advertising, which again come growth hand in hand as we are growing our user base and popularity amongst the users. The third is broadcasting, which is not only in the format of video live streaming, but also audio broadcasting. Fourth, now with the establishment of a community feature, we will also be more innovative and exploring deeper monetization opportunities around these community interactive features.

In terms of your question on profitability, we have never officially commented on any timetable, but rest assured, we feel very, very confident about the growth upside of China's online music industry as a whole, and NetEase as you can now witness for the past few records. we are very disciplined in controlling costs at a reasonable level, as well as be focusing on the return on the various investment, whether it's selling, marketing or R&D into our different business segments. So profitability is ultimately our target.

Alex Poon, Analyst

(Foreign Language)

Operator

We would take our next question from Natalie Wu from CICC. Your line is open, please go ahead.

Natalie Wu, Analyst

Hi. Good morning. Thanks for taking my question. I actually have two here. First one is regarding the Cloud Music as well. You just mentioned about the -- you mentioned the Cloud Village module. Actually I tried that module and it's very innovative and interesting. Just wondering, can management share with us some further operating metrics regarding the user engagement recently for other Cloud Music? I just want to get a sense of how that's -- that new function has improved the user engagement, say the daily active user or the daily time spend, something related with that?

And secondly about the Mobile IP. Just wondering how should we anticipate that use of Mobile IP? Will there be some new brand -- some brand new games or journalists launching under these IPs? Or just new updates with these new features embedded in our existing games? Thanks. (Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you. Natalie. I will answer your first question on operating metrics, and then William will further comment on the Mobile IP. Well, as you know, we've only launched this new updated version almost, I think it's July 29, towards the very end of July. So it's about 10 days. So there's really not a lot of operating metrics that I can specifically share. But we've seen very, very encouraging signs of strong growth in both DAU and MAU, since we launched the most updated version. This data is exactly why we are confident that our innovation in bringing in this new interactive community feature will eventually be very well rewarded. Because it is not only a way of change in people's habit of experiencing music, but hand in hand as this new feature is now not only encouraging users to listen, but also to watch and interacting with other music lovers, it also creates possible opportunities for us to explore monetization potential. And I'll leave the second question to William.

William Ding, Chief Executive Officer

(Foreign Language)

For the Mobile IP, Natalie, it's a big area for a deep-rooted collaboration is that we will buy, we will leverage mobile's global popularity of the IPs to develop games. And it's not only one, it's actually several games across different genres, that we have different schedule and timetable to collaborate literally develop with mobile and the partnership also goes beyond games. For all those details, it will be gradually announced as we further progress along these long-term strategic partnership.

Natalie Wu, Analyst

Got it. Thank you. Looking forward to that.

Operator

We will take our next question from Thomas Chong from Jefferies. Your line is open. Please go ahead.

Thomas Chong, Analyst

Hi, good morning. William, Charles and Margaret. Thanks for taking my questions. Congratulation on solid cost control for this quarter. And my question is mainly focusing on the cost side. Often for the GP margin the innovation and others achieved the first positive gross profit in the past 12 months. Can we basically assume that our cost control, is where we are solid, and we should expect innovation and others to maintain GP margin to be positive going forward, as well as for e-commerce do we need to stay stable GP margin for e-commerce in 2019?

And my second part of the question is about the opex. Can management comments about the headcount that we have in Q2 versus Q1? And how should we think about 2019? In particular for R&D expenses, is there any reason why we see a sequential decline? Should we expect the trend to go -- to be continued in the following quarters? Thank you. (Foreign Language)

Charles Zhaoxuan Yang, Chief Financial Officer

Thank you, Thomas. I will take your questions. On the cost side, let me first begin by saying that NetEase has been listed since 2000 for 19 years and we have gone through various cycles over the last 19 years of journey being a listed company. So we've always been very, very disciplined in terms of making adaptive measures to -- in corresponding to different macro environment. For 2019, as we commented in the previous quarters' earnings call, one key focus is a more disciplined balance between gross and margin, so we are very happy that at least for the last two quarters we have been delivering on what we have promised to the market being very disciplined.

Well, having said that, it doesn't mean a scale back in terms of headcount by the end of the second quarter, the overall headcount is by and large stable versus a quarter ago or end of last year. So a lot of market rumors commenting on massive layoffs and all that, those are actually just not fact. So relating to your other questions R&D, yes, we are a technology company. So R&D is an engine for our continued sustainable growth for the longer term. I do not see any reason why we should scale back or cut down R&D cost significantly. Quarter-to-quarter, small fluctuations that can -- it's difficult to explain, sometimes it relates to some one-off event, sometimes it's the provisions and all that. But I think a general trend is that we are going to dedicate a considerable amount of our net revenue into R&D. But again like I commented earlier on what ever formats of investment, whether it's R&D and or selling, marketing, we focus internally on the return on these investments.

In terms of margin, the reason why we have grouped some business segments into innovative businesses and others is exactly because they are in a relatively early stage. So, as they continue to grow, they are top line at user base. The economies of scale will help us to improve their margin trajectory. It is too early to predict whether all those relatively young business segments, we are then starting from this quarter, always have positive GP margin. But I do not see any indication of margin materially decline. So going forward, as long as my music business, my Youdao are growing healthily, I think earlier on Natalie also -- I think Alex also ask that question, profitability making positive profit and then returning value to our shareholders. It always remains as a priority to NetEase.

Thomas Chong, Analyst

Thank you Charles. And congratulation again.

Operator

Thank you. We will take our next question from Bill Liu, Goldman Sachs. Your line is open. Please go ahead.

Bill Liu, Analyst

Thank you. Good morning and thank you for taking my question. I have a follow-up question on costs, mainly about the sales and marketing line. I noticed that for this quarter, it's almost flattish quarter-on-quarter, but a reduction from a year-on-year perspective. So, I wonder for the sales and marketing expense, so how should we think for this line for rest of the year, given that for on one side, we have a deceleration in e-commerce growth and on the other hand, the new -- the number of new approvals has been rather limited comparing to previous expectation. Thank you.

Charles Zhaoxuan Yang, Chief Financial Officer

Thanks, Bill. I'll again take that question, since it relates mostly to financials. For selling and marketing, majority of the selling, marketing is allocated to games. And as you mentioned, relatively speaking, if a few new games that is being launched in the first half of this year, that explains why the selling and marketing on games is a relatively lower amount comparing to periods where we have major titles that we need to promote.

Now on e-commerce, as I mentioned for now at least two, three quarters, it's always a balanced approach between how fast we want to grow the top line as well as the profit profile of my e-commerce segment, and I think coming into 2019, we are more disciplined in keeping that balance in a sense that, we will not -- it's just never our philosophy that we are to pursue a faster top line growth at the expense of a bigger loss. So that is not our intention, and it's never in our corporate DNA. So these two factors accounts for mostly why in the first half for the past two quarters, selling and marketing expense has been maintained at a very cautious and disciplined level. Well, that does not mean that we face resource constrained. In the second half, if there are new games that's ready for marketing and promotion, we will do so. And if there are opportunities for us to see a re-acceleration of my e-commerce or other business segments, top line growth, we will not hesitate to spend marketing dollars, but whatever marketing dollars we spend, it will be a very calculated investment, focusing on returns and focusing on the results of my marketing dollar expenditure.

Bill Liu, Analyst

Okay. Thank you.

Operator

Thank you. We will take our next question from Eddie Leung, Bank of America Merrill Lynch.

Eddie Leung, Analyst

Hey, good morning guys. Good morning. Thank you for taking my questions. I have two quick questions. The first one is about E-Sports. It seems like there is a plan to invest in a stadium in Shanghai. So wondering how would that affect our capital expenditure going forward. And then secondly, just any update on game regulation? Anything related to the young users, time restriction, anything along that line would be helpful. (Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

So Eddie, I'll translate the first question. I think you noticed the recent news we made at ChinaJoy. Yes, we are going to invest in Shanghai, it was related. And Shanghai is very supportive of e-sports, and overall the new economy as a whole, as you may notice that our team Dragon which most recently won a Championship in the Overwatch League is a team that is based in Shanghai. And we've also had plan to invest. It's not solely just for e-sports stadium, but it's a e-sports and as well as R&D center that is more tilted towards developing e-sports relevant game content. So that's a longer-term strategic plan.

And in terms of CapEx, because its going to be spend across next three, five years or even longer. So from the financial statement, from a cash flow perspective, these are well within our resource capability and control. It is not going to impact our financial results materially at all.

(Foreign Language)

And on your second question, game regulation. We don't have any further update on how the regulation is progressing.

Eddie Leung, Analyst

(Foreign Language)

Thank you.

Operator

Thank you. We will take our next question from Jialong Shi from Nomura. Your line is open.

Jialong Shi, Analyst

Hi, good morning -- Hi, good morning, management. Thanks for taking my call. I have two questions. First question is about your dividend payout and as Charles mentioned in the prepared remark, you revise your dividend payout from a fixed 25% to the range of 20% to 30% going forward. So I still -- I just wonder, the rationale to make this change. Is it fair to think going forward you will be able to pay higher than previous 25% in dividend since your earnings outlook is getting better.

And my second question is about Fantasy Westward Journey 3D, and this game will -- based on the games website, this game will start a new donor testing today. So can you give us some colors on its revenue potential based on the performance during the past rounds of testing? And is there any potential cannibalization risk between the upcoming FWJ 3D and your existing 2D FWJ game?

And finally, how long do you expect this latest round -- how long this latest round of testing may last, and when you expect to monetize this new game?

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

So, to just translate for everyone's benefit. For FWJ 3D, yes, we started -- we will start close beta testing are enjoyed today. As to the official launch and monetization timeline that will be subject to, first of all, obviously the approval, when we can get the license. Secondly also based on the testing results of this closed beta testing round.

On your concerns on internal cannibalization, as this FWJ 3D and the current FWJ PC version and the FWJ mobile version, they are targeting different user appeals. So see -- we see very, very little concern if any at all in terms of user internal cannibalization. We are very, very confident and positive about the future outlook of FWJ 3D upon its official launch.

Charles Zhaoxuan Yang, Chief Financial Officer

For your first part of the question on the dividend payout ratio. Let me comment saying that NetEase is in fact one of the very, very few technology companies globally that has been consistently paying dividend, returning dividend to our shareholders on a quarterly basis. Every quarter the exact dividend payout ratio is obviously subject to the Board approval. So now the Board has authorized management instead of a fixed 25% point to a 20% to 30% range, and does not mean that we are bound by this range. So every quarter the exact dividend payout ratio will be dependent on the financial and operational performance of the company and ultimately, subject to the Board's re-approval, so it does not indicate that in the future we will always be paying 30%, but we are still pleased that this quarter, we are paying more, because we are confident about our sustainable profitability profile down the road. For the future quarters, it all depends on how the macro economy and our outlook of the company's performance change.

Eddie Leung, Analyst

Thank you.

Operator

That concludes today's question-and-answer session. Margaret, at this time, I would turn the conference back to you for any additional or closing remarks.

Margaret Shi, Director, Investor Relations

Thank you again for joining us today. If you have any further questions, please feel free to contact us or TPG Investor Relations. Have a great day.

Operator

And this conclude today's conference. Thank you for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2019-05-16
Event Description: Q1 2019 Earnings Call

Market Cap: 33,530.83
Current PX: 262.04
YTD Change($): +26.67
YTD Change(%): +11.331

Bloomberg Estimates - EPS
Current Quarter: 17.525
Current Year: 70.420
Bloomberg Estimates - Sales
Current Quarter: 19404.636
Current Year: 82190.030

Q1 2019 Earnings Call

Company Participants

- Margaret Shi, Investor Relations Director
- Charles Yang, Chief Financial Officer
- William Lei Ding, Chief Executive Officer

Other Participants

- Eddie Leung, Analyst
- Natalie Wu, Analyst
- Hillman Chan, Analyst
- Alex Poon, Analyst
- Alex Yao, Analyst

Presentation

Operator

Good day, and welcome to NetEase First Quarter 2019 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ms. Margaret Shi; IR Director of NetEase. Please go ahead, ma'am.

Margaret Shi, Investor Relations Director

Thank you, operator.

Please note the discussion today will contain forward-looking statements, relating to the future performance of the Company and are intended to qualify for the Safe Harbor from liability, as established by the US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the Company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and the financial results is included in certain filings of the Company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The Company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2019 first quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an Investor Presentation and a webcast replay of this conference call will be available on NetEase's corporate website at ir.netease.com.

Joining us today on the call from NetEase's senior management is Mr. William Ding; Chief Executive Officer; Mr. Charles Yang; Chief Financial Officer; and Mr. Hilton Hui; Co-President of NetEase Games.

I will now turn the call over to Mr. Yang, who will read the prepared remarks on behalf of Mr. Ding.

Charles Yang, Chief Financial Officer

Thank you, Margaret, and thank you, everyone, for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi.

2019 began on a strong note with robust financial growth and our core businesses strategically aligned for future success. Our total net revenues grew by 30% year-over-year for the first quarter and we more than doubled our non-GAAP net income to RMB3 billion on an annual basis. Our online games revenue grew by 35% as a result of continued strong performance from our flagship titles and our successful diversification initiatives. Beyond online games, we realigned our resources to be more focused on our e-commerce, music and online education divisions, which we believe will improve our profitability in the longer run. Over the last few years we have been steadily amassing a portfolio of high-quality games that span a diverse universe of game types. This has allowed for exceptional stability within our online games segment and enabled us to back navigates the fluid market without having to rely solely on new game introductions.

Combined with the time proven longevity of our games, we delivered another quarter of sequential growth based on just our existing titles. This is the fourth consecutive quarter that we have exceeded RMB10 billion in part [ph] with online games revenue. We delivered this result amid a challenging industry environment with fewer new games being approved for market release in China. With our promising pipeline of upcoming new titles in China and abroad, we are confident in our ability to sustain this growth trend in our online games division.

Our legacy titles such as Fantasy Westward Journey series, New Westward Journey Online series and Tianxia III continues to grow in the first quarter. Quarterly revenue for Fantasy Westward Journey Online keeps breaking new records, hitting another all-time high this quarter. Revenue from New Westward Journey Online II also grows steadily, reaching a new high this quarter in recent years. These are prime examples of our ability to create sustainable games that remain relevant over extended period of time. This is the goal for each one of our games and are coming more apparent for our newer titles as they move into their third or fourth year of operation. For example, our 2015 launch, Invincible continues to deliver new records in terms of revenue and number of active users quarter-after-quarter and Onmyoji, our 2016 launch, has topped the iOS growth in China multiple times in recent quarters. Despite all the hype in the online game market, our efforts to create innovative and interesting content updates for our core base of users is consistently rewarded with longevity and loyalty from our game players.

In the spirit of Chinese New Year, we introduced new features and activities for a number of our games that promote our Chinese heritage. These were very well received by our players. For example, in Justice, we introduced Song Dynasty themed Chinese New Year celebration, allowing users to experience Asian customs and traditions within the game. These additions quickly gained wide recognition from the user community and Central Government media outlets, including CCTV and Xinhua News Agency, with invincible players often use classical Chinese language to communicate, particularly for declaring wars and conducting other actions within the game.

In Minecraft, we released new updates, enabling players to build classical architecture, such as the Beijing Palace Museum and restore historical relics, including the Old Summer Palace. With these updates in place, Minecraft monthly and daily active user numbers reached new heights during the Chinese New Year, and bringing the games total number of registered users to more than 200 million.

One of the benefits of having a broad portfolio of self-developed games is that, we can explore the full potential of our full spectrum of IP, many of them are in-house developed. Based on it's huge fan base, we tested this strategy on Onmyoji. The first spin-off of Onmyoji was its mobile game version Onmyoji Arena, which gained meaningful traction from users and how to reinforce the Onmyoji franchise. We are currently working on another new game based on Onmyoji's IP presently known as Project SSR. This collectible card game, with storyline set on the mysterious ship will offer a new and more casual experience, compared with our previous Onmyoji titles. Based on Onmyoji IP, we now have merchandise music, Fan Art, a musical stage production and the cartoon series. We are continuing to build on Onmyoji's popular brand offering many other Onmyoji based 10 entertainment formats.

We keep looking for ways to improve our R&D process, increase efficiency and address the market with innovative new games. While it is impossible to predict with absolute certainty which games will be the next industrial blockbuster. Over the course of the last two decades of operation in online games, with one of the world's largest teams of in-house game developers and comprehensive infrastructure, we have a fairly good understanding of what game players want by implementing a even more rigorous evaluation process and demanding even higher quality content during the R&D stage, we are confident we can continue to bring blockbuster titles to China and global game communities with lasting IP that stands the best of time.

Turning to our overseas market. We continue to make headway to deepen our presence in key international markets, such as Japan and the US. Knives Out remains a popular title in Japan and again tops the grossing chart a few times in March and May following the introduction of Battle Pass and our collaboration with King of Fighters. Identity V is another fan-favorite in the Japanese market, growing steadily since its launch there. With the release of its new character, Axe boy, Identity V made Japan's top five iOS grossing chart for the first time in April. More recently Night Falls Survival, our cooperative survival RPG and Cyber Hunter, our new Open World Battle Royale game both reached number one on Japan's download chart shortly after their launches in April.

We follow a three tier approach with our international expansion strategy. First, we will continue to invest in global talent and overseas game studios that complement our internal R&D know-how to create proprietary games that are suitable for global audience. Second, we work with many of the world's best gaming companies to help transform some of their most well-known PC or console IP into mobile sensations, such as the Diablo and EVE. Third, we have partnered with some of the world's most successful IPO owners to create games based on their iconic characters and storylines. More news will be reviewed at our May 20 Game Day event next Monday. We will also be showcasing more upcoming game titles in our pipeline, including BuildTopia, Love is Justice, Sky, Fantasy Westward Journey 3D, Xuan Yuan Sword: Dragon upon the Cloud and Ages of Isle.

Now, moving onto our other businesses. Our heightened emphasis on our core businesses, allows us to sharpen our focus on areas where we see the most potential for sustainable and long-term growth. During the first quarter, we made a series of structural optimizations to hone these core growth segments, be escalate inefficient segments and increase our investments in areas that improve our competitive edge. Our profitability improved as a result. Take e-commerce as an example, we successfully enhanced our warehouse logistics operations, adjusted our marketing strategies, improved our product navigation and optimized our pricing.

Kaola sold to capture additional spending from loyal customers by offering authentic and cost-effective products from around the world. Compared with last year, the number of Kaola membership has almost doubled with average spending per user steadily improving. We will continue to add more membership benefits, as more and more of our brand partners become aware of the value of these VIP members.

For Yanxuan, we are determined to build a national brand that is deeply embedded in people's mind when they look for premium quality and affordable price. Over the past three years, we have accumulated a large community of Yanxuan fans. In April, we introduced a new cash back incentive program to encourage user engagement. Moreover, we launched a series of interactive activities online and offline to help Yanxuan fans gain a deeper understanding of the entire production process.

For music, we continue to position ourselves as the gathering place for original Chinese singers and a nursing ground for original music and independent artists in China. The number of paying subscribers on our platform more than doubled year-over-year and continues to grow healthily on a quarter-over-quarter basis, underpinned by our strong growth in MAU and DAU.

In January, we hosted the NetEase's Cloud Music, Original Artist Ceremony 2018 and we launched the third season of our talent hunts program, where we discover and help promote new independent musicians in China. Based on our excellent operational capability and distinguished music community atmosphere, we have helped create a great deal of popular original music, which has been played billions of times on our platform. Our users are typically young, edgy [ph] and have very diversified taste in the music they listen to. In addition to our original music, we try to satisfy our users with music from all over the globe. In April, we added popular Japanese music to our platform through our partnership agreement with Nippon Columbia, Japan's premier label record -- record label company.

For online education, Youdao is a leader in China's learning and online education sector with a decade-long cultivation. Youdao now attracts a diverse and engaged user base comprising over 800 million users and offers a suite of technology driven learning and education products and services. With the comfort and trust, these users have gains from our products and services, NetEase Youdao has become a household name in China's learning and education space. And our users are willing to try out other products we offer as they move on to different stages of learning or even select suitable products for their children. This brand recognition has led to higher conversion rate and rapid growth in Youdao's online cost offerings. K-12 continues to be the primary growth engine for Youdao, where we offer online courses via after school curriculum tutorials, as well as extra curriculum courses in STEM subjects, such as coding.

Youdao online courses focus on creating differentiated, reliable and effective learning and educational content to our users. We achieved this by adapting our sophisticated technology to an online learning environment and application. For example, our proprietary smart pens able to create homework and give feedbacks to our students simultaneously as they use them to right on paper. This technology greatly enhances teaching efficiency and helps us accumulate a large amount of relevant data, which we utilize to further improve our teaching content.

NetEase have come a long way over the last few years. Mobile and PC games remained the crux of our business with e-commerce, music, online education and media following closely behind. These are the core areas that we have identified at constant in an ever evolving online world. This is where we will focus our efforts to continue to grow our business and this is where we provide our users a variety of best-in-class contents and services on the one NetEase brand appeal. As we nurture these non-game businesses to their full potential adapting with intellectually curious Internet population, we believe we will be very well positioned to remain at the forefront of the evolution, shaping trends and bringing new online ideas to our growing community of users around the world. 2019 is off to a strong start and we are excited to continue on this trajectory.

This concludes William's comments. I will now provide a brief review of our first quarter 2019 financial results. Given the limited time on today's call, I will only be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

Our total net revenue for the first quarter were RMB18.4 billion, or $2.7 billion, representing approximately 30% increase year-over-year. Net revenues from online games grew for the fourth consecutive quarter, reaching RMB11.9 billion, representing an increase of 8% quarter-over-quarter and 35% year-over-year. The sequential increase was driven by steady performances from a number of our legacy titles. The year-over-year increase was primarily driven by new game launches in China and abroad, including Knives Out in Japan, Identity V, Justice and Night Falls: Survival.

Mobile games accounted for approximately 72% of net revenues from our online games in the first quarter. The first quarter is typically a slow season for e-commerce and advertising, which explains the sequential decline in net revenues from these business segments.

Net revenues from innovative businesses and others declined sequentially due to reduced revenue from non-core businesses, as a result of the reallocation of our resources to our core business areas, and the decline in Cloud Music and CC live streaming, due to seasonality.

Gross margin was 44.1% in the first quarter, compared with 38.6% in the preceding quarter and 42% for the prior year period. Gross margin for our online games services for the first quarter improved slightly to 63.7%, which is largely stable. As a reminder, our gross margins for games typically fluctuate quarter-to-quarter within a narrow bandwidth based on the revenue mix of mobile, PC, self-developed and licensed games.

For e-commerce, we aim to maintain our gross margin in the high-single digits on an annual basis. For the first quarter, our e-commerce gross margin was 10.2% versus 4.5% and 9.5% in the prior quarter and for the first quarter of 2018, respectively. The sequential increase was because the fourth quarter last year is seasonally the largest promotional quarter of the year.

Gross margin for innovative businesses and others was negative 13.1% versus negative 5.2% and negative 9.9% in the prior quarter and for the first quarter of last year, respectively. This was mainly due to reduced revenue contribution from non-core business division.

For Cloud Music, on a year-over-year basis, gross profit margin is improving due to scale effect. The quarter-over-quarter decline was mainly due to seasonality on advertising and increase in content purchase costs.

For the first quarter, total operating expenses were RMB4.7 billion, down 14% and 1%, respectively, compared to prior quarter and first quarter of last year. We continue to see operating leverage as we benefit from economies of scale and improved operational efficiencies.

Selling and marketing as a percentage of net revenue was 9.2% in the first quarter, consistently coming down from 2018 levels. E-commerce related shipping and handling expenses included in selling and marketing expenses as a percentage of e-commerce revenue was 8.4% in the first quarter, compared with 8.7% in the same quarter last year.

R&D expenses were maintained at around RMB2 billion level reflecting our continued commitment to investing in content creation and product development, which is what defines us as a technology Company.

Operating income for the first quarter was -- increased by 52% quarter-over-quarter and 182% year-over-year to RMB3.4 billion.

Effective tax rate for the first quarter was 34%.

Non-GAAP net income attributable to our shareholders for the first quarter totaled RMB3 billion or $450 million, representing an increase of 28% quarter-over-quarter and 126% year-over-year.

Our non-GAAP diluted earnings per ADS were RMB23.34 or $3.48 for the first quarter of 2019.

Our cash position remains steady and strong. As of March 31, 2019, our total cash and cash equivalent, current and non-current time deposits and short-term investment balance totaled RMB51.9 billion, compared with RMB50.1 billion as of December 31st last year.

For the first quarter of 2019, we plan to pay a dividend of $0.69 per ADS, representing 25% of the net income attributable to our shareholders.

Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead to Q&A.

Questions And Answers

Operator

Thank you. (Operator Instructions) For the benefit of all participants on today's call, if you wish to ask the question in Chinese, please immediately repeat your questions in English. Please ask one question at a time. (Operator Instructions) We will take our first question from Eddie Leung from Bank of America Merrill Lynch. Your line is open. Please go ahead.

Eddie Leung, Analyst

Hey. Good morning, guys. Just I have a question on an industry phenomenon. We have seen a lot of Internet companies talking more and more about focusing on time spend of their users. So just curious if NetEase think about these problem. Do you think time spend is the most important metric internally for a lot of your business unit? If not, why? Especially given your experience in running PC games, which, I guess, what the one of the first Internet applications are facing the challenge of time spend diluting by other applications. So it would be great to hear from you guys in terms of these industry dynamics.

Charles Yang, Chief Financial Officer

Okay. Thank you, Eddie. I will translate the questions for William and the other management team.

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language) So, Eddie, for the benefit of...

(Foreign Language)

Charles Yang, Chief Financial Officer

Okay. Eddie and everyone on the call, for the benefits of the broader population, I would briefly translate William's comment that he made in Chinese. Well, first of all, we don't think this is a question can be answered by one generalized answer. Definitely time spend is an important factor, but this should not be the only or so important factor that is applicable to all the different verticals. For us, what we think are the most critical factors to our success is the back to the essence of a content whether you are providing a unique and differentiated experience to the users that differentiates your product versus of a competitor. So to us, we really think it -- that's the core -- that's the essence that's being attracting users coming back with higher frequency of using our product and services. So, if we were to summarize this broad macro question, it is the frequency of user revisiting and unique and differentiated experiences that we will prioritize when we think about the NetEase product and services.

Operator

(Operator Instructions) We'll take the next question from Natalie Wu from CICC. Your line is open. Please go ahead.

Natalie Wu, Analyst

Hi. Good morning, management. Thanks for taking my question and congratulations on very solid results. My question is related to the innovation -- innovative business and others, including Youdao education, Cloud and others. Just wonder what kind of scale of the investment are you preparing for this business this year, specifically for online education. You know that it is actually quite difficult to reach a sizable level by simply utility app category direction for online K-12 after tutoring -- after-school tutoring, especially those like primary school courses related. So just wondering what kind of the differentiation or unique positioning NetEase has in the competition with other industry leaders, say, (inaudible), et cetera. And what kind of the resources NetEase would allocate on the Group level to facilitate a better development of this business?

And also, a housekeeping question, can you update us about the overseas revenue contribution this quarter? Thank you.

Charles Yang, Chief Financial Officer

Okay. Let me translate again.

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language) Okay. So Natalie, in terms of specifically on Youdao, the one positioning that we would like to emphasize is that, our core Youdao business is only focused on online teaching and learning. So we are not tapping into offline, and the primary focus is K-12 segment of the population. One very unique advantage of NetEase as a technology Company and Youdao that is being cultivating its online education resources for over a decade is that, we have very, very strong technology backed proprietary hardware, AI technology, such as our smart pen, smart device, that's one thing that many other online education or offline educations do not have a strong as us.

And also, in terms of traffic support, at a Group level, we are dedicating lot of traffics from various business segments to contribute and support the growth of Youdao. Many of our users are now in the age of their parenthood. So it's not only them, and it's also extents beyond to their children that can be a potential beneficiary of our Youdao products and services.

And last but not least, a very important factor here around all of these educational asset is NetEase brand appeal. That brand appeal itself is now being widely recognized as a household name in the teaching and learning space, because we again, like I commented earlier, we have over a decade of experience and a period cultivating our Youdao brands in multiple products.

Natalie, to your second question, overseas game revenue this quarter is still approximately 10%.

Natalie Wu, Analyst

Great. Thanks for the color. Just very quick follow-up. Does that mean the focus of traffic acquisition or user acquisition for Youdao online K-12 would be app traffic with direction rather than the traffic purchase through external channel?

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language)

Natalie Wu, Analyst

(Foreign Language)

Charles Yang, Chief Financial Officer

Yeah. So it's a mixture of both. I think we have a unique advantage of traffic. At the same time, we'll also be acquiring users from external traffic channels. But ultimately, that is driven by the efficiency, whether or not the acquisition cost, makes sense vis-a-vis, for instance, the lifetime value of that particular user that can contribute to our Youdao online courses.

Natalie Wu, Analyst

Got it. Thanks.

Operator

(Operator Instructions) A kind reminder to all, please ask one question at a time. (Operator Instructions) We'll take our next question from Hillman Chan from Citibank. Please go ahead.

Hillman Chan, Analyst

Good morning, William, Charles, Margaret and Randy. Thank you for taking my question. I've got two questions. First one is on the overseas expansion strategy for our games in Japan and international markets. Could you share more on our strategy on that regarding the game development and publishing capability? And in that -- in addition, can management highlight the major update on our partnership and synergy with the game studios that we previously invested globally?

And my second question is more a housekeeping one. We see some decrease in the marketing expenses for this quarter, which could be related to the e-commerce seasonality or game launches. Could you share more a color behind that and how should we think about the trend going forward, please, as percentage of revenue -- relative to the revenue growth of respective business lines? Thank you.

Charles Yang, Chief Financial Officer

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language)

Charles Yang, Chief Financial Officer

Okay. So for the overseas game expansion strategy, I think that's also a common question that we've been asked quarter-over-quarter. So, as of today, we have achieved some small achievements in Japan, in particular with Knives Out. To continue on that momentum, we've introduced Night Falls: Survival, Cyber Hunter et cetera, and we will continue to bring more and more games into major markets, like Japan, like US and ultimately into the mainstream Western market. But we also recognize the fact that in many of these mature Western mainstream game market, mobile game is not yet the -- unlike in China is not yet the number one primary conduit for the western market is probably still PC and console, but we do believe that the mobile game market has the most potential in terms of upcoming growth. So as a result, NetEase is going to continue to explore to try different ways of trying to benefit from that upside potential of the international markets turning more and more mobile focused. Our investment strategy is also in line with that.

And Hillman, to your second question comment asking for the general trends in our selling, marketing. Let me broadly answer, for the overall operating expenses, as we mentioned in prior quarters, NetEase is a very prudent and return-focused Company. For us, we continue to invest in areas that we think that can ultimately strengthen our competitive advantage, such as R&D.

In terms of selling and marketing, for the first quarter, the cost is very well controlled, largely because number one, Q1 is generally a seasonality low season for our e-commerce business. So we have been very, very cautious and prudent in spending on e-commerce. Secondly, as you all know, because of the overall regulatory control on the new registration license, there is no new game that is being launched in the first quarter. As a result of combined relatively lower spending on e-commerce, as well as games, that results in our selling, marketing spending in the first quarter very, very disciplined.

Now, looking beyond the first quarter, as we continue to receive more and more approvals on our new games, when the new games are getting ready to be launched. And then for sure, for NetEase, we will be continuing to investing selling, marketing into promoting our newer titles, which we fundamentally believe we have a track record of generating very, very high return on the level of investment.

Also for the second quarter, for instance, there will be more promotional events for e-commerce as a general industry trend for (inaudible) also for our Yanxuan in April, we just celebrated our 30 Anniversary, et cetera. But all in all, I think the way we look at selling, marketing is not a very rigid budgetary percentage application, but rather it is a internal return-driven. For whatever marketing dollars that we spend on the different business verticals, what we are ultimately hoping for is a satisfactory return that's going to be reflected on the top line that may not necessarily happy in the same quarter depending on the business nature. But hopefully now with longer and longer track record of NetEase operating in the non-games business verticals, we have a pretty good track record of keeping on a satisfactory return on our general OpEx spending.

Operator

We'll take our next question from Alex Poon from Morgan Stanley. Your line is open. Please go ahead.

Alex Poon, Analyst

(Foreign Language) I'll translate myself. First, my first question is related to Fantasy Westward Journey 3D version. No doubt, this will be a blockbuster title. How should we think about the user base and revenue potential cannibalization? And also may actually be synergy, some users may play 3D and go back to play the 2D version as well.

And second is regarding the Diablo mobile development and licensing progress.

And third is regarding Music business. Selectively renewing some of the music label may be good for margin, but would that affect user experience? How do -- how should we balance between these two? And regarding your competitor Tencent Music, they have been doing a lot of live streaming and karaoke to monetize. How do you position in this segment? Thank you.

Charles Yang, Chief Financial Officer

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language)

Charles Yang, Chief Financial Officer

Okay. Let me translate the answer to the first question on FWJ 3D first. So, in March, we just completed another testing round, result is pretty satisfactory. In terms of the addressable user market, we do not have much concern about a potential internal cannibalization with existing FWJ titles, because FWJ's 3D is more missions towards broadening a potential user outreach to both the PC and mobile and hot core users, as well as users who play real-time MMO. So when the FWJ 3D is eventually launched, we think that's going to bring incremental net gains to our overall user metrics.

(Foreign Language)

William Lei Ding, Chief Executive Officer

(Foreign Language)

Charles Yang, Chief Financial Officer

So Alex, for Diablo Immortal, the mobile version, it's on track. We will be applying for the regulatory approval in accordance with overall the latest guidance from the Ministry. And, I guess, people do not need to worry too much about it. It's on track. Because Diablo, the PC version was approved, and it's long been launched and release in China. So, for now, we think the approval process is well on track. But again, at this moment, we do not have a specific timetable for the launch of Diablo Immortal as yet.

William Lei Ding, Chief Executive Officer

(Foreign Language)

Charles Yang, Chief Financial Officer

Okay. So, Alex, for your last question on Music. William answers come twofold. First of all, the current status of very high cost in renewing -- essentially a renewing business is kind of the rental business, right. We pay the price to rent the music content for a period of time, a very high cost of that is not healthy to the overall industry, and we fundamentally believe that the cost will come down and be more rationalized in the longer run, which then will be a more conducive environment for the overall healthy and sustainable growth of China's online music streaming industry.

Secondly, from a NetEase perspective, we are also applying a lot of thought and innovation in thinking of how we can potentially change our NetEase Cloud Music from merely just listening to music into a very active forum for music enthusiasts together to facilitate their communication, sharing and if we achieve that, I think the potential for imagination of what NetEase Cloud Music can enable is more than just playing songs, a content IP-driven business.

Operator

Next up we have Alex Yao from J.P. Morgan. Your line is open. Please go ahead.

Alex Yao, Analyst

(Foreign Language) Good morning, everyone, and thank you for taking my question. My question is about the overall capital allocation strategy for 2019. You guys have a touch base on some of the key strategies that you are going to implement this year, including recent focus on core business from gaming to music to e-commerce et cetera, and also cost reduction in the non-core business. Even within these core business, we noticed from the media reports, there seem to be a pretty systematic cost reduction initiatives across different business units. My question is about what is the trigger for such a philosophical change in capital deployment or allocation and how long would this operational strategy last? Thank you.

William Lei Ding, Chief Executive Officer

(Foreign Language)

Charles Yang, Chief Financial Officer

Okay. Alex, I'll briefly translate William's answer. So the guiding principle is really that we've been more selective in terms of what we are good at. For instance, for education, that is a broad sector that many players come and go. For us, we've been here for over a decade. We know what we are good at. We know how we are going to be differentiated and then we continue to invest into our competitive edge. The same applies to e-commerce, whereby this is a relatively crowded vertical, but there are areas we think that we have a better understanding and it's probably more suitable for NetEase, whether it's from a user appeal or from a brand image perspective that we can continue to cultivate, that's creating something of differentiation and with uniqueness. Businesses that we are relatively less familiar with are good at, for instance, comics business that we've divested that business to other players who are probably better positioned to operate. So that is really the guiding principle.

From a financial perspective, NetEase being listed for 19 years, we've always been financially very disciplined. When we think about investments, again, it is return-driven. We are not shy of making big investment into areas that's being highly selective, being our focus areas. But whatever investment amount that we make or the scale, magnitude that we make, ultimately the purpose is to drive our unique and competitive positioning.

Operator

Thank you, everyone, for participating in the Q&A session. Now, I would like to turn the conference back to Ms. Margaret Shi, for any additional or closing remarks.

Margaret Shi, Investor Relations Director

Thank you once again for joining us today. If you have any further questions, please feel free to contact us, or TPG Investor Relations. Have a great day.

Charles Yang, Chief Financial Officer

Thank you, everyone.

William Lei Ding, Chief Executive Officer

Thank you.

Operator

That concludes today's conference. Thank you, everyone, for your participation.

William Lei Ding, Chief Executive Officer

Thank you.

Company Name: Netease
Company Ticker: NTES US
Date: 2019-02-20
Event Description: Q4 2018 Earnings Call

Market Cap: 29,164.16
Current PX: 222.07
YTD Change($): -13.30
YTD Change(%): -5.651

Bloomberg Estimates - EPS
Current Quarter: 17.578
Current Year: 73.735
Bloomberg Estimates - Sales
Current Quarter: 18760.778
Current Year: 83253.839

Q4 2018 Earnings Call

Company Participants

- Margaret Shi
- Zhaoxuan Yang

Other Participants

- Thomas Chong
- Eddie Leung
- Alicia Yap
- Yue Natalie Wu
- Alex Poon
- Alex Yao

MANAGEMENT DISCUSSION SECTION

25Operator: Good day and welcome to the NetEase Fourth Quarter and Full Year 2018 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to IR Director, Margaret Shi. Please go ahead.

Margaret Shi

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors.

Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and the financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update this forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2018 fourth quarter and the full-year financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on NetEase corporate website at ir.netease.com.

Joining us today on the call from NetEase's senior management is William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer; and Mr. Hilton Huang, Co-President of NetEase Games.

I will now turn the call over to Mr. Yang, who will read the prepared remarks on behalf of Mr. Ding.

Zhaoxuan Yang

Thank you, Margaret. Happy Chinese New Year and thank you everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi.

With that said, I would deliver opening remarks on William's behalf. 2018 was an exciting year for us. We ended the year with record total annual net revenues of RMB 67 billion, a 24% increase from 2017. Our strong performance was driven by a diverse portfolio of online games, as well as healthy growth in our e-commerce advertising services and other Internet products and service offerings.

Our online games business remains the core of our strategy. The fourth quarter marked our third consecutive quarter exceeding RMB 10 billion in online games net revenues. In the fourth quarter, our online games revenue reached RMB 11 billion, a 38% increase compared with the same period last year.

Our continued success in online games is underpinned by our commitment and vision to having a positive impact on the online games industry, our ability to deliver best-in-class quality games with an emphasis on in-house R&D and native IP, empowered by our unique corporate culture and the right training mechanisms and infrastructure to nurture talent, all of which we have spent over two decades investing in 2018 was a fruitful year for us in terms of our online games genre diversification initiatives.

In addition to our legacy titles that spend decades of popularity, we are continuously adding new titles and creating new IP that we hope will garner the same longevity. Throughout 2018, we launched a number of highly successful games covering a wide spectrum of categories with chart topping titles such as Chu Liu Xiang, Identity V, QwQ, Justice, Butterfly Sword, Ancient Nocturne and in the fourth quarter Night Falls: Survival. Night Falls: Survival has been the top performer on China's iOS downloads chart since its release in November.

This is a cooperative survival role-playing game, game set against a doomsday background, where players rebuild their living habitat and restore civilization with other survivors after the apocalypse. It has attracted a large fan base with a high degree of innovation that combines MMORPG, sandbox and shooting game play features all in one game.

Night Falls: Survival has stayed consistently at the top of China's iOS grossing chart ranking number three in terms of total grossing games for the month of November and December according to App Annie. This game is now also available in Hong Kong, Macau and Taiwan. While we continue to dominate the MMO genre, many of our new titles are in brand new categories that we have either recently entered or pioneered.

Our ability to break into new territories has helped us capture uses that reach beyond our traditional MMO game players. As a result, our user base has grown rapidly, spanning across different emerging demographics including younger, more casual and more female users.

Turning to our legacy titles, the market is still in all of the longevity of our flagship franchises. After over – for 15 years of operation on PC and more than three years on mobile, our active Fantasy Westward Journey and Westward Journey Online sagas are still growing. We continue to supply this large and sustainable user base with interesting content. In the fourth quarter, we launched content updates for our Fantasy Westward Journey and New Westward Journey Online series on both PC client and mobile platforms.

Tianxia III also celebrated its 10th year anniversary with a new expansion pack at the end of November, delivering encouraging sequential positive revenue growth in the fourth quarter. Some of the titles we launched in more recent years such as Onmyoji have also entered a steady stage of operation. Through the introduction of new content, Onmyoji climbed back to the number one spot on the iOS grossing chart twice in the fourth quarter, two years after it first became a market sensation in 2016.

Invincible, an SLG game we launched over three years ago has been growing steadily year-over-year both in terms of revenue and user numbers since its launch. Other titles such as Onmyoji arena, a multiplayer online battle arena game which we released in early 2018 has also begun to show similar healthy trends.

2018 was also a milestone year for our international expansion, net revenues from our international games accounted for more than 10% of our total game net revenues for two consecutive quarters now. In Japan, Knives Out has become a household name among young gamers. It has remained one of Japan's leading grossing games since March 2018. It has also been ranked as China's top grossing mobile game in overseas market for five consecutive months from August to December 2018 according to Sensor Tower.

During 2018, as well as in recent months, we brought a number of other distinctive new titles to Asian market including Rules of Survival, Identity V and QwQ, each of which opens doors for us in their respective markets. Going global offers an excellent opportunity for us to promote Chinese culture as well as our original IP and best-in-class production quality in markets worldwide. We see huge potential to further build our brand and bring our games to players outside of China, particularly in mainstream western markets.

For example, we plan to bring our popular hit Night Falls: Survival to Japan and the U.S. in the first half of 2019.

We are now working with other world renowned game developers not only to bring their flagship titles to China, but also help transform some of their most important titles into mobile games. Most significantly, we renewed our 11-year partnership with Blizzard Entertainment in Mainland China, extending our publishing agreement until January 2023. And as we previously announced, we are co-developing the highly anticipated new mobile game Diablo Immortal with Blizzard.

Our world-class R&D capabilities, particularly in the mobile arena afford us an excellent opportunity to appeal to a global audience. We plan to continue to invest in global talent and IP to further this momentum. For example, we recently closed a deal with Codemasters, a UK game studio and made minority investments in Quantic Dream, a French game studio as well as Second Dinner, the U.S. studio founded by ex-Blizzard veterans.

We have a number of strong titles in our pipeline, including Fantasy Westward Journey 3D, Xuanyuan Sword, Ages of Isle, and Pokémon Quest, just to name a few. We will continue to introduce thrilling new games that maintain the high level of integrity, innovation and excellence upon which our users rely. Our ability to create unique content has been a driving force in NetEase's success over the last 20 years. This is historically prevalent across our offerings including online games, NetEase News and NetEase some e-mail services.

For our next phase of investment, we again look for areas where our content creation abilities can stand out, succeed and have strong profit growth potential, e-commerce, online education, and music are three factors that fit these criteria and will be the focus of our next phase of strategic growth.

For Kaola, we are increasingly encouraged by the government favorable policies toward cross-border e-commerce, raising the cross-border duty free quota per transaction and raising the duty free annual quota per individual incentivize customers to buy more products across a wider range of categories. We are continuously collaborating with more international brands to raise these company's brand profiles in China. For example, Abbott, a global maternity and baby products manufacturer is one of our more recent partners. Through our strategic agreement, Kaola will be one of the first to sell Abbott high-end baby formula in China.

In the fourth quarter, we also held a NetEase Kaola Super Brand Day Event whereby participating brands were allotted targeted promotion of resources on our platform, many of the internationally renowned brands experienced record sales growth based on Kaola support, including British high street brand [ph] Kettle (00:13:21), American sports equipment brand Under Armour, well known European organic baby food brand Little Freddie and U.S. baby food brand Mead Johnson. For Yanxuan, we continue to enhance the efficiency of our supply chain establishing new workflow progresses in order to work more closely with quality designers and train our premier suppliers to ensure high caliber product design and craftsmanship.

In December 2018 and January 2019, we opened our very first brick-and-mortar Yanxuan store and our flagship Kaola store respectively. These pilot stores offer customers an integrated online to offline shopping experience, where customers can see and try our product in person, enjoying greater convenience.

Located in Hangzhou's busiest business district, the stores generated strong interest and demand from tourists and visitors to Hangzhou proving to be an effective marketing tool as we work to further scale our e-commerce offerings.

In addition education is a large and important area of focus for us. Our influence and reach in the online education arena grew substantially in 2018. We have great confidence in the continued growth of this space, and we believe our strong background in Internet and AI technology provides us with an advantage in delivering a superb user experience in online education.

In 2018, gross billing from Youdao online courses more than doubled from the prior year making this vertical the largest contributor for Youdao. We introduced a dual teacher mode to provide a better studying experience in which students are equipped with one lecture and one assistant counselor for each online session course. This teaching mode proved to be popular with users yielding higher renewal rates for some of our K-12 courses. While our online education offerings currently cover both K-12 education and higher education, we expect our K-12 offerings to be a bigger growth driver going forward.

In 2018 and early 2019, we launched several educational apps supported by AI technology, all tailored towards K-12 users making studying more personalized and targeted.

These apps include Youdao Mathematics, Youdao Verbal English, Youdao Homework, which contain after-school tutorials for children, Youdao Reading, which helps children develop positive reading habits and Youdao Children's Dictionary. We believe like with all our businesses, our dedication to ensuring a positive user experience and creating differentiated and unique content is what will set us apart and allow us to succeed in the online education space in the longer run.

For music, we are receiving more recognition for NetEase Cloud Music, especially among the critical younger generation demographic with over 600 million users. Our NetEase Cloud Music was China's most downloaded free music app on iOS in the fourth quarter according to App Annie. China's digital music market is thriving and we continue to provide our growing community with a differentiated and personalized user experience.

In 2018, the number of paying subscribers more than doubled from the prior year and the sales of digital albums are now in NetEase Cloud Music platform experienced robust growth year-over-year. We completed a round of financing for NetEase Cloud Music in November 2018, and brought in complementary business resources and stakeholders to help ensure a healthy growth outlook for our online music platform.

As we move through the year, online games will remain the backbone of our operations both domestically and overseas. We are proud of our in-house production capabilities and we are excited to take our products abroad and win over global players with our innovative and proprietary content. At the same time, we will take an even more focused and concentrated approach with our investments in non-game segments namely e-commerce, online education and music.

Our relentless drive to create premium content has paved way for our success and our investments in carefully chosen new areas will allow us to stand the test of time in China's rapidly evolving Internet industry. These will continue to be the foundation for our next exciting stage of growth.

This concludes Williams's remarks, I will now provide a brief review of our fourth quarter and full year 2018 financial results.

Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details. We finished the year with a new revenue record both on an annual basis and on a quarterly basis.

Net revenues for the year were RMB 67.2 billion or $9.8 billion representing a 24% increase year-over-year. Net revenues for the fourth quarter of 2018 came in at RMB 19.8 billion or $2.9 billion, representing a 36% increase year-over-year and 18% increase quarter-over-quarter. Net revenues from online games grew for the fourth consecutive quarter reaching RMB 11 billion, representing a 6% increase quarter-over-quarter and 38% year-over-year. The sequential increase was driven by the launch of Night Falls: Survival and Ancient Nocturne, and the yearly increase was primarily driven by the launch of Knives Out, Chu Liu Xiang and Identity V. Mobile games account for approximately 70% of net revenues from our online games in the fourth quarter and for the 2018 full year.

Our e-commerce business continues to demonstrate robust growth in 2018 with total net revenues increased by 65% year-over-year to RMB 19.2 billion. For the fourth quarter, net revenues from e-commerce were up 50% quarter-over-quarter and 44% year-over-year to RMB 6.7 billion. Net revenues from our advertising services business will also up by 4% year-over-year in 2018, yielding RMB 2.5 billion for the full year. For the fourth quarter, net revenues from advertising services were RMB 761 million, representing a growth of 18% quarter-over-quarter and 3% year-over-year. The top-performing verticals were automobile, real estate, and Internet services sectors.

Total net revenues from our innovative businesses and others segments were RMB 5.2 billion for the year, an increase of 40% year-over-year. Net revenues from innovative businesses and others were RMB 1.4 billion for the fourth quarter of 2018, which was relatively flat quarter-over-quarter, and up 14% year-over-year. As you may have noticed, we renamed our email and other segments to innovative businesses and others. With our heightened focus on developing key incubated businesses, we believe this name better reflects the nature of the segments revenue composition.

The main components within this segment has not dramatically changed, and as a reminder include live video streaming, cloud music, online education and certain other cloud application services, among others. Gross margin was 38.6% in the fourth quarter compared with 44.8% in the preceding quarter and 39.3% a year ago.

Gross margin for our online game services for the fourth quarter of 2018 was 62.8%, which is largely stable. As a reminder, our gross margin for games typically fluctuates quarter-to-quarter within the narrow band based on the revenue mix of mobile, PC sales developed and licensed games.

Gross margin for our e-commerce segment was 4.5% in the fourth quarter of 2018, the quarter-over-quarter and year-over-year decreases were due to larger scale e-commerce promotion and discounts during the promotional season. On a full year basis, gross margin for this segment was 8.0% compared to 10.3% last year.

During the fourth quarter, we incurred RMB 5.4 billion in operating expenses, the year-over-year increase was mainly due to increased R&D, mostly related to online games, as well as increased shipping and handling costs related to the growing scale of our e-commerce business.

The increasing R&D is a testament to our commitment to investing in best-class R&D infrastructure, talent and products. While we continue to grow, we take a disciplined view of our spending, staying within a well-controlled range.

Selling and marketing expenses as a percentage of net revenue consistently came down from the first quarter of 2018 coming in at 12.1% in the fourth quarter compared with 14% in the previous quarter and 16.4% in the fourth quarter of 2017. E-commerce related shipping and handling cost, as a percentage of e-commerce net revenues was 8.6% in the fourth quarter, on the full year basis, shipping and handling cost as a percentage of e-commerce revenue was 8.7% in 2018, compared to 10.1% last year.

Operating income for the fourth quarter of 2018 increased by 57% year-on-year to RMB 2.2 billion. The effective tax rate for the fourth quarter of 2018 was 34% compared to 34% and 18% for the preceding quarter and the fourth quarter of 2017 respectively.

Our effective tax rate was 28% for the full-year 2018 compared to 17% for 2017. The year-over-year increase in the effective tax rate for the fourth quarter and for the full year were due to higher operating losses incurred by some of our non-game businesses.

As we have discussed on our prior calls, due to the increase in the scale of some of our loss-making business units we expect effective tax rate to increase further in 2019. Non-GAAP net income attributable to our shareholders for the fourth quarter of 2018 totaled RMB 2.4 billion or $343 million, representing an increase of 4% quarter-over-quarter and 26% year-over-year.

Non-GAAP net income attributable to our shareholders for the full year 2018 totaled RMB 8.7 billion or $1.3 billion compared to RMB 12.8 billion in 2017.

Our non-GAAP diluted earnings per ADS were RMB 18.33 or $2.66 for the fourth quarter of 2018. Non-GAAP diluted earnings per ADS were RMB 66.68 or $9.70 for the full year 2018.

Our cash position remains strong. As of December 31, 2018, our total cash and cash equivalents, current and non-current time deposits and short-term investment balance totaled RMB 50.1 billion compared with RMB 43.2 billion as of December 31, 2017.

For the fourth quarter of 2018, we plan to pay a dividend of $0.48 per ADS representing 25% of the net income attributable to our shareholders. As of November 15, 2018, under our share purchase program for up to $2 billion, we had repurchased approximately 4.6 million ADS for approximately $1.2 billion.

On November 14, 2018, our board announced the approval of a new share repurchase program for up to $1 billion of our outstanding ADS for the next 12 months, beginning on November 16, 2018. No shares were repurchased under this new plan as of December 31, 2018.

Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead to Q&A.

Q&A

Operator

Thank you. [Operator Instructions] We'll go first to Thomas Chong with Credit Suisse.

<Q - Thomas Chong>: Hi. Good morning. Thanks Management for taking my questions. My first question is about our investment approach on e-commerce, education and music business. I just want to get a sense of why we choose 2019 to be the year to step up the investments across these areas? Are we seeing any new trends or industry trend as we see there a lot of potential? And given the facts that the tax rates are maybe higher on the losses, how should we think about the earnings growth or the margin trend that we should expect?

And my second question is about the gaming regulations, in particular, the suspension for the new license applications, just want to see if any color on that? And my final question is about our e-commerce business, can management talk about any view on our synergies to be expected with our strategic partner, if there is any? Thank you.

<A - Zhaoxuan Yang>: Thanks, Thomas. I will translate your question one-by-one for William.

Thomas, the first question William would like to first remind that it has been years for NetEase to be exploring into e-commerce online education, music, for instance for our online education, in particular for Youdao, we have almost a decade of experience, nurturing into this vertical. Now, we are seeing the increased sophistication of AI technology, as well as a much higher level of user acceptance to education format online, that's why we think with a huge potential market, as well as the readiness and maturity of this market, it is time for us to be very focused in making a bigger impact in online education.

Music and games are in essence a content driven business, and we are confident of our content creation, differentiation capability. For e-commerce, again for both Kaola and Yanxuan, we've been investing for years, and this is definitely an area that NetEase is going to continue to invest.

For your second question, any update on gaming regulation? We also noticed there are market news and rumors yesterday talking about large game suspensions, we would like to say that we do not see that some provisional and local regulators have modified the format of material submissions, but we do not interpret that as a shutdown of new game approvals.

For e-commerce, first of all, we do not make comment or response to any ungrounded market rumors, but as a mentality, NetEase is always very open-minded to embrace stakeholders, strategic partners, business partners that can bring synergy and win-win to our e-commerce segment, as well as many of our other segments.

Operator

Again please limit yourself to one question. We'll go next to Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Hey good morning guys. Just actually very quick question on the gross margin of your e-commerce business, I remember you guys, especially, for example, like Charles mentioned that there would be hopefully a target on stabilizing the gross margin of the e-commerce business. So just wondering, if you could provide some outlook on that front, given the fourth quarter fluctuation in gross margin? Thank you.

<A - Zhaoxuan Yang>: Thank you Eddie, I will take your question directly. For our e-commerce, as you have noted that, for Q4, gross margin was lower than prior quarters as well as Q4 of last year. But at the same time I hope that you can also notice that a substantial improvement in us lowering our inventory, which means in Q4, we have engaged in a larger scale promotional events to optimize our inventory structure, going forward in 2019 and forward, it is always a very prudent strategy for NetEase to balance top line GMV/revenue growth, as well as a margin profile. For now, we expect that the overall e-commerce segment in 2019 and forward can still have a very robust top line growth. At the same time with relatively stable GP margin over the full year, but of course quarter-over-quarter, there might be fluctuation, that is just typical to e-commerce seasonality.

Operator

We'll go next to Alicia Yap with Citigroup.

<Q - Alicia Yap>: Hi. Good morning, William, Charles, Margaret and Brandi, thanks for taking my questions. I wanted to ask, could management comment how many titles that NetEase has submitted while still waiting for approval. And if, let's say, China license continues to hold up longer, if the new games is ready, will NetEase actually decided to launch those new games to overseas market first, even though China markets are not yet ready to launch? Follow-up on these, Charles, your questions on the – I mean, your answer on the gross margin for e-commerce you say stable for the full year. Do you mean this 8% on 2018 will be the trend for 2019 and going forward? Thank you.

<A - Zhaoxuan Yang>: Okay. Alicia, I'll take your second – I'll translate your first question and I'll take your second question directly.

So Alicia, first part of your question, we have over 10 title that is already being submitted in the approval pipeline. And as to your second part of the game right relation question, yes for overseas market, it is not restricted by the domestic approval. So there are games for instance that we have already started testing, and trial in overseas market for us we see that as two pillars of further growing our game segment in 2019. And for your second question, e-commerce margin, yes, for us we always strive to seek a disciplined balance between top line growth and margin profile. It is also our intention to maintain e-commerce gross profit margin in the neighborhood similar to 2018 full year, that is in the high-single-digit area. But of course, this is not an easy battle, and it requires a lot of effort and hard work from our business units.

Operator

[Operator Instructions] We'll go next to Natalie Wu with CICC.

<Q - Yue Natalie Wu>: Hi, good morning William, Charles and Margaret. Thanks for taking my question. Firstly very quickly, can you give us some color on the region breakdown for your overseas game revenue, because it's being shown in the couple of last quarters? Also, the margin profiles there, any difference versus the domestic market?

And secondly, you mentioned about the online education endeavor, also the Youdao revenue has been doubled last year. Just wondering can you share with us any color on the contribution from the K-12 business versus the higher education, under which line do you recognize that revenue? And also in the future, just wondering will Youdao be the major business unit, for your online education endeavor or if there would be any synergy with other business lines, should we anticipate or you – is it just to operate independently for Youdao? Thank you.

<A - Zhaoxuan Yang>: Okay. Thanks, Natalie Wu. I'll translate the questions.

Okay, so Natalie I'll provide a brief and summarize translation for the answers. Firstly, for the overseas games contribution, for now, it is mainly coming from Japan contributed by Knives Out performance. And as I just mentioned in the earnings call, our next focus is to further tapping to mainstream western market hopefully by more and more titles.

In terms of margin profile, it's largely the same between domestic games and offshore games, but of course in domestic games given the scale we do enjoy back to economy of scale. So margins are slightly higher, but there is really no significant differences between games, whether it's overseas or in domestic market.

For online education, William has provided a detailed explanation just now in Mandarin. So to summarize, first of all, Youdao has now over a decade of operation, accumulating a sizable user base. We first started as a study tour, Youdao Dictionary, and there is a high degree of overlap with the current focused K-12 online courses in terms of users. In addition, given that NetEase is a controlling shareholder of Youdao, there is also significant overlaps between the users of our email services, music, for instance with online courses whether being students themselves or parents of those students.

And we do see a kind of a coordinated effort in promoting online education by utilizing resources from our matrix of products, and more recently driven by the AI technology, Youdao has also been introducing AI empowered hardwares, which is also being very well received in the market.

So all-in-all for our online education endeavor, we will be mainly focused on online education, which will mitigate and avoid many concerns around offline education that the market is being concerned about.

Operator

And we'll go next to Alex Poon with Morgan Stanley.

<Q - Alex Poon>: Hi, William. Hi, Charles. Hi, Margaret. Congratulations on a great results. I have questions regarding game business. In the last two quarters, you mentioned RMB 10 billion is the online game revenue run rates and this quarter you have surpassed RMB 11 billion. So, can we say RMB 11 billion is your new base, new benchmark we can reference to, especially you have a very strong pipeline in the coming year.

And the second question regarding games is, on the user acquisition side, we are seeing a lot of promotion in short video platforms to get for game business. Do you see this channel as a lower user acquisition cost for game business structurally, that this can improve your overall game return in future? And lastly can you talk a little bit about Diablo Immortal's status? And also Eclipse Isle is missing in the pipeline in your press release, I'm wondering why is that not in your press release? Thank you very much.

<A - Zhaoxuan Yang>: Sorry, Alex, which game that you are referring to, that's missing.

<Q - Alex Poon>: That's [indiscernible] (00:47:47).

<A - Zhaoxuan Yang>: Okay. Thanks, Alex. I'll translate your questions to William.

Okay. So Alex, I will answer your question. Firstly, as you know, we do not provide guidance, revenue, or profit. But, as a general trend, like I have commented in last quarters that we are very confident about a solid foundation of our game revenues.

Going forward, I think it is encouraging to see that we have delivered three quarters, that is spending above RMB 10 billion. We are extremely happy to see that the number has surpassed RMB 11 billion. But like I said, it is a solid foundation, or the future incremental increase will be supported by our continuous effort of launching new and successful games in the pipeline.

For your question on user acquisition, NetEase, given our scale and track record in operating online games, we have a diversified source of new user acquisitions, among which short video live streaming is becoming an increasingly important source of new user acquisitions. Whether the cost is lower, it all depends, but on the average blended basis, it does seem short video is a very cost competitive and cost efficient manner for us to acquire new users.

Diablo Immortal, we are a co-developer on that game together with Blizzard. As to the exact launch timetable, I would encourage the markets to direct the question directly to Activision Blizzard as – from a developers – co-developers perspective, the game development is pretty much ready, of course, there is always space for us to optimize and enhance, but it is not any concern that game development side will cause any potential delay.

As your last bit of questions specific about our pipelines, we did announce several exciting new games that's in our earnings release in the pipeline, as you know that we have over 50 studios on our NetEase games platform, and there are numerous new games of different stages in our R&D, and potential launch pipeline, and we are very, very confident about the robust game pipeline for 2019.

Operator

We'll go next to Alex Yao with JPMorgan.

<Q - Alex Yao>: Thank you management for taking my question. I have a couple of questions on music. First of all how do you think about the competition in Chinese online music industry?

And then secondly regarding monetization, what are our strategies to improve the music monetization, including both the pure music streaming operation and potentially would you be considering adding the live broadcasting feature to music streaming service to include the monetization? Thank you.

<A - Zhaoxuan Yang>: Alex, I will, for the benefit of everyone on the call, I will provide – summarize translation for William's answers. So first of all, about your position in competitive landscape, we recognize the fact that we are-relatively speaking a latecomer into online music segment.

However, we are highly convinced that China's online music market has huge potential and after years of competition it appears now that TME and NetEase Cloud Music are the two clear leaders and as a latecomer we are a little bit disadvantage in terms of copyright et cetera, however, as a latecomer especially with a deep insight in trying to understand the users need, we do have differentiated advantages as well comparing to competitive, especially in terms of user experience and providing trends that represents innovation which links also very relevantly to how to think about potential monetization, it is actually for the whole industry, it is in a trial mode whether it is by paying users, advertising, live streaming or even potentially some other new and innovative format, it is all possible.

Some of the formats of innovation – monetization has already be proven either by us or by our competitors, but we fundamentally believe there will also be other very interesting formats as we can potentially think about music, music user monetization, because after all, we think this huge market potential is underpinned by music content and we believe, after these many years of development, online music, this whole format is becoming now a new habit that is highly receptive by Chinese Internet users and uniquely – as a unique differentiation to many other type of formats, music content is a content that can be enjoyed repeatedly either in different variations by different singers, different settings, and also there's no language boundary. So all-in-all we think NetEase Cloud Music will remain as a pioneer and a innovative leader in terms of providing differentiated music content to our users.

Operator

At this time, I'll hand the call back over to Margaret Shi for any additional or closing remarks.

Margaret Shi

Thank you once again for joining us today. If you have any further questions, please feel free to contact us or TPG Investor Relations. Have a great day. Thank you.

Zhaoxuan Yang

Thank you, everyone.

Operator

That does conclude today's conference. We thank you for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2018-11-15
Event Description: Q3 2018 Earnings Call

Market Cap: 28,854.23
Current PX: 219.71
YTD Change($): -125.36
YTD Change(%): -36.329

Bloomberg Estimates - EPS
Current Quarter: 18.446
Current Year: 69.101
Bloomberg Estimates - Sales
Current Quarter: 20153.143
Current Year: 67707.926

Q3 2018 Earnings Call

Company Participants

- Brandi Piacente, Investor Relations
- Charles Yang, Chief Financial Officer
- William Ding, Founder, CEO & Director

Other Participants

- Thomas Chong, Analyst
- Eddie Leung, Analyst
- Alicia Yap, Analyst
- Jialong Shi, Analyst
- Natalie Wu, Analyst

Presentation

Operator

Good day, everyone and welcome to the NetEase Third Quarter 2018 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente, Investor Relations

Thank you, operator. Please note, the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law. During today's call management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2018 third quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded, in addition an investor presentation and a webcast of this conference call will be available on the NetEase corporate website at ir.netease.com. Joining us today on the call from NetEase's Senior Management of Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer and Mr. Hudson Wang, Co-President of NetEase's Games.

I will now turn the call over to Mr. Yang who will read the prepared remarks on behalf of Mr. Ding.

Charles Yang, Chief Financial Officer

Thank you, Brandi and thank you everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on Renminbi. With that said, I will deliver opening remarks on William's behalf. We are very pleased to report another strong quarter with total revenues up 35% year-over-year. Each of our primary business lines continues to grow, supported by our loyal community of users and our strong R&D team that strives to bring best-in-class games and Internet services to both users in China and internationally.

Total revenues for our online games in the third quarter stood at RMB10 billion for the second consecutive quarter and we are confident that this trend is sustainable. In addition to our growing catalog of games and world class R&D capabilities, our online games portfolio is more diversified than ever before. We now operate numerous games that span a wide variety of genres both domestically and internationally, as well as games that appeal to both PC and mobile players.

Through this diverse catalog, we can appeal to a multitude of players and interest levels worldwide. With the introduction of new games and our work in mobile has propelled our success in recent years. Our flagship titles remain remarkably steady. In the third quarter, Fantasy Westward Journey and Westward Journey series enjoyed another quarter of year-over-year growth, driven by the popularity of new expansion packs released over the summer.

Some of our newer titles released in recent years share this type of longevity, such as Invincible, Onmyoji, Knives Out and Identity V just to name a few. The remarkable longevity of these games is attachment to NetEase unique skill set and ability to operate games successfully over long periods of time. Very few companies globally kind of test this type of endurance in online games through different economic cycles and NetEase is proud to be among these prestigious ranks.

The value of our most popular games reaches far beyond the titles themselves. After years of operation, these games have accumulated huge fan bases, turning them into very powerful IP. Each self developed IP has the potential to become its own sustainable franchise with potential to diversify beyond just online games. One good example of this is with one of our most recognizable games Fantasy Westward Journey. This IP has been in successful operation for 16 years translating across PC and mobile platforms and sustaining interest with continuous expansion packs and new content. A cartoon series based on this IP has been airing on CCTV since October this year in a recent report published by a renowned domestic think tank, Liaowang Institute Fantasy Westward Journey is ranked the sixth most valuable IP in China's entertainment sector.

We are now looking to develop another iteration of this IP on mobile, Fantasy Westward Journey 3D, scheduled for launch in 2019. This pipeline game will be realized as a real time MMO in 3D format and reserve the classic game play and social system, while bringing in brand new experiences to mobile users in a 3D world. In addition to our ability to maintain a strong existing portfolio, NetEase is also one of the very few companies in the world that has consistently created distinct new game IP for both PC client and mobile platforms. A few recent titles that fit this profile are our PC client game, Justice, that we launched at the end of June, mobile game Ancient Nocturne which we launched at the beginning of September and mobile game Night Falls: Survival, which we launched in early November.

For Justice, we recently launched a new expansion pack, which contains a sophisticated set of social systems including faction systems, marriage systems, brotherhood, et cetera, all of which help to produce and solidify an active and deeply integrated user community. This in turn creates another powerful IP for NetEase. On the mobile side, Ancient Nocturne is a innovative mix of role playing and collectible card games. The story line was written by our in-house team of producers, with a dedicated effort towards promoting Chinese culture and Asians mythology. Ancient Nocturne was featured by the iOS app store and shortly after its release it climbed to the top of the iOS growth in charting China.

Night Falls: Survival was launched in early November and became an instant hit. The game is in original cooperative survival RPG setting a doomsday world. This game took us almost three years of in-house R&D effort. Upon release, this innovative game play immediately impressed the market and Night Falls: Survival quickly became the number one downloaded game on the iOS app store and monetization is also ramping up smoothly. Some of our other new titles launched in the third quarter include Butterfly Sword and Fever Basketball, both launches further diversify the genres we offer in our mobile game portfolio. These games also received positive feedback in their respective categories.

For Minecraft in just over a year, we now have attracted over 150 million registered users in China, most of them being K-12 students. Minecraft is great strategic importance to us as it gives us access to a much younger demographic that we never had before. We consider Minecraft an educational asset that stimulates children's creativity, promotes traditional culture and allow them to explore different types of Arts and Sciences. In many schools and universities, Minecraft is also used for teaching purposes. For example, students in 19 University of Aeronautics and Astronautics uses our game in their classes to explore the mysteries of the universe. More recently, Minecraft hosted a science fair in partnership with NASDAQ China using the game to raise public interesting in understanding outer space.

We continue to welcome talented and imaginative developers to create more interesting play modules that inspire our younger users. As of today we have more than 2,000 third party developers on our platform. For many of these kids, Minecraft is the first game that they were exposed to and we take a heightened approach to our social responsibility with new content for this target audience. As with all our games, we take very proactive measures to monitor the time spent and money spent by our users to ensure sustainable growth of our games business.

Moving onto our overseas expansion effort. We are taking a much more global approach to our online games business. We see axle and overseas opportunities to expand our brand and extend our games outreach to a global audience. In the third quarter we took this a step further and for the first time in our company's history, our overseas games revenue accounted for more than 10% of our total games net revenue.

Our success in Japan has been widely witnessed. Knives Out has consistently ranked among the top five games on Japan's iOS revenue grossing chart. We continue to add more localized content to broaden and deepen our geographic footprint in this important market. In August, we introduced some iconic content with Attack on Titan, a popular Japanese Anime/Manga series. This in game collaboration gained overwhelming popularity among users and in October Knives Out reached the People's Choice Award by Google Play in Japan and Taiwan.

Similarly, Identity V was ranked number one on the iOS downloads chart in Japan for 18 consecutive days and was featured by iOS app stores in 50 countries. Out of the three largest online games markets in the world, we now have reached critical claiming two being China and Japan. The United States market is the next frontier for Netease. Earlier this month, Blizzard Entertainment announced that we are collaborating to develop Diablo Immortal. We are very proud that Blizzard has chosen us to help bring one of their largest game franchise to mobile. We consider this is a huge opportunity to show the world and particularly Western gamers, Netease' strong R&D capabilities.

Turning to our e-commerce business. This continues to be our fastest growing business segment. In the third quarter, revenues from our e-commerce business grew 67% year-over-year, well outpacing the industry average. While this business is rapidly expanding, we are conscious of our margin profile. We maintained a disciplined approach to spending and our gross margins were capped at 10% in the third quarter. We continue to look for efficiency enhancement particularly with supply chain integration and fulfillment solution upgrade.

We recently signed a contract with global shipping giant Maersk to support and improve Kaola's global transportation and logistics services. With this agreement in place, we expect deliveries of overseas procurement to be more timely and for Kaola's cross border logistics to be more smoothly. Kaola and Yanxuan are complementary components of our e-commerce ambitions. Kaola is a platform and Yanxuan is our private label brand. We continue to focus on running a one key e-commerce business model built on our differentiated approach and strong consumer recognition. For Kaola, our goal is to bring the best brands across the world to Chinese consumers who are looking for quality and authenticity in their purchases.

At the very China International Import Expo that took place in Shanghai last week, the government shared its intention to encourage import's trade increase consumer confidence, reduce tariff and promote cross border e-commerce. Over the next 15 years, China is expected to import over USD400 trillion goods and services from overseas, which means a growing number of brands from all over the world will benefit from this trend. At the Expo, we connected with a great number of internationally renowned brand committing purchase agreements totaling approximately RMB20 billion.

Additionally, we signed strategic partnership upgrade agreements with Chem Brand including Xenon, Nestle, Swift and Sanofi which will give our users better access to their product and in turn further strengthen our competitive advantage as a global supply chain provider. Under the long-term strategic support of Kaola, some of our partners have achieved better than expected revenue growth in the third quarter, such as Rossmann, one of Germany's largest health and beauty chains and Woolworth, Australians grocery chain. On Yanxuan side, we pioneered innovative e-commerce business model in China. We are responsible for the designing of our products with dedication to the aesthetics, style, material and craftsmanship of each item that we offer. We work with carefully selected manufacturers to produce the product we design and offer these more affordable, yes, high quality items to our consumers.

On the design side, we are partnering with more art institutions that supply us with our regional ideas. We're also bringing products designed by independent designers from both China and overseas. On the manufacturing side, after two years of hard work, we now work with over 500 manufacturers, each of which is top ranked in their own field. Going forward, we plan to take a more concentrated approach and focus on working with the very best partners possible.

Moving onto our other steady businesses that help to put NetEase on the map and continue to support our growth. Our advertising services revenue in the third quarter increased by approximately 2% year-over-year to RMB644 million or USD94 million, with Internet services, automobile and real estate sectors as the top performing verticals. Net revenues from our email and others businesses were RMB1.4 billion or USD204 million in the third quarter, with a year-over-year increase of 32%. We see tremendous value in many of our incubated businesses. NetEase Cloud Music and Youdao are just a few of these business lines with initiatives underway that are yet to be fully realized. For Youdao, our K-12 online education initiatives continue to see robust growth.

We believe our strength in AI technology will give us an upper hand in further delivering best-in-class online learning experiences. For example, we have recently launched a new AI hardware, Youdao smartpen which will recommend personalized academic exercise questions, targeting students weak areas based on their historical study habits, pattern and results.

For music, we are pleased to have completed a new round of financing in NetEase Cloud Music. We believe this financing underscores the value of our proprietary platform and with more external shareholders in place, we are ready to take the business to the next level. We believe China's digital online music market has tremendous potential for continued growth, as younger generations embrace the convenience of streaming music services and online music becomes a way of lifestyle.

Focusing on delivering a differentiated and premium user experience, we now have created what is commonly perceived as China's most engaging music platform with market leading user retention rate and user time spend on the platform, as well as one of the largest catalogs of user generated content.

As of now, we have over 600 million registered users, adding 200 million alone over the last 12 months. To conclude, content creation and user experience differentiation is deeply embedded in our corporate DNA, a focus on quality and craftsmanship is prevalent in all of our product offerings, including online games, e-commerce, media, music, Youdao and others. We strive to further build our brand in China and overseas with content that entertains and gratifies our users and shareholders alike.

This concludes William's comment. I will now provide a very brief overview and review of our third quarter 2018 financial results, given the limited time on today's call, I will be presenting some abbreviated financial highlight. We encourage you to read through our press release issued earlier today for further details.

Net revenues for the third quarter of 2018 were RMB16.9 billion or UDS2.5 billion. This compares with RMB16.3 billion and RMB12.5 billion for the preceding quarter and third quarter of 2017 respectively. The year-over-year and quarter-over-quarter increases were driven by revenue growth across all business segments. Net revenues from online games increased by approximately 28% year-over-year, due to strong performance from both PC client games and mobile games, such as Justice, Fantasy Westward Journey Online, Chu Liu Xiang, Knives Out and Identify V. Mobile games accounted for approximately 68% of net revenues for this quarter, compared with 75% and 68% for the preceding quarter and the third quarter of last year.

Our gross profit for the third quarter of 2018 was RMB7.5 billion or USD1.1 billion, compared to RMB7.2 billion and USD5.9 billion for the preceding quarter and the third quarter of 2017 respectively. Our gross profit for online games segment increased year-over-year and quarter-over-quarter as a result of increase in revenue. Gross margin for our online games improved to 65% in the third quarter compared with 64% in the preceding quarter and 63% a year ago. The quarter-over-quarter increase in gross profit margin was mainly due to increased revenue contribution from PC client games, which have relatively higher gross profit margins, the mobile games.

The year-over-year increase was due to increasing revenue. During the third quarter, gross profit for our e-commerce business increased due to the expansion of both Kaola and Yanxuan. Gross profit margin for our e-commerce business was 10% in the third quarter compared with 10% and 11.5% for the preceding quarter and the third quarter of 2017 respectively.

We strive to keep a disciplined balance of rapid top line growth and steady gross profit margin for our e-commerce business. Gross profit margin for advertising services for the third quarter of 2018 was 64%, this compares with 67% and 68% for the preceding quarter and the third quarter of 2017 respectively. The decreases were mainly due to higher staff related cost and content purchase expenditures. Gross profit, gross loss margin for our email and others business for the third quarter was 3%. This compares to gross loss margin of 7% last quarter and gross profit margin of 13% for the third quarter of 2017 respectively.

The year-over-year decrease in gross margin was primarily due to decreased revenue contribution from certain online platform businesses which have relatively higher gross profit margins, as well as higher licensed music content costs related to our Cloud Music businesses in the third quarter. The quarter-over-quarter improvement was primarily due to higher revenue contribution from certain online platform businesses with relatively higher margins in this quarter.

As we have mentioned before, our other businesses include many promising inculpated businesses such as Youdao, Cloud Music and CC live broadcasting among others. Many of these businesses are undergoing an investment phase as they require up-front spending to acquire content and talent. We believe their upside potential in the long-term will more than justify our current investment. Gross margin will continue to improve as we further expand our scale. Total operating expenses for the third quarter of 2018 were RMB5.4 billion or USD792.1 million. This compares to RMB4.9 billion and USD3.4 billion for the preceding quarter and the third quarter of last year.

The year-over-year increase in operating expenses were mainly due to increased staff related cost, R&D investments and marketing expenditures. The quarter-over-quarter increase were mainly due to headcount expansion during the summer recruitment season and our GNN expense included a bad debt provisions relating to advertising business.

e-commerce related shipping and handling costs included in selling and marketing expenses for the third quarter were RMB385.5 million or USD56.1 million 8.6% of the net revenues from e-commerce businesses, which is an improvement from 8.9% in the preceding quarter and 11.1% in the third quarter of last year.

Effective tax rate for this quarter was 34.2%, compared to 15.7% and 8.1% for the preceding quarter and the third quarter of last year. The year-over-year and quarter-over-quarter changes in the effective tax rate were mainly due to certain subsidiaries of ours that received tax credits recognizing different period, as well as the expansion of some of our loss-making subsidiaries. As we have discussed on prior calls, we expect the effective tax rate for 2018 on an annual basis to be in the high 20's and the effective tax rate will grow higher in 2019. Our net income attributable to shareholders for the third quarter was RMB1.6 billion or USD232.4 million. This compares to RMB2.1 billion and USD2.5 billion for the preceding quarter and the third quarter of last year.

Non-GAAP net income attributable to our shareholders for this quarter totaled RMB2.3 billion or USD328.9 million. This compares to RMB2.7 billion and USD3.0 billion for the preceding quarter and the third quarter of last year. For this quarter, our diluted earnings per ADS were RMB12.43 or USD1.81. Our non-GAAP diluted earnings per ADS were RMB17.50 or USD2.55 respectively.

Our cash position remains strong. As of September 30th 2018, our total cash and cash equivalents current and noncurrent time deposit and short-term investment balance totaled RMB42.6 billion or USD6.2 billion. This compares with RMB43.2 billion as of the end of last year. Returning value to our shareholders remains a top priority.

For this quarter, we plan to pay a dividend of 45% per ADS, representing 25% of the net income attributable to our shareholders. Under our current share repurchase program, which began on November 16, 2017 and the amendment announced on June 11, 2018 authorizing a total repurchase amount up to USD2 billion. We had repurchased approximately 4.5 million ADS for approximately USD1.2 billion as of September 30. Immediately upon the expiration of the current plan, our Board has approved a new share repurchase program for up to USD1 billion of our outstanding ADS for the next 12 months, beginning November 16, 2018.

Thank you for your attention. We would like now to open the call to your questions. Operator. Please go ahead.

Questions And Answers

Operator

Thank you. (Operator Instructions) We'll take our first question from Thomas Chong with Credit Suisse.

Thomas Chong, Analyst

Hi. Thanks, management for taking my questions and congratulations on the solid set of result. My first question is about the online gaming business, in particular recent cooperation with Blizzard, can you share a bit of -- more details about the timing of the launch of the new games, the revenue sharing ratio. And more importantly, do we expect to co-develop other new games in the future? And my second question is about, sorry, directly to the environment, how we should think about the online games outlook in 2019? Thank you.

Charles Yang, Chief Financial Officer

(foreign language)

William Ding, Founder, CEO & Director

(foreign language)

Charles Yang, Chief Financial Officer

Okay. Let me translate the answers for William. So, on the Blizzard cooperation as you all know, our time proven collaboration is almost a decade long, with very, very pleasant partnership with Blizzard, bringing in great experiences to Chinese gamers their titles. And the collaboration on the Diablo mobile game is just another strong testament to the great partnership. We expect if everything goes on smoothly that the mobile game of Diablo Immortal will be launched globally next year.

And regarding your second question on regulatory environment, so first of all, we believe the government's intention to regulate and make that game segment overall as a healthy and sustainable segment and we fully understand and support the government intention. China is the fastest growing and is also now the largest game market in the world and throughout the fast development, there are also certain issues emerging for instance undesired impact on minors, inappropriate content, et cetera. But in the longer-term, the regulators intention is really to promote online game segment as a format of entertainment educational asset, as well as to promote creativity in cultural innovation. So in the longer term, the government is fully supportive of developing online games industry in healthy and sustainable manner.

Operator

Thank you, Thomas.

Charles Yang, Chief Financial Officer

Operator, next question, please.

Operator

We will then take our next question from Eddie Leung with Merrill Lynch.

Eddie Leung, Analyst

Thank you for taking my questions. Management has mentioned that we have accumulated a large base of users. And there are more and more repetitions as far as content available to these users. So I'm just curious, how many of them actually are using multiple services or consuming multiple content on NetEase and how is that ration trending? And how management can encourage different business units to cooperate and hopefully get the users to have more NetEase, so this is.

And then just a separate question on regulation on games. Could you remind us how many of your games in your pipeline already obtained the ISBN approval. Thank you.

Charles Yang, Chief Financial Officer

Eddie, can you translate your question in Mandarin, we didn't really get your question.

Eddie Leung, Analyst

(foreign language)

Charles Yang, Chief Financial Officer

Okay, thank you. Eddie. So you've translated the first question and I will translate your second question to William. (foreign language) Eddie, I will answer your first question. So first of all, we do not disclose user specific metrics to our different lines of businesses. But having said that, as you know, NetEase now has evolved into a much more diversified franchise more than just game company. So definitely users of NetEase products and services are enjoying the more and more content, premium content and elevated user experiences from the NetEase overall brand.

We do not have the specific metrics to evaluate the overlap, but we think the overlap should be a significant ratio because after all users in different verticals they want to simply use the very best products and services they can find in the market. And as some of you may know, earlier this month, we have experimented a VIP membership program which upon purchase of the membership you will get a lot of membership benefit across different lines of our products, games, e-commerce music, et cetera. So that is also a measure to promote a kind of a cross experience of different product and services to our user base.

(foreign language)

William Ding, Founder, CEO & Director

(foreign language)

Charles Yang, Chief Financial Officer

(foreign language)

So, Eddie to answer your second question, Netease is never a name to compete based on quantity of games. As you know, the games that we launched the top priority to emphasis is always premium quality, best in class experiences we provide to the users. So for the next quarter -- for next year, we are very optimistic about the rich pipeline that we are going to bring differentiated contents to the users. So all in all, it is not a game about quantity, but rather it is the quality of the games and the user experience upon the release of our games. As you can see we've been quite active and bringing in newer games throughout 2018, we think the trend will continue into 2019.

Operator

We'll move next to Alicia Yap with Citi.

Alicia Yap, Analyst

Hi. Good morning, management. Thanks for taking my questions. I have two quick questions. Number one is that, with recent external funding for NetEase music, could you share with us the strategic thinking about this music business, does that mean we could try to use these funding to offset some of the cash need for the business and NetEase turn to separately spin-off the music business in the future, what is the competitive landscape given the dominant positions from Tencent music, will these be any special value proposition that NetEase music attract users to come over or do you think users actually will be using both NetEase and Tencent music platform?

So second question just very quickly that on the online games revenue, we have been keeping the promise that we're actually able to achieve the quarterly run rate of RMB10 billion, so should we actually expect these growth to maintain and that we will keep these quarterly run rate stable and gradually improving. Thank you.

Charles Yang, Chief Financial Officer

(foreign language)

William Ding, Founder, CEO & Director

(foreign language)

Charles Yang, Chief Financial Officer

So Alicia, to answer your two questions, first on Cloud Music, first of all, we view the competition with TME as a very healthy competitive dynamics. As you know TME and NetEase Cloud Music are now probably the leading two camps of online music on differentiated value propositions. For us, we are going to continue invest into R&D, maintaining Cloud Music's strong reputation as a trend settler with emphasis on innovation. This round of financing is a strong testament of recognition and support from both strategic and financial investors. So, it is also -- this also provide a strong motivation for us to keep Cloud Music as independently operated business franchise, which will set a stage for its potential spin-off IPO in the future when the time is ready.

For your second question, short answer is, yes. We are very optimistic about maintaining sustainable and healthy growth trend of our online games revenue in the longer-term. This is underpinned by our continued R&D effort, investment and collaboration with multiple game studios. But aside from just financial metrics, William also wants to emphasize that a healthy and sustainable growth for games businesses is not only measured by financial metrics, but rather we care a lot more about user satisfaction and user recognition of our game quality, that applies to boast the gamer audience in China and in overseas. This would require NetEase to continuously invest to ensure that our competitive advantage in innovation, in localization, in understanding different geographies of the market are always ahead of the curve and we are confident to achieve that.

Operator

Next we'll move to Jialong Shi with Nomura Securities.

Jialong Shi, Analyst

William, Charles, Margaret, good morning and congratulations on a very solid quarter. I will first ask my questions in Chinese.

(foreign language)

I have two questions here. My first question is about the regulations and in particular the regulation M2 to protect or to restrict minors' game play time. And we noticed NetEase competitor Tencent recently has adoped measures to restrict minors' time spent on Tencent's games. So, I just wonder if NetEase may follow suit and if yes and what will be the potential impact on NetEase gain revenue going forward. My second question is about your strategies for towards NetEase's e-commerce business, we saw NetEase's music and also your dollar subsidiary were both spun-off within the past year by raising capital from external -- external investors. And now looking across NetEase incubated businesses, the e-commerce business is the only baby tiger, there has yet to be a spun-off. And so I just wonder if NetEase may consider inviting external strategic investors into your e-commerce business, so that you guys may leverage external resources brought by those investors. Thank you.

William Ding, Founder, CEO & Director

Okay. (foreign language)

Charles Yang, Chief Financial Officer

Thanks, Jialong. I will translate briefly the William's answers. First on your question on the anti-addiction measures. So, yes, we agree that our game operators share the responsibility to create a healthy online gaming environment for minors. In fact more than a decade ago when we were operating PC games, we already had measures in place to provide protection to minors to prevent addiction. For our logging system, we always encourage and require real name, with real personal age information for your logging.

So on that we are going to continue to improve and enhance our mechanism to ensure that we share the appropriate responsibility as a game operator. But beyond that, William also commented that for anti-addiction for minors probably this should not be only narrowly focused on online games. In fact, in this cyber world on this mobile Internet age, there are multiple parties who can contribute their asset and obligation in creating a more conducive and healthy Internet mobile Internet environment for the minors.

For your second question on e-commerce, so, as you know, Kaola and Yanxuan are two supplementary arms of our e-commerce businesses. In particular for Kaola, we've chosen it to focus on the cross-border e-commerce as a entry point, which we believe this is the right choice especially most recently President Xi saying that China Import Expo is being strongly encouraging imports -- China's imports in the coming years. We think there is huge upside to Kaola being a dedicated and leading operator in this cross border e-commerce.

We do not rule out the possibility that along the way of the development of both Kaola and Yanxuan in its growth phase when there is the right and strategic partners emerge. But for now, we do not have any plan or any disclosure to make.

Operator

And we'll take our next question from Natalie Wu with CICC.

Natalie Wu, Analyst

Hi. Thanks for taking my question. I have two here. First one about my -- about your e-commerce business. There is some concern on the market regarding the inventory issue of your e-commerce business. Just wondering, can you share some color on the SKU management, methodology of that business. Second question is about the overseas revenue contribution, you mentioned that, your overseas revenue contributed brand those hit games surpassed 10% for the first time, which is a very great number, last quarter, I remember the number was nearly 5%. So just wondering, can you help us understand about extra 5% contribution, how much is related with Knives Out and how much by Identity V. If they and also is there a blueprint for your overseas revenue contribution in the mid-term? And also the IP growth, how much is related about the overseas expansion endeavor. Thank you. I will translate myself.

(foreign language)

Charles Yang, Chief Financial Officer

Thank you. Natalie. In the interest of time, I will take the questions and answer that directly in English. First of all for e-commerce, when you look at inventory of our e-commerce, I think the market needs to understand that it is not really apple-to-apple to many domestic e-commerce operators, because for cross border e-commerce, the inventory days will invariably be longer, it started when we make overseas procurement, including shipping et cetera. But we -- as we scale up, we are continuously optimizing our inventory management and we are confident that there is still a lot of space for us to improve and optimize here.

Secondly, for the overseas revenue contribution, well, in fact, this is the first time that we announced this split, it was a quite a milestone achievement for us to arrive at above 10%. In the past couple of quarters, while we do not provide specific ratio, but it is climbing up trend. As we communicated in prior calls, the overseas contribution today primarily comes from Knives Out strong performance in Japan.

Now with Identity V, with some other new games that we plan to bring to the international market, we are confident that the overseas revenue contribution will be more diversified going forward. But as to a percentage ratio, we really cannot give out any specific target, because you would understand that it is also dynamics right, it can be domestic games, growth is also very, very strong. So what I can say is that, the absolute dollar amount for sure, we are very, very confident that overseas games revenue is going to witness a strong growth. But as to the percentage, it is actually difficult for us to predict.

For your third question, R&D expenses is acting fast, it's less so affected by the overseas expansion, because majority -- super majority of our game studios are domestically situated in China. So whether the game is distributed in China or distributed in the overseas market, bulk of the R&D expenses they incur in China anyways. And with successful game that's being proven in China and by launching this game in a new geography outside of China, it does not necessarily incur a great amount of margin or additional R&D expense.

Natalie Wu, Analyst

Thank you.

Operator

And due to time constraints, we will take no further questions. I would like to turn the call back to management for closing remarks.

Brandi Piacente, Investor Relations

Thank you once again for joining us today. If you have further questions, please contact, NetEase's IR Director, Margaret Shi, based in Hangzhou, or or TPG Investor Relations. Thank you and have a great day.

Charles Yang, Chief Financial Officer

Thank you everyone.

Operator

Everyone, that does conclude our conference call. We do thank you all for your participation, you may now disconnect.

Company Name: Netease
Company Ticker: NTES US
Date: 2018-08-09
Event Description: Q2 2018 Earnings Call

Market Cap: 33,222.22
Current PX: 252.97
YTD Change($): -92.10
YTD Change(%): -26.690

Bloomberg Estimates - EPS
Current Quarter: 21.873
Current Year: 74.393
Bloomberg Estimates - Sales
Current Quarter: 17711.467
Current Year: 69388.571

Q2 2018 Earnings Call

Company Participants

- Brandi Piacente, Investor Relations
- Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Thomas Chong, Analyst
- Eddie Leung, Analyst
- Alicia Yap, Analyst
- Natalie Wu, Analyst
- Alex Poon, Analyst
- Han Joon Kim, Analyst
- Karen Chan, Analyst
- Marcus Yang, Analyst
- Bill Liu, Analyst
- Jin Yoon, Analyst
- Billy Leung, Analyst
- John Choi, Analyst

Presentation

Operator

Good day, and welcome to NetEase Second Quarter 2018 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente, Investor Relations

Thank you, operator. Please note, the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the safe harbor from liability, as established by the US Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update these forward-looking information except as required by law. During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2018 second quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

Joining us today on the call from NetEase's senior management is Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer; and Mr. Hilton Huang, Co-President of NetEase Game.

I will now turn the call over to Mr. Yang, who will read the prepared remarks on behalf of Mr. Ding.

Zhaoxuan Yang, Chief Financial Officer

Thank you, Brandi, and thank you, everyone, for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi. With that said, I will deliver opening remarks on William's behalf.

We are pleased to report the strong quarter with continued growth momentum in each of our core divisions. Our total net revenue reached RMB16.3 billion, a 15% increase from the previous quarter and our non-GAAP net income more than doubled from the prior quarter coming in at RMB2.7 billion. Our online games reached RMB10.1 billion, representing 15% sequential growth; the strongest growth rate for this segment since the first quarter of 2017. Our mobile and PC client games remain our dual growth engines for online games.

On the PC side, our self-developed PC client game Justice was officially launched on June the 29th. Justice has taken us five years to develop and as one of the very big PC game productions in recent years it was long anticipated by game players in China featuring state-of-the-art technology and stunning graphics. The new game immediately attracted millions of fans and reset expectations for PC games. Justice appears not only to traditional PC MMO gamers, but also the coveted generation re-gamers, many of whom became first time PC gamers because of this game. Our primary goal for Justice at this stage is to expand its fan base, establish a strong and stable gamers' community and create another valuable IP for NetEase.

On the mobile side, our diversification strategy is progressing smoothly. We launched several new games in non-MMO categories during the second quarter, including Shadowverse, Identity V and QwQ. Each of these titles quickly climbed to the top of the download chart in China. While we continue to dominate the MMO market, we are rapidly finding a place in the non-MMO space. Importantly, our games in more casual genres are cultivating a completely different and incremental user base. We are fairly new to non-MMO games, but we have come a long way in a very short amount of time. Our decade of focus on technology, creative art and fostering talent have laid the foundation for us to quickly gauge and adapt with changing trends. We are large but nimble and we have gone through similar transitions within this ever evolving technology market. We did it successfully with the PC to mobile transition and we are now doing it again expanding from MMO to include more casual genres. Since we began diversifying our product mix we have already established some hugely successful game titles such as Onmyoji, Knives Out, and Terminator 2. In recent quarters we have started to experience higher success rates than before with many of our new casual titles. Identity V, QwQ and several other games all did very well in their respective categories. And we believe there a still a number of avenues we can pursue to further increase our hit rate.

Moving on to our overseas strategy. Now that we have more non-MMO games in our portfolio, international expansion comes naturally. Our new non-MMO games are typically less impacted by cultural influences making them more suitable for global audience. The advanced quality of these games coupled with our decade long experience in marketing and operations have let us to see early signs of success in the global market. In Japan, Knives Out has been consistently ranked in the top three on the iOS grossing chart and took the number one position for most of June. Similarly, Identity V was launched in Japan in early July and has become number on iOS and Google Play downloads chart in Japan. To broaden and deepen our geographic footprint, we will be adding more localized content to our games, specifically to cater to local user appetite. In the US, we also had a strong start with the launch of Rules of Survival and Onmyoji Arena earlier this year. We are also very encouraged by the performance of Identity V in the US, launched in July.

Turning on to our legacy titles. Our leading PC client and mobile games such as Fantasy Westward Journey, Westward Journey Online, Onmyoji and Invincible continue to captivate longtime fans. These flagship titles are steady performers and we expect this trend to continue throughout 2018. The prevailing success of these games demonstrates our remarkable ability to operate games for long period of time. We have created a massive social community within each game and we continue to supply our users with engaging content through periodic introductions of high quality expansion packs. We also host supporting gaming events and tournaments to maintain community competition and general enthusiasm around our games. Our focus remains on quality and innovation as we continue to introduce games that thrill audiences domestically and overseas and strengthen the NetEase brand. We are excited about all of our games in the pipeline including Ancient Nocturne and Night Falls: Survival, which we currently plan to introduce at the end of the third quarter or the beginning of the fourth quarter.

Looking at our e-commerce business, both Kaola and Yanxuan mentioned continue to thrive. For the second quarter, we grew our e-commerce revenue by 75% year-over-year to RMB4.4 billion. Our gross margin for this business also improved to 10% from the previous quarter despite a promotional season. Our main objective for e-commerce at this stage is to continue to grow at scale, while maintaining a reasonable gross margin. Over the long run, we believe we will achieve a sustainable profit margin through continuous optimization of product mix, upgrading our supply chain management and achieving economies of scale. With the growing trend of consumption upgrades amongst the rising middle class in China, quality e-commerce is in growing demand. The incumbent e-commerce business model in China has not yet fully addressed this opportunity. Kaola and Yanxuan are designed to fill this void in the market. Cross border and private label has been our two primary inroads into the e-commerce business. But the entire quality e-commerce market is what we are after. For Kaola, we intend to bring the best products available across the world to Chinese consumers. For Yanxuan, we pioneered the ODM model in China where we are in-charge of the design of the product and our manufacturing partners are the very best manufacturers in their respective categories. Over the past two years of operation and even before that we worked, tested and evaluated thousands of manufacturers and carefully selected top echelons to work with. This is one of the biggest barriers to entry that we have created. Going forward, we will further strengthen our first mover advantage in supply chain management and continue to upgrade our product offerings to give our Yanxuan customers the best online shopping experience in the market.

Turning onto our other business segments. For advertising services, revenues in the second quarter increased by approximately 7% year-over-year to RMB634 million or $96 million with automobile, internet services and real estate sectors as top performing verticals. Over 85% of advertising net revenues were generated from setting advertising space on the NetEase News App and NetEase website with a year-over-year increase of nearly 10%. E-commerce and others were RMB1.2 billion or $185 million in the second quarter with a year-over-year increase of 43%. Within our other services, there are a number of incubated businesses we are very excited about. For Youdao, we set a new record for online education live streaming with close to 50,000 concurrent viewers on one of our online English language test preparation classes. For our K-12 education offering, we rolled out new summer school classes, which were very well received by the market. As a result, our Youdao Online Education revenue grew considerably. For music, we continue to run the largest social community for music lovers in China measured by user engagement and UGC. Our offering reflects our passion for music, attracting the largest consistency of independent musicians and genuine music enthusiasts in China. This community of our user will shape China's future music trends and our objective is to help them promote their original content.

Innovation and craftsmanship continue to serve as the cornerstone of each of our businesses. For more than two decades, we have maintained these principles, propelling our relevancy and competitive edge. We believe these core values, our considerable R&D capabilities, and strong business acumen will continue to drive our future success. This concludes William's comments.

I will now provide a very brief review of our second quarter 2018 financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

Net revenue for the second quarter of 2018 were RMB16.3 billion or $2.5 billion, this compares with RMB14.2 billion and RMB13.4 billion for the preceding quarter and second quarter of 2017 respectively. The year-over-year and quarter-over-quarter increase was driven by revenue growth across all business segments. Net revenues from online games increased by approximately 15% quarter-over-quarter due to the strong performance from Chu Liu Xiang, Knives Out and Identity V. Mobile games accounted for approximately 75% of net revenues from online games for the second quarter of 2018 compared with 72% for both the preceding quarter and the second quarter of 2017.

Our gross profit for the second quarter of 2018 was RMB7.2 billion or $1.1 billion compared to RMB6 million and RMB6.7 billion for the preceding quarter and the second quarter of 2017, respectively. Our gross profit for our online games segment increased year-over-year and quarter-over-quarter in the second quarter, primarily due to the increased revenue contribution from some of our aforementioned self-developed mobile games. Consequently, gross margin for our online games segment improved to 64% in the second quarter compared with 63% a year ago and 62% in the preceding quarter. During the second quarter, gross profit for our e-commerce business increased as we continued our rapid expansion of Kaola and Yanxuan. Gross profit margin for our e-commerce business was 10.1% in the second quarter compared with 9.5% and 12.6% for the preceding quarter and the second quarter of 2017 respectively. The quarter-over-quarter increase in e-commerce gross profit margin was primarily due to improved product mix and procurement process. The year-over-year decrease in e-commerce gross profit margin was primarily due to certain sales discounts in the second quarter of 2018 to support the rapid development of Kaola and Yanxuan.

Gross profit margin for advertising services for the second quarter of 2018 was 67%. This compares with 59% and 68% for the preceding quarter and the second quarter of 2017 respectively. The quarter-over-quarter increase was primarily due to seasonality. Gross loss margin for our e-mail and others business for the second quarter of 2018 was 7.3%. This compares to gross loss margin of 9.9% and gross profit margin of 7.7% for the preceding quarter and the second quarter of 2017 respectively. The year-over-year decrease in gross margin was primarily due to decreased revenue contribution from certain online platform businesses, which have relatively higher gross profit margins as well as higher licensed music content costs related to our cloud music business in the second quarter.

As we have mentioned before, our businesses include many promising business initiatives that we are incubating such as Youdao, Cloud Music and our live broadcasting services like CC amongst others. Many of these businesses are undergoing an investment phase as they require upfront spending to acquire content and talent. We believe their upside potential in the longer term will more than justify our current spending.

Total operating expenses for the second quarter were RMB4.9 billion or $742 million. This compares to RMB4.7 billion and RMB3.3 billion for the preceding quarter and the second quarter of 2017 respectively. The year-over-year increase in operating expenses was mainly due to the overall increase in business scale. The quarter-to-quarter increase was mainly due to increased R&D costs, which is partially offset by decreased marketing expenditure related to online games. E-commerce related shipping and handling costs included in selling and marketing expenses for the second quarter of 2018 were RMB387 million or $58 million. This compares to RMB326 million and RMB281 million for the preceding quarter and the second quarter of 2017 respectively.

The effective tax rate for the second quarter of 2018 was 16% compared to 26% and 19% for the preceding quarter and the second quarter of 2017 respectively. The year-over-year and quarter-over-quarter changes in the effective tax rate were mainly due to the fact that certain of our subsidiaries have been recognized related tax credit in the second quarter of 2018 as explained in the previous quarter due to the rapid expansion of some of our loss making subsidiary. We expect effective tax rate for 2018 on an annual basis to be in the high-20s.

We incurred a foreign exchange gain of RMB233 million or $35 million in the second quarter of 2018. This compares to exchange losses of RMB375 million and RMB131 million for the preceding quarter and the second quarter of 2017 respectively. The changes of foreign exchange gains and losses were primarily due to the unrealized exchange gains and losses arising from the US dollar denominated bank deposits and short-term loan balances as the exchange rate of the US dollar against the renminbi fluctuates over the period.

Our net income attributable to shareholders for the second quarter of 2018 was RMB2.1 billion or $318 million. This compares to RMB752 million and RMB3 billion for the preceding quarter and the second quarter of 2017 respectively. Non-GAAP net income attributable to our shareholders for the second quarter of 2018 totaled RMB2.7 billion or $412 million. This compares to RMB1.3 billion and RMB3.5 billion for the preceding quarter and the second quarter of 2017 respectively. For the second quarter of 2018, our basic and diluted earnings per ADS were $2.45 and $2.44 respectively. Our non-GAAP basic and diluted earnings per ADS were $3.17 and $3.15 respectively for the second quarter of 2018. Our cash position remained strong. As of June 30th, our total cash and cash equivalents, current and non-current time deposits and short-term investment balance totaled RMB44 billion or $6.7 billion. This compares with RMB43 billion as of the December 31st, 2017.

Returning value to our shareholders remains the top priority. For the second quarter 2018, we plan to pay of dividend of $0.61 per ADS, representing 25% of the net income attributable to our shareholders. Under our current share repurchase program, which began on November 16, 2017 and amendment announced on June 11, 2018 authorizing a total repurchase amount up to $2 billion. We had repurchased approximately 3.4 million ADS for approximately $912 million as of June 30th, 2018.

Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead.

Questions And Answers

Operator

Thank you. The question-and-answer session will be conducted electronically. (Operator Instructions) Our first question today comes from Thomas Chong of Credit Suisse.

Thomas Chong, Analyst

Hi. Thanks management for taking my questions. I have a question about our second half mobile games outlook. Given the fact that we showcase a lot of games more than 20 games in ChinaJoy, should we expect mobile games revenue to remain strong momentum in second half? And how should we think about the deferred revenue in Q2? And my follow-up question is about our overseas strategies. How should we think about our overseas mobile games revenue contribution over the next few years? Thank you.

Zhaoxuan Yang, Chief Financial Officer

Okay. Thomas, I'll translate the question for William and the management.

(Foreign Language)

So I'll translate the answers for the questions, Thomas. For your first question, we remain confident for our second half mobile games outlook. As you have noticed, on ChinaJoy we have announced quite some new products in the diversified game genres as well as some very promising upgrades of our existing titles. So we believe those are the foundation for a very solid second half. For the overseas strategies, Knives Out and Identity V have so far achieved very successful performance, in particular in Japanese market. Going forward, we plan to bring more products across more genres and hopefully also diversifying the overseas market. So that summarizes our overseas strategy.

Next question please.

Operator

Certainly. Our next question will come from Eddie Leung with Merrill Lynch.

Eddie Leung, Analyst

Hi, good morning. I'm just wondering, if you could share a bit of a color that you have seen on the user profile difference between your MMO games and non-MMO games? (Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So Eddie to translate for the answers. Well as you all know, since last year we have successfully introduced couple of hit games in the non-MMO genre. That have attracted a differentiated and incremental user base to our core MMO user base. The users who play our non-MMO games are generally speaking younger and covers a more diversified geography of these new incremental users actually serve as a very good data point and guidance towards our future R&D development and introducing new non-MMO games.

Operator

And next will be -- I'm sorry go ahead.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So Eddie, William further commented that in our view, MMO and non-MMO these two core categories are equally important in the China's game market. So for us while maintaining the dominance in MMO, we're also expanding more and more into the non-MMO genre.

Next question please, operator.

Operator

Thank you. Our next question will come from Alicia Yap with Citigroup.

Alicia Yap, Analyst

Hi, thank you. Good morning William, Charles and Brandi, thanks for taking my questions. And congrats on the solid results.

Have questions related to the overall PC games industry. So if you can give us some insight into how you view the PC games industry. So given your recent success of new PC game, Justice, have you -- despite the whole industry facing some declining trends of the PC gamers shifting to mobile. Could you share with us some of the success factor? Is it because of the game genre or the promotional effort that you guys have? And then similarly on some of these user profile, are these more hardcore players that always play PC games or you actually have attracted some mobile gamers that actually go back and play the PC game. And is Justice also attracted to younger group or the older group? So just in general how do you see the PC game industry outlook in China? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So to translate the answers. First of all, when you look at PC and mobile, you can't look at them from a rigid framework because it's on a relative terms and the main driver for the outlook of the PC industry is highly dependent on whether the industry witnesses high quality products, game content, such as Justice we've introduced or last year when PUBG is another good example of the high quality PC products. So in a way maybe mobile games are easier choice for amateur level beginner gamers, but for a real hardcore gamer and a game enthusiastic, it is very common to have multiple devices, PC, mobile, even console and switch devices, and to attract these users what you need is high quality content.

And going back to your other half of the question on Justice, the game is designed as a top notch, high quality PC game, highly attractive to the hardcore gamers. So we are seeing some of the real hardcore gamers even in their 40s, 50s relatively older, as well as the game is highly appealing to the younger generation post '95, because some of those users may have experienced MMO mobile games in the past. Now when they are seeing a high quality state-of-the-art top notch MMO games that is available on the PC device, it is also very attractive to convert them into a Justice user.

Operator

And our next question will come from Natalie Wu with CICC.

Natalie Wu, Analyst

Hi. Good morning, management. Thank you for taking my question. I just have a follow-up question on your PC game, Justice. Could management share some color on how should we think about the longevity or the life span of Justice and the future revenue contribution to a PC game. Could we expect PC game revenue to grow again with the help of Justice from the next quarter? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So Natalie, let me translate the answers for the broader audience. So Justice has been launched for slightly over a month now. We saw the data gathered so far. It indicates good signs of confident success, particularly two remarks. One is that we are seeing the community, the user community around the game slightly being established. And secondly, we are also seeing very good progress on the new user growth. So we saw these data points it gives us confidence that -- we are confident that Justice will perform in line with many of our other legacy PC games for very longevity and lifespan.

Operator

And our next question will come from Alex Poon with Morgan Stanley.

Alex Poon, Analyst

Hi, William. Hi, Charles. Good morning, thanks for taking my questions. So for different segments, it looks like most have gone through the investment phases in the past two, three years including Yanxuan and Kaola, CC live music, et cetera. And also game diversification is seeing good progress overseas, gaining user base, brand establishment and margin has started to improve. Do you think we are at a stage that you can accelerate the monetization in the second half of '18 and 2019 for example for across all these businesses and we could see accelerated margin expansion in the coming quarters? Could you please touch a bit on every segments? And finally, could you give us a separate say for non-core business how -- what is the net -- roughly what is the net profit level, so we can have a better sense of valuation, so everybody can push the price higher. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Thank you, Alex. Let me take this question. So as you know for our games that is the longest track record. And we have commented quite a bit just now on the previous questions. We are confident that for our games segment while maintaining a steady performance of our legacy titles. The growth will be mainly driven by the performance of our newly launched games. And we are confident about maintaining strong momentum into the second half of this year.

With respect to the other incubated businesses. E-commerce, music, Youdao, et cetera we believe it is still in the relatively early phase of investment. So the near-term focus on these business segment is not solely focused monetization. We think in the near-term for the second half of next year, the top priority is still to grow its scale maintaining its leading position amongst the user reputation and user recognition, because for us we have full confidence about the potential future upside of all these businesses that we are incubating and we wants to do it right, do it in a healthy way to ensure a sustainable longer term growth of all these respective segments.

Operator

And moving on to Han Joon Kim with Deutsche Bank.

Han Joon Kim, Analyst

Great. Thank you for the chance to ask question. Just one on my end. We continue to hear about some delays to game approvals even outside of PUBG in China. So do you think there is a risk that there is some slowness in game releases into 2019. And wondering if that may affect first half or second half of '19 or if you see no problems at all of getting approvals from the government? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So Han Joon, to answer your question to NetEase the impact is insignificant because as you all know all the games actually go through a relatively long phase of development and testing. So for our games particularly the games in our pipeline is not so much affected by the current delay on the game approval due to the government bureau restructuring.

Operator

And our next question will come from Karen Chan with Jefferies.

Karen Chan, Analyst

Great. Thank you management for taking my question. So first we saw a sequential decline in sales and marketing expense. Just wondering if we should be expecting similar trajectory in second half as we adjust our sales and marketing strategy? Secondly, on the deferred revenue we noticed around 10% sequential drop there. It seems to be coming from a higher than usual game revenue recognition. Can management share more color on why is that so? Thank you very much.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So Karen for our selling and marketing expenses, we made a comment that it's been -- we'll start normalizing the selling and marketing expenses. Doesn't necessarily mean we are decreasing it. We will still continue to invest into selling and marketing, R&D and all the operating expenses that is required by the ordinary course of business, for instance, new game launches, game development, et cetera. So in this way, we think increased investment is the trend. However, from a margin -- from a percentage of net revenue perspective, we don't think we are deviating too much from our historical levels.

On your second question on deferred revenue, because this is again, deferred revenue is an accounting treatment. So part of the gross billing is recognized in the quarter. Some of the gross billings are deferred and recognized in future quarters. So a decline in deferred revenue indicate some of the games experienced some decline in the gross billing. But I think with all the new games in particular many of the games we only launch towards the end of the second half. So its financial contribution or it's not fully released in the second quarter. So we still remain fairly confident about our second half performance on the games side and the overall business segment.

Operator

And moving on to Marcus Yang with Macquarie.

Marcus Yang, Analyst

Thanks for taking my questions. My first question is, we understand that NetEase had a series of investments in overseas company such as Bungie and Improbable in the first half of this year. Can you talk about your investment status on these companies and your strategy with them going forward? And also on financial-wise, you mentioned that the gross margin expansion in your e-commerce business was primarily driven by the improved product mix and also procurement process. Can you elaborate more about that and do you consider that kind of gross margin level sustainable? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Our investment thesis and strategy still remains very prudent and more focused on the strategic side. When we are screening and exploring potential investment targets or potential partnership collaboration, the main focus is to look at our own product portfolio, R&D pipeline, finding companies and partners that are synergistic to us either by supplementing our existing products or filling some of the relative weaknesses that we need to further improve. So that is the overall kind of investment thesis and strategy.

For your second question on the gross profit margins, as explained, for e-commerce, our near-term primary focus is to continue to grow its scale and to expand its addressable user market in further enhancing its brand awareness and user reputation. So with that in mind, our focus is not in the near-term is not to expand its gross profit margin. Having said that, while we are growing our scale in a robust way, we are also cautious to maintain the gross profit margin at a relatively steady level.

Operator

And our next question will come from Bill Liu with Goldman Sachs.

Bill Liu, Analyst

Thank you management for taking my question. I have one question about our R&D expense. So I understand that we have probably two, three dozens of games in the pipeline and we are actively expanding into more genres. So how should we think about this R&D expense going forward? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Bill for the R&D expenses, as you have noticed that starting from Q1, we have increased our investment into R&D. But I think that's what a tech company should do to invest into its core competence. After all I think comparing to our top-line growth, if you look at the R&D from a ratio perspective, it is still in a very controllable manner, but we think with increased investment into R&D, it is hugely beneficial for our longer term sustainable growth. And by the way, the R&D increase it's mainly driven by the headcount. So in a way the company is growing, company is expanding and we are attracting more and more talents into NetEase.

Operator

And moving on to Jin Yoon with New Street Research.

Jin Yoon, Analyst

Hi, good morning guys. So gross margin fared across all your segment lines, much better than expected. Just kind of want to touch upon your music business. I was wondering if you guys could readily share some metrics behind that in terms of membership growth, usage and the trajectory we should see for that business going forward. Thanks.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Jin, for music, so first of all music has been growing. The total registered user has surpassed 500 million and paying ratio for the whole industry, the music paying ratio is still at a relatively low level even comparing to the live streaming and video site. So there is huge potential of enhanced monetization potential from the subscription base and with the growing scale in user and increased focus on the content, we think our Cloud Music is doing -- what we are doing is building a very solid foundation for a lot of monetization potentials in the near-term.

Operator

And we have a question from Billy Leung with Haitong International.

Billy Leung, Analyst

Hi, management. Thanks for taking my question. Just one question on Minecraft, I think we discussed this last time, but there seems to be lack of information this time around. So I was just wondering if there is any updates development on Minecraft and any changes in terms of the amortization strategy we discussed last time. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So over the last year, we have brought quite some innovative and new experiences to the Chinese Minecraft users that is different from the offshore global version of Minecraft. Going forward, we will continuously work with Microsoft to enhance the user experience and also in our earnings release, we believe we've also announced that Minecraft registered user has already crossed over 100 million user benchmark.

Operator

And we'll take the next question from John Choi with Daiwa.

John Choi, Analyst

Good morning, guys. So thanks for taking my question. Just quickly on your live broadcasting, NetEase CC, I know that NetEase has been starting to invest quite a bit here. Is there any metrics that you could share and what kind of development procedures management has put in place? And secondly also just to follow-up on your overseas strategy, right now you guys have been doing pretty well in Japan. Any other regions or countries that will be a focus in the near-term? Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Okay. To translate the answers. So for CC it is a strategic platform to our overall NetEase games ecosystem. So we will continue to invest into CC and making the game broadcasting platform a strategic asset to our game profiles. Secondly, to your overseas strategy, so aside from Japan, our focus will also be on the North America and European market. We think that our games has the potential to also excel and prove itself amongst those mainstream western markets.

Operator

And that does conclude our question-and-answer session. I'll now turn the conference back over to management.

Brandi Piacente, Investor Relations

Thank you once again for joining us today. If you have any further questions please contact NetEase's IR Director, Margaret Shi, based in Hangzhou, or TPG Investor Relations. Have a great day.

Operator

Thank you. That does conclude today's conference. We do thank you for your participation today.

Company Name: Netease
Company Ticker: NTES US
Date: 2018-05-17
Event Description: Q1 2018 Earnings Call

Market Cap: 34,933.43
Current PX: 266.00
YTD Change($): -79.07
YTD Change(%): -22.914

Bloomberg Estimates - EPS
Current Quarter: 21.129
Current Year: 92.927
Bloomberg Estimates - Sales
Current Quarter: 16202.083
Current Year: 69919.500

Q1 2018 Earnings Call

Company Participants

- Brandi Piacente, Investor Relations
- Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Thomas Chong, Analyst
- Alicia Yap, Analyst
- Eddie Leung, Analyst
- Bill Liu, Analyst
- Alex Poon, Analyst
- Alex Yao, Analyst
- Hanjoon Kim, Analyst
- Natalie Wu, Analyst

Presentation

Operator

Good day and welcome to the NetEase First quarter 2018 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente, Investor Relations

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the US Private Securities Litigation reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its annual report on Form 20-F. The company does not undertake any obligation to update this forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the 2018 first quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an Investor Presentation and a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

And joining us today on the call from NetEase's senior management is Mr. William Ding, Chief Executive Officer; and Mr. Charles Yang, Chief Financial Officer.

And I will now turn the call over to Mr. Yang who will read the prepared remarks on behalf of Mr. Ding.

Zhaoxuan Yang, Chief Financial Officer

Thank you, Brandi. And thank you, everyone, for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi. With that said, I'm pleased to deliver opening remarks on William's behalf. We are pleased with the progress we made across the board this quarter with total net revenue coming in at RMB14.2 billion or USD2.3 billion. We are excited by the longevity of our flagship games, our players loyalty and the strong performances of the new titles we launched in the first quarter.

Additionally, our e-commerce business continues to expand rapidly and our advertising business remains healthy. Our online games revenue resumed growth in the first quarter at approximately 10% quarter-over-quarter and we expect this momentum to continue into the year. For MMORPGs, we continue to dominate the market with continuous innovation. Our new chart-topper Chu Liu Xiang made a huge impression on the space, completely modernizing conventional gameplay for MMORPGs. Chu Liu Xiang brings players best-in-class graphics with a highest degree of freedom to customize and design their own characters and story lines. These exciting new features have attracted a large base of new players beyond the traditional MMORPG players.

Our diversification strategy to introduce games in the non-MMORPG genres is also beginning to bear fruit. Monetization for Knives Out, Terminator 2: Judgment Day and Rules of Survival is ramping up smoothly. Over the last year or so, we have observed increasing demand for more diversified games from a growing base of new players. With successful launches of new titles across a broad spectrum of game genres, we are effectively extending our addressable user audience.

As a premium content provider our objective continues to focus on innovation to lead the market and provide different game genres that satisfy this growing user base. Identity V is amongst the first of these games. As our very first asymmetrical battle arena game Identity V has amassed a considerable fan base since its launch in April. It achieved more than 10 million active users in just one week following its release. We are very pleased with the monetization from this game so far and we have a variety of new games in our pipeline that we believe will be impactful to our user-base upon launch.

Some of our other titles under development include manga-based PvP game QwQ and Chinese-style collectible card game, Ancient Nocturne. These games as well as a number of others are scheduled for launch later this year. We will be discussing these games and more details of our pipeline at our upcoming Annual May 20th Game Day event.

With a more diverse portfolio and more non-MMORPG games in our pipeline, we now have more games suitable for the global audience. Over the past year, we have seen Onmyoji gaining strong traction in Southeast Asia. Knives Out consistently top the chart in Japan, and Rules of Survival remains popular in the US market.

Throughout the year, we plan to launch more games on the global scale. As we work to expand our international footprint. For our existing PC and mobile games, they continue to stand the test of time over the course of more than a decade of operation. We have seen social communities emerge within some of our games. To many players, our flagship IP such as Fantasy Westward Journey Online, Fantasy Westward Journey mobile, new Westward Journey Online II and Westward Journey Online mobile are more than just games. They are part of the gamers' lifestyles. We expect this trend to continue and strive to achieve this type of impact and longevity with our newer games. We are already seeing the signs of this endurance with titles such as New Ghost, Invincible and Onmyoji.

Even though revenues from Onmyoji have come down from its peak a year ago, it is still a substantial revenue generation on a standalone basis. We continue to bring to users new expansion packs, new content and user experience upgrades and its revenue is starting to stabilize. Over the short course of its operation Onmyoji has emerged as one of our strongest self developed IPs. Following its original release, we successfully adapted it's IP to a mobile game and we are confident in our ability to operate this game and further expand its IP over the long term.

Monetization for Minecraft is also progressing well in accordance with management plan. We now have accumulated well over 60 million registered users in China. As Minecraft's primary demographic is K12 students, we feel it is our duty to find a socially responsible and innovative way to monetize this huge educational asset. We are currently undergoing an ambitious endeavour to build an educational platform for children. In January, we launched a open platform for third-party developers to assist in creating inspiring content. This professional group of developers can provide users with exceptional innovation and a larger variety of content options to choose from. While it will take some time for this large-scale project to reach its potential, once it does, we see an opportunity for a major impact on both the education and online games industry, as well as a long-term sustainable monetization model.

One of the things that makes NetEase unique is our world-class R&D capabilities. We are one of the very few game companies in China with a track record of creating a blockbuster mobile game without a PC game backing. We attribute this to our talented pool of R&D professionals, who are focused, energetic and passionate about what they do. We have spent the last decade building leading R&D infrastructure in China to support these creative minds and turn their ideas into reality. As the competitive landscape evolves, the next frontier will be left to those who are able to create new mobile game IPs. We are very well versed in this modality with a formidable resume of mobile hits, including Onmyoji, Knives Out, Chu Liu Xiang and Identity V.

Now moving on to our e-commerce business; Kaola.com and Yanxuan just celebrated their third and second anniversaries in March and April respectively. These two platforms continue to lead the market with strong triple-digit year-over-year growth in the first quarter, reaching revenues of RMB3.7 billion or USD595 million. Both platforms benefit from an upgraded consumer base in China as Kaola.com and Yanxuan offer access to cost-effective, high quality and trustworthy product. As Chinese consumers become more concerned with the quality and authenticity of the product. The addressable market for quality e-commerce continues to expand. And Kaola.com and Yanxuan have become their go-to-platforms to find these products

On the supplier side, we further deepened our relationships with our existing brand partners and introduced more international brands to our platforms in the first quarter. On the user front, we saw another step-up in our user base and membership subscriptions. Our e-commerce platforms are still relatively young and our primary near-term focus continues to be gaining broader user recognition and providing an elevated experience to users.

As we grow our e-commerce business, we are experiencing greater economies of scale, leading to more efficient spending in shipping and handling, marketing and other expenses. Our goal for our e-commerce business is to grow as fast as we can, while achieving a sustainable profit margin over the longer term. This can be achieved through continuous optimization in GMV structure and procurement, increasing operating leverage and technological upgrades. Both Kaola and Yanxuan platforms offer significant opportunities for growth and their full value to the company is yet to be unlocked.

Turning on to other business segments; for advertising services, revenues in the first quarter increased by approximately 4% year-over-year to RMB462 million or USD73.7 million with real estate, Internet services and the automobile sectors as the top performing verticals. E-mail and others net revenue were RMB1.2 billion or USD194.1 million in the first quarter with a year-over-year increase of 102%.

In addition to the above, we incubate and develop an exciting portfolio of promising new business initiatives such as Youdao online education, cloud music and live broadcasting services amongst others. The common emphasis on craftmanship and the goal to offer enhanced user experience is shared among all NetEase products. We choose our strategic directions carefully, and once we do, we dedicate our efforts and resources to deliver the best products available on the market. Take Youdao online education as an example, this business focuses on pass preparation for Chinese students, and has grown tremendously over the past year leveraging the 700 million users we have accumulated across the Youdao product matrix.

For cloud music, although we are latecomer to the scene, through a differentiated user appeal we are now the second-largest player in this highly competitive sector, and we are focused on creating the largest interactive community for music lovers in China. We are confident that these products have the potential to become something big and their value will gradually unfold.

For 2018, we will work to ensure that each of our business lines continue to prosper with a focus on diversification, innovations and globalization. We are committed to our loyal and growing user base, and we remain focused on creating additional value for all of our shareholders.

This concludes William's comments.

I will now provide a brief overview of our first quarter 2018 financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further details.

Net revenues for the first quarter of 2018 were RMB14.2 billion or USD2.3 billion. This compares with RMB14.6 billion and RMB13.6 billion for the preceding quarter and first quarter of 2017 respectively. The year-over-year increase was mainly attributable to increased revenue contribution from our e-commerce division, partially offset by a decline in revenues from Onmyoji, which was at its peak in the first quarter of 2017. The sequential decrease in revenues was primarily due to a decrease in revenues from our e-commerce business due to seasonality. Net revenues from online games increased by approximately 10% quarter-over-quarter due to the successful launches and monetization of our recently launched titles.

Our gross profit for the first quarter of 2018 was RMB6.0 billion or USD949.1 million, compared to RMB5.7 billion and RMB7.5 billion for the preceding quarter and the first quarter of 2017 respectively. Our gross profit for our online games segment declined year-over-year in the first quarter as a result of decreased revenue contribution from some of our sales developed mobile games such as Onmyoji, which was partially offset by increased revenue contribution from Knives Out and Chu Liu Xiang. The quarter-over-quarter increasing in online gaming segment gross profit was primarily due to the increased revenue contribution from Knives Out and Chu Liu Xiang. Margin for our online games segment was relatively stable at 62.1% in the first quarter compared to 63.9% a year ago, and 61.4% in the preceding quarter.

During the first quarter, gross profit for our e-commerce business increased as we continued our rapid expansion of Kaola and Yanxuan. Gross profit margin for our e-commerce business increased quarter-over-quarter to 9.5% in the first quarter of 2018 from 7.4% in the fourth quarter of 2017, and decreased year-over-year from 13.1% in the first quarter of 2017. The quarter-over-quarter increase was due to seasonality as we typically offer larger scale promotions and sales discount in the fourth quarter of the year. The year-over-year decrease was due to certain sales discounts being offered in the first quarter this year to support continued development and growth of Kaola and Yanxuan.

Gross profit margin for advertising services for the first quarter of 2018 was 59%. This compares to 71.2% and 57.3% for the preceding quarter and the first quarter of 2017 respectively. The quarter-over-quarter decrease in gross profit margin was mainly due to seasonality.

Gross loss margin for our e-mail and others business for the first quarter of 2018 was 9.9%. This compares to gross loss margin of 3.3% and gross profit margin of 20.3% for the preceding quarter and the first quarter of 2017 respectively. The year-over-year decrease in gross margin were mainly due to discontinuation of certain online platform businesses, which have relatively higher gross profit margins as well as higher recognized costs related to certain copyright in the first quarter of 2018. Contained within this segment are promising business initiatives that we are incubating such as cloud music and our live broadcasting services like CC amongst others. These businesses are undergoing a investment phase now, as they require upfront spending to acquire content and talent. We believe the upside potential in the longer term will more than justify our current spending.

Total operating expenses for the first quarter of 2018 were RMB4.7 billion or USD756.7 million. This compares to RMB4.3 billion and RMB2.7 billion for the preceding quarter and the first quarter of 2017 respectively. The increase in operating expenses was mainly due to increased selling and marketing expenses, R&D development, investments and staff related cost. The majority of operating expenses pertaining to our online games segment and the contents to the new game launches and effective promotion of our successful hit games.

E-commerce related shipping and handling costs included in selling and marketing expenses for the first quarter of 2018 were RMB325.8 million or USD51.9 million. This compares to RMB393.3 million and RMB213.3 million for the preceding quarter and the first quarter of 2017 respectively. The effective tax rate for the first quarter of 2018 was 26% compared to 18.2% and 19% for the preceding quarter and the first quarter of 2017 respectively. The changes in the effective tax rate were mainly due to certain of our subsidiaries experiencing higher operating losses in the first quarter of 2018. We expect that the effective tax rate for 2018 will be significantly higher than our 2017 effective tax rate.

We incurred a foreign exchange loss of RMB375.1 million or USD59.8 million in the first quarter of 2018. This compares to exchange losses of RMB159.1 million and RMB48.5 million for the preceding quarter and the first quarter of 2017 respectively. The increase in foreign exchange losses are due to depreciation of US dollar against the RMB.

Our net income attributable to shareholders for the first quarter of 2018 was RMB751.9 million or USD119.9 million. This compares to RMB1.3 billion and RMB3.9 billion for the first -- for the preceding quarter, and the first quarter of 2017 respectively. Non-GAAP net income attributable to our shareholders for the first quarter of 2018 totaled RMB1.3 billion or USD213.2 million. This compares to RMB1.9 billion and RMB4.3 billion for the preceding quarter and the first quarter of 2017 respectively.

For the first quarter of 2018, our basic and diluted earnings per ADS were USD0.91 each. Our non-GAAP basic and diluted earnings per ADS were USD1.62 and USD1.61 respectively for the first quarter of 2018.

Our cash position remains strong. As of March 31st 2018, our total cash and cash equivalents, current and non-current time deposits and short-term investments balance totaled RMB43.5 billion or USD6.9 billion. This compares with RMB43.2 billion as of December 31st 2017.

Returning value to our shareholders remains a top priority. For the first quarter of 2018 we plan to pay a dividend of USD0.23 per ADS representing 25% of the net income attributable to our shareholders. Under our current share repurchase program, which began on November 16, 2017. We had repurchased approximately 1.2 million ADS for approximately USD376 million as of March 31st 2018.

Thank you for your attention. We would like now to open the call for to your questions. Operator, please go ahead.

Questions And Answers

Operator

Thank you. (Operator Instructions) We will take your first question from Thomas Chong from Credit Suisse. Please go ahead.

Thomas Chong, Analyst

Hi. Good morning, William, Charles and my best friends for taking my questions. I have two questions. My first question is about the competition in the online games sector across PC and mobile, and how should we think about the performance as of our upcoming new games versus industry competition? And my second question is about the cross border e-commerce competition, and how should we think about the impact on trade war as well as any color about offline initiative in new (inaudible) if there is any? Thank you.

Zhaoxuan Yang, Chief Financial Officer

Okay. I would translate the question for William.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Okay. I'll do a quick translation.

William Ding, Chief Executive Officer

So for us, PC and mobile games remain as two dual engine for our games segment. We will continue to invest in the PC segment, because we think PC games still carries its own unique features and appealingness to the users. For instance, in -- towards the end of June we are going to introduce a new PC game Justice to the market and also for Knives Out, even though we self developed this as a mobile game, but we have also introduced a highly attractive PC version of that game. For mobile games, in the upcoming May 20 Game Day event. We are going to introduce more details about the pipeline. So overall, we remain very confident about both of our PC and mobile pipelines vis-a-vis industry competition.

(Foreign Language)

For the cross border e-commerce, we see no impact from the recent geo political trade war on the business. From a competitive landscape perspective, we are currently a leading player in the cross-border e-commerce and we are confident that we will maintain this leadership. This is really underpinned by the higher than industry standard user recognition and the overall elevated user experience.

Thomas Chong, Analyst

Thank you. I asked a follow-up question on the offline initiative. Thank you.

William Ding, Chief Executive Officer

(Foreign Language)

So offline is part of our overall e-commerce strategy. For now, we view that more as a supplement to our core online strategy. For instance, maybe in major cities we will open up one or maximum two flagship offline stores, mainly as a showroom to demonstrate the quality of our products and to provide a enhanced user experience.

Thomas Chong, Analyst

Thanks William and Charles.

Operator

(Operator Instructions) We'll move next to Alicia Yap from Citi.

Alicia Yap, Analyst

Hi. Good morning William and Charles. Thanks for taking my questions. I have a couple of questions. First is, with a heavy marketing promotion that you've spent during the first quarter, should we expect those spending should translate and benefit to the increasing grossing for Knives Out and Wilderness in the second quarter. If you could help us think about the sequential, maybe year-over-year trend for the mobile games would be helpful, in terms of just broadly would be helpful?

And then second for Chu Liu Xiang, how would you quantify the quality and the comparisons of the game versus the other RPG games that you have previously. Do you think the game attract quite a bit of gamers from Ghost or maybe Westward Journey Mobile or is it actually mostly come from the external gamers? Thank you.

Zhaoxuan Yang, Chief Financial Officer

(Foreign Language)

So Alicia, I will answer your first question, and then William will answer your second question. For our spending, this is indeed like a upfront investments to promote new genres, the Survival genre in different geographies. So as we explained earlier, they will result into increasing contribution from these new games in the following quarter and we're very happy to see that Knives Out, Terminator 2, Rules of Survival, these games are contributing significantly to our gross billing and to our revenue. We remain highly positive about the continued and sustained contribution from these games. And spending, marketing spending, again, some of them are corresponding to the game launches, right. So in Q4, Q1, we have more new games that's been launched. That corresponds to higher marketing expenditure. Going into the year with respect to the trend, again, it will be normalized, but it also depends on our the new game pipeline and new game launch schedule.

For the second question, William will answer and I will translate it. (Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

So for your second question on CRX, we see that Chu Liu Xiang is mainly be attracting new users that represents the expanded user outreach in particular younger users, post 95, is very, very little internal cannibalization we are observing from internal data to see that the new games being attracting existing players from our existing MMOs.

Operator

We'll move to the next caller in the queue, Eddie Leung from Merrill Lynch. Your line is open.

Eddie Leung, Analyst

Hey. Good morning, guys. Just a quick question. Hey, Charles, I remember you mentioned that you would expect the -- you would expect the revenue momentum in mobile games to continue for the rest of the year. So just wondering how much we are buffering contributions from new games and how much we are confident that even without new games, the existing games and upgrades would carry revenue momentum for the rest of the year? Thanks.

Zhaoxuan Yang, Chief Financial Officer

(Foreign Language)

So, Eddie, so I translate William's response.

William Ding, Chief Executive Officer

For our existing games, we are confident that throughout 2018, the games will represent a very stable level with potentially some small increments. So the majority of the extra growth will come from the contribution from new games, new games that we recently had -- already launched as well as pipeline new games.

Operator

We'll have next from Bill Liu from Goldman Sachs.

Bill Liu, Analyst

Hello. Good morning, management. This is Bill on behalf of Piyush Mubayi. I have a question about your e-commerce and -- sorry, e-mail and others revenue line. So I realized in this quarter, we saw a 100% year-on-year growth. Could you just elaborate a bit more, what you see in this line and what is the nature of the business, is it more of advertisement, which should have high-margin or is this some new initiative? Thank you.

Zhaoxuan Yang, Chief Financial Officer

Okay. So for that e-mail and others line, because every one knows that starting Q4 of last year we have separated out e-commerce into a standalone reporting segment. So for that e-mail and others, the major revenue contributors are our live broadcasting platforms CC and Bobo, our cloud music, as well as some other business that we incubate internally also including some of the R&D results. So that's the major components of that others line now with respect to this triple-digit year-over-year growth, again, that again reflects the healthy and robust growth momentum of some of the new businesses, in particular, cloud music and broadcasting.

Operator

Your next question will come from Alex Poon from Morgan Stanley.

Alex Poon, Analyst

Hi, William. Hi, Charles. Good morning, thanks for taking my questions. I have a question about your overseas game revenue contribution. Would you let us know how much revenue is coming from overseas at the moment, roughly speaking? And for your overseas strategy, could you let us know how are you going to develop overseas revenue and about your partnership with overseas like Blizzard, which you comment on or is there any possibility of launching more mobile games on that front?

And my second question is about your OpEx spending, the sequential increase in G&A, R&D is quite significant compared to previous quarters, could you let this know how much comes from headcount increase and how much comes from one-off game promotion spending increase? And lastly, you mentioned that your effective tax rate would increase significantly in 2018. What level should we use for the year and also in '19 and '20? Thank you very much.

Zhaoxuan Yang, Chief Financial Officer

Okay. I will answer most of the questions, and I'll leave part of the overseas strategy to William.

(Foreign Language)

So Alex, firstly, overseas revenue for this first quarter is still at a low single-digit, but it's been trending up. And we are very confident that with a more diversified portfolio of games that we bring to users more and more games will be more suitable and appealing to our global introduction. So we do expect that the overseas revenue contribution will continue to grow.

To your second question, the R&D and G&A increase is mainly attributable to headcount increase. As you all know, we are a premium best-in-class content provider in China. So we do spend significantly into our talents and into our core competitiveness in this regard. Your last question on the effective tax rate, as I briefly explained in the earnings call just now, it is mainly due to a larger absolute dollar losses from some of our subsidiaries like e-commerce, like music et cetera. So mathematically speaking, the effective tax rate has gone up significantly comparing to the past year. For the first quarter, we used 26% as the rate to accrue our provisional income tax and that represents management's latest estimation for the ETR rate. And I would leave the overseas strategy part to William.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

So for our overseas strategy, again, two-folds. First is that we will self develop games that's -- and tailor some of our self developed games towards overseas publishing, and for instance taking Knives Out as an example, it is very successful in Japan and in other overseas market. Second fold of our overseas strategy is that we are going to deepen collaboration with global industry peers by leveraging IPs by co-developing some of the interesting IPs and jointly promote that towards a global audience. And hopefully we will be bringing in some of those concrete examples to the market later this year.

Operator

Alex Yao from JP Morgan. Your line is open.

Alex Yao, Analyst

Hi. Good morning, William and Charles. Thank you for taking my questions. I have a two questions on gaming. First of all, I'd like to pick your brands and tournament games in China or the Jingji Yoshi [ph]. In the past seven years or so, tournament game rose with dominance of League of Legends globally, as well as in China. In recent quarters a major breakthrough in this category is the Tactical Survival shooting game or the (inaudible) Yoshi, which has been gaining a lot of the usage. Looking into the next one to two years, so where do you see the biggest opportunity for this tournament games Jingji Yoshi which usually require high DAU, low APRU but a decent paying ratio. And how would you position in with the tournament game categories?

And secondly regarding the tactical survival game, we noticed Knives Out still have a pretty resilient iOS approach [ph] to ranking, seems to as the revenue generation is okay, but we also notice the sharp decline in downloads ranking. Is it fair to say, you guys have strategically given up the China market for this game genre? And how do you think about the commercial value of overseas market for this game? Thank you.

Zhaoxuan Yang, Chief Financial Officer

Sorry. Alex, just to clarify, your last bit is asking us are we giving up China opportunity?

Alex Yao, Analyst

Yeah. Because the download rank is continuing to decline and it doesn't seeming that you guys are continue to aggressively pushing sales marketing for Knives Out in China.

Zhaoxuan Yang, Chief Financial Officer

Okay. I'll translate for William.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Okay. So Alex for your first question, e-sports strategy is one of our core games strategy internally at NetEase. We do also notice the trend you described from Dota ll into the survival genres. And in fact, at NetEase, we are also leveraging our strength in R&D and we are also providing, for instance, Identity V is a asymmetrical battle arena games. We are also exploring and also taking advantage of our R&D trends in developing more and more suitable games that's catering to this e-sports.

For your second question for Knives Out, just to set the record, we are never going to give up China market. After all, that's our home market, right. We think this is still a very appealing and attractive genre to the Chinese market and our way of attracting the users is mainly through innovations through creative ideas, game plays to attract and retain the core effective user base.

Operator

We'll hear next from Hanjoon Kim from Deutsche Bank.

Hanjoon Kim, Analyst

Good morning. Thank you very much for the chance to ask questions. The first question is really on the mix between e-commerce and (inaudible) Yanxuan, and if you have any perspective on how we can scale Yanxuan further or the bottleneck is for us in scaling that? And then I have a follow-up question.

Zhaoxuan Yang, Chief Financial Officer

Okay. So, Hanjoon, the first question, for our e-commerce, we don't separate -- like separate Kaola and Yanxuan. Majority of the e-commerce at this stage is contributed by Kaola. And I will translate your second question, Yanxuan, to William.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

So for your question on Yanxuan, we see -- we really see no bottleneck or any slowdown in the development of Yanxuan. For anyone, if you have used or have experienced Yanxuan's online shopping, you would know this is a very innovative way, not only to us, but we brought this innovation to the whole supply chain, the whole market here in China. The user loyalty remains very strong, reputation is very high. And the next focus for us is that we are going to bring this brand, this Yanxuan brand and Yanxuan product, market that more efficiently and effectively to bring them to a much broader addressable users throughout China.

Hanjoon Kim, Analyst

Okay. Great. So that -- the second question is really on the gaming kind of trends in the mid-term, the battle arena segment is obviously (inaudible) but repeating the focus on 2018, but as we think about a bit longer term, what are some of that underlying trends that you're seeing in the game business that you continue to allocate more resources to and then [ph] get back foot [ph] in the mid-term? Thank you.

Zhaoxuan Yang, Chief Financial Officer

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language) Hanjoon, two angles to answer your question. We think longer term into the future, mobile game will represent a larger, broad and, probably, faster growing segment vis-a-vis PC games. Within the mobile games, for us, currently, we think at the trending wise, games that's more suitable for live broadcasting games that requires more competitive element and games that same about [ph] in nature that gives user higher degree of freedom in terms of the game play, game mode, those are, probably, some of the trends that will be more appealing and promising into the future.

Operator

We'll hear next from Natalie Wu from CICC.

Natalie Wu, Analyst

Hi. Good morning, William and Charles. Thank you for taking my question. I have two questions here. The first is regarding your e-commerce business, we see very robust growth for your EC business in recent quarters, I am wondering if it will require more and more working capital going forward as your EC business grows bigger and bigger? And do you have any plan to deal with this kind of situation of like increase in working capital requirement?

And also the second question, could management give us some comments on the current competition landscape for online music market and how should we think about the monetization strategy for your cloud music product going forward? Any color on this will be appreciated. Thank you.

Zhaoxuan Yang, Chief Financial Officer

(Foreign Language)

So, Natalie, I'll take the first question on the e-commerce working capital. You are right, because we operate a self-operated e-commerce model that underpins the product authenticity and reliability. So mathematically speaking as we scale up, it will represent a higher absolute dollar amount on the working capital. We are not overly concerned about that, because as we scale up there are plenty of options from a financing angle, from an operation leverage angle that we can deploy to address a fine balance of keeping a robust growth as well as a financing need. Currently, all we can say is that our e-commerce as a latecomer comparing to the big competitors there, our skill is relatively still at a nascent stage. As we fast -- keep on this fast and robust growth along the way, we will find and deploy the best financing structure for the business.

The second question I will let William to answer and translate.

William Ding, Chief Executive Officer

(Foreign Language)

So naturally for your second question, we're currently a leading player in China's online music segment, particularly with very strong brand name and user loyalty and reputation there. We see this market as a very promising market with strong demand, because whether it's from mobile phones, PC or other smart hardware and smart devices into the future. There will be a very strong demand for music, high quality music content.

Currently, the main issue, we are seeing for the industry is that online music operators pay a hefty amount to the labels to acquire the IPs of the songs. For us, one important strategy is that we will prioritize our future development strategy to cater to the content that is demanded by the Chinese music lovers. An important piece to that is the original music, we are enjoying original music that is created by Chinese musicians and we want to be a effective channel to promote that, those original music to the Chinese music lover community.

Operator

This does conclude the Q&A portion of today's call, the conference. At this time I would like to turn the conference back over to your host. Please go ahead.

Brandi Piacente, Investor Relations

Thank you, once again for joining us today. If you have further questions, please contact NetEase's IR Director, Margaret Shi, based in Guangzhou, or TPG Investor Relations. Have a great day.

Operator

Thank you.

Zhaoxuan Yang, Chief Financial Officer

Thank you, everyone.

Operator

That does conclude today's teleconference. We thank you all for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2018-02-08
Event Description: Q4 2017 Earnings Call

Market Cap: 40,219.19
Current PX: 309.00
YTD Change($): -36.07
YTD Change(%): -10.453

Bloomberg Estimates - EPS
Current Quarter: 21.846
Current Year: 111.477
Bloomberg Estimates - Sales
Current Quarter: 13826.444
Current Year: 68056.967

Q4 2017 Earnings Call

Company Participants

- Brandi Piacente, Investor Relations
- Charles Yang, Chief Financial Officer

Other Participants

- Alicia Yap, Analyst
- Eddie Leung, Analyst
- Thomas Chong, Analyst
- Cheryl Yang, Analyst
- Analyst
- Marcus Young, Analyst
- Jialong Shi, Analyst

Presentation

Operator

Good day, everyone, and welcome to the NetEase Fourth Quarter and Fiscal Year 2017 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente, Investor Relations

Thank you, operator. Please note, the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act.

Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release in this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update its forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures, and a reconciliation of GAAP to non-GAAP financial results, please see the 2017 Fourth Quarter and Full Year Fiscal Year financial result news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

Joining us on the call from NetEase's Senior Management is Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer; and Mr. Hilton Hui, Co-President of NetEase Games.

I will now turn the call over to Mr. Yang, who will read the prepared remarks on behalf of Mr. Ding

Charles Yang, Chief Financial Officer

Thank you, Brandi, and thank you, everyone for participating in today's call.

Before we begin, I would like to remind everyone again that all percentages are based on renminbi. With that said , I'm pleased to deliver opening remarks and William's behalf.

We are pleased with another year of strong performance with a 42% increase in total net revenues. During the year, we launched a number of popular new titles including two global hit Knives Out and Terminator 2, Judgment Day. These games quickly became the best performers in their genre. This further strengthens and diversifies our high-quality game portfolio, and also makes us a meaningful player in the international online games space.

As we continue to advance our international expansion strategy, many of our games have proven to have large universal appeal. With over 200 million players globally, Onmyoji, is now available in 69 countries. Knives Out was also particularly well received internationally with Google Play Store recommending it in over 10 countries. Similarly, Terminator 2 has been ranked as one of the most popular games on iOS and Google Play platforms, across multiple countries, including the US market.

Also during the year, our e-commerce business more than doubled achieving net revenues of RMB11.7 billion. E-commerce is now our second largest business segment accounting for approximately 22% of our total net revenues in 2017.

For the fourth quarter, our total revenues came in at RMB14.6 billion, representing an increase of approximately 21% year-over-year. Non-GAAP net income was RMB1.9 billion compared to RMB4 billion in the previous year. The year-over-year decrease to our bottom line reflects the strategic investments we made this year particularly in Mobile Games and e-commerce. These investments offer us extended reach and momentum. They also support our diversification strategy as we build a solid foundation to our long-term growth. Online game services continue to lead our business. On the PC side, we propelled the success of our flagship PC-client titles.

During the fourth quarter, we introduced new expansion packs for longtime fan and favorites including Fantasy Westward Journey Online, Westward Journey Online 2 and Tianxia III. These compelling new expansion packs invigorate existing players as well as attract new players.

Mojang's Minecraft is now available across all platforms in China since October. We are currently on track to commence small scale monetization for the mobile version of Minecraft in the first half of this year. Total revenues from mobile games accounted for approximately 68% of our online games revenue in the fourth quarter.

Our flagship mobile games such as Fantasy Westward Journey Mobile and Westward Journey Online 2 Mobile continue to impress the market with their strong and sustainable performance. For other popular titles such as Onmyoji and New Ghost mobile game we released new content in the fourth quarter which revised our user interest. Onmyoji's November release in Thailand and December expansion packs brought back earlier players and brought in brand new players. For New Ghost, players are also delighted by the new content including new characters and promotions with other traditional Chinese animation IP.

In terms of new mobile games Knives Out and Terminator 2 along with its global version Rules of Survival were launched in early November. Both games became immediate blockbusters. To-date, Knives Out boost over 100 million registered users and Terminator 2 has accumulated 80 million registered users. We also started early monetization asset for these titles in December.

Moving on to e-commerce. This business segment has grown substantially with revenues in the fourth quarter increasing nearly 175% year-over-year to RMB4.7 billion. By partnering with leading providers Kaola.com and Yanxuan focus on providing customers with the highest quality products and services.

Our primary objective in this market is to create an elevated user experience that sets the standard for what online e-commerce should be. Our goal is to provide our growing user community with the best-in-class interface as well as broad purchase options. We plan to continue adding new product and premiere services to further enhance our customer experience. For advertising services, revenues in the fourth quarter increased by approximately 11% year-over-year to RMB736.6 million with automobile, internet services, and real estate as the top performing verticals. The mobile advertising market in particular continued to expand. We hold considerable advantage in the mobile arena proving to be a reliable partner to current and new clients.

E-mail and others net revenues were RMB1.2 billion or US$186.4 million in the fourth quarter with the year-over-year increase of 55%. 2018 is off to a strong start. Our online games pipeline, we are focused on expanding and diversifying our portfolio, as well as increasing our global footprint. January has been a busy month, as we have already begun executing on this strategy with a handful of thrilling new releases. We introduced the English-language version of Onmyoji to Canada, Australia, New Zealand and Scandinavia. Additionally players greeted the highly anticipated mobile version of Onmyoji with great enthusiasm and the game's early performance has exceeded our expectations.

We also launched MMORPG Chu Liuxiang and the game is currently available for play on all major platforms. With an extremely receptive fan base and its innovative game play, Chu Liuxiang, has been recognized as one of the top grossing games on iOS since its launch. We plan to launch new mobile games across a variety of genres. Strengthening our position by appealing to a broad range of players and user preferences. Our release scheduled presently cost for an array of new -- for battle arena game Identity V, RPG Sky and 2.5D casual battle arena game Alive.

To further strengthen and diversify our product offering, we will continue to invest in self-developed games. We also plan to broaden our reach through partnerships with other industry leaders that help us bring games to users worldwide. Under our recently announced Joint Venture with Mattel and the formation of Mattel163. We are delighted to extend the Mattel's popular IPs, such as UNO, Barbie, Hot Wheels, Fisher-Price and Thomas & Friends to create mobile games and education apps that users everywhere can enjoy on an exciting new digital level.

As we move through the year we will continue to make efforts towards our long-term growth objectives. Our strategy cost for diversification across our business lines, our games pipeline is strong. Our e-commerce business is developing rapidly and our advertising services and e-mail and others business are also growing.

Each of these offers growth opportunities where we can generate value for our partners, shareholders and community. This concludes William's comments. I will now provide a brief review of our fourth quarter 2017 financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlight. We encourage you to read through our press release issued earlier today for further details. I would also like to remind our audience that effective beginning the fourth quarter of 2017 we moved from three to four reporting segments. We are now reporting financial results for our e-commerce business, which primarily includes Kaola.com and Yanxuan.

All historical quarterly and year-end amounts for 2016 and '17 that we will be discussing today reflects this change. Net revenues for the fourth quarter of 2017 were RMB14.6 billion or US$2.2 billion. This represents an increase of 17.1% and 20.7% compared with the preceding quarter and fourth quarter of 2016 respectively. The increase was mainly led by our e-commerce business and partially offset by a decline in revenue contribution from our online games services.

Our gross profit for the fourth quarter of 2017 was RMB5.7 billion or US$882.9 million compared to RMB5.9 billion and RMB6.5 billion for the preceding quarter and the fourth quarter of 2016 respectively.

Our gross profit for our online game segment declined year-over-year and quarter-over-quarter in the fourth quarter as the result of decreased revenue contribution from some of our self-developed mobile games. Margins for our online game segment was relatively stable at 61.4% in the fourth quarter compared to 60.7% a year ago and 62.5% in the preceding quarter. With the rapid development and expansion of Kaola.com and Yanxuan gross profit for our e-commerce business increased.

Gross margin decreased to 7.4%, which was primarily impacted by larger-scale promotions and certain sales discounts in the fourth quarter of 2017, such as Singles Day on November 11, 2017.

This compares with gross margins of 11.5% and 12.5% for the preceding quarter and the fourth quarter of 2016 respectively. Gross profit and margin for our advertising services business increased year-over-year and quarter-over-quarter in the fourth quarter of 2017. Gross margins were 71.2% compared to 68.0% and 66.5% for the preceding quarter and the fourth quarter of 2016 respectively.

Gross loss margin for our e-mail and others business was 3.3%, compared to gross profit margin of 13.1% and 46.9% for the preceding quarter and the fourth quarter of 2016 respectively.

Total operating expenses for the fourth quarter of 2017 were RMB4.3 billion or US$663.6 million. This compares to RMB3.4 billion and RMB2.6 billion for the preceding quarter and the fourth quarter of 2016 respectively. The increase in operating expense was mainly due to increased selling and marketing expenses, research and development investments, staff-related costs and increased operating expenses due to our e-commerce businesses. E-commerce related shipping and handling costs included in selling and marketing expenses for the fourth quarter of 2017 were RMB393.3 million or US$60.4 million. This compares to RMB294.8 million and RMB177.2 million for the preceding quarter and the fourth quarter of 2016 respectively.

The effective tax rate for the fourth quarter of 2017 was 18.2% compared to 8.1% and 19.2% for the preceding quarter and the fourth quarter of 2016 respectively. The changes in the effective tax rate were mainly due to certain of our subsidiaries being recognized as Key Software Enterprises in the third quarter and fourth quarter of 2017, and subject to a preferential tax rate of 10% for 2016.

We recognized related tax credit in the third quarter and fourth quarter of 2017 accordingly. Our net income attributable to shareholders for the fourth quarter of 2017 was RMB1.3 billion or US$197.6 million. This compares to RMB2.5 billion and RMB3.7 billion for the preceding quarter and the fourth quarter of 2016 respectively.

Non-GAAP net income attributable to our shareholders for the fourth quarter of 2017 totaled RMB1.9 million or US$288.8 million. This compares to RMB3.0 billion and RMB4.0 billion for the preceding quarter and the fourth quarter of 2016 respectively. For the fourth quarter of 2017, our basic and diluted earnings per ADS were US$1.50 and US$1.49 respectively. Our non-GAAP basic and diluted earnings per ADS were US$2.20 and US$2.18 respectively for the fourth quarter of 2017.

Turning to some highlights from the full-year 2017 financials. Total net revenues for fiscal year 2017 were RMB54.1 billion or US$8.3 billion, compared to RMB38.2 billion for the preceding year. Gross profit for fiscal year 2017 was RMB25.9 billion or US$4.0 billion, compared to RMB21.7 billion for the preceding fiscal year. The increase was mainly due to one, increased revenue contribution from our self-developed mobile games, such as Onmyoji and the mobile version of New Ghost. Two, the increased monetization effort for mobile applications primarily our mobile news app and three, the expansion of our e-commerce business.

Total operating expenses for fiscal year 2017 were RMB13.8 billion or US$2.1 billion, compared to RMB9.0 billion for the preceding fiscal year. The increase in operating expenses in 2017 was primarily due to increased selling and marketing expenses, research and development investments and higher staff-related costs as well as increased operating expenses related to our e-commerce businesses.

E-commerce related shipping and handling costs included in selling and marketing expenses for fiscal year 2017 were RMB1.2 billion or US$181.8 million, compared of RMB503 million for the preceding fiscal year. The effective tax rate was 16.6% for fiscal year 2017, compared to 15.1% for fiscal year 2016. The changes in the effective tax rates were mainly due to the higher withholding tax recorded in fiscal year 2017.

Net income attributable to our shareholders for fiscal year 2017 totaled RMB10.7 billion or US$1.6 billion, compared to RMB11.6 billion for the preceding fiscal year. Non-GAAP net income attributable to our shareholders for fiscal year 2017 totaled RMB12.7 billion or US$2.0 billion, compared to RMB12.9 billion for fiscal year 2016. Our basic and diluted earnings per ADS were US$12.5 and US$12.41 respectively for fiscal year 2017. Non-GAAP basic and diluted earnings per ADS were US$14.85 and US$14.73 respectively for fiscal year 2017.

Our cash position remains strong. As of December 31st, 2017, our total cash and cash equivalents, current and non-current-time deposits and short-term investments balance totaled RMB43.2 million or US$6.6 billion. This compares with RMB36.9 billion, as of December 31st, 2016. Our cash flow generated from operating activities was RMB11.9 billion or US$1.8 billion for fiscal year 2017, compared with RMB15.5 billion for the preceding fiscal year.

Returning value to our shareholders remains a top priority. For the fourth quarter of 2017, we plan to pay a dividend of US$0.38 per ADS in accordance with our 25% dividend distribution policy. Under our current share repurchase program, which began November 16, 2017 we had not yet purchased any ADSs as of December 31st, 2017.

Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead.

Questions And Answers

Operator

Yes, thank you. (Operator Instructions) We'll take our first question from Alicia Yap with Citi.

Alicia Yap, Analyst

Hi. Good morning, William and Charles. Thanks for taking my questions. I actually have couple of questions, if I may. Number one, is related to the sales and marketing spend and overall margins. So, can management share with us the step-up spending in the more aggressive to promote your e-commerce and your gaming business. What is the rationale behind the strategic decisions? And how should we be thinking and modeling in the upcoming spend for 2018. Should the fourth quarter level be the similar level that we should be thinking for 2018? Thank you. (Foreign Language)

Charles Yang, Chief Financial Officer

Okay. Thank you, Alicia. This is Charles. So, first of all, sales and marketing expense is a format of our strategic investment to build a very solid foundation for NetEase's long-term growth objectives. And specific to Q4, there are certain seasonality impacts, for instance, in Q4 sales and marketing expenses e-commerce is relatively higher due to the promotional season, Double 11, Double 12, Black Friday. For games in Q4, as you all know, we have very successfully launched a couple of very promising titles. And related sales and marketing expenses on those titles are relatively higher comparing to the preceding quarters. Overall, I would say we remain very, very confident about the return of our investment in the format of sales and marketing. And also as I noted in the transcript just now, embedded in the sales and marketing are also the e-commerce related shipping and handling cost which you can get the numbers from our earnings release.

Operator

Next we move to Eddie Leung with Merrill Lynch.

Eddie Leung, Analyst

Hey, good morning. Thanks for taking my questions. I have questions on the cross border Kaola pieces, so when we look at the very fast growth of your e-commerce revenues. I am just curious, how much you think that's driven by industry growth and how much that's driven by successful market share gain over some of over competitors. And then along the line, I am just curious on your thought in terms of your longer term strategy. How you can differentiate from a couple of the more general e-commerce platforms, which potentially have better economic scale in terms of the infrastructure? Thank you. (Foreign Language)

Charles Yang, Chief Financial Officer

So Eddie to answer your question let me do a quick summary and translation. For Kaola, since the inception of our Kaola business, we have focused on the cross border e-commerce segment, which over the past years we have already build a leadership in terms of market share. And we are the fastest growing player in this cross border segment. Talking about competition, we do not think this hats to hats competition with the major players for this cross border segment because there is a huge Chinese consumption demand when you see a Chinese tourist spending overseas when they do a physical travel.

So that we are talking about trillions of spending. And that's obviously a very, very potential market, addressable market for our cross border e-commerce Kaola business. With respect to Yanxuan, again our strategic position and rationale is that China is now already the largest manufacturing base for the world. A lot of made in China products represent very high quality. So, we have close partnerships with the select manufacturers in terms of designing and manufacturing product specific tailoring to the Chinese consumer user demand and this consumption upgrade trends. So a longer term, we are very confident that we are going to sustain a very fast growth of our both Kaola and Yanxuan e-commerce business.

Operator

Next we'll move to Thomas Chong with Credit Suisse.

Thomas Chong, Analyst

Hi. Good morning, William, Charles and Margaret. And thanks for taking my questions. I have a couple of questions. The first question is about survival games. Can management provides us some color about our expectations in terms of user and monetization by year end in China and overseas market? And follow up on that, how should we think about the competition of the survival games in China and overseas? And my second question is about the e-commerce business. Can management provides us some additional color because we have the shipping expenses, but how should we think about on the operating profit level in terms of the operating profit and the timing of profitability? And my third question is about the trend in terms of the operating expenses in 2018. And my final one is about the online game broadcasting business that we recently see that NetEase want to invest around RMB1 billion in this area? Thank you.

Charles Yang, Chief Financial Officer

Okay. Thomas that's four questions in total. Let me translate for William.

(Foreign Language) Okay. So, for your first question, we have already established a early mover advantage in the survival genre both domestically and globally. And we also very glad to see that the games that we have launched has achieved its success in both domestic and overseas market. The way we think about this genre is this is a very, very exciting genre with very promising long-term sustainability by combining the survival battle arena sandbox element into the new and innovative game play.

So, we are very confident that this genre will be a very long lasting genre that can create different innovative game play and apply that into different genres. And accordingly we have also deployed our strategic resources in new games pipeline in this broader survival battle arena and sandbox genre.

(Foreign Language) For our e-commerce in terms of the trend for operating margins, given we are comparatively speaking we are relatively new entrant into e-commerce. So, in the near term our primary focus will be gaining broader user recognition and providing an elevated experience to the users. So, margin profitability is not a eminent near focus.

However, given our continued growth and skill up effect, margins will continue to improve, and we are very, very confident that about the future profitability of our e-commerce business.

(Foreign Language) Thomas for your question on the trend, overall trend for the operating expense and margins. So, as I explained earlier question, Q4 was a little bit unique with a couple of one-off impact e-commerce seasonality, as well as the promotion of our newly launched games in Q4.

For those strategic investments we made in Q4 based on the results now we continue to receive were very satisfactory with respect to the returns on those investments. And for R&D throughout the year and going forward, we will continue to focus and invest because that is building our core confidence. And so overall, we think margin trend we are confident and William also commented that in Q4 there were certain copyright related one-off expenses in relation to our online music business that is also one-off.

(Foreign Language) So, online broadcasting and eSports are becoming increasingly more important elements of the overall game industry ecosystem. We observe that from the newest trend that players, they do not only play and experience the game, but they also enjoy watching and participating in the games from another format. So, with that trend and also given that, NetEase, we have very suitable and relevant IPs both self-developed as well as licensed that we are making very prudent and strategic deployment of our capital and resources in terms of online game broadcasting and eSports which we think will also bring positive value to our games ecosystem overall.

Operator

We'll move next to Natalie Wu with CICC.

Cheryl Yang, Analyst

Hi, good morning, management. Thank you for taking my question. This is Cheryl speaking on behalf of Natalie. Actually I have a follow-up question regarding our survival type games. We noticed Knives have launched a couple of new survival games recently. Could management share your thoughts on the positioning of these new games, and how they differentiate from previous ones and how they differentiate from the Knives Out and Terminator 2? And how they differentiate from each other in terms of the positioning? And also could management give us some color on your promotion plans for the survival games going forward especially during Chinese New Year? Thank you.

Charles Yang, Chief Financial Officer

(Foreign Language) Okay. So in terms of the survival battle arena sandbox genre, we do have a very strong pipeline with differentiated games, with differentiated from multiple aspects. Some differentiated from the view angle, some differentiated from 2.5D, 3D, different highest qualities in their respective category. Some are differentiated in terms of play mode with some new and innovative concept embedded into these games. We think those will be very strong supplements to our existing games. With respect to the upcoming Chinese New Year or our exiting games Knives Out and Terminator 2, we will have a series of interesting new contents and new game plays being introduced. At the end of January, Terminator 2, has introduced eight times, eight biggest map that can accommodate 300 concurrent players which again set a record for game this in genre. Knives Out, very recently have introduced a 50v50 a new concept of game play. Again these are just some specific examples of a series of innovative action we plan to bring exciting and creative concepts to the players.

Analyst

We'll move next to Marcus Young with Macquarie.

Marcus Young, Analyst

Hi, William and Charles. (Foreign Language) So I got three questions. So, first one regarding to, Chu Liuxiang, always has been performing pretty well since launch last month. So, can you share some like data like your ARPU at the moment and if it is, is this kind of mix genre and sandbox with MMORPG in this case like this high freedom become a key direction for NetEase to work on? And how does that compare to typical MMORPG or sandbox game in terms of our pool of user base? And my second question is about the survival genre. Can you share the customer acquisition calls for Knives Out and Terminator 2? And my third question is regarding the overseas retention? Can you share some monetization strategy comparison between the overseas market and domestic market especially for Knives Out and Terminator 2? Thank you.

Charles Yang, Chief Financial Officer

(Foreign Language) Okay. So I will do a very quick translation of the answers. First question regarding Chu Liuxiang, this is a highly anticipated game we recently launched. We call this as MMO2.0, it represents a highest quality. As you all know, MMORPG games is the most complicated genre with the highest entry barrier. And NetEase has a core competence in this genre. We think in terms of ARPU and overall performance of Chu Liuxiang, this will be in line with our other previous legacy games that has a very sustainable long-term growth. For the second question, for the user acquisition cost for Knives Out and Terminator 2, as William earlier commented, we incurred relatively higher selling and marketing expenses in Q4 when the games were initially launched. But longer term we think the trend on the user acquisition, on these survival battle arena games should be comfortable ending line without our other games. And with respect to overseas monetization, currently the monetization assets are more or less consistent with the monetization attempts we launched in domestic market. Going forward, we will also gradually introduce more tailor-made monetization offerings dedicated to differentiated overseas market for the global audience.

Operator

Next we'll move to Jialong Shi with Nomura Securities.

Jialong Shi, Analyst

Hi. Good morning, William and Charles and Margaret. Thanks for taking my questions. I have two follow-up questions. I think management mentioned in previous question, in Q4 there were some expenses related to the royalty fees for your online music service. So, I just want to know how big that expense was in Q4. And second question regarding, Chu Liuxiang. Just wondered if management can share some colors on the popularity spend of this game? I will do the translation myself. (Foreign Language)

Charles Yang, Chief Financial Officer

Okay. Jialong, let me answer your first question in English directly. With respect to our copyright expenses for online music, there are two components. One, is the natural ongoing accrual basis of the copyright. The one-off copyrights we talked about are with respect to certain additional copyright that we expect to incur. So, from accounting perspective, we will need to do expense provision. And the magnitude is -- we don't disclose the specifics, but it is in line with the copyright expense increase as a general market trend. Your second question I would refer to the rest of the management.

(Foreign Language) As you all know, NetEase, we hold our core competence and track record in operating some of the most successful MMORPG games in the industry. So, equally we are highly confident about the ongoing sustainable performance of Chu Liuxiang. And this represents like previously mentioned elevated experience in the MMO or we call this the MMORPG 2.0 new generation.

Operator

And due to time constraints, we are not taking any more questions at this time. I'd like to turn the conference back over to the management for any closing or additional remarks.

Brandi Piacente, Investor Relations

Thank you once again for joining us today. If you have further questions, please contact NetEase's IR Director, Margaret Shi based in Hangzhou or TPG Investor relations. Have a great day.

Operator

Everyone, now that concludes our conference call. We do thank you all for your participation. You may now disconnect.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2017-11-16
Event Description: Q3 2017 Earnings Call

Market Cap: 39,701.97
Current PX: 302.47
YTD Change($): +87.13
YTD Change(%): +40.462

Bloomberg Estimates - EPS
Current Quarter: 22.658
Current Year: 103.614
Bloomberg Estimates - Sales
Current Quarter: 13650.357
Current Year: 53366.742

Q3 2017 Earnings Call

Company Participants

- Brandi Piacente, President
- Zhaoxuan Yang, Chief Financial Officer
- William Ding, Chief Executive Officer

Other Participants

- Hillman Chan, Analyst
- Natalie Wu, Analyst
- Jialong Shi, Analyst
- Wing Wong, Analyst
- Tian Hou, Analyst
- Han Joon Kim, Analyst
- Sef Chin, Analyst
- Marcus Yang, Analyst

Presentation

Operator

Good day, everyone, and welcome to the NetEase Third Quarter 2017 Earnings Conference. Today's call is being recorded. At this time, I'd like to turn the conference over to Brandi Piacente. Please go ahead ma'am.

Brandi Piacente, President

Thank you, Tiwari. Please note, the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect [ph] NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update its forward-looking information except as required by law. During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures, and a reconciliation of GAAP to non-GAAP financial results, please see the 2017 third quarter financial results news release issued earlier today. As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast of this conference call will be available on the NetEase corporate website, at ir.netease.com.

Joining us today on the call from NetEase's senior management are, Mr. William Ding, Chief Executive Officer; Mr. Charles Yang, Chief Financial Officer; and Mr. Hilton Hui, Co-President of NetEase Games.

I will now turn the call over to Mr. Yang, who will read the prepared remarks on behalf of Mr. Ding.

Zhaoxuan Yang, Chief Financial Officer

Thank you, Brandi and thank you everyone for participating in today's call. Before we begin, I would like to remind everyone that all percentages are based on renminbi. With that said, I'm pleased to deliver opening remarks on William's behalf.

Since establishing NetEase in 1997, our focus has been on innovation, high quality content and community. 20 years later, we are pleased to be implementing the same values as we develop and operate some of China's most popular mobile and PC client games as well as some of the country's most prominent advertising communication and e-commerce services. The cornerstones of our future success are based on these principles, along with our ability to continue to broaden and diversify our portfolio of online products and services, enhance our brand equity and extend our global footprint.

During the third quarter, we did exactly that. We advanced each of our core business segments year-over-year, growing our quarterly net revenues by nearly 36%. Our growth was spearheaded by our online games services sector, and in particular, our mobile games, which accounted for approximately 68% of this segment's net revenues, led by our self developed mobile games including; Onmyoji, New Ghost, Land of Glory, Invincible and Demon Seals. The popularity of several of our legacy games continues to grow and our PC client game Fantasy Westward Journey Online and mobile game, Invincible achieved another record quarterly revenues during the third quarter.

In addition to our legacy titles, players are also responding enthusiastically to our newer hit games such as Onmyoji. Although Onmyoji's performance in China slows down in the third quarter, this popular title regains traction when we introduce new content and gameplay, supported by promotional activities through media, literature and merchandise collaborations to further expand the success of the Onmyoji brand and to captivate players, we are developing a battle arena game based on the Onmyoji IP. The initial testing for this game is progressing well and on track with our expectations.

In line with our expansion strategy to bring exciting titles overseas, Onmyoji's international presence remains strong. After being introduced in Japan and Southeast Asia, Onmyoji was also successfully launched in Korea, followed by promising use of feedback during closed beta testing in the US and Canada. We also strengthened our portfolio in the third quarter by introducing a number of new expansion packs that extends life cycles of our games as well as launched new mobile titles. The highly anticipated release of Minecraft in China went exceptionally well, as we introduced the game for PC JAVA and iOS in the third quarter and Android shortly thereafter in October. On its first day of release, Minecraft was ranked the number one downloaded mobile game on both the iPhone and iPad. Minecraft has received considerable accolade in China and by the end of October, the game had accumulated nearly 30 million registered users. Early monetization efforts for Minecraft are underway, with server rental and partial content monetization for the PC JAVA version, which began in mid-September.

We have also initiated monetization testing for Hypixel server and we plan to commerce small scale monetization for the mobile version in early 2018. Our renounced portfolio of games continues to delight Chinese players. In addition to Minecraft, we also introduced Index, a Japanese-themed RPG to millions of gamer and fans during the third quarter. We are focused on growing our portfolio, with a number of new exciting games in our pipeline that broaden and diversify our offering in a variety of genres. We have a rich pipeline that leverages our top resources in R&D and talented pool of developers and the optimal strategy to license and operate marquee games.

In the coming quarters, we are looking forward to bringing new titles across different genres to gamers including MMORPG, such as Chu Liu Xiang and Tribes and Empires, Storm of Prophecy, Japanese-themed RPG Forever 7 and card game HAN-GYAKU-SEI Million Arthur as well as a battle arena game based on Onmyoji IP and our 3D PC-Client game Conqueror's Blade.

In addition to our domestic offerings, we are bringing our vision to audiences across the globe, markets where mobile games are growing at a steady pace. International expansion allows us to grow our brand worldwide and introduce our games to audiences around the world, eager for the thrilling high quality game experience that NetEase players love. Games like Onmyoji and Crusaders of Light are performing very well overseas and Crusaders of Light has now been recognized as one of the top grossing games in more than 20 different countries since its launch.

Now turning to our other business segments. Leveraging our technology advantage, premium brand and larger user base, we continue to strengthen our market position with NetEase media. During the third quarter, we grew our advertising services net revenue by approximately 12% year-over-year with automobile, real estate and Internet services as our top performing verticals. Our planned [ph] entertainment marketing program is supporting a growing number of high-profile projects and we are also seeing the increase in demand for performance-based advertising to support our growth in otherwise mature market. Investment in both our original and third-party high quality content, customized smart push technology, video content and innovative marketing solutions amid evolving advertising climate support our ability to remain one of the most sought after advertising platforms in China.

Our email, e-commerce and other business also continued to grow in the third quarter, with net revenues increased by nearly 80% year-over-year, primarily due to increased revenue contribution from our e-commerce businesses, such as Kaola and Yanxuan. These e-commerce platforms are prospering the net revenues from Kaola and Yanxuan of RMB2.7 billion, accounting for approximately 71% of the segment's net revenues. Each of our business line is an integral to our growing brand as we continue to amass one of China's preeminent game portfolios. We are simultaneously focused on advancing our Internet service offerings to support our healthy business platform.

We will continue to invest in the growth of each of these business segments, together they strengthen not only the NetEase brand, but our commitment to our investors and the user community. This concludes William's comments.

I will now provide a review of our third quarter 2017 financial results. Given the limited time on today's call, I will be presenting some abbreviated financial highlights. We encourage you to read through our press release issued earlier today for further detail. Our gross profit for the third quarter of 2017 was RMB5.9 billion our $893.9 million, compared to RMB6.7 billion and RMB5.3 billion for the preceding quarter and the third quarter of 2016, respectively. Our gross profit grew year-over-year for our online games segment in the third quarter. However, as mobile games become an increasing revenue contributor, gross margin for our online games business decreased slightly. For the third quarter of 2017, gross profit margin for our online games was 62.5% compared to 63.1% and 65.0% for the preceding quarter and the third quarter of 2016 respectively.

Gross profit and margin for our advertising services business increased year-over-year and quarter-over-quarter in the third quarter of 2017, with gross margin of 68.0% compared to 67.6% and 65.3% for the preceding quarter and the third quarter of 2016 respectively. Gross profit decreased year-over-year for our email, e-commerce and others businesses for the third quarter of 2017, with gross margin of 11.9% compared to 11.3% and 33.5% for the preceding quarter and the third quarter of 2016 respectively. This is mainly a result of a change in product mix with Kaola and Yanxuan representing increasingly significant revenue contribution.

Total operating expenses for the third quarter of 2017 were RMB3.4 billion or $510.7 million compared to RMB3.3 billion and RMB2.5 billion for the preceding quarter and the third quarter of 2016 respectively. For the third quarter of 2017, we recorded a net income tax charge of RMB225.5 million or $33.9 million compared to RMB703.5 million and RMB427.2 million for the preceding quarter and the third quarter of 2016 respectively.

The effective tax rate for the third quarter of 2017 was 8.1% compared to 19.0% and 13.3% for the preceding quarter and the third quarter of 2016 respectively. The changes in effective tax rate were mainly due to the recognition of tax credit related to key software enterprises for certain subsidiaries in the current quarter and the third quarter of 2016. Our net income attributable to shareholders for the third quarter of 2017 totaled RMB2.5 billion or $379.9 million compared to RMB3.0 billion and RMB2.7 billion for the preceding quarter and the third quarter of 2016 respectively.

Non-GAAP net income attributable to our shareholders for the third quarter of 2017 totaled RMB3.0 billion or $454.6 million, compared to RMB3.5 billion and RMB3.0 billion for the preceding quarter and the third quarter of 2016 respectively.

For the third quarter of 2017, our basic and diluted earnings per ADS were $2.88 and $2.86 respectively. This compares to basic and diluted earnings per ADS of $3.39 and $3.37 respectively for the preceding quarter and $3.14 and $3.12 respectively for the third quarter of 2016. Our non-GAAP basic and diluted earnings per ADS for the third quarter of 2017 were $3.45 and $3.43 respectively. This compares to $3.96 and $3.94 respectively in the preceding quarter and $3.46 and $3.43 respectively for the third quarter of 2016.

Our cash position remains strong. As of September 30th, 2017, our total cash and cash equivalents current and non-current time deposits and short-term investment balance totaled RMB40.7 billion or $6.1 billion. This compares with RMB36.9 billion as of December 31st 2016. Our cash flow generated from operating activity was RMB1.7 billion or $248.8 million for the third quarter of 2017 compared with RMB2.3 billion and RMB3.7 billion for the preceding quarter and the third quarter of 2016 respectively.

Returning value to our shareholders remains a top priority. For the third quarter of 2017, we plan to pay a dividend of $0.72 per ADS in accordance with our 25% dividend distribution policy. Under our current share repurchase program, we repurchased approximately 1.1 million ADS for approximately $306.1 million, as of November 14th, 2017, the last day of this program. To continue this activity, our Board has approved a new 12 months share repurchase program beginning on November 16, 2017 for up to $1.0 billion.

Thank you for your attention. We would like now to open the call to your questions. Operator, please go ahead.

Questions And Answers

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) We'll move first to Hillman Chan with Citigroup.

Hillman Chan, Analyst

Good morning, management. Thank you for taking my question. This is Hillman on behalf of Alicia. My first question is regarding the monetization strategy and potential for Wilderness (Foreign Language) and also Minecraft piece for both PC JAVA and mobile. And regarding (Foreign Language) Wilderness how do we see the competition from several games of similar genres in the market?

(Foreign Language)

And then I have another follow-up question.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Okay, so let me translate the response from William. Firstly to address the competition, Wilderness is a sandbox battle arena game and currently, it's in internal testing stage. So we will continue to optimize this game and to inject innovations, bring this exciting new game to our global audience. In terms of monetization for Minecraft, this is a sandbox platform, so essentially you can think of this as a marketplace, we encourage developers to come to this marketplace, this platform to come up with exciting innovative modes and users willing to pay for these modes to get enhanced user experience on Minecraft platform.

So Wilderness as you know, this is a FPS game and this is also based on a sandbox concept and you should take full confidence in NetEase's almost two decades of experience in developing games, bringing in innovations. We have full confidence on this game, and we think there's quite many opportunities in terms of monetization in this game without compromising the user experience of this fair battle arena game. So at this stage, we are not really rushing out for any of the monetization initiatives for these games.

Operator

Next, we'll move to Natalie Wu with CICC.

Natalie Wu, Analyst

Good morning, management Thanks for taking my question. I actually have three questions. The first one is regarding your deferred revenue. As we noted that your total deferred revenue this quarter increased to 2.7 sequentially, so what are the drivers behind the sequential increase?

My second question is about your international expansion. Can management please share your current progress and future plans for the overseas expansion? What are the revenue contributors from overseas market at current stage and how should we expect this contribution going forward? My third question is regarding your Cloud Music business. Can management please elaborate more about your current strategy for this business, especially that the competition of music copyrights are getting fierce for major players. Can management please share your thoughts for current competition landscape, any comments would be helpful. Thanks.

Zhaoxuan Yang, Chief Financial Officer

So Natalie, let me answer your first two questions, financials and then I will translate the third question to William and the management. On deferred revenue, this quarter's differed revenue has been stabilized, this is largely because of our game grossing performance has been stabilized in the recent quarter. And as you know, deferred revenue, we never changed any accounting policy for the revenue deferral, so the numbers reflect the stability of the performance of the games.

For your second question on international expansion, as you know, we are continuing with this initiative. Overseas revenue this quarter accounted for approximately 2.4% of the total revenue, which has been quite stable comparing to the preceding quarter and a significant improvement comparing to prior year.

For your third question, I will translate for the management.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So our -- as you know, our Cloud Music is quite unique in terms of the competitive landscape. Our smart push [ph] technology is the best in class. But beyond that, we've also been quite focused on original music. There are millions of independent musicians in China that creates very exciting music and cloud music, this platform is dedicated to be the priority choice of the platform to help these independent musicians to broadcast and distribute their music to a broader audience of music lovers.

Operator

Next, we'll move to Jialong Shi with Nomura Securities.

Jialong Shi, Analyst

(Foreign Language)

I will translate my questions. My first question is about the e-commerce services. I was quite impressed by the strong growth of NetEase's e-commerce service in the past quarters and as NetEase's e-commerce revenue, e-commerce business has reached such a big scale and I just wonder if NetEase may consider partnering with any strategic -- external strategic investors. And if yes, what types of investors NetEase likes to work with?

My second question is about a recent media report, NetEase -- based on the report, NetEase recently issued [ph] one of the game live broadcasting -- one of the Chinese game live broadcasting platforms for live streaming NetEase online games. I just wonder what's the rationale for NetEase to take this action, and how does NetEase think of its relationship with these external game live broadcasting platforms?

Zhaoxuan Yang, Chief Financial Officer

Okay, well -- first question for our e-commerce, as you know e-commerce remains one of our pivotal focus of broadening our Internet products and services. We remain open minded. We welcome all strategic partnerships, particularly on the business level and at appropriate time, we will also consider bringing in external strategic shareholders. For now, I think our top priority is to continue a buildup, Kaola and Yanxuan brand equity amongst the users by focusing on the user experience and -- by bringing in a new e-commerce concept to the Chinese users. The second question I will defer to the management.

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So to your second question, Jialong, this incident was actually referring to three years ago in 2014, when that platform was broadcasting Fantasy Westward Journey during the broadcasting they have inserted advertisement that direct the users, the audiences to a sub-optimal quality web game, we think that is not appropriate. We have been following written communications with the platform and because we did not get the reasonable response within the reasonable time frame, so we have initiated this litigation process. But overall, in terms of our relationship to all the live streaming platforms, we remain very open minded. We in fact welcome all these partnerships and broadcasters to come experience our NetEase games. We have a lot of exciting games; Minecraft, Overwatch, Hearthstone as well as our own self developed games, all of these are very suitable contents for game live streaming. But of course, we will require reasonable and rational restrictions, not to do things inappropriate and jeopardize the user experience when other platforms are broadcasting our games.

Operator

And we'll move next to Chi Tsang with HSBC.

Wing Wong, Analyst

Hi, management. Thank you for taking my questions. This is Wing Wong speaking on behalf of Chi. So I have a question regarding to the monetization of Wilderness. So as management has mentioned that we will come up with some interesting idea about monetization, so I have noted that, so there was some recently some in-game advertisements in Wilderness, for example like the JD's advertisements on the plane. Will that be the majority, main monetization approach in going forward? And will that be included in advertising services segments or online games segment.

And also as (inaudible) says in this quarter, so in Kaola's margin, since you have slightly Q-on-Q recovered, so what's our long-term expectation about Kaola? I mean, the email segment, segment margin get Q-on-Q slightly improved. So how should we think about the long-term expectation about the second margin or maybe the e-commerce margin going forward? Thank you very much.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So let me first translate for William's comments. So first of all, for Wilderness or more broadly for these survival category games, because this is a new genre and we will take a holistic approach to in terms of monetization, just like this high quality game has surprised users, just give us some patience and confidence. We, as you know, we will have a very comprehensive approach to monetize this game in due course and at this stage do not worry too much and we are not overly rushed out in terms of this monetization effort.

To your second question on the margins, overall, we are happy to see that email, e-commerce and other segments, the margin has now been stabilized. I think going forward, we remain -- the margin will be stabilized at this level. As we further grow our e-commerce and other business units within this segment, over the longer term, we think the scale factor will start to kick in. But that obviously would also require some time.

Operator

Next we'll move to Tian Hou with T.H. Capital. Please go ahead Tian Hou. We are not able to hear you. Please check if your receiver is on --

Tian Hou, Analyst

Oh, I am here. Hello? Hello?

Operator

Yes, hello?

Tian Hou, Analyst

William. So, okay, so good morning management, William, Dennis [ph] and Brandi. I have a question not really related to your game. I do believe you guys have a strong capability of come out surprising good content. The question is really related to what is really the best word, AI, big data. And at NetEase, you have a lot of -- lots of data, emails and the dictionaries and games and commerce and news. And I haven't heard a word from you about the big data, about AI. I wonder how NetEase actually benefit or using such kind of a property and to benefit your own content creation? That's my question, William.

Zhaoxuan Yang, Chief Financial Officer

Okay. Let me translate for the management.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So to answer your question, AI, we also agree and recognize its importance of AI towards the future success. However, we are also a little bit concerned that in media in particular, AI big data, these buzzwords have been overly exaggerated. To NetEase, we invest significantly into AI, big data and all these new trend of technologies, but ultimately, we believe these technologies are best reflected out of the products, the user experience of the product to give some concrete example for instance our Youdao Dictionary. We have been adopting the AI technology into this product and it can now utilize this app for audio verbal translation as well as translating the contents, when you take a photo for instance. In this regard, we think we are very advanced.

And another example using our cloud music for instance, we've also been embedding AI technology into our daily push. So this is our belief, we think instead of over exaggerating AI as a mysterious science, our approach is that we take this very modern technology, embed them into the products and the users eventually will feel the difference, but they don't necessarily needs to recognize the codes, the science behind it. What they get is the product experience they ultimately have, and it represents an elevated and enhanced user experience.

Operator

Next we'll move to Han Joon Kim with Deutsche Bank.

Han Joon Kim, Analyst

Great. Thank you for taking my questions. I have to two. One is on Wilderness versus Terminator II. Now, I think they're similar games, but what do you think we're seeing better kind of responses from one over the other, apart from the IP? If you could just give us some qualitative color on that, that will be great. And then the second one is on Minecraft KPI. If you can just give us a little bit more on DAU or time spent or any other metrics apart from registration, that will be helpful. Thank you.

Zhaoxuan Yang, Chief Financial Officer

Okay. Let me translate for the management.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So to answer your first question, while the Terminator II, yes, broadly speaking, they fall into the same genre, the same category. And that there are very subtle differences in terms of user experience on the technology perspective, both games are our self developed and we utilize two different self-proprietary engines for these games and they bring different subtle, but they bring different experience catering to different user demands. So in terms of the data, we see that the user profiles of playing these two games are actually quite different.

(Foreign Language)

For Minecraft, as you all know, this is at a relatively early stage and we are starting early monetization after -- in recent months as well as in early 2018. So at this stage, other than the accumulated users, we don't plan to disclose any other additional KPIs, but again, to reiterate, we have full confidence in this game in the longer run.

Operator

And next, we'll move to Fan Liu with Goldman Sachs.

Sef Chin, Analyst

Hi management, this is Sef asking on behalf of Fan. Thank you for taking my question. I've two questions. The first question is on e-commerce. So given the rising revenue contribution, perhaps when could we expect maybe a separate disclosure of the segment on a quarterly basis? And then the second question is on whether management could shed some color on the game performance of Blizzard?

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

So for the first question, let me answer you. We are actively exploring the possibility of separating out our e-commerce. We are actively discussing that amongst our auditors, counselors et cetera and we hope to materialize that as early as next quarter.

For the second question, I'll -- let me defer to the management.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Okay, so with respect to Blizzard, they are a very close business partner with us, a couple of key titles that we licensed from Blizzard are performing well in China, and we expect to further deepen our strategic relationship with Blizzard. With Starcraft II, we are in the efforts to make it a free to play mode. So overall, because of this close partnership with

Blizzard, we are actually keeping a very active dialog to collectively bring the best product experience and user experience to the Chinese gamers.

Operator

We'll move to Marcus Yang with Macquarie.

Marcus Yang, Analyst

Thanks for taking my question management. I've got two questions. First of all, regarding the survival genre games, can you share the rationale behind the popularity of this genre, mainly in your view? Well, which I guess, one of them could be the social community element. And do you think that factor will continue for the upcoming potential new hit genres or anything that you can share, I mean, regarding the key elements for the next potential genres? And my second question is regarding -- how's the regulation issues being fixed here? And regarding the survival game genre also from your perspective, is this a winner take all genre or market? And that is my question.

(Foreign Language)

William Ding, Chief Executive Officer

(Foreign Language)

Zhaoxuan Yang, Chief Financial Officer

Okay, so first of all, I would like to correct the concept. This genre, we don't, we don't agree to call this genre as a survival type of games. To us, this broadly falls in to a sandbox category and one important element of the sandbox category is that you enjoy the total freedom every time you enter into the game, you have the total freedom to experience the game with endless possibilities. This is the same for Minecraft for instance and same for our Wilderness and Terminator II. We don't encourage anyone to view this game as, so to speak, a survival type of game. So that's something we would like to elaborate here.

Operator

And due to time constraints, there are no further questions. I'll turn the call back over to management for any closing or additional remarks.

Brandi Piacente, President

Thank you once again for joining us today. If you have any further questions, please contact Juliet Yang, NetEase's Senior IR Manager based in Huangzhou, at ir@service.netease.com or TPG Investor Relations. Thank you.

Operator

And everyone, that does conclude our conference call for today. Thank you all for your participation. You may now disconnect.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2017-08-09
Event Description: Q2 2017 Earnings Call

Market Cap: 37,310.43
Current PX: 284.25
YTD Change($): +68.91
YTD Change(%): +32.001

Bloomberg Estimates - EPS
Current Quarter: 24.435
Current Year: 110.305
Bloomberg Estimates - Sales
Current Quarter: 12907.643
Current Year: 54055.469

Q2 2017 Earnings Call

Company Participants

- Brandi Piacente
- William Ding
- Zhaoxuan Yang

Other Participants

- Alicia Yap
- Eddie Leung
- Jia Long Shi
- Natalie Wu
- Karen Chan
- Hanjoon Kim
- Angela Xu

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the NetEase Second Quarter 2017 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ms. Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente

Thank you, Operator. Please note, the discussion today will contain forward-looking statements relating to future performance of the company, and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of a non-GAAP financial measure and a reconciliation of GAAP to non-GAAP financial results, please see the company's 2017 second quarter financial results release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Charles Yang, Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

William Ding

Thank you, Brandi. And thank you everyone for participating in today's call. I would like to start by saying that I'm very, very excited to join NetEase. For the past decade, my career has been dedicated to corporate finance and investment banking with a focus on China's TMT sector. Like many of you, I have followed NetEase for some time, both personally and professionally and it is a great honor to join a great company and becoming a part of this reputable management team.

Before we begin, I would like to remind everyone that all percentages are based on renminbi. With that said, I'm pleased to deliver opening remarks on William's behalf. Providing people with outstanding services and product is the heart of our business. With each piece of new content that we introduce, we are keeping our community connected and engaged, and our business is thriving.

During the second quarter, our net revenues grew almost 50% compared with the same period last year. Our net revenue for our online game services grew 46.5% year-over-year, led by our self-developed mobile games. These remain our primary growth engine, accounting for 72.4% of our online game services net revenue in the second quarter.

Looking at our game portfolio, the popularity of many legacy titles continues to be strong. During the second quarter, our PC client game, Fantasy Westward Journey Online, and mobile game Invincible reached record high quarterly revenues. We also saw positive momentum from Fantasy Westward Journey and Westward Journey mobile games, as well as mobile version of New Ghost. In addition to new content for our Legacy titles, we launched a number of new mobile games to enthusiastic audiences during the second quarter including Land of Glory and Treasure Hunter, both of which were very well received.

In mid-July, we also brought Crusaders of Light to the U.S.: that's the international version of Land of Glory, and we are pleased with the initial reception. While we saw some pullbacks from Onmyoji, this is within the management expectation, given the title's huge success with players since its launch late last year. We see this as part of a natural ebb and flow while our players still crave for new content. The latest content update, [ph] Fireworks Festival (4:48) was well received once released at the end of July. We plan to frequently launch high quality content update to meet players' growing appetite. Additionally, to leverage its strong IP, we've launched a media strategy to expand the brand influences, and Onmyoji continues to increase in popularity among players internationally.

During the second quarter, Onmyoji reached record high downloads in Japan and Southeast Asia. We are continuing to expand its reach and plan to bring this popular mobile RPG to players in Korea, Canada, Europe, and the U.S. later this year. Onmyoji has already reached high – record high pre-registration levels with our licensing partner in Korea and the release on Facebook's Gameroom platform is further fortifying this game's overseas presence. While we bring our community new exciting content and games, we are simultaneously exploring creative market segments where we see complementary growth opportunity. Producing games for additional platforms and adding new game play capabilities such as VR and AR enables us to leverage our strong and innovative R&D competencies and employ our pioneering spirit.

At the end of the second quarter, we released Twilight Spirits, our first title for the Steam platform. Initial feedback has been positive and we will look for other opportunities where we can expand our reach. We also continue to invest in VR and AR related projects and are exploring investment opportunities in both hardware manufacturers and content developers.

Our mobile portfolio currently stands as one of the most robust in China. We intend on growing this business with current plans to introduce new titles and content that support our position. We have an exciting pipeline of upcoming games for the third quarter. We have already released a handful of titles and on July 21, we began closed beta testing for PC-client game, Open Range.

We are also moving forward with the highly anticipated sandbox game Minecraft. We initiated open beta testing for the PC version on August 8, and plan to roll out our initial beta testing for Minecraft mobile version soon.

Our primary focus during this initial stage will be to attract users and development partners. Other new coming – upcoming games include Index and Forever 7, two exciting Japanese-themed RPGs and a stunning 3D PC-client game, Conqueror's Blade, which was formally known as War Rage. In addition to our leading position in China's online games market, we are expanding our global footprint as we see ample opportunity to grow our brand and bring more of our games to overseas market.

Now, turning to our other business segments. Our net revenues from advertising services increased by 12.1%, compared to the same period last year, supported by our award winning NetEase News App. Automobile, internet services and real estate services segment were the top performing verticals.

Mobile advertising continues to rise as the preferred means of advertising, which bodes well for us as we hold considerable mobile reach with our users. Our e-mail, e-commerce and others business segment also increased in the second quarter, growing by 68.9%, compared to the same period last year. E-commerce in particular is becoming a increasingly important revenue contributor. Kaola and Yanxuan are flourishing among the market [ph] ride (9:28) for high quality products and both of them did quite well during the June 18 sales event.

We continue to invest in our future development. We are introducing exciting new games and services that continue to strengthen and diversify our portfolio, support our ability to broaden our reach within our expanding community worldwide and continue to grow each of our business lines.

This concludes William's comments.

Zhaoxuan Yang

I will now provide a review of our second quarter 2017 financial results. As in past quarters, the discussion we are primarily focused are margins, expense fluctuations, and net profit. Our gross margin for the second quarter was RMB 6.7 billion or $993.7 million, compared with RMB 7.5 billion and RMB 5.3 billion for the preceding quarter and the second quarter of 2016 respectively.

The year-over-year increase in online game gross profit was primarily driven by increased revenue contribution from mobile games such as Onmyoji and the mobile version of New Ghost. The quarter-over-quarter decrease in online game gross profit was primarily due to decreased revenue contribution from mobile games.

The year-over-year increase in advertising services gross profit was primarily due to our enhanced monetization assets. The quarter-over-quarter increase in advertising services gross profit was primarily due to seasonality.

The year-over-year decrease in e-mail, e-commerce and others gross profit was primarily due to decreased revenue contribution from certain e-commerce businesses with relatively higher gross profit margins. Gross profit margin for our online game business for the second quarter of 2017 was 63.1%. This compares with 63.9% and 66.2% for the preceding quarter and the second quarter of 2016 respectively.

The year-over-year decrease in gross profit margin was mainly due to increased revenue contribution from mobile games, which have relatively lower gross profit margins as a percentage of our total online game services net revenues. Gross profit margin for our advertising services business for the second quarter of 2017 was 67.6%. This compares with 57.3% and 65.5% for the preceding quarter and the second quarter of 2016, respectively. The year-over-year increase in gross profit margin was mainly due to our enhanced monetization assets. The quarter-over-quarter increase in gross profit margin was mainly due to seasonality.

Gross profit margin for our e-mail, e-commerce and others businesses for the second quarter of 2017 was 11.3%. This compares with 14.8% and 33.8% for the preceding quarter and the second quarter of 2016 respectively. The year-over-year and quarter-over-quarter changes in gross profit margin were primarily attributable to changes in our e-commerce business mix.

Total operating expenses for the second quarter of 2017 were RMB 3.3 billion or $491.4 million, compared with RMB 2.7 billion and RMB 2.2 billion for the preceding quarter and the second quarter of 2016, respectively. The year-over-year and quarter-over-quarter increases in operating expenses were mainly due to higher staff-related costs resulting from a increase in head count and average compensation, increased selling and marketing expenses mainly related to online games, and increased operating expenses related to our e-commerce businesses.

For the second quarter of 2017, we incurred a net income tax charge of RMB 703.5 million or $103.8 million. This compares with RMB 943.0 million and RMB 262.7 million for the preceding quarter and the second quarter of 2016, respectively. The effective tax rate for the second quarter of 2017 was 19.0%, compared with 19.0% and 8.6% for the preceding quarter and the second quarter of 2016, respectively. The year-over-year increase in the effective tax rate was mainly due to the fact that certain of our subsidiaries were recognized in Key Software Enterprises in the second quarter of 2016 and subject to a preferential tax rate of 10% for 2015, and we recognized related tax credits in the second quarter of 2016. The effective tax rate represents our estimates as to the tax obligations and benefits applicable to us in each quarter.

Net income attributable to the company's shareholders for the second quarter of 2017 was RMB 3.0 billion or $438.4 million. This compares with RMB 3.9 billion and RMB 2.7 billion for the preceding quarter and the second quarter of 2016 respectively.

Non-GAAP net income attributable to the company's shareholders for the second quarter of 2017 was RMB 3.5 billion or $512.2 million. This compares with RMB 4.3 billion and RMB 3.2 billion for the preceding quarter and the second quarter of 2016, respectively.

During the quarter, we had a net foreign exchange loss of RMB 131.3 million or $19.4 million. This compares with a net foreign exchange loss of RMB 48.5 million and a net foreign exchange gain of RMB 77.3 million for the preceding quarter and the second quarter of 2016 respectively. The year-over-year and quarter-over-quarter changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our U.S. dollar denominated bank deposits and short-term loan balances, as exchange rate of the U.S. dollar against the renminbi fluctuated over the period.

Our basic and diluted earnings per ADS were $3.33 and $3.31, respectively for the second quarter of 2017. This compares with basic and diluted earnings per ADS of $4.40 and $4.36 respectively for the preceding quarter and basic and diluted earnings per ADS of $3.06 and $3.04 respectively for the second quarter of 2016.

Our non-GAAP basic and diluted earnings per ADS were $3.89 and $3.86 respectively for the second quarter of 2017. This compares with non-GAAP basic and diluted earnings per ADS of $4.86 and $4.82 respectively in the preceding quarter, and non-GAAP basic and diluted earnings per ADS of $3.62 and $3.60 respectively for the second quarter of 2016.

As of June 30, 2017, our total cash and cash equivalents, current and non-current time deposits and short-term investments balance totaled RMB 41.2 billion or $6.1 billion compared with RMB 36.9 billion as of December 31, 2016.

Cash flow generated from operating activities was RMB 2.3 billion or $342.4 million for the second quarter of 2017, compared to RMB 4.0 billion and RMB 3.3 billion for the preceding quarter and the second quarter of 2016, respectively.

As part of our commitment to return value to our shareholders, our Board of Directors approved a dividend of $0.83 per ADS for second quarter of 2017, which is expected to be paid on September 1, 2017 to shareholders of record as of the close of business on August 25, 2017. Additionally, under our share repurchase program announced on November 15, 2016, we had repurchased approximately 366,000 ADSs for approximately $100.3 million by the end of the second quarter, 2017.

Thank you for your attention. We would like now to open the call to your question. Operator, please go ahead.

Q&A

Operator

Thank you, sir. [Operator Instructions] And we'll take our first question from Alicia Yap with Citi.

<Q - Alicia Yap>: Hi, good morning, William and Charles. Thanks for taking my questions. Congratulations to Charles on your new role. I have two questions. The first one is related to your sales and marketing expense line. So the...

<A>: [indiscernible] (21:41)

<Q - Alicia Yap>: ...spending grew quite a – hello? Yeah. Can you hear me?

<A>: Yeah.

<Q - Alicia Yap>: Okay.

<A>: Yeah. Yeah.

<Q - Alicia Yap>: Yeah. So my – my first question is related to the sales and marketing expense. So – because the line actually grew quite a bit on the sequential and year-over-year basis and from your prepared remark seems to indicate that increased spending is more related to game promotions. So wanted to know, is that mainly related to overseas Onmyoji promotion?

And I recall, in the past, management actually has a disciplined approach in spending the sales promotion and tend not to allocate for example more than 10% of specific games' revenue on marketing. Has that target actually changed? And then, were you able to receive the effective promotional traction with this step-up spending during the quarter? How should we think about the spend for the second half this year?

Then second questions is, for your new games, can you share [indiscernible] (22:48) expectations for the Forever 7 and Index? Will that be more similar to Onmyoji, and how should that be different versus other existing Japanese game in the market? Thank you.

<A - Zhaoxuan Yang>: Okay. Okay, let me translate the questions. The second questions – the first question, I will answer that and then the second question I will translate for the management to answer. So Alicia, the first question on the sales and marketing expense, number one, the 10% you mentioned the target. The target remains pretty much unchanged. For the second quarter of 2017, the sales and marketing expense increase is mainly a combination of continued spending on games, as well as some of the sales and marketing related promotion expenses on our e-commerce businesses, which are again largely in line with the management's budget and expectation.

And going forward, we are going to be still remain disciplined by our target, and we do we see that sales and marketing expenses will continue to grow on a dollar basis, but overall that principle and discipline would remain unchanged.

So for the second question, let me quickly translate for the management.

[Foreign Language] (24:24 – 24:54)

Okay. So, for these two games, they are Japanese-themed RPGs, our expectation is that this will further broaden our game portfolios and targeted to the ACG generation for these two mobile games.

<Q - Alicia Yap>: Okay. Thank you management.

<A - Zhaoxuan Yang>: Yeah. And these – by the way, these two games, we are now targeting for a launch by end of this year.

<Q - Alicia Yap>: Okay. Great. Thank you.

Operator

We'll take our next question from Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Hey. Good morning, guys. Thank you for taking my questions. Quickly on two things. We note Minecraft has been just launched. So wondering if there is any user feedback and indications of the user engagement. And then secondly, about the e-commerce business, we notice that the gross margin is coming down because of – in the press release about the mix shift within the e-commerce business. So wondering if you could clarify a little bit on what's the mix shift within the e-commerce business? Thanks.

<A - Zhaoxuan Yang>: Okay. I will translate the first question first.

[Foreign Language] [26:31 – 27:00]

<A - Zhaoxuan Yang>: Okay. So for Minecraft – Eddie, for your first question, Minecraft, the preliminary feedback from the PC version is positive and within the management expectation and we are happy to see that and we continue to plan to launch the mobile version in Q3 of this year. Your second question is asking for the gross profit margin shift for the e-mail, e-commerce, and other business segments, right, Eddie?

<Q - Eddie Leung>: Yes, [indiscernible] (27:35).

<A - Zhaoxuan Yang>: Yeah. The GP margin change is mainly a reflection of the product mix change. As you know that the contribution from Yanxuan and Kaola continued to increase in that segment, so naturally it brings down the margin given the product – the mix shift.

Going forward, the management is contemplating for potentially more disclosure on the e-commerce so that analysts, audience and shareholders will gain more information on the performance of our e-commerce segment.

<Q - Eddie Leung>: Understood. That would be great. Thank you very much.

<A - Zhaoxuan Yang>: Thank you, Eddie.

Operator

And we will take our next question from Jia Long Shi with Nomura Securities.

<Q - Jia Long Shi>: Hi, good morning William, Charles and [indiscernible] (28:36). Thanks for taking my question. I have two question here. Firstly, I heard management mention in the prepared remarks, you will continue to invest in VR and AR games going forward. So I just wonder if management can provide any colors regarding how long you think it may take before we can see these AR, VR game market to take off. Secondly, about your e-commerce business – and based on my calculation, e-commerce revenue already represent 20% of our total revenue. So I just wonder, at such a scale, is it time for management to consider improving the probability of your e-commerce business or you think it's still too early to consider probability and your focus remains on growing the market share at current stage?

I will translate it into Chinese. [Foreign Language] (29:33 – 33:15)

<A - Zhaoxuan Yang>: So let me speak for the benefits of the audience. Let me quickly translate the answers addressed by William. So first question on the AR/VR games, William commented that AR and VR are slightly different here in China. For VR, he thinks it takes at least another two years or so to be ready in China. Again, it's mainly restricted by the readiness of the equipment and hardware. On that note, NetEase, we've actually started early and we currently do have a VR game, Twilight Pioneers that is distributed on the Google Daydream platform. For AR, we see more effort that's been put into game plays. We are yet to see a mature and successful AR game in the market. More of deploying AR as part of a game play. So, we will be excited to see the development on the AR side.

Second question on the e-commerce, the balance between growth and profitability: as you all know, we have Kaola which is mainly focused on cross-border e-commerce, and Yanxuan, that is our private label e-commerce platform. And at this stage, our focus is still mainly to grow the growth and market share. We want these two platforms and our services and products to cover more families and users. In China, we see a huge upside of consumers demanding for reliable high-quality goods and valuable goods. So, profitability is not a near-term focus. Having said that, we will not undermine the profitability by doing subsidies and all other activities.

Operator

We'll take our next question from Chi Tsang with HSBC.

<Q>: Hi, management. This is [ph] Weng Wang (35:37) speaking on behalf of Chi. So I have a question regarding to Yanxuan. So I have noticed that Yanxuan recently opened their first hotel in Hangzhou. Does management has any expectation on this new hotel, and is this a kind of like strategic role played by Yanxuan Hotel, and will Yanxuan do more initiative in new hotel going forward?

[Foreign Language] (36:05 – 37:46)

<A - Zhaoxuan Yang>: Okay. So for the question on the hotel, so first of all, William would like to clarify that NetEase, we actually do not own or operate any hotels in Hangzhou. The news mentioned about the hotel, that is a business collaboration between Yanxuan and Atour Hotel, and we – again, we don't own or operate that hotel. We have 10 rooms and a lobby in that hotel that we decorate and design with the products from our Yanxuan platform.

So we view this as more of an offline marketing promotion event because we want to give the users or the guest of the hotel a first-hand experience and exposure to the Yanxuan products and they can feel and they can see how the Yanxuan products can help lift up the experience of a [ph] home-stay (38:48). So that's the intention of our collaboration with this Atour Hotel.

<Q>: Thank you very much.

Operator

And we'll take our next question from Natalie Wu with China International Capital Corporation.

<Q - Natalie Wu>: Hi, good morning, William, Charles, and Juliet. Thanks for taking my question. So two questions here. The first one is, what's the licensed games revenue contribution this quarter, and what do you expect that will be listed on future license game pipeline that would possibly have a impact on the license game revenue contribution. And also, can you touch a little bit on the future overseas expansion plan? Second question is that you've – for William. You mentioned that, about the five-year target for your Kaola e-commerce business, earlier, like 2016 in some media reports to grow Kaola's GMP to RMB 100 billion. So, just wondering if the target still holds. Thank you.

[Foreign Language] (40:07 – 40:54)

<A>: [Foreign Language] (41:02 – 43:30)

<A - Zhaoxuan Yang>: Okay. So let me quickly translate William's comment. First, on the games, we – obviously we are continuing our effort for the collaborative games. And the most anticipated title is Minecraft, and we have high expectations of Minecraft into the future. And for the overseas game expansion plan, again, NetEase puts in many effort in actively exploring foreign titles, bring that into China, as well as good opportunities of internationalization of [ph] value-owned (44:14) IPs.

Second question on Kaola, so as you all know, the policies and regulations shifted a little bit in China last year, April, the policy on the tariff rate, as well as some annual spending caps on individual consumers on cross-border e-commerce purchase. But having said that, we think cross-border e-commerce has huge potential – growth potential going into the future. As you all know, a lot of Chinese tourists, when they travel abroad, their spending can reach $1.6 trillion last year and that's physical spending overseas, and that just represents a fraction of the cross-border e-commerce opportunity. And for Kaola, we are very happy and proud that it is now the number one cross-border e-commerce platform in China, and we are in a leading position in terms of the [ph] G&Bs (45:25) and revenues generated on our Kaola platform.

<Q - Natalie Wu>: Olay. Very helpful. Thank you, William, and thank you, Charles.

Operator

We'll take our next question from Karen Chan with Jefferies.

<Q - Karen Chan>: Thank you, William, Charles, and Juliet for taking my questions. So, two question here. First question is, we saw some pretty good encouraging performance coming out of Onmyoji launch recently in South Korea. Just wondering if management has a target on overseas revenue contribution to mobile game? And secondly, just want to get your thoughts on any M&A plan strategy in the mobile gaming business? Thank you.

<A - Zhaoxuan Yang>: Okay. Let me quickly translate the questions. [Foreign Language] (46:11 – 47:09)

<A - Zhaoxuan Yang>: So, let me translate the first question. Onmyoji, in Korea, we see good – great feedbacks and it was ranked number seven in terms of growth and number one in terms of the number of downloads. We are happy about the results and we will continue other internationalization plan for this game.

<A>: [Foreign Language] (47:45 – 48:02)

<A - Zhaoxuan Yang>: For M&A, William's comment is that, again NetEase, we are always very open-minded. We are actively exploring potential opportunities, but at this stage, we do have anything that we would need to disclose or comment.

<Q - Karen Chan>: Thank you very much.

Operator

We'll take our next question from Hanjoon Kim with Deutsche Bank.

<Q - Hanjoon Kim>: Great. Thank you very much for the opportunity to ask questions. I have two as well. The first one is just your overall impressions as you continue to do overseas expansion. So you've launched a few games into the U.S., Onmyoji into Japan, you've had your trial with [indiscernible] (48:51) in Korea and so forth. What do you guys feel like you need to do more of or less of? I mean, it could be ranging from more R&D – having more R&D overseas, could be just having to do more marketing or so forth. Just kind of want to get your overall impressions, as I feel like this is still an evolutionary process.

And then the second question is just on the relative volatility that we're seeing for Westward Journey mobile relative to FWJ and Ghost as far as the third quarter is concerned. So, within the iOS ranking, it seems to be showing a little bit more volatility than the others. Do you think there is a particular reason for that? Is it just kind of the receptivity to the latest content update and just kind of more seasonal? Thank you.

<A - Zhaoxuan Yang>: Okay. Let me translate these two questions for the management.

[Foreign Language] (49:46 – 51:45)

So, let me translate the answers. First question on the overseas overall plan strategies. So we currently have our R&D offices in Korea and in the States, and we will continue to invest into resources overseas. And in terms of our games, we prioritize the market that may have higher receptivity of our contents and products. For the near-term, we are focusing on Japan, Korea and Southeast Asia. In addition, we are also developing games and contents that's more tailored for North America and European markets. For instance, Crusade of Light, the U.S. version of Land of Glory was successfully launched into the U.S. market.

On your second question, on the volatility around Westward Journey. So as you know, Westward Journey and Fantasy Westward, both are MML, RPG games. They have been up and running for over a decade and was actually very, very encouraging to see that legacy titles like these with such a long operating history are still growing and their short-term volatility performance, that's very well within the management's operational expectation.

<Q - Hanjoon Kim>: That is it. Thank you very much.

Operator

We will take our next question from Angela Xu with UBS.

<Q - Angela Xu>: Hi. Good morning, gentlemen. I have two questions. One is on the e-commerce margin – [ph] so, I will ask (53:35) questions on the e-commerce margin. So other than the product mix shift, so – but how is margin trends of Kaola and Yanxuan respectively over the last quarters and also the future trend. And also, when can we expect Kaola to breakeven? And the second one is on the international expansion. So I'm just wondering how is the margin profile of international business compared to domestic business? Thank you.

<A - Zhaoxuan Yang>: Sorry, just to clarify your second question. Your second question is asking for international expansion for games, for the...

<Q - Angela Xu>: Yeah. Yeah, for games, yeah, correct.

<A - Zhaoxuan Yang>: For games, okay. Let me answer the first question first and then I will translate the second question for the management. For Yanxuan and Kaola, the margins are relatively stable and as we continue to grow our scale, we do see the skill factor will benefit us. And on your – on the breakeven point for Koala, as Mr. William Ding mentioned previously, our near-term focus is still mainly to grow the market share and the user base growth and we – the margin or breakeven profitability is not our near-term focus and that will naturally come as we reach a critical mass in terms of scale.

And the second question I will translate. [Foreign Language] (55:12 – 55:22)

<A>: [Foreign Language] (55:25 – 56:15)

<A - Zhaoxuan Yang>: So for your second question, in terms of the margin impact from our overseas games, so it really depends on the type of how we distribute our games overseas. Just for instance, in Korea, when – Onmyoji's distribution is through local partnership with a Korean distributor, then in – under this mode, this will not affect our margins generally speaking. But in other countries, for instance Japan, when we launched Onmyoji, was operated by ourselves and we do see some impact in terms of overall margins because we need to spend on the marketing and promotion assets, as well as the user acquisition profile in overseas market might be different from the Chinese market, again depending on the target market.

<Q - Angela Xu>: Okay. [indiscernible] (57:18). Thank you.

Operator

And ladies and gentleman, that is all the time we have tonight for questions. So at this time, I'd like to turn the call back over to management for closing remarks.

Brandi Piacente

Thanks again everyone for joining us. If you have any further questions, feel free to contact Juliet Yang, NetEase's Senior IR Manager in Hangzhou or The Piacente Group, Investor Relations. Have a great day.

Operator

This does conclude today's conference. We appreciate your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2017-05-10
Event Description: Q1 2017 Earnings Call

Market Cap: 36,327.29
Current PX: 276.76
YTD Change($): +61.42
YTD Change(%): +28.522

Bloomberg Estimates - EPS
Current Quarter: 27.289
Current Year: 111.267
Bloomberg Estimates - Sales
Current Quarter: 12446.400
Current Year: 52292.115

Q1 2017 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Fan Liu
- Alicia Yap
- Natalie Wu
- Tian X. Hou
- Jia Long Shi
- Eddie Leung
- Hillman Chan

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the NetEase First Quarter 2017 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company, and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause the actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update these forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the first quarter 2017 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on the corporate NetEase website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. I would like to start by providing opening remarks on behalf of William. As a reminder, all percentages are based on renminbi.

2017 is off to a strong start, and our ability to successfully develop and distribute innovative content continues to be the cornerstone for our growth. Mobile has taken hold as the dominant force in the online community and we are actively cultivating our mobile reach across our business to extend the NetEase brand to users not only in China, but around the world.

During the first quarter, we advanced a number of strategic initiatives in each of our core divisions, increasing our total net revenues by approximately 72.3% year-over-year and 12.7% quarter-over-quarter. Specifically, we introduced multiple new mobile games and added new expansion pack to our popular PC-client games. We also enhanced our monetization capabilities for our advertising services and expanded our e-commerce business.

Led by our self-developed mobile games, the year-over-year increase of net revenues from our online game services was 78.5%. Net revenues from our advertising services and e-mail, e-commerce and other segment were also up by 13.2% and 53.2%, respectively, all compared to the same period last year.

Our mobile games continue to make greater contributions to our online games revenues. In the first quarter, mobile games accounted for approximately 73% of our total online games net revenues, up from about 64% in the preceding quarter as well as the first quarter of 2016.

We released a number of new mobile titles in the first quarter including well-received games such as Demon Seals mobile; Westward Journey: Rage; and Land of Glory, an epic 3D Westward Fantasy real-time MMORPG. Hit titles, like Onmyoji, continue to gain popularity with multiple content updates throughout the first quarter. And on February 20, 2017 it achieved 200 million global downloads.

Other legacy mobile titles including Fantasy Westward Journey and Westward Journey Online mobile games, Invincible, Heroes of Tang Dynasty mobile, and the mobile versions of New Ghost as well as the PC-client game such as New Ghost and Fantasy Westward Journey Online also maintain good user attractions during the period.

We are also pleased to be expanding our global presence where NetEase operated games are being widely embraced. In February, we released Onmyoji in Japan following its Southeast Asia release late last year. And we plan to continue our global rollouts of this game this year with Korea, Canada, Europe and U.S. as the next destinations. We have similar international aspirations with other self-developed games such as Land of Glory.

Popular games that we operate in China are also enriching the domestic online games market. In particular, the closed beta testing for Minecraft PC versions launch in April is progressing well, and we are on track with the official launch planned for later this year. Additionally, for the first quarter, Blizzard Entertainment's Hearthstone achieved record number of quarterly active users, and players have logged into the game's newest expansion pack, Journey to Un'Goro, launched last month.

Essential theme to our game strategy is to explore where is market segments while simultaneously attracting users to our legacy titles. We have a rich pipeline lineup for 2017 with a number of mobile games under development to strengthen and diversify our portfolio that includes more than 100 titles.

In April, we released several new mobile titles to positive user feedback including Treasure Hunter, a cartoon-style TPS game or third-party shooting game. We plan to reveal more detailed pipeline informations for the rest of the year at the NetEase Game Annual Press Conference on May 20, 2017 in Guangzhou.

With our PC-client games, we launched new expansion packs for New Ghost and Kung Fu Master II recently, and plan to introduce new expansion packs for several popular games in the coming months including Tianxia III, Heroes of Tang Dynasty Zero, Demon Seals, Revelation and New Westward Journey Online II. The advertizing and e-commerce markets are also core components of our growth.

During the first quarter, the automobile, real estate and telecommunication services centers were our top performing verticals, with our year-over-year gains driven by strong growth in mobile, media supported by our top-ranked mobile news app. Additionally, both Kaola.com and Yanxuan are thriving with promising growth trajectories.

Our focus remains on creating premium content for and enriching the imaginations of our massive community in online games, media and e-commerce. It is these ideas and strategies that support our ability to maintain our commitments to our shareholders, increased our profits and expanded our company across each of our business lines.

This concludes William's comments. I will now provide a review of our first quarter 2017 financial results, and primarily focus on margins, expense fluctuations and net profit.

Our gross profit for the first quarter was RMB 7.5 billion or $1.1 billion compared to RMB 6.5 billion and RMB 4.6 billion for the preceding quarter and first quarters 2016, respectively.

The year-over-year increase in online games gross profit was primarily driven by revenue contributions from mobile games such as Onmyoji to mobile versions of New Ghost and Demon Seals mobile, as well as Blizzard Entertainment's Overwatch and World of Warcraft.

The quarter-over-quarter increase in online games gross profit was primarily driven by revenue contributions from mobile games such as Onmyoji, the mobile version of New Ghost and Demon Seals mobile. Quarter-over-quarter, we saw a decrease in advertising services gross profit, which was primarily due to seasonality.

The year-over-year increase in e-mail, e-commerce and others gross profit was primarily due to increased revenue contributions from certain e-commerce businesses as Kaola.com. The quarter-over-quarter decrease was primarily due to lower revenue contributions from certain e-commerce businesses with relatively higher gross profit margin.

First quarter gross profit margins for online games was 63.9%, compared to 60.7% and 67.1% for the preceding quarter and the first quarter of 2016, respectively. The year-over-year decrease in gross profit margin was mainly due to increased revenue contributions from mobile games, which have relatively lower gross profit margins, as a percentage of our total online games net revenues.

The quarter-over-quarter increase was mainly due to decreased revenue contributions from licensed games, which have relatively lower gross profit margins and the one-off recognitions of certain royalty expenses related to licensed games in the fourth quarter of 2016, and partially offset by the increase of revenue contributions from mobile games in the current quarter.

First quarter gross profit margins both the advertising services business was 57.3%, compared to 66.5% and 62.4% for the preceding quarter and the first quarter of 2016, respectively. The year-over-year decrease in gross profit margin was mainly due to higher staff-related and content purchase costs and the quarter-over-quarter decrease was mainly due to seasonality.

First quarter gross profit margins for e-mail, e-commerce and others was 14.8%, compared to 23.4% and 20.4% for the preceding quarter and the first quarter 2016, respectively. The year-over-year and quarter-over-quarter decreases were primarily attributable to decrease of revenue contributions from certain e-commerce businesses with relatively higher gross profit margin.

Total operating expenses for the first quarter were RMB 2.7 billion or $394 million, compared to RMB 2.6 billion and RMB 1.7 billion for the preceding quarter and the first quarter 2016, respectively.

The year-over-year increase was mainly due to higher sale and marketing expenses related to online games, higher R&D investments and higher staff-related course, as well, as operating expenses related to Kaola.com. The quarter-over-quarter increase was mainly due to higher staff-related cost.

During the first quarter, we recorded a net income tax charge of RMB 943 million or $137 million, compared to RMB 882 million and RMB 530.7 million for the preceding quarter and the first quarter 2016, respectively. The effective tax rate for the first quarter was 19%, compared to 19.2% and 17.5% for the preceding quarter and the first quarter 2016, respectively. The change in effective tax rates represents our estimates for the first quarter 2017.

Net income attributable to the company's shareholders for the first quarter totaled RMB 3.9 billion or $569.9 million, compared to RMB 3.7 billion and RMB 2.5 billion for the preceding quarter and the first quarter 2016, respectively. Non-GAAP net income attributable to the company's shareholders for the first quarter totaled RMB 4.3 billion or $630 million, compared to RMB 4 billion and RMB 2.7 billion for the preceding quarter and the first quarter 2016, respectively.

During the quarter, we had a net foreign exchange loss of RMB 48.5 million or $7 million, compared to a net foreign exchange gain of RMB 90.5 million and a net foreign exchange loss of RMB 36 million for the preceding quarter and the first quarter of 2016, respectively.

Our first quarter basic and diluted earnings per ADS were $4.33 and $4.29, respectively. This compares to basic and diluted earnings per ADS of $4.08 and $4.04, respectively, for the preceding quarter and basic and diluted earnings per ADS of $2.72 and $2.7, respectively for the first quarter 2016.

Our first quarter non-GAAP basic and diluted earnings per ADS were $4.79 and $4.75 respectively. This compares to non-GAAP basic and diluted earnings per ADS of $4.38 and $4.34 respectively in the preceding quarter, and non-GAAP basic and diluted earnings per ADS of $2.94 and $2.92 respectively for the first quarter 2016.

As of March 31, 2017 our total cash and cash equivalents, current and non-current time deposits and short-term investment balance total RMB 40.6 billion or $5.9 billion, compared to RMB 36.9 billion as of December 31, 2016. Cash flow generated from operating activities was RMB 4 billion or $585.7 million for the first quarter 2017, compared to RMB 5.4 billion and RMB 3.1 billion for the preceding quarter and the first quarter 2016 respectively.

As part of our commitments to return values to our shareholders, our board of directors approved a dividend of $1.08 per ADS for the first quarters of 2017, which is expected to be paid on June 2, 2017 to shareholders of record as of the close of business on May 26, 2017.

On November 15, 2016 the company announced that its board of directors approved a share repurchase program of up to $1 billion of the company's outstanding ADS for a period not to exceed 12 months. As of March 31, 2017, the company have repurchased approximately 83,000 ADS or approximately $23.7 million under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

[Operator Instructions] And our first question comes from Fan Liu with Goldman Sachs.

<Q - Fan Liu>: Hi, management. Thanks for taking my questions. So, your deferred revenues this quarter has declined by 8% quarter-on-quarter, would you mind to guide the reason behind that? And also do you mind to share with us what's your company's strategy to prolong the life longevity of the existing titles this year and what's your plan of the new product pipeline in the second half?

And also, do you want to guide with us, what's the revenue contribution from Kaola and Yanxuan this quarter? And also, any color on the margin profile will be also appreciated. Thank you.

<A - William Ding>: [Foreign Language] (17:40-18:44)

<A - Onward Choi>: Okay. So, basically, with regards to your questions about how the company plans to maintain the longevities of the game products in place are the strategies that we are adopting. Basically, you can make reference to what we have been doing in fact especially on the PC games front for our legacy game titles like the FWJs or WJ2. You will see that we have accumulated quite good experiences, and the knowledge about how to maintain a long life cycles for various game titles that we have operated for long.

And, in a way, you can also observe that, through so many years, we have also been able to upkeep a very stable and perhaps a growing performance for those legacy game titles and a couple of other game titles that we have put in place in the market.

And we would definitely be making good use of those experience that we have accumulated over the years, as well as adopting similar strategies for moving on to our mobile brands. And we believe that those experiences would be very helpful to enabling us to make sure that the same thing would happen on our mobile brands.

And on the other hand, we are also looking upon the fact that NetEase is a company very strong in delivering high quality and premium game products to the marketplace. And we believe that by offering those good quality game products to the marketplace, this can also enhance the overall gaming experiences to our players or the gamers in general.

And so, we believe that this would also be another positive points that we would like to share with you. And on top of that, we have also got a very solid plans to roll out a couple of new quality and premium games to the markets in the future periods.

And so, this basically, would couple what William would like to share with you about how we think about our strategies to ensure the longevities of the game products.

And now, getting back to your questions more on the financial side of the operations. I believe that in the first quarter, and this is obvious, that if you look at the deferred revenues on a Q-on-Q comparisons, there has been this drop of about 8%. And we do believe that this is still a very understandable NPLs and also not a very significant decrease in terms of the deferred revenues. Because if you look back in, especially in the last quarter, because already we got a very high base in the fourth quarter.

And in the first quarter of 2017, this also been a quarter with not too many new games being rolled out. And so, the drop are still quite within our expectations and we are still feeling that all of our game titles are still doing good and most of them are still up, keeping a very stable performance at the same as and when we are rolling out some more new content updates or new expansion pack. We are also expecting that there will be a positive impact that brought about to the overall performances of various other game titles in the marketplace.

And in so far as to your third questions about the revenue contributions of Kaola businesses in our three business segments which is the e-mail, e-commerce and others, we'll start giving you to the exact percentages. I would say that in the first quarter of 2017 our e-commerce related businesses are including both the Kaola and also our Yanxuan already accounts for a very significant portions of our overall revenue contributions in our [ph] first-timers (22:55), mainly the e-mail, e-commerce and others.

Operator

Thank you. [Operator Instructions] And our next question comes from Alicia Yap with Citigroup.

<Q - Alicia Yap>: Hi. Thank you. Good morning, William and Onward. Thanks for taking my questions and congrats on the strong quarter. My question is related to the recent fluctuations of Onmyoji. Is that mainly due to more intensified competition from other new games or is that more related to Onmyoji on operation efforts and what would be the team currently are working on to improve and overturn the fluctuations of the game?

And then, second question is related to Activision recently on their conference call. They note that they thought about 30% year-over-year increase in the item sales for World of Warcraft and Overwatch. Do you see the similar type of growth rate for the China franchise for this game? Any color for that will be appreciated. Thank you.

<A - William Ding>: [Foreign Language] (25:03-26:44)

<A - Onward Choi>: So, basically, first of all with regard to your first question about the Onmyoji's performance lately, definitely we also see kind of some fluctuations in terms of the performance. But after all, we still believe that the game by itself is a very successful mobile games and we have very strong teams and high quality products being rolled-out to the market. And at the same time, we are holding a very confidence will about is our performance going forward because in terms of both the depth and the breadth of the contents that we are offering for this particular games, this is also still very good and we have still lots to offer in the times to come. And so, we believe that this game will still be performing well in the future.

And on the other hand, with regards to how we will avouch the licensed games performances, in particular, to all the games that we have been licensed from Blizzard Entertainment, not only including the World of Warcraft and Overwatch, but also extending to Diablo III and also to Hearthstone and some other games as well.

One of the highlights that we would like to share with you is that in the last week, it happens on [ph] its dominance that (28:02). All those games has also made another record-high performances in terms of the user matrix that has been very encouraging to us. And we are still looking forward that by offerings some very quality products to the market. We still believe that this can also ensure a good business experiences being confirmed upon our players and this can also ensure a long-term performance of the games in the times to come.

Operator

Thank you. Our next question comes from Natalie Wu with CICC.

<Q - Natalie Wu>: Hi. Good morning, William, Onward and Juliet. Thanks for taking my question and congratulations on another solid quarter. And also, thanks, Onward, for the support in the past years and best wishes for you for your future endeavor.

So, my question is about PC game. So, I have noticed that there's some kind of the softness regarding the self-developed PC game last year. So, just wondering if it's an issue to be worried about, because PC game industry seems to be already sophisticated in China and cannibalization is taking place. Or if NetEase is just confident to maintain the healthy development of PC games business, given your solid game operation experience, I just want to hear about management views on that. Thank you.

<A - William Ding>: [Foreign Language] (30:23-31:54)

<A - Onward Choi>: So, with regard to your questions about the company's view on the PC game developments, basically, we do believe that the user experience is being given to the PC games players cannot be fully replaced by just playing the mobile games in some ways. And in particular, especially for our licensed game that we licensed from places like the Overwatch. We have also been offering this game free-to-play to all the users.

And in fact, in the last week, we have also been seeing that the games has also been reaching another record high that has been very encouraging to us. And in a much longer term, in terms of its market potentials, we still believe that the PC game still got these opportunities in the future periods. But of course, if you are talking about how we view about its growth potentials, of course, this wouldn't be able to compare directly with what the mobile games can be offered.

But after all, we always believe that for some outstanding products both in terms of its qualities of the game play, the designs, the contents that we operate and of course how we are giving out the – where a unique user experiences when playing the games to our pocket of users, we believe that this would be the areas that can offer the opportunities to further develop especially in the PC game area. And after all, we always believe that the innovations and the abilities to create some new stuff would be also very crucial to ensure a much longer term success of the company, not only in the PC game fronts but also covering the whole gaming industry.

<A - William Ding>: [Foreign Language] (33:54-34:05)

<A - Onward Choi>: Okay. Another supplements that William would like to add in this year that we would also be planning to roll-out two more new PC games in the market, and in a way, this can also reflecting that we are still looking good upon the potentials about the PC game developments going forward.

Operator

Thank you. We'll take our next question from Tian Hou with T.H. Capital.

<Q - Tian X. Hou>: Hi, Onward and William. I have two questions. The first one is related to your game revenue, like a deferred revenue. Deferred revenue appeared in the balance sheet pretty often, and there are a lot of investors and also I, myself, feel a little bit confused about how you record your game revenue, and how much growth revenue will be recorded in the current quarter? How much – what percentage of that will be in the deferred? So, that is one of the major questions.

So, I have a second question. In the seasonality, Q1 is supposed to be the lower season for e-commerce, but to your e-commerce, it seems, has an up quarter and I wonder what's the driver behind this?

<A - William Ding>: [Foreign Language] (36:20-37:11)

<A - Onward Choi>: So, first of all, maybe I just get back to your questions about how we feel about the seasonality issues surrounding our e-commerce businesses in particular in the first quarter.

First of all, the main part of it would be [indiscernible] (37:27) from the Kaola businesses. And as you may well aware of, this would be focusing on the overseas market and also depends on the prototypes that we are being selected and being offered to our targeted customers in the China market. And, of course, more of the products would be women focused and we believe that relatively good performances on our e-commerce businesses in the first quarters can be attributed to the fact that we have also been doing quite numbers of promotional sales during the period. And also, we have also been doing a little bit more marketing campaigns to promote the overall businesses that can also bring up a positive impact to the overall – the performance for the e-commerce in the first quarter.

And with regard to your second questions about the game revenue and stuff like that, I believe that we have always been reiterating that we have a standard – a kind of policies in order to amortize the revenues of our various game products for a period of not more than six months, and we have been following it all the way through in a consistent manner. And basically, we wouldn't be able to give you an exact percentages on how much of it would be recorded in the different revenues and how much would be in the revenues that we recognize. But we would be doing it on an overall basis, and it also varies from different game titles.

Operator

Thank you. We'll take our next question from Jia Long Shi with Nomura Securities.

<Q - Jia Long Shi>: Actually, I have three questions for the management. My first question is about Minecraft. I just wonder what is Minecraft potential monetization models in China. And also I wonder – I would like management to share any colors on the revenue potential for this game in China.

My second question is about Overwatch. Management mentioned earlier Overwatch was made free since May 1 this year. I just wonder if Overwatch may have some other revenue sources such as from the sales of virtual items?

And my last question is about the quarterly dividend. And the company has – NetEase has 25% dividend payout ratio currently. I just wonder if management may consider raising the quarterly dividend payout ratio? Thank you.

<A - William Ding>: [Foreign Language] (41:40-42:44)

<A - Onward Choi>: So, getting back to your questions, Jia Long, about the Minecraft. Basically, in China, there wouldn't be any copy sales as what the overseas market has been doing. In fact, the Minecraft that will be launched would be adopting the free-to-play model and the current timelines that we're expecting to launch this game would be somewhere around the July timeframe.

And on your second questions about the Overwatch, basically, we would be adopting strategies to offering free-to-play to the users during the period from the 1st of May till the end of May which is the 31st of May, and subject to the review after how the market would be reacting to this kind of arrangements, then maybe – there would be a chance that we would be extending it to a much longer period.

And with regards to the monetization's model or the business models that we are looking upon for the Overwatch product, basically this will still be adopting the sales of virtual items within the games.

And with regard to your third questions about the dividend policies, I will say that for now the company will still be quite happy with its current dividend payout ratios. But of course, the companies and the board would be regularly reviewing the overall situations and consider all potential changes, whether we are talking about the further increase in terms of this dividend ratios in the future periods. But for now, we would still upkeep the current payout ratios at approximately 25%.

Operator

Thank you. Our next question comes from Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Hi. Good morning. Thank you for taking my question. Just a quick follow-up question on Minecraft. Wondering if you could share your thought with us on the target user segment of Minecraft. How is it going to be different than the current Chinese user base?

<A - William Ding>: [Foreign Language] (45:21-46:32)

<A - Onward Choi>: So, with regard to your question about how we look upon the Minecraft, especially since [indiscernible] (46:41) user segments and how it would happen in China. First of all, I would like to share with you about – on some statistics or some previous track records in the past couple of years that the two of the most popular games in the market, the number one would be Tetris and the second one would be Minecraft, and in some ways, we also observed that in terms of the search index of searching the Minecraft Games, this definitely would got a more than double search than the number one games.

And insofar as the game is concerned, about its launch and the operations in the China market, basically, we would be adopting different models from the rest of the world because in China we would be offering that game free of charge to play for the players. And we are also looking upon that with many new contents and features that we are offering within these games. The rollout of the Minecraft in China will also be another successful one that we are expecting.

Operator

Thank you. We'll take our next question from Hillman Chan with Macquarie.

<Q - Hillman Chan>: Good morning, management. Thank you for taking my question. Regarding Minecraft, could you share more about the PC beta testing particularly from that? And also, could you talk about the timeline for the mobile version of Minecraft in China?

And my other question would be about the e-commerce business. I noticed that we have been aggressive in Kaola, for example, going to Europe for big orders and Yanxuan is also getting aggressive in China on procurement as well. Just wondering if you can share more on the growth outlook and also, GMV target for this year if possible. In the longer term, what's the margin program that we should be expecting from this e-commerce business? Thank you.

<A - William Ding>: [Foreign Language] (48:49-49:17)

<A - Onward Choi>: So basically with regard to the PC beta testing, we are feeling very happy with this performance so far, and everything has been progressing well. And in terms of when we are going to roll out the mobile versions of the Minecraft, the tentative date would be somewhere around July of the year.

<A - William Ding>: [Foreign Language] (50:13-53:53)

<A - Onward Choi>: So, basically, we would like to share with you about how we will about our strategies or the executions on our e-commerce businesses especially on the Koala and the Yanxuan fronts. For the Koala, basically, the reasons that NetEase would be getting into these new businesses is coming from three years before when the Chinese government has already opened the e-commerce businesses, or in fact the cross-border e-commerce businesses to all the entrepreneurs in the China market and we have – making good news of this policy support in order to move into this new area.

And in fact, there has been a slogans that we have always been talking about when we are undertaking the Koala businesses because we are importing some overseas products but the prices that we are offering would be just the local price. Meaning that, we are targeting and aiming to giving a very good value for moneys to our targeted customers when they're buying some quality products from the overseas market. And so far as the Europe market is concerned, of course, we have our own merchandising departments out there, and we are also in close partnership with some [ph] formerly milk (55:16) manufacturers like [ph] the Danone (55:18) and in Japan we are also in close collaborations with Kao in order to offer some of the more popular items to our targeted customers.

And on the other hand when we look upon to how we are moving to another area of doing the e-commerce businesses like the Yanxuan because we have been seeing that there has been a very good demand from the local markets for some good-quality products in the marketplace. But many of the times especially in the past, the people would be just doing it – the product itself is being produced locally, but when they just place their brand name from some overseas markets, then the price will be very expensive. But what we have been doing is that we are doing it by collaborating with the manufacturers locally for some premium product or the brand names, and then we'll be just [indiscernible] (56:27) manage to buy out certain designs, because basically for Yanxuan, the models that we have been adopting would be the ODM model.

And there will be two things that we would like to offer to our targeted customers. First of all, quality products, and those would be something that they actually would like to have. And on the other hand, we are offering very good price to them. And insofar as the overall populations in China is concerned, because by now, China has already surpassed more than 1.3 billion people in China, and this definitely will be a very huge market.

And we do believe that in the future periods that there would be a certain consumption upgrade. And we are also confident and also feeling proud that we will be one of the players, a leading player in the e-commerce area especially on the Yanxuan fronts by offering a very good – good quality products but at a very cheap or a very – a better price to our targeted customers. And also in terms of the user experiences, because we are also adopting a very renowned and reputable logistic service provider like [indiscernible] (57:52), and we have also been getting a very positive feedback from our customers, so far.

Operator

And that concludes today's question-and-answer session. At this time, I will turn the conference back to management for any additional or closing remarks.

Brandi Piacente

Thank you once again for joining us today. If you have any further questions, please feel free to contact Juliet Yang, NetEase's Senior IR Manager based in Hangzhou or TPG Investor Relations. Have a great day.

Operator

That does conclude today's presentation. We thank you for your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2017-02-15
Event Description: Q4 2016 Earnings Call

Market Cap: 39,611.84
Current PX: 298.73
YTD Change($): +83.39
YTD Change(%): +38.725

Bloomberg Estimates - EPS
Current Quarter: 27.631
Current Year: 112.792
Bloomberg Estimates - Sales
Current Quarter: 11952.333
Current Year: 51434.320

Q4 2016 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Eddie Leung
- Natalie Wu
- Fan Liu
- Jialong Shi
- Hillman Chan
- Thomas Chong

MANAGEMENT DISCUSSION SECTION

Operator

And ladies and gentlemen, we apologize for that slight interruption in today's conference. Good day, again, and welcome to the NetEase Fourth Quarter and Full Year 2016 Earnings Conference Call. Today's conference is being recorded.

And at this time, I'd like to turn the conference over to Ms. Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company, and are intended to qualify for the Safe Harbor and liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance, and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including at the Annual Report on Form 20-F. The company does not undertake any obligation to update these forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the fourth quarter and fiscal year 2016 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. I would like to remind you that for the purposes of these discussions, all percentages are based on renminbi. Before we discuss the financials, I will provide some opening remarks from William.

Good morning, and thank you, all, for joining us on today's call. As one of the largest mobile gaming markets in the world, there is a massive appetite for premium game contents for us in China. NetEase has been serving the growing online populations for the past two decades. And now, it is a great honor to be one of the leading publishers in the mobile market, where we strive to introduce premium game contents to entertain and inspire our growing community. These are the efforts that have supported our growth across our business.

In 2016, our total net revenues grew by 67.4% for the year and 53.1% in the fourth quarter compared to the same quarter in 2015. For the fourth quarter, we saw year-over-year net revenue increases of 62.8% from our online games segment, 9.2% from advertising services segment, and 38.2% from our e-mail, e-commerce and others segment.

It is no surprise that our recent growth has been led by our accomplishments in the mobile market. In 2016, we introduced more than 14 new mobile games titles, including a number of chart toppers. It is through our considerable focus and investments in R&D that enables NetEase to bring timely, desirable games to Chinese and the global players.

Our hit game, Onmyoji, has been widely embraced since its introductions in early September. It was named one of the Top 10 Outstanding Games of 2016 in China's iOS App Store. We are very pleased with this game's early success, and we see exciting opportunities to extend its popularity worldwide. In December, we began to release Onmyoji internationally beginning with Southeast Asia, where it has been welcomed by a new wave of players. We expect to further broaden its reach with plans to bring Onmyoji to additional markets including Japan, Canada, Europe and the United States later this year.

Some of our added games that delivered excellent performances in the fourth quarter included our self-developed mobile games, Tianxia III mobile and OverOcean, as well as HIT, a stunning new licensed ARPG. The mobile additions of Westward Journey Online, Fantasy Westward Journey and New Ghost also continue to be among our most popular games.

We recently released Demon Seals mobile and Heroes of Tang Dynasty mobile, both of which were well received. Other new mobile titles planned for near-term introductions include Westward Journey: Rage, which is an exciting ARPG editions of our legacy game that celebrates the 15th anniversary of this title, and a new innovative RPG called Treasure Hunter.

We will continue to build our formidable and diverse mobile portfolio where there remains ample opportunities for future growth. With over 100 mobile games, we plan to build on this momentum by introducing more mobile versions of our legacy titles, as well as new self-developed and licensed mobile games.

We also had some strong showings from some of our PC-client games in the fourth quarter, including our flagship game, Fantasy Westward Journey Online. Our PC-client games continue to perform steadily, and we released several new expansion packs during the fourth quarter; Kung Fu Master II, Demon Seals, Tianxia III, Heroes of Tang Dynasty Zero and New Ghost to name a few. New expansion packs for Fantasy Westward Journey Online and Revelation were also recently released. And in the coming months, we plan to introduce a new expansion pack for New Westward Journey Online II.

Blizzard Entertainment's Overwatch, World of Warcraft with its latest expansion pack, Legion, and Hearthstone with its latest expansion pack Mean Streets of Gadgetzan, also remained popular among loyal players in China eager for new content and attracted new players. Overwatch also established a new sales record in the category of buy-to-play PC-client games in Mainland China, with more than 5 million copies sold by the end of December since its late May release. Furthermore, we are currently working to bring to Chinese players, both PC and mobile versions of the highly anticipated, globally acclaimed game, Minecraft.

As more and more people gravitates toward a mobile lifestyle, there has been a dramatic shift in the way that overall data is consumed. An evolving advertising climate is a clear byproduct of these changes with mobile Internet becoming one of China's primary advertising platforms. As a comprehensive Internet company, NetEase is well suited for this trend, and our advertising services business continues to enjoy steady growth.

Automobile, Internet services and financial services were our top-performing advertising verticals in the fourth quarter, supported by our industry-leading Mobile News App, as well as high-profile events such as the 2016 NetEase Annual Economist Summit and the 2016 NetEase Annual Attitude Award Ceremony. Additionally, our e-commerce business continues to thrive. Both Kaola.com and Yanxuan demonstrated strong growth in the fourth quarter. This business is still in its development stage, and we believe there is substantial opportunity here as these platforms mature.

We have a great view to look forward to in 2017. We have always taken pride in providing innovative and outstanding products and services that reflects the needs of the exciting and ever-changing Internet community. As we move through the year ahead, we will continue to populate to China's Internet market with excellent mobile and PC games and online resources that support our growth and create values for all of our stakeholders.

This concludes William's comments. I will now provide a review of our fourth quarter and fiscal year 2016 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit. Our gross profit for the fourth quarter of 2016 was RMB 6.5 billion or $930.9 million compared to RMB 5.3 billion and RMB 4.2 billion for the preceding quarter and the fourth quarter of 2015, respectively.

The year-over-year increase in online games gross profit was primarily driven by increased revenue contributions from our mobile games such as Onmyoji and the mobile versions of New Ghost, as well as Blizzard Entertainment's Overwatch and World of Warcraft. The quarter-over-quarter increase in online game gross profit was primarily driven by increased revenue contributions from mobile games such as Onmyoji and the mobile versions of New Ghost. The year-over-year and quarter-over-quarter increases in advertising services gross profit were primarily attributable to our monetization efforts for our mobile applications, primarily our Mobile News App.

The year-over-year increase in e-mail, e-commerce and others gross profit was primarily due to increased revenue contributions from our e-commerce business such as Kaola.com. The quarter-over-quarter decrease in e-mail, e-commerce and others gross profit was primarily due to decreased revenue contributions from certain e-commerce businesses with relatively high gross profit margins.

The gross profit margins for our online games business in the fourth quarter was 60.7% compared to 65% and 67.2% for the preceding quarter and the fourth quarters of 2015, respectively. The quarter-over-quarter decrease in gross profit margin was mainly due to the one-off recognitions of certain royalty expenses related to license games in the four quarters of 2016, as well as increased revenue contributions from mobile games.

The year-over-year decrease in gross profit margin was mainly due to increased revenue contributions from mobile games and license games, which have relatively lower gross profit margins as a percentage of our total online games revenues.

Gross profit margin for our advertising services business for the fourth quarters of 2016 was 66.5% compared to 65.3% and 68.1% for the preceding quarter and the fourth quarter of 2015, respectively. The year-over-year decrease in gross profit margin was mainly due to higher staff-related cost.

Gross profit margin for the e-mail, e-commerce and others business for the fourth quarters of 2016 was 23.4% compared to 33.5% and 6% for the preceding quarter and the fourth quarters of 2015, respectively. The year-over-year and quarter-over-quarter changes in gross profit margin were primarily attributable to changes in our e-commerce business mix.

Total operating expenses for the fourth quarter of 2016 were RMB 2.6 billion or $374 million compared to RMB 2.5 billion and RMB 1.8 million for the preceding quarter and the fourth quarters of 2015, respectively. The year-over-year increase in operating expenses was mainly due to higher staff-related costs resulting from an increase in head count, average compensations, research and development investments, and selling and marketing expenses. The quarter-over-quarter increase in operating expenses was mainly due to higher staff-related costs and research and development investments, which was partially offset by decreased selling and marketing expenses.

We recorded a net income tax charge of RMB 882 million or $127 million for the fourth quarters of 2016. This compares to RMB 427.2 million and RMB 513.8 million for the preceding quarter and the fourth quarters of 2015, respectively. The effective tax rate for the fourth quarter of 2016 was 19.2% compared to 15.3% and 19.2% for the preceding quarter and the fourth quarter of 2015, respectively.

The quarter-over-quarter change in the effective tax rate was mainly due to the fact that certains of our subsidiaries were approved as Key Software Enterprises in 2016, and subject to a preferential tax rate of 10% for 2015. We recognized certain related tax credits in the third quarter of 2016.

Net income attributable to the company's shareholders for the fourth quarters of 2016 total RMB 3.7 billion or $530.5 million. This compares to RMB 2.7 billion and RMB 2.2 billion for the preceding quarter and the fourth quarter of 2015, respectively.

Non-GAAP net income attributable to the company's shareholders for the fourth quarters of 2016 total RMB 4 billion or $569.9 billion. This compares to RMB 3 billion and RMB 2.4 billion for the preceding quarter and the fourth quarters of 2015, respectively.

During the fourth quarters of 2016, we have a net foreign exchange gain of RMB 90.5 million or $13 million. This compares to net foreign exchange gains of RMB 14.8 million and RMB 66.3 million for the preceding quarter and the fourth quarters of 2015, respectively. These gains were mainly due to unrealized exchange gains and losses arising from our U.S. dollar-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollars against the RMB fluctuated over the periods.

We reported basic and diluted earnings per ADS of $4.04 and $4.01, respectively, for the fourth quarters of 2016. This compares to basic and diluted earnings per ADS of $3.01 and $2.99, respectively, for the preceding quarter, and $2.37 and $2.35, respectively, for the fourth quarters of 2015.

Non-GAAP basic and diluted earnings per ADS were $4.34 and $4.30, respectively, for the fourth quarters of 2016. This compares to non-GAAP basic and diluted earnings per ADS of $3.31 and $3.29, respectively, for the preceding quarter, and $2.58 and $2.56, respectively, for the fourth quarter of 2015.

Turning to our fiscal year 2016 financial results, our gross profit for the year was RMB 21.7 billion or $3.1 billion compared to RMB 13.4 billion for the preceding fiscal year. The increase in online game services gross profit in 2016 was primarily attributable to increased revenue contributions from our self-developed mobile games such as the Westward Journey Online and Fantasy Westward Journey mobile games, Onmyoji and the mobile versions of New Ghost, as well as licensed games such as Blizzard Entertainment's Overwatch.

The increase in advertising services gross profit in 2016 was due to the monetization efforts for our mobile applications, primarily our Mobile News App. The top-performing advertising verticals in fiscal year 2016 were automobile, Internet services and telecommunication services. The increase in e-mail, e-commerce and others gross profit in 2016 was primarily due to business development and gross profit margin improvement of certain e-commerce businesses.

Our total operating expenses for fiscal year 2016 were RMB 9 billion or $1.3 billion compared to RMB 6.1 billion for the preceding fiscal year. The increase in operating expenses in 2016 was primarily due to increased selling and marketing expenses, higher research and development investments, and higher staff-related cost resulting from an increase in head count and average compensations.

We recorded a net income tax charge of RMB 2.1 billion or $302.8 million and RMB 1.3 billion for fiscal years 2016 and 2015, respectively. The effective tax rate was 15.1% for fiscal year 2016 compared to 15.7% for fiscal year 2015.

Our net income attributable to the company's shareholders for fiscal year 2016 total RMB 11.6 billion or $1.7 billion. This compares to RMB 6.7 billion for the preceding fiscal year.

Non-GAAP net income attributable to the company's shareholders for fiscal year 2016 total RMB 12.9 billion or $1.9 billion compared to RMB 7.4 billion for fiscal year 2015.

We have a net foreign exchange gain of RMB 146.5 million or $21.1 million for fiscal year 2016, compared to RMB 133.8 million for fiscal year 2015. The net foreign exchange gains were mainly due to unrealized exchange gains arising from our U.S. dollar-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over these periods.

Our basic and diluted earnings per ADS for fiscal year 2016 were $12.73 and $12.63, respectively. This compares to basic and diluted earnings per ADS of $7.38 and $7.34, respectively, for fiscal year 2015.

Our non-GAAP basic and diluted earnings per ADS for fiscal year 2016 were $14.11 and $14, respectively. This compares to non-GAAP basic and diluted earnings per ADS of $8.13 and $8.08, respectively, for fiscal year 2015.

As of December 31, 2016, our cash and cash equivalents, current and non-current time deposits, and short-term investment balance total RMB 36.9 billion or $5.3 billion compared to RMB 26.8 billion as of December 31, 2015. Additionally, our cash growth generated from operating activities was RMB 15.5 billion or $2.2 billion for fiscal year 2016 compared to RMB 8.1 billion for the preceding fiscal year.

We remain committed to returning values to our shareholders and are pleased to announce that our board of directors approved a dividend of $1.01 per ADS for the fourth quarters of 2016, which is expected to be paid on March 10, 2017, to shareholders of record as of the close of business on March 3, 2017. Additionally, using our working capital, we repurchased approximately 1.5 million ADS for approximately $205.3 million and our previous share repurchase program that expire August 31, 2016.

To continue this trend, our board approved a new 12-month share repurchase program beginning on November 15, 2016, for up to $1 billion. As of December 31, 2016, no ADS were repurchased under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you, sir. [Operator Instructions] We'll take our first question from Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Good morning. Congratulations on a very good quarter. Two questions on your mobile game business, the first one is more housekeeping. Could you give us some color on the contribution of mobile games within your online game revenue segment? And then the second question is about the gross margins. Besides the mix shifts to licensing games, as well as mobile games, just wondering within mobile games, are we seeing a change in gross margins as well? And if so, what will be the reason? Thanks.

<A - Onward Choi>: Okay. So, first of all, maybe regarding the – your first questions about the mobile contributions for the game businesses, up to the end of the fourth quarters, it has come up to 64%. And with regards to the gross margins for the licensings and the mobile, I believe that it has also uplift to a relatively stable levels. But, of course, if you compare to the overall gross margins for the gaming segments, the decrease was mainly due to the high contributions being – coming from the mobile games and also the license games.

<Q - Eddie Leung>: Got it. Thank you.

Operator

And we'll go next to Natalie Wu with CICC.

<Q - Natalie Wu>: Hi. Good morning, William, Onward Choi and Brandi, congratulations on a very strong quarter and thanks for taking my question. Two questions from me. The first one is can management update us the recent development of Minecraft, including the launch date, monetization methods, expectation, and also, how to collaborate Minecraft with education?

And the second one is that can William show some color with us regarding the international expansion plan in the future?

[Foreign Language] (26:05-27:00)

<A - William Ding>: [Foreign Language] (27:01-29:09)

<A - Onward Choi>: So, with regard to your first questions about the Minecraft developments. So, basically, William highlighted that historically, there would be two games that got the highest revenue on a global basis. The number one would be the Tetris and the second one would be the Minecraft. And basically, for the launch date for the – our own Minecraft game titles, we expected to launch it by July this year. And this would be one of the new versions and different from the prevailing international versions that are currently in place.

And with regard to your second questions about the international expansion plans, and this is – we already got the plans to launch the Onmyoji Japanese versions on the 23rd of February. And earlier then, we have already launched the games in some other areas like Taiwan, Hong Kong and also New Zealand. And [indiscernible] (30:08) got the number one ranking on those iOS App Store chart on those places.

And coming along, we are also expected to launch the English versions of the Onmyoji by May this year. And at all times, we believe that NetEase, by accumulating with over 15 years to 16 years of game development experiences, and with the fact that we have also got very strong capabilities to self-develop the games, and we are also expected that there would be more games to come along in the periods to come. And basically, this would be our current plan about the international expansions.

Operator

And we'll take our next question from Fan Liu with Goldman Sachs.

<Q - Fan Liu>: Morning, Will and Onward and Juliet. Thanks for taking my question. Could you please share with us, what your expectation for the next few titles such as WJ and WJO this year? We know that you plan to add more game content and also launch more promotion campaigns for the titles, so – which is – now, maybe you can add some colors on this front. Then, I have a follow-up question.

[Foreign Language] (31:33-32:13)

Operator

Pardon the interruption. We are experiencing, again, an interruption in the conference. And, Ms. Liu, with you with just one moment. You may want to restate your question. Let me put everybody on hold for just a moment. I'll let you know as soon as we have our speakers back on.

[Technical Difficulty] (32:37-33:06)

<A - Brandi Piacente>: Hi, Fan Liu.

<Q - Fan Liu>: Hi. Can you hear me?

<A - Brandi Piacente>: Yes. Could you just repeat your question, please? There were some technical difficulties.

<Q - Fan Liu>: Sure. Of course. So, my question is, could you please show with us what's your expectation for the next few titles such as FWJ and WJO this year? So, we know that you plan to add more game content and [ph] attitudes (33:41) this year for these next few titles, so just want to know maybe you can add some colors on this launch. Then I have a follow-up question.

[Foreign Language] (33:50-34:02)

<A - William Ding>: [Foreign Language] (34:04-35:19)

<A - Onward Choi>: Sorry, Fan. Maybe you just give me to recap in English very quickly. So, basically, with regard to the expectations about the company's on two games, WJ and also FWJ, basically, with a very long history. So, game developments in the past 10-plus years, we do have very strong capabilities to deliver the highest qualities and premium game to our players.

And no matter we are talking about the PC and mobile games, we definitely would be able to deliver more new and innovative contents to our targeted players, and as well as to serve our fans with the highest qualities and enabling them to experience the best-ever contents that they can from those games.

And early of the year, we have also been implementing some tryouts on the AR technologies. And going forward, we would also be planning to incorporate these kind of features to our existing games like WJO and also the FWJ. So, Fan, you can [indiscernible] (36:37).

<Q - Fan Liu>: Thank you. So, my question – yeah. Thank you. My second question is about we know that the e-commerce, e-mail [indiscernible] (36:45) saw quarter-on-quarter decline on gross margin this quarter. So, may I know the reason behind that? Is that possible to have maybe a revenue breakdown between [audio gap] (36:57) business and also platform business, if possible?

[Foreign Language] (37:02-37:28)

<A - Onward Choi>: Okay. So, Fan, maybe I will take these questions. So, basically, this is quite obvious that in the past quarters, there has been a drop in the revenue coming from the e-mail, e-commerce and other segments. And just as what we have also highlighted in the press release, because there are certain e-commerce businesses that has also been scaling down in the past quarters, of which they would possess relatively higher gross margins. And that's why you will see that there has been a decrease in terms of the gross margins in the fourth quarter.

And in terms of the overall makeup of these segments, just as what we have also previously highlighted, I will say that a high portions of it will be coming from our e-commerce businesses like the Kaola.com and also the Yanxuan.

Operator

And we'll take our next question from Jialong Shi with Nomura.

<Q - Jialong Shi>: Hi. Good morning. Thanks for taking my questions. Congratulations on a very solid quarter. I have two quick questions, first is about – we noticed there is a one-off royalty expense booked into your cost of sales in Q4. So, I just wonder which game is this royalty expense for. Is it a new game or it is related to some existing games?

And also, I just wonder for Kaola and Yanxuan, both business have seen quite strong growth in the past quarters. If we look at the next few quarters, do we expect to see the growth rate for Kaola and Yanxuan to slow down because of the rising base effect? And also, what is the trend for the margins of Kaola and Yanxuan over the next year? I will translate the questions myself.

[Foreign Language] (39:26-40:27)

<A - William Ding>: [Foreign Language] (40:30-42:22)

<A - Onward Choi>: So, maybe I'll just recap your second questions about how we will launch the Kaola and Yanxuan development, especially in 2017. So basically, for both the Kaola and also the Yanxuan platforms, they are both were importance to us as an e-commerce businesses.

And for Koala, basically, we are doing a huge and a lot volumes of purchases from overseas by our self, and – which, in a way, we can ensure the authenticities of the goods. And at the same time, we are also offering very good pricings to our customers who are purchasing from our Kaola.com platforms. And in 2017, in terms of these growth expectations, we do anticipate that the growth rate would be much faster than the last year, which is 2016. And also, another point that we would like to reiterate is that the Kaola.com e-commerce platform is very unique by itself from all the other platforms who are doing similar businesses.

And as for the Yanxuan businesses, basically, we're adopting the ODM models, and we are partnering with some very established, renowned and large factories who are producing still quality goods to our customers. And we are also making good use of these platforms to deliver the highest values to our customers, especially the China customers who are buying those stuff in a way that they can have very good experience from those buying experiences.

And going back to your previous questions about the one-off recognitions of the royalty expenses, this is related to some of our existing licensing games, and that it has also come to the timing that we have to do it as a onetime treatment.

Operator

We'll take our next question from Hillman Chan with Macquarie.

<Q - Hillman Chan>: Congratulations to the team, to Onward, Brandi, Juliet, on a very strong quarter. I have two questions. First one is that regarding our overseas expansion, [indiscernible] (44:46), would you also share more games in the pipeline that would want to bring to your overseas market? And in this overseas market, what is our strategy to publish the games? Are we publishing on our own or are we partnering with some local distributors?

[Foreign Language] (45:04-45:23)

<A - William Ding>: Okay. [Foreign Language] (45:29-46:09)

<A - Onward Choi>: So, basically, with regard to our overseas expansion plans, apart from the – a very good success that we have already made for Onmyoji, there are definitely some other games that we are also making good progress, things like the real games, which is called the Twilight Pioneers, and the other one in Chinese which is the [indiscernible] (46:34). And we have also been rolling the overseas versions as well.

And we believe that in three years to five years' time, based on our efforts by expanding our footprint in overseas markets, we do definitely got a much better developments on that front.

<Q - Hillman Chan>: And also on the VR or AR game pipeline, could you share more color for this year or next year? And when do you see the VR/AR market will take off more meaningfully in China? And how do you see that area on [indiscernible] (47:15) right now?

[Foreign Language] (47:17-47:29)

<A - William Ding>: [Foreign Language] (47:30-48:25)

<A - Onward Choi>: Okay. So with regard to the company's strategies on the real and AR front, NetEase is definitely very serious in taking a leading role in terms of these developments and the potential games rollout in the market. And early this year, in 2017, we have also been embedded some AR features within our Onmyoji games, which also got very good feedback from the market. And, in fact, on other games which can be considered as our first real games, which is called the Twilight Pioneers that we have grown out on the Google platforms, that have also been got very good feedback so far.

Operator

We'll take our next question from Thomas Chong with BOC International. Well, Mr. Chong, your line is open. Please check your mute button on your phone.

<Q - Thomas Chong>: Hi, William, Onward, Juliet. Thanks for taking my questions. I have a question about Onmyoji, it's about how should we think about the January performance versus the month of December? Because we see there are some marketing promotions for the games for other peers. So, are we seeing month-for-month trend in January?

[Foreign Language] (49:54-50:09)

<A - Onward Choi>: So, I believe that for now, because we would be focusing more on the year-end performances so far, and so we would perhaps give more colors perhaps at a later stage.

<Q - Thomas Chong>: Thanks, Onward. May I ask another follow-up question, is about the online advertising trend? Is there any color about the sentiment this year, and how should we think about the growth rate in this year?

[Foreign Language] (51:04-51:24)

<A - William Ding>: [Foreign Language] (51:27-52:48)

<A - Onward Choi>: So, there would be two parts of the responses that William would like to highlight. So, with regard to the advertising services trend, so basically, the simple answer to it is that we are still expecting that there would be a good growth in 2017, owing to the fact that we have quite a comprehensive mobile applications in place. Apart from the mobile user applications, we have our own Youdao Dictionary stuff and also the Cloud Music stuff, and all of those would be able to generate a meaningful and good traffic there, of which we can also enjoy a good growth in 2017.

And another points that William would like to highlight would be with regard to how we [indiscernible] (53:39) the overall performances on the Onmyoji, because NetEase has been a company that has been built up to very good capabilities of developing its own game. And things like – games like the FWJ, WJ Onlines have already been in operations for 15 years, and they are still doing very successfully. Somehow, these would be attributers to our strength in order to develop some very unique and premium contents that can also fit the expectations of our targeted gamers and players. And in three years to five years' times, we do see that not only just the Onmyoji, there would be perhaps some more great titles to put into the markets that can also be doing very good in the gaming businesses. And at the same time, we are also expecting that the Onmyoji would be following the similar trend that we have seen from the FWJ and WJ Online. That would also be a very lost lasting game titles.

<A - William Ding>: Okay. [Foreign Language] (54:57-55:09)

<A - Onward Choi>: Okay. So, another supplement that William would also like to highlight is that with regards to how the performances of Onmyoji in January was, is that the overall spending, the consumption has also been rising in January this year.

Operator

And, ladies and gentlemen, that is all the time we have for questions today. I'd like to turn the call back over to management for any closing remarks.

Brandi Piacente

Thanks, everybody, for joining us. If you have further questions, you can feel free to contact us or Juliet Yang in Hangzhou for the Investor Relations. Thank you so much.

Operator

Ladies and gentlemen, this does conclude today's conference. We appreciate your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2016-11-09
Event Description: Q3 2016 Earnings Call

Market Cap: 30,315.20
Current PX: 228.62
YTD Change($): +47.38
YTD Change(%): +26.142

Bloomberg Estimates - EPS
Current Quarter: 24.123
Current Year: 87.056
Bloomberg Estimates - Sales
Current Quarter: 10592.154
Current Year: 37146.000

Q3 2016 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Eddie Leung
- Alicia Yap
- Jialong Shi
- Fan Liu
- Tian X. Hou
- Natalie Wu
- Hillman Chan

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone and welcome to the NetEase Third Quarter 2016 Earnings Conference Call. Today's conference is being recorded.

And at this time, I'd like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its annual report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the third quarter 2016 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that for the purposes of these discussions, all percentages are based on renminbi. Our ability to look towards the future has enabled us to build a dedicated community of followers who count on the quality and innovations of our products and services. With our top of the line games and products, we've furthered this growth in the third quarter demonstrating improvements across each of our business lines.

Our total net revenues increased by 38.1% year-over-year, led by our online game services segment, which grew 26%, followed by 23.8% revenue growth in advertising services, and 107.2% growth in our e-mail, e-commerce and others segment.

Our mobile games continue to be among the industry's most popular games. In the third quarter, we introduced new chart-topping games attracting a multitude of players. Onmyoji, our latest 3D mobile experience became an instant success. [indiscernible] (03:12) released in early September. This exciting new game quickly surpassed our expectations and was rated as one of the top-grossing games in China's iOS app store for both the iPhone and iPad. The popularity of our Fantasy Westward Journey and Westward Journey Online mobile games and the mobile versions of New Ghost also persisted in the third quarter.

Other mobile games launched in the third quarter included Tianxia III mobile, OverOcean and Audition Mobile. These games were followed by the launch of HIT, a stunning new ARPG in October, and we're planning to bring additional original titles in the near-term to our growing mobile portfolio of over 100 games with titles including Heroes of Tang Dynasty Mobile, Demon Seals Mobile, and Land of Glory.

Our PC-client games also delivered a steady performance in the third quarter. We continued to introduce new contents and expansion packs for our leading games, including Fantasy Westward Journey Online, which was formerly named Fantasy Westward Journey II. New Westward Journey Online II, New Westward Journey Online III, Heroes of Tang Dynasty Zero, Revelation and New Ghost.

To further the life span of our most popular titles, we also launched new expansion packs for Kung Fu Master II and Demon Seals recently. And planned to launch new expansion packs in the upcoming months for games including Tianxia III and Heroes of Tang Dynasty Zero.

Blizzard Entertainment's Overwatch and Hearthstone: Heroes of Warcraft with this new adventure, One Night in Karazhan continued to gain favorite among Chinese audiences in the third quarter demonstrating the universal strength of these world renowned brands. Similarly the latest expansion pack for Blizzard's World of Warcraft, Legion, has gathered considerable attentions from players in China supporting our expectations, since its September 1 release in Mainland China.

Our competitive edge among the expanding Internet technology industry remains strong as we work to develop new and improved products. More and more users are looking into link their online activities and connect with each other. And we're thriving to introduce innovative content and gameplay that improves this interconnectivity. Some of the ways we can achieve this goal is through enhanced interactive communications for mobile users and by introducing virtual and augmented reality interfaces that further grow our community and improve players experiences.

Turning to our advertising services business, we saw sequential and year-over-year revenue increases in the third quarter with the automobile, internet services and telecommunications sectors as our top performing verticals. There remains considerable opportunities with this business and we're creating attractive options for our advertising partners with our industry leading Mobile News App, and diversify mobile products, as well as high profile events such as the 2016 Summer Olympics.

Additionally, our Kaola.com e-commerce offering continues to grow at a healthy pace. While our primary focus is on direct merchandise sales, we also look forward to maximizing the values of complementary services that extend the reach of these platform.

NetEase pose a rich history of innovations and growth. We believe that there remains significant opportunities for our company with exciting developments in the Internet services market place, where we hold considerable experience with a track record of leaderships and competitive R&D capabilities. As we continue to grow our business, we remain focused on bringing our users premium internet products and services that capture the imaginations and keep them connected.

This concludes William's comments. I'll now provide a review of our third quarter 2016 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profits.

Gross profits for the third quarter of 2016 was RMB 5.3 billion or $799.8 million compared to RMB 5.3 billion and RMB 3.8 billion for the preceding quarter, and the third quarter of 2015 respectively.

The year-over-year increase in online games gross profit was primarily driven by increased revenue contributions from mobile games such as the Westward Journey Online mobile games. The mobile versions of New Ghost and Blizzard Entertainment's Overwatch and World of Warcraft.

The year-over-year and quarter-over-quarter increases in advertising services gross profit were primarily attributable to a strong demand from advertises and our monetization efforts for mobile applications, primarily our Mobile News App.

The year-over-year and quarter-over-quarter increases in e-mail, e-commerce, and others gross profit was primarily due to increased revenue contributions from our e-commerce business. Our gross profit margins for the online games business for the third quarter of 2016 was 65%, compared to 66.2% and 67.9% for the preceding quarter and the third quarter of 2015 respectively.

The year-over-year decrease in gross profit margin was mainly due to increase the revenue contributions from mobile games and license games, which have relatively lower gross profit margins as a percentage of our total online game revenues. The quarter-over-quarter decrease in gross profit margin was mainly due to increased revenue contributions from licensed games.

Our gross profit margins for the advertising services business for the third quarter of 2016 was 65.3%, compared to 65.5% and 67.6% for the preceding quarter, and the third quarters of 2015, respectively. The year-over-year decrease in gross profit margin was mainly due to higher staff-related costs and content purchase costs.

Our gross profit margins for the e-mail, e-commerce and others business for the third quarter quarters of 2016 was 33.5%, compared to 33.8%, and 0.1% for the preceding quarter, and the third quarters of 2015, respectively. The year-over-year increase in gross profit margin was primarily attributable to the business developments and the gross profit margins improvement of NetEase's certain e-commerce businesses.

Our total operating expenses for the third quarters of 2016 were RMB 2.5 billion or $372.9 million, compared to RMB 2.2 billion and RMB 1.8 billion for the preceding quarter and the third quarter of 2015 respectively. The year-over-year and quarter-over-quarter increases in operating expenses were mainly due to higher staff-related costs, resulting from an increase in headcounts, average compensations, research and development investments, and selling and marketing expenses.

We recorded a net income tax charge of RMB 427.2 million or $64.1 million for the third quarters of 2016 compared to RMB 262.7 million and RMB 399.2 million for the preceding quarter and the third quarters of 2015 respectively. The effective tax rate for the third quarters of 2016 was 13.3% compared to 8.6% and 17.1% for the preceding quarter and the third quarter of 2015 respectively.

The year-over-year and quarter-over-quarter changes in the effective tax rate was mainly due to the fact that certain of our subsidiaries were approved as key software enterprises in the second quarter of 2016 as subject to a preferential tax rate of 10% for 2015. We recognized the related tax credits in the second quarters and third quarters of 2016. The effective tax rate represents certain estimates by us as to the tax obligations and benefits, applicable to us in each quarter.

Net income attributable to the company's shareholders for the third quarters of 2016 totaled RMB 2.7 billion or $410.9 million compared to RMB 2.7 billion and RMB 1.9 billion for the preceding quarter and the third quarter of 2015 respectively.

Non-GAAP net income attributable to the company's shareholders for the third quarter of 2016 totaled RMB 3 billion or $452.5 million compared to RMB 3.2 billion and RMB 2.1 billion for the preceding quarter and the third quarter of 2015 respectively.

During the third quarter of 2016, we had a net foreign exchange gain of RMB 14.8 million or $2.2 million compared to net foreign exchange gains of RMB 77.3 million and RMB 66.5 million for the preceding quarter and the third quarter of 2015 respectively.

The net foreign exchange gains were mainly due to unrealized exchange gains and losses arising from our U.S. dollar-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

We reported basic and diluted earnings per ADS of $3.13 and $3.11 respectively for the third quarters of 2016. This compares with basic and diluted earnings per ADS of $3.11 and $3.09 respectively for the preceding quarter, and basic and diluted earnings per ADS of $2.15 and $2.13 respectively for the third quarters of 2015.

Non-GAAP basic and diluted earnings per ADS were $3.45 and $3.42 respectively for the third quarter of 2016. This compares with non-GAAP basic and diluted earnings per ADS of $3.68 and $3.66 respectively in the preceding quarter. And non-GAAP basic and diluted earnings per ADS of $2.34 and $2.32 respectively for the third quarter of 2015.

As of September 30, 2016, our total cash and cash equivalence, current and non-current time deposits and short-term investment balance totaled RMB 32.1 billion or $4.8 billion, compared to RMB 26.8 billion as of December 31, 2015. Cash flow generated from operating activities was RMB 3.7 billion or $559.3 million for the third quarters of 2016, compared to RMB 3.3 billion and RMB 2.2 billion for the preceding quarter and the third quarters of 2015, respectively.

Our growth and success allows us to continue returning capital to our shareholders. As such, our Board of Directors has approved a dividend of $0.7 per ADS for the third quarters of 2016. The dividend is expected to be paid on December 2, 2016 to shareholders of record as of the close of business on November 25, 2016.

Also as you may recall on September 1, 2015, we announced that our Board of Directors approved a new share repurchase program of up to $500 million of our outstanding ADS for a period not to exceed 12 months. As of August 21, 2016, the last date to repurchase shares under this program, we have repurchased approximately 1.5 million ADS for approximately $205.3 million under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you. [Operator Instructions] We'll take our first question from Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Hey. Good morning. Just two quick questions. The first one is about the mobile game revenues. If I calculate correctly, it seems like there was a small decline sequentially in the third quarter for the segment. And we know that we launched the new game in September which is pretty successful. So just wondering why there was a small decline in the revenues in the quarter sequentially?

And then secondly, just wondering what's the increase in investment income in the third quarter? Thank you.

[Foreign Language] (19:01-19:22)

<**A - William Ding**>: [Foreign Language] (19:26-20:28)

<**A - Onward Choi**>: So Eddie with regard to your first question – so basically although we appreciate the fact that we have launched the new games like Onmyoji in early September, like the second or third on the iOS platforms, but the full platform launch was only happened until towards the end of September like September 22, including the Android platforms.

So basically, you would appreciate that the full impact of those games contributions wouldn't be that apparent in the third quarters. And also there would also be certain deferred revenue that we have to account for such that the revenue would be amortized in the upcoming periods.

And with regard to William's projections and estimates about how our old gaming, mobile games business would be performing in the upcoming quarters and the periods ahead. We are still quite confident on this front, because as always NetEase has been very strong on these innovation front, and also we have also got a very strong strength in terms of exploring [indiscernible] (21:45) specialized in the mobile games arena.

And so, we are still looking forward that we can upkeep our leading positions in the China market in terms of the mobile games developments. And so, this basically would be the reasons to explain your first questions.

And so with regard to your second question, I believe that you'll see that there has been an increase in terms of the investment income in the third quarter of 2016 versus the last quarter there has been a loss. Because if you recall, we have also made an – kind of an investment impairment provisions in the second quarters, and this explains why the number has returned to a positive numbers in the third quarter.

<**Q - Eddie Leung**>: Got it. Thank you very much.

Operator

Next, we'll move to Alicia Yap with Citi.

<**Q - Alicia Yap**>: Hi. Good morning, William and Onward. Thanks for taking my questions. My questions is related to your new game Onmyoji. So wanted you to help us understand where are the incremental new users of Onmyoji come from? And also, based on your cracking and your big data, what is the percentage of overlaps of Onmyoji gamers, who you're assisting games? If there are some as our overlaps, then which games are most affected or cannibalized by Onmyoji? Is that the Fantasy or the Westward Journey?

And then, lastly related to Onmyoji as well, with the October and November tracking, Onmyoji is now surpassing Fantasy mobile. Is that mean that we will experience some sequential decline for Fantasy revenues or Onmyoji actually helped to expand our gaming's revenues high that we should not worry about Fantasy? Thank you.

<**A - William Ding**>: [Foreign Language] (23:52-25:30).

<**A - Onward Choi**>: So basically with regard to your [indiscernible] (25:33), the performance on our Onmyoji launch, basically we consider that this game by itself is a globally popular and a popular content, especially touching on the second generation stuff.

And so, we have also been seen that we have recorded quite a lot of successes on a worldwide basis, say for example in the Australia, [indiscernible] (26:02) entire has been give up in the top five positions. And whereas, so perhaps we can also share more data about its performance in other overseas markets like UK and U.S. of which we also believe that they have been performing very well so far.

And on the other hand, we do see that Onmyoji by itself is a game with a storyline that kind of taking into the interest of all the Chinese audiences on a global basis and apart from putting the games in the China markets and some other overseas markets, we are also looking other parts to explore and also into Japanese market as well.

And as always, we believe that this game has got a very high popularity amongst the Chinese audiences. And in the past one month to two months times of its launch in the market, we have been received very well and high – received by the users and also got high recognitions by the players as well.

<A - William Ding>: [Foreign Language] (27:13-27:59).

<A - Onward Choi>: Okay. Thank you. So another point that William would like to reiterate is that, there is no need to be too much concerned about the launch of the Onmyoji [indiscernible] (28:13) negative impact or cannibalize the existing games for our legacy game IPs like the Fantasy Westward Journey or Westward Journey Online and New Ghost, because [indiscernible] (28:24) new products that we are designing we would incorporate different and unique user experiences within that, such that all the products that we launched in the markets will be complementary by themselves rather than cannibalizing on one another.

Operator

Next we'll move to Jialong Shi with Nomura Securities.

<Q - Jialong Shi>: Hi. Good morning management. Thanks for taking my questions. I have two questions. For your two legacy mobile blockbuster titles, Fantasy Westward Journey and Westward Journey II, the ranking on app store fluctuated through Q3, especially WWJ II. I just wonder how are the user traffic for both titles? And how long do you think the lifecycle for these two titles may potentially last?

And also for Onmyoji, just wonder when you'll bring it to Japan? And are you working with Japanese publisher or you will operate the game by yourself in Japan. And I have a follow-up on e-commerce.

[Foreign Language] (29:40-32:26)

<A - Onward Choi>: So basically with regard to your questions about the gaming fronts, first of all, William highlighted that with regard to the user traffic in the third quarter, in fact we're still quite happy and confident to see that the [indiscernible] (32:44) going up rather than what you will see, by referring to the top grossing chart data, by seeing the ranking that it has been volatile for some time.

And another thing that we would like to reiterate is that NetEase should be the only one company on a worldwide basis that will possess the strength and abilities to operate the gaming businesses on a very long lasting manner. This can be reviewed from the fact that we have been doing very good on the PC front, and we also got the confidence that we can extend these capabilities and abilities to the mobile game fronts as well. And we are also in anticipation that in the upcoming five years to 10 years time, we would not be able to grow out a very good qualities game products to the markets that receive the highest user satisfactions that we are expecting.

And on your second [inaudible] (33:55), the expected launch of Onmyoji in the Japanese market so far [ph] we do not have affirmative and (34:03) definitive timeframe. But in the meantime, we will first make some more observations on how it has been doing in other overseas markets like the Australia and in New Zealand. And so far, we have also been receiving a very favorable and positive feedback from those areas as well.

Operator

Next we'll move to Fan Liu with Goldman Sachs.

<Q - Fan Liu>: Hi, William. Hi, Onward. Thank you for taking my questions. So my question is very quick, just about the revenue contribution for your mobile games. How much is from iOS platform? And how much is from Android platform? And also could you please give us a update of Overwatch? And so [Foreign Language] (34:57-35:48).

<A - William Ding>: [Foreign Language] (35:49-36:49)

<A - Onward Choi>: Okay. So I'll get back to you on the part about Overwatch's performance lately. First of all, the company has been very satisfied with this performance so far. And one of the latest initiatives that we have been doing so far – doing promotions at the Internet cafes where we have been encouraging some new users to try out the games without buying the CD key before. So they can – this would also be a very effective way for us to develop a new group of users to participate in trying out these games.

And on the other hand, we are also looking forward in terms of the future developments of the Overwatch games. We will try to translate it into a more eSport type of games on a global basis. And with regard to your question so far about the revenue contributions from our mobile games on the iOS and Android platforms, still up to the end of the third quarters, more than half of this contributions would still be coming from the iOS fronts.

<Q - Fan Liu>: Thank you, William and Onward.

Operator

Next we have Tian Hou with T.H. Capital.

<Q - Tian X. Hou>: Hi, William and Onward. I have a question related to your e-commerce, particularly the brand, the in-house brand Yixin. I experienced some – I have good experience of Yixin product. And I also noticed some of my friends also use Yixin product. So, I wonder what's your market position or proposition for this part of the business? What's the relationship with the other part of e-commerce?

[Foreign Language] (38:47-39:10)

<A - William Ding>: [Foreign Language] (39:14-42:13)

<A - Onward Choi>: So basically, William has made a very comprehensive introductions and highlights about our positioning and our visions about how we would like to use the Yixin businesses. Basically all products that we're offerings on the Yixin platforms would be of the highest product design and manufacturing standards. And we're also engaging with some high qualities and proprietary PLC and also Japan factories in doing the production process.

And as the name of our product lines implies, we would be strictly selecting the best products for offerings to our targeted audiences and customers. And our market positioning would be embracing free directions. First, a very competitive and good pricing. And second, offering the highest qualities of products we are delivering to our customers, and the highest customer service. And one of the highlights that we have been doing so far is that we are offering a 30 days goods return policy without any reasons that no other peers in the space has been doing, and we're the only one that are offering this kind of incentive to our customers.

And in terms of the product categories that we are currently covering, this would be including something like the household type of items, the stationary items, the kitchen stuffs, and up to now, we have about 500 plus SKU in place. And we are also very encouraged with the fact that the goods return rate has been very low of as low as 0.6% to 0.7% so far which reflect that our customers are really very satisfied with the products and the services we're offering so far.

And of course, NetEase also got a very huge and immense wishes of running these platforms, and we would like to make a very well blend of technologies and the products and delivers those products to our targeted customers. And we also believe that this would only be just one thing that we are positioning ourselves as a NetEase product line, but this will be something that we would be proud to say from the country, the Chinese perspective, this would be a very good platforms that we're servicing to the customers by offering them with the best products with the very good pricing, qualities and service.

And all-in-all, all the products that we are currently offering would be fulfilling some of the highest and strictest industry standards like SGS and BV certifications. And so, all the customers who are using our products can have the full satisfaction and happiness. Yeah.

Operator

Next, we'll move to Natalie Wu with CICC.

<Q - Natalie Wu>: Hi. Good morning William, Onward, Juliet and Brandi. Thanks for taking my questions. So firstly, congratulations on launching another hit mobile game title of your legacy. My question is regarding our mobile gaming business, can management share with us, what's the secret of [indiscernible] (46:01)? And what do you expect regarding the lifecycle of Onmyoji?

And it is kind of [indiscernible] (46:07) do you expect can surprise us for another time after Onmyoji? So besides what do you expect the mobile game industry competitive landscape will become several years later?

And also [indiscernible] (46:23) if my calculation is correct, your legacy mobile game FWJ and WWJ revenue experienced some kind of decline in the third quarter. So just wondering if it's just a [indiscernible] (46:38) fluctuation or something else?

[Foreign Language] (46:41-47:23)

<A - William Ding>: [Foreign Language] (47:25-50:03)

<A - Onward Choi>: So when we look back in the past 15 plus years on NetEase business operations, NetEase thus in fact got a very good and in-depth understanding about the PC gaming markets and also a very good knowledge about the research and development fronts. And we do see that FWJ and WJs has been growing very nicely in the past 15 years owing to the fact that we have a very strong story game IP with good storylines and good qualities of the contents and user experiences that we are offering to our targeted audiences.

And dated back in 2009, since the launch of the iPhone 4 to the market, the company has also taken a very proactive initiatives to look into how this kind of changes will turn the market difference in the years ahead. And in fact we have also been setting up over more than tens of mobile studios in order to do the explorations, innovations and research on some new games, especially on the mobile front. And definitely Onmyoji is one of those coming from those studios.

And we're also having the confidence that there would be lots of more similar games to come in the future periods. And for all the games that we are currently developing and launching to the market, we are targeting to the game in future and for games like the Onmyoji that originally based on some Japanese Onmyoji stuff. Then we are quite happy to see that this has also gotten a very good tractions and receptions from the market. And we would upkeep and continue our efforts to do our explorations, innovations for those very original stuffs in the market.

<A - William Ding>: [Foreign Language] (52:31-54:28)

<A - Onward Choi>: Okay. Thank you. So another point that William would like to supplement is that, in last year we have two another new initiatives about how we are marketing and promoting our existing games and one example would be our Ghost game titles that we are in collaborations with another TV show in Chinese which is called [Foreign Language] (54:51).

This cross promotion efforts has also proved to be very successful and also very effective in terms of bringing up the overall user base. And since the startup of the TV shows since the August 22, we have been seeing that the user numbers, the user base of the New Ghost Mobile has been rising up very nicely to our field force to the previous levels and we are also seeing that this game by itself has also received very high user satisfactions. And this has also been reflective from the fact that the ranking in the top rising chart in the iOS China app store for the New Ghost Mobile games has also been rising very nicely since then.

And so, we would just like to highlight and conclude that the DNA of NetEase is that we are very good at doing the innovation and exploration type of stuff. And for things not only on the gaming fronts and for stuff like our new e-commerce initiative like the Yiyuangou, we would like to try to explore a new way that we can position ourselves and to deliver some good stuff to our targeted audiences. And for businesses like Tianxia, again we're targeting on good pricing, good qualities, and also good service, and this is an old way that we've been doing all along.

Operator

We'll take our final question from Hillman Chan with Macquarie.

<Q - Hillman Chan>: Good morning, William, Onward, Brandi, and Juliet. Thank you for taking my question. I have a question regarding the e-commerce business. I noticed that on our Mobile platform, we withdrew some of the high ticket items and also dropped Alipay as one of the payment method and there may be some slowdown coming for payments in third quarter and fourth quarter. Just wanted to have more color on our strategy on the [indiscernible] (57:05) business. And quickly on Kaola, noticed that the inventory was sort of flat quarter-on-quarter. Would that be due to low third quarter seasonality formality or it's something else? And how should we think about how you look forward the fourth quarter of Kaola and future?

[Foreign Language] (57:21-57:51)

<A - William Ding>: [Foreign Language] (58:28-59:48)

<A - Onward Choi>: Okay. So basically, whether we're talking about Duobao or Kaola, basically these would be different types of e-commerce, certainly modest that we have been executing. For example, on the Kaola fronts, this would be focusing more on the offices, perch and merchandise sales for items like cosmetics type of stuffs and also women's accessories, and this would somehow be complementary to our Yiyuangou business model.

And for the Kaola businesses, of course, we have also been in collaborations with other world famous and renowned brands like the Costco where we have been procuring items like the Kirkland product lines and also we are in collaborations with Sa Sa, a cosmetic company in Hong Kong. And also another one like the Emart in Korea and also Kao in Japan. And basically whether we're talking about the Kaola, Yiyuangou, Duobao, so basically we are just touching on the different type of e-commerce business model.

<Q - Hillman Chan>: Okay. Thank you, William, Onward, Brandi and Juliet.

Operator

This concludes our question-and-answer session. I'll turn the call back over to management for additional or closing remarks.

Brandi Piacente

Thank you, everyone for joining us today. If you have further questions, please feel free to contact Juliet Yang, NetEase's IR Manager based in Hangzhou, or the Piacente Group Investor Relations. Thank you, and have a wonderful day.

Operator

That does conclude our conference call. We do thank you all for your participation. You may now disconnect.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2016-08-17
Event Description: Q2 2016 Earnings Call

Market Cap: 27,297.31
Current PX: 207.62
YTD Change($): +26.38
YTD Change(%): +14.555

Bloomberg Estimates - EPS
Current Quarter: 19.281
Current Year: 82.371
Bloomberg Estimates - Sales
Current Quarter: 9208.417
Current Year: 36524.409

Q2 2016 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Eddie Leung
- Jialong Shi
- Tian X. Hou
- Alicia Yap
- Hillman Chan
- Kenneth Fong
- Alex Yao
- Martin Bao

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the NetEase Second Quarter 2016 Earnings Conference Call. Today's conference is being recorded.

And at this time, I would like to turn the conference over to Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente

Good day, everyone, and thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its annual report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the second quarter 2016 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, an investor presentation and a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that for the purposes of these discussions, all percentages are based on renminbi.

Our outstanding second quarter results reflect our leadership in China's dynamic online games industry, where we continue to introduce premium game contents, innovative technology and effective marketing strategies. Each of our business segments delivered a strong financial performance and is positioned to sustain success in the second half of the year.

Our total second quarter net revenues grew 96%, compared with the second quarter of 2015. Online game services revenue increased 76% year-over-year, highlighted by the strength of legacy IP titles and new mobile games. We grew advertising services revenue by 24.2%, driven by our proven ability to provide a more effective return on advertisers' budgets.

Our e-mail, e-commerce, and others business is leveraging new opportunities to accelerate growth and increase the revenue by 310.6% year-over-year. As we have noted previously, the dominant trend in our business and for the entire online game industry is the popularity and demand for mobile games. We are very well positioned to exploit this trend with a mobile game portfolio that now includes more than 100 titles.

We are very pleased with the market response to our new and classic mobile games, and there are several highlights we would like to report on today.

In the second quarter, we launched the mobile versions of New Ghost, which ranked as a top 10 grossing title on China's iOS app store. We also launched Fantasy Westward Journey: Warriors and Raven, Korea's top ARPG, which quickly attracted large audiences following the introductions in the second quarter.

Two of our best-selling mobile games, the Fantasy Westward Journey and Westward Journey mobile games maintained their popularity on China's iOS app store throughout the second quarter. Our other successful mobile games such as Invincible and Kai-ri-sei Million Arthur also made solid contributions to our second quarter year-over-year growth.

In additions to the launch of well-received 3D Tianxia III mobile on July 29, our audience can look forward to [ph] planned and (4.24) new mobile game [ph] thesis (4:25) in the next several months. That include the 3D RPG Onmyoji, Audition Mobile, the mobile versions of the popular dancing game and HIT, a breathtaking ARPG.

To bolster the growth of our PC-client games, we launched several new expansion packs and new versions for a number of our highly popular PC-client games in the second quarter, including New Ghost, Tianxia III, Demon Seals, Kung Fu Master II and Revelation, which gained players' attention. In addition, new expansion packs for Fantasy Westward Journey II, New Westward Journey Online II, New Westward Journey Online III and Heroes of Tang Dynasty Zero were also released more recently. The new expansion packs for Revelation and New Ghost will be released on August 18 and August 19, respectively.

We are also preparing for the first closed beta testing of our real-time action tactic thriller, War Rage. We are pleased with the ongoing developments of the Chinese versions of Minecraft and bringing this game to our audience would be a major event for NetEase. Our cooperation in this effort with Microsoft and Minecraft's creator, Mojang AB, reflects how the worldwide game industry recognizes our deep understanding of the Chinese market and ability to successfully launch the most renowned PC-client and mobile games.

On May 24, we brought Blizzard Entertainment's highly anticipated team-based first-person shooter game, Overwatch, to players in China in conjunction with its global launch. Following the release, Overwatch received unprecedented attention and praise from the online players' community. It broke the sales record established last year by Blizzard Entertainment's Diablo III: Reaper of Souls in the category of buy-to-play PC-client games in China, with nearly 3 million copies sold by the end of June and counting.

In addition, Blizzard Entertainment's Hearthstone: Heroes of Warcraft achieved new records for revenues and the number of active players in the second quarter, following the April release of its third expansion pack, Whisper of the Old Gods. As we focus on delivering the highest quality games and unmatched user experiences, we are also moving the industry forward by exploring new technologies such as virtual reality and augmented reality and developing content for a variety of genres.

Throughout the coming quarters, we look forward to reporting on many exciting new initiatives, led by the automobile, Internet services, and real estate sectors, we achieved another quarter of solid growth in advertising revenue. We continued to promote our Mobile News App live streaming services and further invested in high-quality content and simultaneously, we launched our NetEase Media Platform to broaden our Professionally Generated Content or PGC platforms, all of which we hope will attract additional advertisers and enlarge the user base.

In addition, our cross-border e-commerce platform, Kaola.com, sustained its strong revenue and gross profit margin growth in the second quarter due to economies of scale and an improved product sales mix and is also creating exciting partnership opportunities.

China is now the world's largest online games market, and we are working diligently and creatively to further expand our loyal customer base, develop new strategic business partnerships and enhance our industry leadership positions.

Our progress in the first half of 2016 clearly demonstrates that we have the resources and commitment to continue the exceptional growth and success of each of our business segments. This concludes William's comments.

I will now provide a review of our second quarter 2016 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit.

Our gross profit for the second quarter of 2016 was RMB 5.3 billion or US$794.5 million compared to RMB 4.6 billion and RMB 2.8 billion for the preceding quarter and the second quarter of 2015, respectively. The year-over-year increase in online games gross profit was primarily driven by the revenue contributions from mobile games such as the Fantasy Westward Journey and Westward Journey Online mobile games, Invincible and licensed games such as Blizzard Entertainment's Hearthstone: Heroes of Warcraft and Overwatch.

The quarter-over-quarter increase in online games gross profit was primarily driven by the revenue contributions from Blizzard Entertainment's Hearthstone: Heroes of Warcraft and Overwatch, as well as the Fantasy Westward Journey mobile games. Our year-over-year increase in advertising services gross profit was primarily attributable to strong demand from the automobile, Internet services and real estate services sectors, and our monetization assets for mobile applications primarily our Mobile News App. The quarter-over-quarter increase in advertising services gross profit was primarily due to seasonality.

The year-over-year and quarter-over-quarter increases in e-mail, e-commerce and others gross profit was primarily due to increased revenue contributions from our e-commerce businesses such as Kaola.com and other e-commerce products.

The gross profit margins for our online games business for the second quarter of 2016 was 66.2% compared to 67.1% and 69.3% for the preceding quarter and the second quarter of 2015, respectively. The year-over-year decrease in gross profit margin was mainly due to increased revenue contributions from mobile games, which have relatively lower gross profit margins as a percentage of our total online game revenues.

The gross profit margins for our advertising services business for the second quarter of 2016 was 65.5% compared to 62.4% and 68.2% for the preceding quarter and the second quarter of 2015, respectively. The year-over-year decrease in gross profit margin was mainly due to higher staff-related costs resulting from an increase in head count and average compensations. The quarter-over-quarter increase in gross profit margin was mainly due to seasonality.

The gross profit margin for our e-mail, e-commerce and others businesses for the second quarter of 2016 was 33.8%, compared to 20.4% and 4.2% for the preceding quarter and the second quarters of 2015, respectively.

The year-over-year and the quarter-over-quarter improvement in gross profit margin was primarily attributable to the gross profit margins growth from our e-commerce businesses, such as Kaola.com, as well as our continued shift in business strategies from direct merchandise sales to focus on providing platform services for certain e-commerce businesses.

Total operating expenses for the second quarter of 2016 were RMB 2.2 billion or $335.9 million, compared to RMB 1.7 billion and RMB 1.4 billion for the preceding quarter and the second quarter of 2015, respectively.

The year-over-year and quarter-over-quarter increases in operating expenses were mainly due to higher staff-related costs resulting from an increase in head count and average compensations, increased research and development investments, and selling and marketing expenses, as well as increased operating expenses related to Kaola.com.

We recorded a net income tax charge of RMB 262.7 million or $39.5 million for the second quarter of 2016, compared to RMB 530.7 million and RMB 145.9 million for the preceding quarter and the second quarters of 2015, respectively.

Our effective tax rate for the second quarter of 2016 was 8.6%, compared to 17.5% and 9.2% for the preceding quarter and the second quarter of 2015, respectively.

The quarter-over-quarter decrease in the effective tax rate was mainly due to the fact that certain subsidiaries of the company were approved as Key Software Enterprises in the second quarter of 2016, and subject to a preferential tax rate of 10% for 2015, and the company recognized related tax credits in this quarter. The effective tax rate represents certain estimates by us as to the tax obligations and benefits applicable in each quarter.

Net income attributable to our shareholders for the second quarter of 2016 totaled RMB 2.7 billion or $409.4 million, compared to RMB 2.5 billion and RMB 1.4 billion for the preceding quarter and the second quarter of 2015, respectively. Non-GAAP net income attributable to shareholders for the second quarter of 2016 totaled RMB 3.2 billion or $484.6 million, compared to RMB 2.7 billion and RMB 1.6 billion for the preceding quarter and the second quarter of 2015, respectively.

During the second quarter of 2016, we have a net foreign exchange gain of RMB 77.3 million or $11.6 million, compared to net foreign exchange losses of RMB 36 million or RMB 21.7 million for the preceding quarter and the second quarter of 2015, respectively.

The year-over-year and quarter-over-quarter changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our U.S. dollar-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

Our basic and diluted earnings per ADS were $3.12 and $3.1, respectively, for the second quarters of 2016. This compares with basic and diluted earnings per ADS of $2.81 and $2.79, respectively for the preceding quarter, and basic and diluted earnings per ADS of $1.63 and $1.62, respectively, for the second quarter of 2015.

Our non-GAAP basic and diluted earnings per ADS were $3.7 and $3.67, respectively for the second quarter of 2016 compared to non-GAAP basic and diluted earnings per ADS of $3.05 and $3.03, respectively, in the preceding quarter. And non-GAAP basic and diluted earnings per ADS of $1.82 and $1.81, respectively, for the second quarter of 2015.

As of June 30, 2016, our total cash and cash equivalents, currency and non-current time deposits and short-term investment balance totaled RMB 29.8 billion or $4.5 billion, compared to RMB 26.8 billion as of December 31, 2015. Cash flow generated from operating activities was RMB 3.3 billion or $494.6 million for the second quarter of 2016, compared to RMB 3.1 billion and RMB 835.9 million for the preceding quarter and the second quarter of 2015, respectively.

Our growth and success allows us to continue returning capitals to our shareholders. As such, our Board of Directors has approved a dividend of $0.78 per ADS for the second quarter of 2016. The dividend is expected to be paid on September 9, 2016 to shareholders of record as of the close of business on August 31, 2016.

Also, you will recall that on September 1, 2015, we announced that our Board of Directors approved a new share repurchase program of up to $500 million for our outstanding ADS for a period not to exceed 12 months. As of June 20, 2016, we had repurchased approximately $1.5 million ADS for approximately $205.3 million under this program.

Thank you for your attention. We'd now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you. [Operator Instructions] At this time, we'll take a question from Eddie Leung with Merrill Lynch. Please go ahead.

<Q - Eddie Leung>: Good morning. Thank you for taking my question. Could you [ph] talk (19:19) a bit about the potential of virtual reality and augmented reality to NetEase? And do you think it's more an upgrade to [ph] exceed thinkings (19:34) or is it going to be a new market, which could attract incremental users?

And then just a housekeeping question. Could you also update us the percentage of mobile games as total game revenues? Thanks.

<A - William Ding>: [Foreign Language] (20:00-21:58)

<A - Onward Choi>: So, basically, with regards to your first question, Eddie, I believe that for NetEase, we are very focused on the recent development regarding the AR and VR. And in fact, recently, the company has also been investing in other company in U.S. called NextVR, which is focusing on doing some streaming and broadcasting services. And we believe that this would also be another very good initiative that will be rolled out to gear up our service offerings.

And with regards to another trend that we observed lately about the Pokémon GO in the overseas market, we do see that this actually is a new trend. But instead of, just seeing that this would be an emerging trend, we would still need to critically evaluate and assess whether this would be sustainable in a much longer term. And we believe, at all times, that NetEase would not be fall behind of this trend. And, in fact, we would keep our leading positions in the overall market developments.

And in fact, we have also been paying quite a lot of efforts in the past couple of years to get ourselves prepared to explore and innovate on some new areas that we believe would also bring us to the forefronts of the market.

<A - William Ding>: [Foreign Language] (23:31-23:54)

<A - Onward Choi>: Another point that William would also like to make [ph] a supplement (23:58) is about that we have also another business partners with Google on AR platforms called the Daydream. And another thing is that we will also be partnered with other VR contents providers in order to make sure that we would upkeep a leading position in that sense. And I believe this will be more or less the feedback on your first question.

And with regard to your second question about our mobile games revenue percentages, for the second quarter 2016, this has been standing at 60.9% out of our total game revenues.

<Q - Eddie Leung>: Thank you.

Operator

At this time, we'll take a question from Jialong Shi with Nomura.

<Q - Jialong Shi>: Hi. Good morning, William, Onward, Juliet. Thanks for taking my call. Congratulations – firstly, congratulations on a strong quarter. I have a few questions. My first question is a quick follow-up on the previous question. So, I just want to ask, as a game player, when can we expect to play NetEase's first AR or VR game?

[Foreign Language] (25:11-25:30)

<A>: [Foreign Language] (25:33-26:03)

<Q - Jialong Shi>: [Foreign Language] (26:05-26:08)

<A>: [Foreign Language] (26:11)

<Q - Jialong Shi>: [Foreign Language] (26:14)

<A>: [Foreign Language] (26:15)

<A - Onward Choi>: So, basically to recap on William's setback about Jialong's questions about NetEase VR and AR game progress. Basically, for both the AR and VR games, we both have some products apparently still in the internal testing phase. And in terms of timeframe, we believe that we are may be a bit later because currently the availabilities of the hardware or the equipment in the market is still not that many and perhaps we do see that the AR would come up a little bit earlier as we expected.

And to supplement on what Jialong has been following up about the expected timeframe, we do believe that it would hopefully for the AR games be launched hopefully before the end of this year.

<Q - Jialong Shi>: Thanks, Onward and William. My second question is about the e-commerce service, and I just wonder if management can give us an update on the cross-border e-commerce and also your private label service called [ph] Yixin (27:24) and what was the current growth rate in the GMV size for the two e-commerce services in 2Q and particularly for the cross-border e-commerce, we understand the authority has postponed the implementation of some of the new regulations for one year.

So, I just wonder what's your current strategy for this cross-border e-commerce now given the regulation uncertainty, where you continue to invest as much as before or you are holding back investments as many of your peers do and your policies are becoming more clear. And for the private label business, what's the current gross margin, and what is the highest margin that may achieve in the future?

[Foreign Language] (28:09-29:06)

<A - Onward Choi>: So maybe I would take these questions. So, Jialong, with regard to your questions about how our e-commerce businesses has been progressing in the past quarters, I believe that we are still quite happy with both its growth and both is trending in terms of its GMV. Both are quite aligned with our expectations. And so far, as you have mentioned about the [indiscernible] (29:36) policies that has previously been implemented and is currently in its tentative suspension phase for another one year. We believe that just as what we have highlighted before we do not expect that the implementation of such new policies or the rules would have any significant impacts to NetEase cross-border e-commerce businesses. But rather, we do see that this would be another things to mix – making sure that this would be a good business to go on in the near future.

And with regard to the private label businesses that you highlighted especially on [ph] Yixin (30:16), so far, because this would be another new initiatives that we are currently implementing and we do see that, from the gross profit margins perspective, this is also a good business to move on. But so far, we do not – got any additional highlights to share at this point of time.

Operator

We'll move along to Tian Hou with T.H. Capital.

<Q - Tian X. Hou>: Yeah, William, Onward and Brandi, good morning. Congratulation on the quarter. It is not a surprise to me. I do have a question related to the new [ph] things (31:03) in China, which is the live broadcasting. It seems like it certainly become a very popular in all fronts, in commerce, in entertainment, in news, in everywhere. And what NetEase also has some kind of broadcasting activities in news, in your Mobile News App, as well as game broadcasting. I wonder, do we have any plans to continue in this area to do something, to accomplish something?

[Foreign Language] (31:41-32:07)

<**A - William Ding**>: [Foreign Language] (32:09-35:44)

<**A - Onward Choi**>: [Foreign Language] (35:45)

So, just to recap on William's comments about our thoughts and mainly our efforts working on these new live broadcastings initiatives, I believe that we have been working on quite a lot of things so far. I will walk you through one by one.

In four-and-a-half years before, we have already introduced our product called CC. This would basically be a game-related broadcasting services we are offering to our users. And this would be related to our direct broadcastings of how to play the games or some content-related sharings. And we believe that for games like our very famous and popular, Fantasy Westward Journey and also Hearthstone, have also been – got quite a lot of stuff on these platforms.

And in two-and-a-half years before, we have introduced another platforms called Bobo. It's official website is bobo.com. And basically, this would be...

<**A - William Ding**>: Bobo.com.

<**A - Onward Choi**>: Bobo.com. Yes. Yes. So, this would basically be a performance-based broadcastings, where people would be doing [ph] something (37:00) performance, or doing some events and stuff like that.

And thirdly, in the start of this year on our own Mobile News Applications, we have also introduced another live broadcastings initiatives about the news-related content disseminations. And one of the most remarkable incidents would be the heavy rainings earlier in Beijing this year and another some broadcasting about [ph] the HoNan, the executions of (37:33) the government officials stuff that we have also been doing a sharing and got a very positive feedback from the market as well. And we do see that, well, all those businesses are currently working in a profitable [indiscernible] (37:54), but we haven't been separately disclosed all those information yet.

And some other stuff that we would like to share with you would be our thoughts about the newer developments on the [ph] WEAU (38:08) broadcasting, direct broadcasting stuff where we would be active – not, because we think that the broadcasting would not only be just a two-dimensional stuff, but this will be a multi-dimensional stuff that we can share with our targeted users.

And another interesting initiatives that we are also thinking would be getting into the educations areas, just like our online education course and our cloud class products. And we do see that in the near future, perhaps that people can just wear up their [ph] glasses (38:55) and then, they can also share some of the educational stuffs as such.

Operator

At this time, we'll take a question from Alicia Yap with Citigroup.

<**Q - Alicia Yap**>: Hi. Thank you. Good morning, William, Onward, Brandi and Juliet. Thanks for taking my questions. Congrats on the good results. I have a question related to Overwatch. So, can you share with us, given in the latest user engagement level for the game and given Blizzard comment that recently that there are new content and features that being introduced, that will encourage digital content purchase? So, have you seen that already happen for the China user base? And what would be the revenue upside for this game? And related to that, can you remind us for the accounting treatment for booking the backfills for Overwatch, how long it will amortize? Thank you.

<**A - Onward Choi**>: Okay. So [Foreign Language] (40:02-40:20)

<A>: [Foreign Language] (40:21-42:29)

<A - Onward Choi>: [Foreign Language] (42:30) Okay. So, with regard to your questions about the user engagement and the features about Overwatch, we believe that the Overwatch has actually made a very good success since its first launch, since May 24 till now. And, first of all, we would like to extend our gratitudes and the appreciations to our partner, Blizzard Entertainment, for having full confidence on NetEase. And at the same time, they have also been very good at developing and rolling out some good content stuff to the market, especially in China.

And insofar as the sales performances of the Overwatch is concerned, just as what we have highlighted earlier, it has already surpassed Blizzard's record established last year by Blizzard Entertainment's Diablo III in the category of buy-to-play PC games in China, and we do see that in terms of the user satisfactions. They are very pleased with these games, and we believe that with the innovative contents that we have been offering so far, they are also very happy to play this new game by Blizzard.

And another incidence that we'd like to share with you is that we have also [ph] launched (43:56) that in Korea in the Internet cafés, the games, [ph] which – that is the (44:02) Overwatch has been ranked as the number one game, which is popular amongst the players there. And we are also looking upon that. The same would happen in China sooner or later, that the Overwatch would become another very highly received popular games in the PC games category.

Another thing that we are looking upon is that sooner when there would be the next expansion packs to roll out for the Overwatch, we do see that there would also be more local contents that we would be offering to our [ph] popular (44:43) gamers in the China market.

And on a separate note, we would also like to highlight that on the 1st of September this year, the World of Warcraft would have another new expansion pack called [ph] Legends (44:55) to roll out, and we do see that this would make some positive surprises to our existing gamers and the new gamers alike.

Okay. So, on another separate point about Alicia's question about the accounting treatment on the Overwatch, because just like all of our other games that we are currently operating, this would be harmonized over a period of not more than six months period, because we have different games, whether we are talking about item-based games and also the buy-to-play games but basically we will adopt these policies.

Operator

We'll now move along to Hillman Chan with Macquarie.

<Q - Hillman Chan>: Hi. Good morning, William, Onward, Brandi, and Juliet. Congrats on the strong quarter and thanks for taking my question. My first question is about Minecraft. Could management talk about the current status of the development and also share more on the timeline and also the monetization model? I think we were talking about changing from the [ph] one-off license (46:14) to the in-game monetization model. I'm just wondering if you can share more color in that.

<A>: [Foreign Language] (46:24-48:10)

<A - Onward Choi>: So with regard to your questions about the Minecraft, I believe that in this year – early this year, we have already entered into a strategic cooperations with Microsoft and Mojang AB that we would be responsible for launching the games in the China market. And we are also [ph] foreseeing (48:30) that currently in the China market, this has been record as the number one PC and mobile games categories.

And in – if we look at the business models that has been adopted in overseas market, this basically will be the sales of clients to the gamers. But when we are soon to introduce this game in the China market, we are expecting that this would – the client itself would be offering free of charge to our gamers. And we would also be introducing some innovative business models to make it another new experiences to our gamers on a much recurring basis.

And very soon when we launch these games to the market, we do expect that there would be some contents that will be especially targeted to the local market. And also, we would also introduce some innovative contents to attract our targeted gamers as well. And at all times, we always believe that we would leverage the experiences that NetEase have made out so far over the years, especially in the gaming industry, and to make the introductions of these new versions of the Minecraft to the China market a success.

Operator

And we'll move along now to Kenneth Fong with Credit Suisse.

<Q - Kenneth Fong>: Hi. Good morning, management. Thanks for taking my question and congrats on a very strong result. My question is mainly on the margin front. First is on the online games, I noticed that the margin have declined Q-on-Q slightly. Despite lower margin, mobile game actually decreased its – in contribution. So, is there any reason behind it?

And the second question is on e-commerce, others, the gross margin is around like 38% – 33.8% in the second quarter, so how should we think about the sustainable gross profit margin for that segment? And that's it. Thank you.

<A - Onward Choi>: Okay. So, with regard to your first question about the gross margin on online games, you're quite right in saying that in terms of the mobile revenues percentages that this has come down a bit, but still we do see that there has been a slight drop in terms of our gross margin on our overall gaming businesses because of the fact that the major increase was contributed by games like Overwatch and also Hearthstone, which is a licensed game and of which the gross margins were relatively lower as compared with our own self-developed PC games. And while, at the same time, of course, there would also be some incremental contributions bring about by our FWJ as well.

And with regard to your second questions about the e-commerce gross margin percentages, we are quite happy to see that there has been another new growth in terms of our gross margins from the 20.4% in the last quarter to 33.8% this quarter. And we do see that this has mainly brought about by a better product mix and economy scales that brought about by our cross-border e-commerce businesses and also our other e-commerce products because we have also been adopting a shift in terms of our strategies from the direct merchandise sales models to the platform service models. And so, this would also help us to have an improvement and enhancement on the overall gross margins in this business segment.

Operator

We'll move now to Alex Yao with JPMorgan.

<Q - Alex Yao>: Hi. Good morning, everyone. Thank you for taking my question and congrats on a solid quarter. So, if my calculation is correct, your PC gaming revenue actually declined quarter-over-quarter and year-over-year despite very successful launch of Overwatch. Can you guys talk about the trends for the legacy PC game? How should we think about the life cycle and the revenue outlook over the next few quarters? Thank you.

<A>: [Foreign Language] (52:57-54:26)

<A - Onward Choi>: So, with regard to your questions, we believe that in the past three months we do see that Overwatch had actually made very good success in terms of its performances. And so, in this sense, we do see that with newer and innovative contents that we are offering to the game markets, we do actually get some good performances as such.

And on the other hand, we do see that for NetEase, we do have another – new PC game soon to launch that we have also highlighted in this quarter's earnings release, which is called War Rage. And we do believe that while we do see that there has been a growing trend in terms of the mobile games, but it doesn't mean that there wouldn't be any growth potentials for the PC games, but rather we do see that a better balance should need to strike between the PC and also the mobile games in order to ensure a much longer-term development of our gaming businesses.

<A>: [Foreign Language] (55:35-55:44)

<A - Onward Choi>: So, basically, in fact, in terms of our PC games revenue, basically in the same quarters, we do see that there has been a growth rather than a decline on an overall basis, this we can share with you.

Operator

We'll now move on to Martin Bao with Bank of China.

<Q - Martin Bao>: Thank you for taking my question. I have a question regarding to the Cloud Music business. I wonder whether the management can share with us the strategic target for this business as with the latest round of [ph] funding (56:24).

[Foreign Language] (56:25-56:44)

<A>: [Foreign Language] (56:47-58:46)

<A - Onward Choi>: So, with regard to our own Cloud Music products, basically we started off with this product development three years before by our own development teams located in Hangzhou. And since the launch of this product [ph] you (59:07) made a very good success of this product because you see that with the introduction of this Cloud Music product to the market this is not just facilitate the users, just to listen musics but more importantly, we do see that with the introductions of a very good design product, this can help to solve some of the problems of the users when they are doing their music listening or experiencing sessions.

Say, for example, we would able to make a more targeted recommendations on some musics that the users actually prefers and interested to listen to, and we do see that this would also make another good appeal to our users for using the music product. And insofar, as the choosing the [ph] partners (1:00:06), the Cloud Music, by itself is not just simply plugging – put on the earplugs and listen to musics and using the handset that's simple and easy, but rather, we do see that there is lots of potentials especially in the offline interactions with other TV stations or other radio stations in order to further enhance and leverage the experiences of our music lovers. And we do see that with the introductions of this very good products to the marketplace, with some innovative features that we have already built on, we do see that – and [ph] with the will (1:00:51) that we would upkeep our visions on our ongoing pursuits of the excellency. We do believe that for the music lovers this would be a very good products that they will enjoy and love.

<A>: [Foreign Language] (1:01:07-1:01:38)

<A - Onward Choi>: Another supplement that William would like to highlight is that one of the very unique features of our NetEase Cloud Music versus all the other's products currently available in the market is that rather than just facilitating the users just to listen to the music or the songs that they would like or love to listen, we would be able to recommend and push the songs that we believe that they would be interested and love to hear. And this is also proved to be very helpful especially to the music lovers.

Operator

That is all the time that we have for questions. I'll turn it back over to management for any additional or closing remarks.

Brandi Piacente

Thank you, everyone, once again for joining us today. If you have any further questions, please feel free to contact Juliet Yang, NetEase's IR Manager who's based in Hangzhou, or TPG Investor Relations.

Thanks and have a wonderful day.

Operator

And again, that does conclude today's conference call. Thank you all for your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2016-05-11
Event Description: Q1 2016 Earnings Call

Market Cap: 19,169.39
Current PX: 145.80
YTD Change($): -35.44
YTD Change(%): -19.554

Bloomberg Estimates - EPS
Current Quarter: 17.507
Current Year: 71.667
Bloomberg Estimates - Sales
Current Quarter: 8349.000
Current Year: 34381.350

Q1 2016 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Dan Zhao
- Fan Liu
- Jialong Shi
- Jin-Kyu Yoon
- Tian X. Hou
- Thomas Chong

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the NetEase First Quarter 2016 Earnings Conference Call. Today's call is being recorded.

At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente

Thank you, operator. Please note that the discussion today will contain forward-looking statements relating to future performance of the Company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the Company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the Company with the Securities and Exchange Commission, including its annual report on Form 20-F. The Company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial measures and results, please see the first quarter 2016 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer at NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that, for the purposes of these discussions, all percentages are based on renminbi.

We are very pleased with our first quarter performance and how it positions NetEase for a successful 2016. All areas of our business demonstrated strong growth, which reflects our continued leadership in China's online games industry, and the continued growth of our overall audience across our mobile and online PC client games, as well as our appetizing e-commerce and other Internet services businesses.

Our total first quarter net revenues grew 116.3%, compared with the first quarter of 2015. Our new games are resonating well with players and our classic titles continue to be popular. We have a strong portfolio of mobile and online PC client games that yields an increase in net revenues of 104.5% year-over-year for our online game services segment in the first quarter.

Our advertising services business also remained strong despite the usual first quarter seasonality and we grew this segment by 32%. Additionally, our email, e-commerce and others business is robust and rapidly expanding, and we grew net revenues in this division by 257.8%.

Mobile games remained the primary growth driver for our business in the first quarter. Our classic titles continue to lead the market, and recently introduced games have been well-received and are engaging new players. Player favorites Fantasy Westward Journey and Westward Journey Online mobile games continue to dominate China's iOS app store as two of the most popular grossing games in the first quarter.

We also launched new mobile titles such as Kung Fu Panda 3 and The X-World in January. And these games drew favorable attentions from players. Some of the titles we launched in 2015 such as Invincible, Kai-ri-sei Million Arthur and Battle to the West also continued to appeal to new users in the first quarter. We add to these successes, on April 15 we launched Raven, Korea's top ARPG game, and it received expected positive receptions.

Our mobile game pipeline explores a variety of genres and we are certain it will appeal to a wide audience of new and veteran players. This month we plan to introduce potential market hits such as the mobile versions of New Ghost, which received outstanding results in closed beta testing, and Fantasy Westward Journey Warriors. Later this year, we intend to release new mobile games based on our legacy titles, such as Tianxia III, Heroes of Tang Dynasty Zero, and Westward Journey: Rage, as well as a series of new game titles based on the best-selling novels by Mr. Gu Long, a widely-read and popular wuxia writer.

With a diverse market-leading portfolio of more than 19 mobile games that we continue to expand, we are positioned to remain a top choice for both new and existing players both in 2016 and for years to come.

Similarly, the performance of our PC client games was steady in the first quarter and our portfolio remained strong as we host some of China's most popular and longest-running titles. Our growth initiatives include satisfying pent-up player demand with the introductions of expansion packs in April for games including New Ghost, Kung Fu Master II, and Demon Seals.

In the coming months, we plan to introduce expansion packs for Westward Journey Online II and Tianxia III. Building on the popularity of our leading titles, we also plan to unveil new games such as the real-time action tactic thriller, War Rage. To complement our release schedule for our self-developed titles and in conjunction with the global launch, we expect to bring Blizzard Entertainment's highly anticipated first-person shooter game, Overwatch to players in China on May 24.

Our commitment to research and game development, as well as our deep understanding of Chinese audience preferences places NetEase at the forefront of market trends and player satisfactions. It is these values that will continue to propel our success and leadership in this expanding marketplace.

Turning to our advertising services, NetEase continues to be a leading choice for advertisers despite a challenging overall economic environment. Our top advertising verticals in the first quarter were the automobile, Internet services and telecommunication services sectors, [indiscernible] (06:43) supported by the enhanced monetization efforts of our Mobile News App as well as our diversified mobile product portfolio.

Advertisers in major industries are becoming more selective on where to budget their resources, and we believe this is leading to an increase in Internet advertising in general, and mobile media in particular. With our large base of high-quality customers, a diversified portfolio of mobile apps, and precision marketing technology driven by big data, we believe NetEase will remain a primary destination for advertisers providing strong momentum in 2016.

Our cross-border e-commerce platform, Kaola.com, continues to grow at a healthy pace. In the first quarter, Kaola.com demonstrated strong momentum and we are seeing improved margins as the business achieves economies of scale.

We have built the foundations for sustained success by providing the highest quality mobile and PC client games, along with exceptional user experiences with our e-commerce services and other Internet products. With these tools and our passion for providing our community with innovative internet products and services, we will continue to deliver great values to our shareholders, customers and partners both in China and overseas.

This concludes William's comments. I will now provide a review of our first quarter 2016 financial results. I will primarily focus on the discussions of margins and expense fluctuations, along with net profit. Gross profit for the first quarter of 2016 was RMB4.6 billion or $711.3 million, compared to RMB4.2 billion and RMB2.5 billion for the preceding quarter and the first quarter of 2015, respectively.

The quarter-over-quarter increase in online games gross profit was primarily driven by the increase of revenue contribution from mobile games such as the Westward Journey Online mobile game, Kung Fu Panda 3, Invincible, and Blizzard Entertainment's Hearthstone: Heroes of Warcraft.

The year-over-year increase in advertising services gross profit was primarily attributable to strong demand from the automobile, internet services and telecommunication sectors, and our monetization efforts for our mobile applications, primarily the Mobile News app. The quarter-over-quarter decrease in advertising services gross profit was primarily due to seasonality.

The year-over-year increase in email, e-commerce and others gross profit was primarily due to the increased revenue contribution from our e-commerce businesses such as Kaola.com, which was partially offset by the suspensions of high margin e-commerce services related to third-party lottery products since February 2015. The quarter-over-quarter increase in email, e-commerce and others gross profit was primarily due to the increased gross profit from our e-commerce businesses such as Kaola.com and other e-commerce services.

The gross profit margins for our online games business for the first quarter of 2016 was 67.1%, compared to 67.2% and 73.1% for the preceding quarter and the first quarter of 2015, respectively. The year-over-year decrease in gross profit margin was mainly due to increased revenue contributions from mobile games, which have relatively lower gross profit margins as a percentage of our total online game revenues.

The gross profit margins for our advertising services business for the first quarters of 2016 was 62.4%, compared to 68.1% and 59.2% for the preceding quarter and the first quarter of 2015, respectively. The year-over-year increase in gross profit margin was mainly due to enhanced economies of scale driven by revenue growth. The quarter-over-quarter decrease in gross profit margin was mainly due to seasonality.

The gross profit margins for our email, e-commerce and others business for the first quarters of 2016 was 20.4%, compared to 6% and 38.9% for the preceding quarter and the first quarters of 2015, respectively. The year-over-year decrease in gross profit margin was primarily attributable to the suspension of higher margin e-commerce services related to third-party lottery products. The quarter-over-quarter improvement in gross profit margin was mainly due to the revenue growth from our e-commerce businesses such as Kaola.com, as well as the shift in business strategies to focus on providing platform services for certain e-commerce businesses.

Total operating expenses for the first quarter of 2016 were RMB1.7 billion or $266.6 million, compared to RMB1.8 billion and RMB1.2 billion for the preceding quarter and the first quarter of 2015, respectively. Our year-over-year increase in operating expenses was mainly due to increased operating expenses related to Kaola.com, increased selling and marketing expenses related to online games and advertising services, higher research and development investments, and higher staff-related costs resulting from an increase in head count and average compensations. The quarter-over-quarter decrease in operating expenses was mainly due to decreased selling and marketing expenses for online games and advertising services, which were partially offset by the increased operating expense related to Kaola.com.

We recorded a net income tax charge of RMB530.7 million or $82.3 million for the first quarter of 2016, compared to RMB513.8 million and RMB214.5 million for the preceding quarter and the first quarter of 2015, respectively. Our effective tax rate for the first quarter of 2016 was 17.5%, compared to 19.2% and 14.1% for the preceding quarter and the first quarter of 2015, respectively. The change in effective tax rate represents our estimates of the effective tax rate for the first quarters of 2016.

During the first quarter of 2016, we had a net foreign exchange loss of RMB36 million or $5.6 million, compared to net foreign exchange gains of RMB66.3 million and RMB22.7 million for the preceding quarter and the first quarter of 2015, respectively. The year-over-year and quarter-over-quarter changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our U.S. dollar-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

Net income attributable to our shareholders for the first quarter of 2016 totaled RMB2.5 billion or $381.6 million, compared to RMB2.2 billion and RMB1.3 billion for the preceding quarter and the first quarter of 2015, respectively. Non-GAAP net income attributable to our shareholders for the first quarters of 2016 totaled RMB2.7 billion or $413.5 million, compared to RMB2.4 billion and RMB1.4 billion for the preceding quarter and the first quarter of 2015, respectively.

We reported basic and diluted earnings per ADS of $2.90 and $2.88, respectively, for the first quarters of 2016. We reported basic and diluted earnings per ADS of $2.55 and $2.53, respectively, for the preceding quarter, and $1.50 and $1.49, respectively, for the first quarter of 2015. Our non-GAAP basic and diluted earnings per ADS were $3.14 and $3.12, respectively, for the first quarters of 2016. This compares to non-GAAP basic and diluted earnings per ADS of $2.78 and $2.76, respectively, in the preceding quarter, and $1.69 and $1.68, respectively, for the first quarters of 2015.

As of March 31, 2016, our total cash and cash equivalents, current and non-current time deposits and short-term investments balance totaled RMB28.4 billion or $4.4 billion, compared to RMB26.8 billion as of December 31, 2015. Cash flow generated from operating activities was RMB3.1 billion or $479.6 million for the first quarters of 2016, compared to RMB3.1 billion and RMB1.9 billion for the preceding quarter and the first quarter of 2015, respectively. We continue to give back to our shareholders and our Board of Directors has approved a dividend of $0.73 per ADS for the first quarters of 2016. This dividend is expected to be paid on June 3, 2016 to shareholders of record as of the close of business on May 25, 2016.

Additionally, on September 1, 2015, we announced that our Board of Directors approved a new share repurchase program of up to $500 million of our outstanding ADS for a period not to exceed 12 months. As of March 31, 2016, we had repurchased approximately 0.69 million ADS for approximately $92 million under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you. [Operator Instructions] And first we'll go to Dick Wei with Credit Suisse. Your line is open.

<Q - Dan Zhao>: Hi, management. Thanks for taking my question. This is Dan Zhao calling on behalf of Dick Wei. I have two questions. The first one is, as to the deferred revenue, how much is for PC and mobile, respectively? And we see that it's down 1% quarter-on-quarter. So, how should we look at the correlation between games revenue growth?

<A - Onward Choi>: Okay. With regard to your question about the small decline in the deferred revenue, basically we wouldn't separate the breakdown, or to give us the breakdown, but how much of this will be attributable to the mobile or the PC fronts. But from our observations, basically we do see that, on our mobile games front, we are still having a good traction as of the end of the first quarter. And the major decline would be more attributable to the PC client games.

<Q - Dan Zhao>: Thanks. Another question is on our cross-border e-commerce. How do you see the impact from the cross-border e-commerce policy change? And do you have any promotion plans this year?

<A - Onward Choi>: [Foreign Language] (20:00 – 20:03).

<A - William Ding>: [Foreign Language] (20:04 – 20:58).

<A - Onward Choi>: So with regard to your second question about our view on the impact on the e-commerce new policy implementation since the April 2016, basically from our own perspective, this won't pose any significant impact to NetEase. And we are still holding a good confidence on our upcoming development of our cross-border e-commerce business activities. And of course, we do see that this implementations of the new policy do have some impact to smaller players in the space, but to us, we believe that this wouldn't be that significant. And again, we do view it quite positively about that, the government is also encouraging that more and more people will be getting into this new cross-border e-commerce business going forward.

<Q - Dan Zhao>: Got it. Thank you very much.

Operator

And next we'll go to Fan Liu with Goldman Sachs.

<Q - Fan Liu>: Thank you, management. So I have two questions. The first question is about your new games pipeline. So we know you will announce the second batch of new games of 2016 just a couple of days later. So, do you mind sharing with us, what's the difference between this batch of new games versus the previous batch of new games announcement? Apart from several legacy PC titles, do we have any other highly anticipated titles which will be announced?

And the second question is about cross-border e-commerce. We noticed that you are seeing that quarter-on-quarter decline of email, e-commerce and other segment mainly due to your business strategy shift from direct merchandise sales to platform businesses to certain e-commerce segments. Would you mind add some color on like certain e-commerce business, what will be this look like? Thank you.

<A - Onward Choi>: Okay. New game pipeline.

<A - William Ding>: [Foreign Language] (23:19 – 24:52).

<A - Onward Choi>: So, basically in – on May 20, we would be targeting to launch another new game. And this game at this moment, what we can share with you is that this will be a community-based game with innovative business models. And we are also looking forward that this game will also have a very good traction to our targeted audiences. And might as well, on May 24, there will be another game that will be launched on a global basis, which is Overwatch, a game from Blizzard Entertainment. And since we are right before the official launch of this game, we have also tried out 45 days trial testing of this game and we are also receiving a very positive reception and feedback from the players as well. And for this game, this will be a PC version, and for the other games, this would also be another PC-based game.

<A - William Ding>: [Foreign Language] (25:54 – 26:14).

<A - Onward Choi>: Okay. To supplement on William's remarks earlier, there would also be another [ph] appealing (26:18) games that we are going to launch tomorrow, which is the Ghost Mobile or the mobile version of our New

Ghost game. And this will be launched on the iOS app store and this would – this game would also be another MMORPG game type game. And this is something that we would like to share at this moment.

And with regard to your second question about the change in the cross-border e-commerce or in our first segments, so to call email, e-commerce and other segments, there has been some changes in the revenue, so to call, because we have also changed in some of the business strategies of doing our business from the traditional merchandise models with the platform services. And this would be related to some other e-commerce business other than our [indiscernible] (27:19).

<Q - Fan Liu>: Thank you, Onward. So what will be this other business look like [indiscernible] (27:30)?

<A - Onward Choi>: Basically, I would say that this business will be related to the [indiscernible] (27:40) business.

<Q - Fan Liu>: Oh, okay, okay. Thank you. Thank you.

Operator

[Operator Instructions] Next we'll go to Jialong Shi from Nomura.

<Q - Jialong Shi>: Hi, good morning, management. I have a few follow-up questions. And firstly, I think [ph] Ding-zong (28:06) mentioned you will soon launch – tomorrow you will launch Ghost, the mobile version Ghost, and I also noticed in your earnings release you mentioned Ghost had a very impressive performance during the closed beta testing. So just wondering if management can share some colors on that. And my second follow-up is about the gross margin for the – for other business segment. We saw a big improvement, a sequential improvement on the gross margin for this business. Just wondering, for the prospective quarters, should we expect the gross margin for the other business segment to continue to improve or at least can hold up to Q1 level? I will translate my questions.

[Foreign Language] (28:52 – 29:36)

<A - William Ding>: [Foreign Language] (29:38 – 32:38).

<A - Onward Choi>: Okay. So getting back to your questions, Jialong, on the first one regarding how our views on the testing performance of our Ghost Mobile. Basically just a quick recap, the Ghost game was first launched five years before as a PC game and a real-time action game. And tomorrow would be the day that we would be launching the mobile versions of it, because over the years, we have accumulated a good user base there and we are also having a very satisfied players participating in the games as well. And through the testing phase, we do see that the players are generally quite satisfied with all the game settings and stuff like that. And we look forward that this will be another successful game for NetEase to launch on the mobile front.

And a small supplement on the cross-border e-commerce new policy implementations that William would also like to share will all of you guys is that, since the launch of this new policy on the 8, in fact for the initial few days up to April 11, in fact there has also been quite an impact to the whole industry. But perhaps the impact would be more significant to the smaller players in the industry, and perhaps some of those has also been [indiscernible] (34:11) because of the rollout of the new policies.

And for NetEase, we do adjust and make some corresponding changes on our strategy and how to cope with the new policies so implemented. And just as many of you might have aware, lately the government has also been turned back to the implementations of the new policies right before the April 8 positions, meaning that [indiscernible] (34:45) first uphold for what the cross-border e-commerce business players would need to follow for the time being. And by saying so, this means that this would allow another one year transition period for people, for the players in the space to get a better understanding on the new rules and perhaps to make themselves adaptive to the new policy as well.

And in view of that, this would be a globalization on the cross-border e-commerce businesses. From our perspective, we are also looking forward that there will be more and more companies, e-commerce related companies getting to the cross-border e-commerce areas as well. And if you look back to what our Kaola.com has been doing in the past one and a half years, we did accumulate quite a valuable experiences and abundance of resources, especially on the warehousings and stuff like that.

And we are also feeling confident that, with our more innovative way of doing this cross-border e-commerce businesses, as well as we have a very strong and unique merchandising capability to put forward some good stuff to our targeted buyers or the customers, so to call, on our platforms, we do see that this would leave us a very good potential to develop our cross-border e-commerce business in general.

<Q - Jialong Shi>: Thanks for the color.

<A - Onward Choi>: Yes. Okay. And the last point that William would also like to comment on is about how do we view about the gross margin [indiscernible] (36:41), especially on the email, e-commerce and others segment that, Jialong, you have just mentioned. Basically at all times, NetEase has upheld a very stringent and a very prudent way to look after our spending, and we are also having a very formalized control in our costing structures. And we do see that this could be reflected in a much better financial returns in the way of executing the operations. And so, at least for the time being, you do see that there has been an improvement in terms of our gross margins in the first quarters of 2016. But without commenting whether this would be further – there would be further improvement or enhancements in terms of the gross margins on this area, but at least, you will see that this will be upkeep as a relatively more stable position for now.

Operator

And next we'll go to Chi Tsang with HSBC.

<Q>: Hi, management. This is [ph] Ching (37:57) calling on behalf of Chi. We've got actually two questions. One is regarding the mobile game, FWJ and WJO. And can management comment on the monetization and the user trends for the FWJ and WJO? And what do you think of the lifespan of these games? The other question is a follow-up on the Kaola. Can management share the 3P strategy for Kaola? Because like you shift from the merchandise model to the platform models, like what categories are you targeting at and what is like GMV level of Kaola currently? Thanks.

<A - Onward Choi>: [Foreign Language] (38:40 – 39:00).

<A - William Ding>: [Foreign Language] (39:04 – 39:45)

<A - Onward Choi>: Okay. So, basically, with regard to the performances of our Fantasy Westward Journey and also Westward Journey Online, basically since the launch of both games, for the past couple of months, we do see that their performances has been progressing well and [indiscernible] (40:04) a stable performance in the first quarter. And we do not see that there has been any fall on its reception or the usage or engagements of the players. But rather we are also having a good expectation that this has still got room to grow, a growth potentials in the upcoming periods.

And secondly, on – tomorrow we will be launching another game which is the Ghost Mobile. This will be an MMORPG game. And unlike the FWJs or the WJO, which [indiscernible] (40:45) game, we do see that this would also have to supplement a more diverse genre on our mobile games portfolio.

[Foreign Language] (40:57)

<A - William Ding>: [Foreign Language] (40:59 – 41:58)

<A - Onward Choi>: Okay. [indiscernible] (42:00). So with regard to your second question about NetEase's 3P strategies on the Kaola.com platform, basically we do view that the 3P strategy will be a supplement to our 1P business model. Because after all our 1P strategies will still be, our main focal point in executing our cross-border e-commerce strategy.

And the reasons that we're introducing the 3P is that we do see that there would also be some good products that we can consider to introduce on our platforms and work together with our business partners. And we can rest assure you that we have a very stringent selection process in selecting what kind of products we would be allowing on our own platforms. And we do make sure that they would be of the highest quality and that would be – could appeal to our targeted audiences before we actually do this.

And unlike what our other peers has been doing in the space, just setting up a marketplace and push through [indiscernible] (43:16) we do believe that we have a very stringent control and defense, making sure that we are offering the best products to our targeted customers.

Operator

And we'll go next to Jin Yoon with Mizuho Securities.

<Q - Jin-Kyu Yoon>: Hi, good morning guys. Could we just talk about the PC side of the business, PC gaming side of the business? So, just according to [indiscernible] (43:48) calculation, it's like PC gaming has declined for a couple of consecutive quarters now on a year-over-year basis. And then you kind of mentioned the deferred revenue decline, largely I think due to PC as well. So I guess what's driving that deceleration? How much of that is due to cannibalization of mobile, how much of it is just the natural maturity of the business? So, why are we seeing it today, given the fact that deferred revenues I think declined for the first time sequentially in the last four years? So, can you just kind of give us some color on that?

And just to follow up, I think you guys have a precious metals exchange business. Is that included in the e-commerce business and is that contributing to the margin upside we saw on the gross margins? Thanks guys.

<A - Onward Choi>: So, Jin, I didn't get your second question clearly. Would you mind repeating your second question again, regarding the gross margins on the...

<A - Brandi Piacente>: He's asking [ph] precious metals business in the e-commerce (44:59).

<A - Onward Choi>: The purchase...

<A - Brandi Piacente>: Metals exchange.

<A - Onward Choi>: Okay. Okay. So, William, [Foreign Language] (45:06 – 45:35)

<A - William Ding>: [Foreign Language] (45:39 – 47:42)

<A - Onward Choi>: Okay. So with regard to your first question, Jin, basically, although there has been declines in terms of our PC games performance in the past couple of quarters, but we are still holding a positive view about its lifecycle in a much longer terms. In fact we do see that, if we look back in the history since 2001 when we first launched the PC games in the space from 2001 up to 2014, we have been seeing that the PC game has been progressing very, very well. And since then, with the introductions and the emerging popularities of the mobile games, we do see that that has been a new change in terms of the gaming businesses.

At this point of time, I believe that we do view that, in terms of the overall trend of the gaming businesses. We do see that there's a change from the PC to mobile and hopefully in the foreseeable future and near future we will also get into the [indiscernible] (48:53). And for NetEase we have accumulated quite an abundance of important resources over the years, and on the premises that on the 20th of May and also to 24th of May. There will also be two PC games that we will announce and to launch in the upcoming periods. In particular on the 24th, this will be the Overwatch.

And so we do see that, at this point of time, while we do have a very strong self-developed game platforms, but we are getting ourselves more open to cooperate and partnering with other game developers to get the right resources, good game content, so to call, and with – by so doing, we would also be upkeep the momentums to roll out more PC games, and we do see that there we're still – this would still be a big and potential market we are seeing it. Although there has been some drop in the past, but we're still seeing that there will be good potentials there.

And with regard to your second question on our another new e-commerce business initiatives which is the precious metals platforms, basically this will be something similar to what we have been doing on the virtual products e-commerce area, and we are also seeing that this new business initiative is having a good traction for the time being, although it's in terms of revenue contributions, for now it's still relatively small. But we are seeing that this can complement to our overall e-commerce business strategy.

Operator

And we'll go next to Tian Hou with T.H. Capital. Your line is open.

<Q - Tian X. Hou>: Hi, Onward and William. I have two questions. One is related to the mobile game. I wonder if you have any mobile game revenue come from overseas. If you do – I don't know if you have or not, regardless you have or not, in terms of overseas income, what is the outlook for that? That's number one.

Number two is related to deferred policy. What is the deferred policy? In general, when you have like $100 income from users, from a player, on average, how much you will recognize in the current quarter, how much you will recognize in the later quarter, what's the schedule? So that's the two questions.

<A - Onward Choi>: So, William. [Foreign Language] (51:56 – 52:35)

<A - William Ding>: [Foreign Language] (52:36 – 52:44)

<A - Onward Choi>: So with regard to your first question, Tian, basically we do have some of our self-developed games being distributed and launched in the overseas market contributing some revenues there, but of course the amount is still quite nominal for the time being. But having said that, we do believe that after accumulating so many years of experience in the gaming industry and by making so many successes so far, we are having a vision that it would be a very good and strategic thing for us to move out to overseas market as well. And we are also very – priced positively.

And as for your second question, it's about the revenue recognition policies for our deferred revenue, basically just as what we earlier shared with you guys, basically for the games, different games would have different expected lifecycles that we would be amortizing the revenues. Usually this would be ranging from two months to not more than six months. And it is depending from games to game.

Operator

And we'll go next to Thomas Chong with Citigroup.

<Q - Thomas Chong>: Hi. Thanks management for taking my questions. My question is more related to the online advertising business. Can management give us some color about the improved monetization that you guys have been doing in the past couple of quarters? And any color about the [indiscernible] (54:27)? And secondly is all about regulations. Does management see that there are more regulations trying to control the Mobile News app? Thanks.

<A - Onward Choi>: [Foreign Language] (54:39 – 54:59)

<A - William Ding>: [Foreign Language] (55:01 – 57:32)

<A - Onward Choi>: So, Thomas, with regard to your first question about our improved monetization, especially on advertising services segment, basically we do view that we have a very comprehensive media context for NetEase. Apart from our very popular portals and including our Mobile News app as well, we have some other very popular products or services being offered to our targeted users, including our email, both offering free to our users and also the enterprise email services, as well as our Youdao dictionary and also our cloud music and stuff like that. All of that would make us to be a very comprehensive media platform offering a very wide array of content needs or service needs and also to leverage those needs to the advertising services potential.

And as well, we do have a very strong sales team that has been working very hard and doing a very good job over the periods in order to making this to be a reality. In fact, in the first quarter, so to call, it would be usually a low season for the advertising industry. But I have to accept that. We are still seeing that there has been a quite good performances in the first quarter. And in fact, if you look back, we are still making a good year-over-year growth on our advertising services segment.

And with regard to your second part of your question about the potential regulations being implemented by the government, from our view that is always imposed and implemented a much higher and stringent requirements in our business execution, and for stuff like the medical related advertisers. And these are the stuff that we have never been allowed to put through on our own platforms.

And if you – just to give you an example, by looking back to one of our products, which is called the Youdao Dictionary. Youdao by its name in Chinese, meaning that an upright person, if he really wants to make money, he do need to make it in a diligent and proper way, or so to call, in a legal way. And so you will see that this is how we position ourselves and establish efficiency in executing our business.

And at the same time, I believe that for NetEase, we are always making sure that we are creating the values both to our customers, the communities, and to ourselves by way of technology, developments and also the innovations by this kind of strength, this can make us to create the success in the field.

And apart from that you would also see that, on other areas like our online games, we do have new initiatives like the cross-border e-commerce, stuff like the Kaola.com. And there would also be more and more new surprises and good stuff that we would be launching in the upcoming periods.

Operator

And thank you, ladies and gentlemen. This concludes the question-and-answer portion of the call today. At this time I would like to turn the call over to management for any additional or closing remarks.

Brandi Piacente

Thank you once again for joining us today. If you have any further questions, please feel free to contact Juliet Yang in the Hangzhou officer of NetEase or to PG Investor Relations.

Thanks and have a great day.

Operator

That concludes our call for today. Thank you for your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2016-02-24
Event Description: Q4 2015 Earnings Call

Market Cap: 17,807.99
Current PX: 136.23
YTD Change($): -45.01
YTD Change(%): -24.834

Bloomberg Estimates - EPS
Current Quarter: 16.770
Current Year: 68.064
Bloomberg Estimates - Sales
Current Quarter: 8172.286
Current Year: 33785.850

Q4 2015 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Fan Liu
- Eddie Leung
- David Hao
- Vivian Hao
- Thomas Chong
- Natalie Wu
- Tian X. Hou

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the NetEase Fourth Quarter and Full Year 2015 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente

Thank you, operator. Please note the discussion today will contain forward-looking statements, relating to future performance of the company, and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act.

Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the company's control, and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its annual report on Form 20-F. The company does not undertake any obligation to update this forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial results, please see the fourth-quarter and fiscal year 2015 financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, a webcast replay of this conference call will be available on the NetEase corporate website, at ir.netease.com.

I would now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer at NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that for the purposes of this discussion, all percentages are based on renminbi.

We accomplished a great deal in 2015, demonstrating growth and achievements throughout the company. Our mobile games grew rapidly, captivating new players and reaching exemplary rankings. Our premium PC client games continue to delight Chinese audiences and our advertising and other business lines thrive.

With each of our businesses flourishing, our total net revenues grew by 94.7% for the year, including a 128.2% increase in the fourth quarter, compared to the same quarter of 2014. The combination of leading PC client games, along with our mobile games, has proven vital to the success of our growth strategy. This winning combination is demonstrated in net revenue increase of 103.2% from our online game in the fourth quarter compared to the same quarter of 2014.

The popularity of mobile games continues to grow rapidly and, over the last year, we introduced a number of new mobile games that have resonated with Chinese audiences. We have now established ourselves as a formidable player in China's increasingly competitive mobile games market with a diverse and growing portfolio of more than 80 games.

Two of our most popular games, the Fantasy Westward Journey and the Westward Journey Online mobile games, continue to thrive and were listed as the top two grossing games in China's iOS App Store in the fourth quarter.

I would also like to highlight a few of our new mobile ambitions that demonstrated strong performances during the fourth quarter, which include our licensed game Kai-ri-sei Million Arthur, as well as Invincible, the Kung Fu Panda mobile game and Chrono Blade.

The foundations of our online games business can be seen in our PC-client games which have delighted players for more than 15 years. Our passion for these games remain strong and with that ideal comes new developments to complement our long-running successes. For example, our self-developed 3D oriental fantasy MMORPG, Revelation, [ph] remain (4:29) strong tractions in the fourth quarter. And in November, we launched open beta testing for our 3D warfare MMORPG Hegemon-King of Western Chu.

During the fourth quarter, we also released a number of new expansion packs for PC-client games, including Tianxia III, Heroes of Tang Dynasty Zero and Kung Fu Master II, as well as launched a promotional campaign for Demon Seals.

In addition to our successful and growing portfolio of self-developed online games, Blizzard Entertainment's Hearthstone: Heroes of Warcraft continued to perform well and attract new players.

The steps we talked in 2015 to grow our business sets us on course to advance and diversify our games portfolio in 2016. To this end, we recently released a trailer for War Rage, a real-time tactical action game for PC-clients, which we expect to launch in 2016. We also plan to build on the popularity of our established PC client titles with upcoming expansion packs for games, including New Westward Journey Online II, Tianxia III, Heroes of Tang Dynasty Zero, Demon Seals and Kung Fu Master II.

Our mobile portfolio is also growing, as we work to introduce a number of gripping new titles this year. In January, we released Kung Fu Panda 3 and The X-World. These games quickly gained traction with players along with other compelling new mobile games, including Raven, Fantasy Westward Journey: Warriors and the mobile version of New Ghost. A series of new titles based on the best-selling novels by Mr. Gu Long, a famous [indiscernible] (6:26) writer, are also scheduled to premiere in the coming months.

In addition to our games, we are expanding our reach with our Internet service offering. In the fourth quarter, our advertising services grew 68.1% and our email, e-commerce and others business grew 355.5%, both compared with the same period in 2014.

During the fourth quarter, we further strengthened our brand by hosting high-profile events, such as NetEase Annual Economist Conference. These types of events, along with the steady popularity of our mobile news app, helped to grow our advertising services business with the automobile, Internet services and telecommunication sectors as the top-performing advertising verticals in the fourth quarter.

As advertisers seek more and more mobile Internet marketing opportunities, our leading mobile product matrix provides us with a considerable competitive advantage, enabling us to maintain and grow our partnerships with leading advertisers.

Our e-commerce platforms, including Kaola.com, also continued to grow at a swift pace during the fourth quarter. We plan to keep expanding this business where we see considerable growth opportunities. Our focus remains on creating innovative experiences for our community by delivering the highest quality Internet games and services. With the continued support of our investors, we plan to further these efforts in 2016, while simultaneously giving back to this constituency.

Through our share repurchase and regular dividend program, we returned more than $247 million to our investors in 2015. Our plan for diligent expansion across our business lines positions us well to continue these measures that create and return values to shareholders throughout the year.

This concludes William's comments. I will now provide a review of our fourth quarter and full year 2015 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit.

Gross profit for the fourth quarter of 2015 was RMB4.2 billion or $651.4 million, compared to RMB3.8 billion and RMB2.5 billion for the preceding quarter and the fourth quarter of 2014 respectively.

The year-over-year increase in online games gross profit was primarily driven by revenue contributions from our mobile games, such as the Fantasy Westward Journey and the Westward Journey Online mobile games, and licensed games such as Blizzard Entertainment's Hearthstone: Heroes of Warcraft and Diablo III: Reaper of Souls, as well as Kai-ri-sei Million Arthur and our new self-developed PC-client games such as Revelation.

The quarter-over-quarter increase in online games gross profit was primarily driven by revenue contributions from mobile games such as the Westward Journey Online mobile game and Kai-ri-sei Million Arthur, as well as Blizzard Entertainment's Hearthstone: Heroes of Warcraft.

Our year-over-year and quarter-over-quarter increases in advertising services gross profit were primarily attributable to strong demand from the automobile, Internet services and telecommunication sectors, as well as the monetization of our mobile applications, primarily our mobile news app.

The year-over-year decrease in our email, e-commerce and others gross profit segment was primarily due to the temporary suspension of higher-margin e-commerce services related to third-party lottery products since February 2015. The quarter-over-quarter increase was mainly due to increased revenue contributions from our e-commerce-related businesses, such as Kaola.com.

Gross profit margin for the online games business for the fourth quarter of 2015 was 67.2%, compared to 67.9% and 76% for the preceding quarter and the fourth quarter of 2014 respectively. The year-over-year and quarter-over-quarter decreases in gross profit margins were mainly due to increased revenue contributions from mobile games, which have relatively lower gross profit margins as a percentage of our total online games revenues.

Gross profit margin for the advertising services business for the fourth quarter of 2015 was 68.1%, compared to 67.6% and 65.9% for the preceding quarter and the fourth quarter of 2014 respectively. Gross profit margin for the email, e-commerce and others business for the fourth quarter of 2015 was 6%, compared to 0.1% and 48.2% for the preceding quarter and the fourth quarter of 2014, respectively.

The year-over-year decrease in gross profit margin was primarily attributable to the temporary suspension of higher margin e-commerce services related to third-party lottery products discussed above, as well as increased revenue contributions from our other e-commerce platforms, which have relatively lower gross profit margins. The quarter-over-quarter improvement in gross profit margin was mainly due to the revenue growth from our e-commerce businesses such as Kaola.com.

Our total operating expenses for the fourth quarter of 2015 were RMB1.8 billion or $278.1 million compared to RMB1.8 billion and RMB1.2 billion for the preceding quarter and the fourth quarter of 2014 respectively. The year-over-year increase in operating expenses was mainly due to increased selling and marketing expenses relating to our online games and advertising services, higher research and development investments and higher staff-related costs resulting from an increase in head count and average compensations. The quarter-over-quarter increase in operating expenses was mainly due to increased selling and marketing expenses for mobile games.

We recorded a net income tax charge of RMB513.8 million, or $79.3 million, for the fourth quarter of 2015, compared to RMB399.2 million and RMB187.9 million for the preceding quarter and the fourth quarter of 2014, respectively.

The effective tax rate for the fourth quarter of 2015 was 19.2%, compared to 17.1% and 12.8% for the preceding quarter and the fourth quarter of 2014 respectively. The year-over-year increase in the effective tax rate was mainly the result of certain subsidiaries being approved as Key Software Enterprises and subject to a preferential tax rate of 10% for 2014. Those subsidiaries were subject to a tax rate of 15% in 2015.

During the fourth quarter of 2015, we had a net foreign exchange gain of RMB66.3 million, or $10.2 million, compared to a net foreign exchange gain of RMB66.5 million and a net foreign exchange loss of RMB7.1 million for the preceding quarter and the fourth quarters of 2014 respectively. The year-over-year and quarter-over-quarter changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our U.S. dollar-denominated bank deposits and short-term loan balances, as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

Our net income attributable to the company's shareholders for the fourth quarter of 2015 totaled RMB2.2 billion, or $334.1 million, compared to RMB1.9 billion and RMB1.3 billion for the preceding quarter and the fourth quarter of 2014, respectively.

Our non-GAAP net income attributable to the company's shareholders for the fourth quarter of 2015 totaled RMB2.4 billion or $363.5 million, compared to RMB2.1 billion and RMB1.4 billion for the preceding quarter and the fourth quarter of 2014 respectively.

Basic and diluted earnings per ADS were $2.54 and $2.52 respectively for the fourth quarter of 2015. This compares to basic and diluted earnings per ADS of $2.21 and $2.2 respectively for the preceding quarter, and basic and diluted earnings per ADS of $1.50 and $1.49, respectively, for the fourth quarter of 2014.

Non-GAAP basic and diluted earnings per ADS were $2.77 and $2.74 respectively for the fourth quarter of 2015. This compares to non-GAAP basic and diluted earnings per ADS of $2.41 and $2.39 respectively in the preceding quarter and non-GAAP basic and diluted earnings per ADS of $1.65 and $1.64 respectively for the fourth quarter of 2014.

Now, for an overview of the 2015 fiscal year financial results. Gross profit for fiscal year 2015 was RMB13.4 billion or $2.1 billion, compared to RMB8.5 billion for the preceding fiscal year.

The increase in online game services gross profit in 2015 was primarily attributable to increased revenue contribution from our mobile games, such as the Fantasy Westward Journey mobile game, the Westward Journey Online mobile game and Battle to the West, and licensed games such as Blizzard Entertainment's Hearthstone: Heroes of Warcraft and Diablo III: Reaper of Souls, as well as our self-developed PC-client games, such as Revelation.

The increase in advertising services gross profit in 2015 was due to a rise in demand, mainly from the automobile, Internet services and real estate sectors, as well as the monetizations of our mobile applications, primarily our mobile news app. The decrease in email, e-commerce and others gross profit in 2015 was primarily attributable to the temporary suspensions of higher-margin e-commerce services related to third-party lottery products since February 2015.

Our total operating expenses for fiscal year 2015 were RMB6.1 billion, or $946.5 million, compared to RMB3.7 billion for the preceding fiscal year. The increase in operating expenses in 2015 was primarily due to increased selling and marketing expenses for online games, advertising services and other mobile products, higher research and development investments and higher staff-related costs resulting from an increase in head count and average compensations.

We recorded a net income tax charge of RMB1.3 billion, or $196.6 million, and RMB662.7 million for fiscal years 2015 and 2014 respectively. The effective tax rate was 15.7% for fiscal year 2015, compared to 12.1% for fiscal year 2014. The change in the effective tax rate was mainly due to the fact that certain subsidiaries were approved as Key Software Enterprises and subject to a preferential tax rate of 10% for 2014. Those subsidiaries were subject to a tax rate of 15% in 2015.

We reported a net foreign exchange gain for the 2015 full year of RMB133.8 million, or $20.7 million, compared to a net foreign exchange loss of RMB18 million for the preceding fiscal year. The net foreign exchange changes for fiscal year 2015 and 2014 were mainly due to exchange gains and losses arising from the our U.S. dollar-denominated bank deposits and short-term loan balances, as the exchange rate of the U.S. dollar against the RMB fluctuated over this period.

Our net income attributable to the company's shareholders for fiscal year 2015 totaled RMB6.7 billion, or $1 billion, compared to RMB4.8 billion for the preceding fiscal year. Our non-GAAP net income attributable to the company's shareholders for fiscal year 2015 totaled RMB7.4 billion or $1.1 billion, compared to RMB5.1 billion for fiscal year 2014.

Our basic and diluted earnings per ADS were $7.91 and $7.86 respectively for fiscal year 2015. This compares to basic and diluted earnings per ADS of $5.62 and $5.60 respectively for the 2014 fiscal year. Our non-GAAP basic and diluted earnings per ADS were $8.72 and $8.66 respectively for fiscal year 2015. This compares to non-GAAP basic and diluted earnings per ADS of $6.04 and $6.01 respectively for fiscal year 2014.

As of December 31, 2015, our total cash, current and non-current time deposits and short-term investment balance was RMB26.8 billion, or $4.1 billion, compared to RMB23.2 billion as of December 31, 2014. Cash flow generated from operating activities was RMB8.1 billion, or $1.2 billion for fiscal year 2015, compared to RMB5.9 billion for the preceding fiscal year.

As part of our commitment to returning values to our shareholders, we are pleased to announce that our Board of Directors approved a dividend of $0.64 per ADS for the fourth quarter of 2015. We expect to pay this on March 18, 2016 to shareholders of record as of the close of business on March 11, 2016.

Additionally, on September 1, 2015 we announced that our Board of Directors approved a new share repurchase program of up to $500 million of the company's outstanding ADSs. As of December 31, 2015, we have repurchased around 190,000 ADS for approximately $20.7 million under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

[Operator Instructions]

We'll take our first question from Fan Liu with Goldman Sachs.

<Q - Fan Liu>: Hi, management. Thanks for taking my questions. So, I have two questions. Number one is about the mobile games. So, we witnessed actually some volatility [indiscernible] (25:11) recently. Does the management think the competition landscape is getting more challenging, or would you mind to comment on the user engagement and also monetization for both these two top titles? Also for the new games pipeline, what kind of – which titles do you think may be the next blockbuster for NetEase? And what would be your expectation for Blizzard games agreement in the coming year? Thank you.

<A - Onward Choi>: Okay. So, thank you for your questions. So, with regard to your first question, about our view on our mobile games, especially on the Fantasy Westward Journey and Westward Journey Online, we believe that for now the competition landscape in this area is getting very competitive. But having said that, we still believe that for companies that could actually deliver some high-quality products and care about the user experiences, then we would be able to deliver something very meaningful and also very supportive from the player communities.

And insofar as those two games are concerned, we have been seeing that they have been performing very well in the past years since their first launch in the market. And we have been seeing that the user engagement has been very good and we are also seeing that there has been a good growth that we have experienced in the past quarters as well. And we are also looking forward that those games will upkeep their current performances in the foreseeable future.

And with regard to your second question about the new games pipelines and whether or not there would be any particular blockbuster games and things like that, basically, we have been upkeep a very good momentum of rolling out the games, especially the mobile games, to the market. If you look back in the past quarter, which is the fourth quarter of 2015, we have come up to 80 plus mobile games in the market. That's compared to about 50 plus in the third quarter of 2015. And you will see that we have upkeep these visions and also the passion to roll out those interesting games to the market.

And just as what we highlighted earlier in the earnings sharing, there will also be quite a lot of – some other games coming up to the market in 2016, including some games like the Raven, Fantasy Westward Journey: Warriors and the mobile version of our New Ghost. And we are also seeing that those games will have a good traction from the market as well.

And insofar as your third question about our expectations on the Blizzard games, we believe that in 2016 there will also be some new games that we are looking forward from it, and one of those will be the Overwatch and there will be some new additions to some current games that we are currently working.

And we – just as what we previously shared about, Blizzard is a very good company, and they are also delivering some good-quality games to the market as well. And so we are looking forward that this will also got an appeal to the market in 2016.

<Q - Fan Liu>: Thank you, Onward. If I may, can I have two follow-ups. [indiscernible] (29:21). Do you mind to share with us the mobile games' contribution, revenue contribution this quarter? And also secondly, about your cross-border e-commerce, so assuming the most of the incremental revenue coming from Kaola, so with the revenue contribution rising up, would you be planning to have a separate disclosure for this segment in the coming quarters? And also the margin, if we see the gross margin for the e-commerce and email and others segments, the margin is actually up 6% quarter-on-quarter. So, it seems that there [indiscernible] (29:59). Would you mind to share with us the outlook for the profitability for this segment in the coming quarters? Thank you.

<A - Onward Choi>: Okay. So, I believe there would be a couple of questions that you just raised up in the follow-up. And with regards to the mobile contributions from the game businesses in the fourth quarter, it would be about 57%.

And with regard to your second follow-up about our e-commerce businesses, of course we have been doing very well in the past quarters. The overall revenue generation has been doing good as well. And we are also keeping track on how big the business will be before we will make a decision on whether or not those numbers will be separately disclosed in the foreseeable future.

But having said that, we are still quite happy with this performance over the past couple of quarters, since we first launched these new business initiatives to the market. And insofar, as the improvement in the gross margins on our email, e-commerce, and other segments, I believe that one of the [indiscernible] (31:23) there has been some operating leverage that we have been enjoying.

And other thing is that, if you recall, back in the third quarter of 2015, there has also been a one-time about certain costs that we have been charged in those segments that impact the overall gross margins in different quarters. And so we have been seeing that. The current levels of the gross margins in the fourth quarter would be a more – a better reflection of this current situation.

Operator

[Operator Instructions]

We'll take our next question from Eddie Leung with Merrill Lynch.

<**Q - Eddie Leung**>: Good morning. I would like to get a sense on the strength in your advertising business in the fourth quarter. since like there has been some acceleration. So, just wondering whether there has been any one-time impact for certain industry promotion? And then could you also talk a little bit about the advertising outlook for the upcoming few quarters, especially given the seasonality in the first quarter? Thanks.

<**A - William Ding**>: [Foreign Language] (33:00 – 34:14)

<**A - Onward Choi**>: So, Eddie, with regard to your first question about the reasons attributed to the good performances of our advertising services in the fourth quarter. First of all, from the product perspectives, including our mobile news app, the Cloud Music, the Youdao Dictionary and stuff like that, we have invested quite a lot. And also, coupled with some effective marketing promotions to keep it aware and recognized in the market.

And more importantly, because the product quality is very good, and we have got a very well recognitions by our advertisers [inaudible] (34:58) performances in the fourth quarter of 2015. And on the other hand, we also appreciate the [inaudible] (35:10) that our sales team has been doing to sell those advertising inventory to the market, and that has resulted in relatively good performances in the fourth quarter.

<**A - William Ding**>: [Foreign Language] (35:26 – 36:01)

<**A - Onward Choi**>: So, with regard to our general outlook in 2016, basically we would still be putting quite a focus on developing our non-game-related mobile apps and in order to making sure that this can also make another step-up in these performances in 2016.

And in particular, for apps like the Cloud Music and also the news reader and stuff like that, we are also seeing that there has been quite a lot of new features that we have added into the applications, and also getting good traction from the market. And so we are holding a positive view about the overall performances in our advertising services in the 2016.

Operator

And our next question comes from David Hao with Credit Suisse.

<**Q - David Hao**>: Good morning, gentlemen. So, my question will be focusing on the games, film, and drama ecosystem. So, back in December last year, the company announced [indiscernible] (37:10) strategies. So, can you let us know more on the progress of carrying-out these strategies currently? And will we see meaningful revenue earnings contribution this year? Thanks.

<**A - Onward Choi**>: David, excuse me. Would you mind to repeat it in Chinese again, about your questions?

<**Q - David Hao**>: Yeah, sure. No problem. [Foreign Language] (37:37 – 38:02)

<**A - William Ding**>: [Foreign Language] (38:19 – 39:35)

<A - Onward Choi>: So, with regard to your questions, David, basically we very appreciate and also cherish the successes that we have been – built up in the past couple of years on our gaming businesses. And along this line, we are also thinking that those IPs would be very receptive and also popular amongst the audiences in the market in general.

And so, along this line, we have also got some plans to develop some stuff like the movies or the serial TV shows and stuff like that to make our popular IP to be being recognized and enjoyed by much wider population. And at the same time, this kind of format, or the way that we are doing it, would be a good way to further leverage or to extend our current content offerings.

And some of the achievements that we have made so far is that in 2016, early this year, we have also introduced games like the Kung Fu Panda series games, which we have also got very good traction from the market. And those popular IPs got a very good potential to make some better traction to our targeted audiences in general.

Operator

And we'll go next to Vivian Hao with J.P. Morgan.

<Q - Vivian Hao>: Hi, Onward. Hi, William. Thank you for taking my questions. I'll keep it brief. Just on the [ph] news app (41:27) front, and also the [indiscernible] (41:28) can you share with us the monetization plan on mobile news app this year, particularly how do you see the competition has been shaping up in this area? I think we have seen quite a few of those news apps, like Today's Headline and also Tencent News App doing very well, as well.

[Foreign Language] (41:50 – 42:22)

<A - William Ding>: [Foreign Language] (42:24 – 45:00)

<A - Onward Choi>: So, basically, just a quick recap on William's highlights. From our perspective, we believe that there would be quite a couple of companies that would be engaged in the news app businesses. And every company has got its own distinct features or the own differences.

And of course, NetEase would have our own unique differentiations from the others. And two of the most significant features that we have that we are having leading positions with include our mobile news applications, would be able to promote a more unique news sharings, perspective sharings and stuff like that. And at the same time, the [ph] follow and post (45:50) function has been doing very, very well in the market, and this has made us to surpass our competitors in this space.

And insofar as 2016 is concerned, from the development perspective, we believe that there will be some new products or service being offered in this year, like the direct broadcasting for some video stuff. And also, there would be some innovative product that we will also be introduced in the market as well.

And from the marketing perspective, we would also upkeep our investment in these areas in order to promote our news app. And from the technical side, we would also be doing some things to promote the personalized readings and coupled with all those initiatives that we are going to roll out in the market in this year, we are quite confident that we will be able to secure our leading position in this space.

And one more thing. In 2016, this would be a sports, because there would – and we would also be – invest more on some sport related contents. And this is something that – what our peers like the Today's Headlines has not been doing much in that sense.

And in summary, we are quite confident that we would upkeep a good growth and our popularity of our mobile news apps in the market and also bring some good performances in 2016 and higher.

Operator

We'll go next to Thomas Chong with Citigroup.

<**Q - Thomas Chong**>: Hi. Good morning, William, Onward, and Juliet. Thanks for taking my questions. I have two questions. My first question is about mobile advertising revenue. Can management give us some color about the contribution to your total online advertising in the fourth quarter? And my second question is about management comments about the PC game industry trend outlook. And I'm just wondering how we should think about the lifecycle for FWJ for the PC version. Are we seeing some weakness as we go into 2016? Thanks.

<**A - William Ding**>: [Foreign Language] (48:31 – 49:50)

<**A - Onward Choi**>: So, with regard to your question about how we will reverse the lifecycles of the games like our Fantasy Westward Journey, basically we are still quite happy with its performance so far. And it's still [indiscernible] (50:00) very good momentum, terms of its performance and the user engagements. And of course, with the developments or the growth in the mobile areas, there will be a certain impact to PC games. But we still believe that those impacts will not be that significant in that sense.

And on the other hand, in 2016, and perhaps towards the ends of this quarter, the first quarter of 2016, we will also be rolling out some other PC versions games to the market as well, which is a reflection on our confidence that the PC games would form an integral part of our gaming business or the gaming strategies.

And with regard to your second question about the mobile ads revenue percentages, basically [indiscernible] (50:54) double-digit percentage, just as what we have talked about in the previous quarters. We have also been seeing that those contributions has been at been at a very good level and we are still seeing some good traction from the advertisers going to our mobile platforms [indiscernible] (51:15) advertisements. And so this is what we would like to share for now.

<**Q - Thomas Chong**>: Thanks, William and Onward.

Operator

And we'll go next to Natalie Wu with CICC.

<**Q - Natalie Wu**>: Hi. Good morning, management. Thanks for taking my question. Firstly, I have a quick question for Onward. If we look at your balance sheet, the account receivable, actually it went up a lot in 2015, especially in the second quarter and fourth quarter. Wondering what's the story behind. What kind of business is related to that item? And also

[Foreign Language] (51:58 – 52:24)

Also, I have a question for William. What do you think the next hit title might be? Will it be Ghost or some other titles? And also, what will be the new move for NetEase in 2016? Is there any new strategic initiative like virtual reality et cetera? Thank you.

<**A - William Ding**>: [Foreign Language] (52:54 – 54:00)

<**A - Onward Choi**>: So, basically, we believe that the more important elements in our game business strategies is the innovations, as an ongoing and integral part of our development cycle, because we are all the time trying to do new things in order to meet and surpass the expectations or the demand from the players.

And also, for those new game titles that we are going to roll out in the market in 2016 and years ahead, we would also be focusing on the qualities and also the innovative elements within the games in order to meet the expectations from the players, just like what we have been doing for games like the FWJ, because we have always cared about the qualities of the products that we are going to roll out or launch to the market and also the users' experiences and stuff like that. And [indiscernible] (55:04) with all those elements, we are believing that this will ensure us to be playing very successfully in the market in 2016.

And with regard to your second question, Natalie, about the accounts receivable balances in the balance sheet, basically, you would see that in the past couple of quarters, perhaps since the second quarter of 2015, there has been a growth in the net balances. And the major reasons for the increase was attributed to those mobile games [indiscernible] (55:40) platforms. And this is also a good reflection from what we have been doing in terms of our revenue growth that has been experienced in the mobile game businesses.

Operator

Tian Hou, T.H. Capital.

<Q - Tian X. Hou>: Hi William, Onward, and Brandi. I have a couple of questions. One is related to your advertising business. The normal seasonality Q3 is the highest one and Q4 could be flat with Q3. And NetEase is a little bit different. I wonder is it a one-time thing or you're advertising business actually against normal seasonality? William

[Foreign Language] (56:37 – 57:11)

So, the follow-up question is what is the major driver of the industry for your advertising growth? The third question is related to [indiscernible] (57:21).

[Foreign Language] (57:22 – 57:30)

So, the download of [ph] E-chat (57:32) is increasing rapidly. So, I wonder if William can give us some color. How do you plan to use [ph] E-chat (57:40) going forward? That's all my questions. Thank you.

<A - William Ding>: [Foreign Language] (57:47 – 59:31)

<A - Onward Choi>: Okay, so with regard to this first part of the question, basically nowadays, the whole markets would be looking on both the PC and the mobile front. And for NetEase, we have quite a couple of new product initiatives in the market that has rolled out so far, including [ph] the news (59:54), the Youdao Dictionary, the [ph] eMail Master (59:56), the Cloud Music and also [ph] News Reader (59:59).

And for products like our email services, we would be the absolute leader in the market in terms of the user engagement and stuff like that, and for the dictionary. I believe that so far, it would be – no second one that could perform much better than us.

And with regard to the Cloud Music, we have accumulated quite a huge population of high-quality and high-level users there. And with all those comprehensive user base, we have gotten a very good recognitions from the market and the advertisers alike. And coupled with our very strong and diligent sales team, we have also been doing a very good job in order to grow our advertising businesses in the past couple of months.

And even though you will see that the overall revenue contributions coming from the advertising services will be quite similar to the third quarters, but we are still seeing that there has been a good growth area going ahead. This is the first part.

<A - William Ding>: [Foreign Language] (61:17 – 61:52)

<A - Onward Choi>: So, with regard to your second and third questions, I believe that we have no further comments for the time being.

Operator

And that concludes the question and answer session. I would like to turn the conference back over to management, for any additional or closing comments.

Brandi Piacente

Thank you once again for joining us today. If you have further questions, please feel free to contact Juliet Yang, NetEase's IR manager, based in Hangzhou, or TPG Investor Relations. Have a wonderful day.

Operator

And that concludes today's conference. We thank you for your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2015-11-11
Event Description: Q3 2015 Earnings Call

Q3 2015 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Dick Wei
- Alicia Yap
- Eddie Leung
- Martin Bao
- Tian X. Hou
- Thomas Chong

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the NetEase Third Quarter 2015 Earnings Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead, ma'am.

Brandi Piacente

Thank you, operator. Please note that discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors.

Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial measures results, please see the third quarter financial results news release issued earlier today. As a reminder, this conference is being recorded. In addition, a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that, for the purposes of these discussions, all percentages are basically on renminbi. China's online game industry has undergone a rapid transformations over the last two years. While traditional online games remained popular, more and more players are adopting mobile options to suit their on-the-go lifestyles. The combinations of these complementary platforms is putting China on pace to become the world's largest gaming market. NetEase has been at the forefront of this market, and we are honored to be a leading developer and operator of some of the country's most popular games.

We have long been a successful innovator in China's evolving Internet, and third quarter results reflect the continued commitments to our community with total net revenues increasing by 114.1% compared with the same period last year. We grew our top line net revenues of our three business segments both sequentially and year-over-year, with year-over-year increases of 124.5% in online games, 10.5% in advertising services and 162.2% in e-mail, e-commerce and others. Our self-developed and licensed PC-client games continue to spend the best of time, while our mobile games are driving new growth and attracting new constituencies.

We have felt some exciting success, introducing mobile adoptions of our popular games to Chinese audiences. In particular, during the third quarter, we launched our Westward Journey Online mobile game, which together with our Fantasy Westward Journey mobile game, are now the top two grossing games in the iOS China app store. Players' appetite for new PC-client games and content remain strong. And during the third quarter, we were very pleased with the performance of our new self-developed 3D oriental fantasy MMORPG, Revelation.

We also saw continued interest in Blizzard Entertainment's Diablo III: Reaper of Souls and Hearthstone: Heroes of Warcraft. To view on this momentum, our strategy will be to continue to increase the longevities of these games with new features and content. To this end, during the third quarter, we introduced a number of expansion packs for our PC-client games that were warmly received, including Fantasy Westward Journey II and then new versions of Ghost II called New Ghost.

Additionally, we have entered into collaborations with New Ghost and an urban TV show, which is based on a renowned youth romance novel. This cooperation represents the initiations of our strategies to utilize innovative marketing models for our games that further extend our brand. Similarly, we are strengthening our mobile positions. And today, we have a solid mobile portfolio that hosts more than 50 games. This July, we have launched a number of new mobile titles to enthusiastic receptions with games such as Fairy Tales: The World of the Brave, Kai-ri-sei Million Arthur, Lunar Flowers, The Beautiful Dream and Chrono Blade.

In addition to the domestic popularity of our mobile initiatives, we have now launched several new games for overseas audiences. The initial feedback has been positive, and we are actively growing our international presence. We plan to continue fortifying our mobile foothold with SaaS-developed and license games that delight our players. Other new games slated for introductions include our highly anticipated Kung Fu Panda mobile games in late November, as well as the X-World, Fantasy Westward Journey: Warriors and Raven in the coming months. Looking at our PC-client game pipeline, we look forward to bring our PC client players, thrilling new experiences with expansion packs planned for Tianxia III, Heroes of Tang Dynasty Zero, and the new release of Hegemon-King of Western Chu in the coming series.

Our other business segments are also very well. Advertisers are continuing the transitions from PC to mobile platforms where we offer numerous advantages based on our leading apps, including our Mobile News application. Accordingly, we have seen continued growth in our advertising revenues from mobile platforms. During the first quarter, our top-performing advertising verticals were the automobile, Internet services and food and beverage sectors.

E-commerce is another area where we see an opportunity to expand. Our cross-border e-commerce platform, Kaola.com also continued to grow rapidly during the third quarter, and we are seeing sustained strong momentum from our e-commerce business. Our businesses are robust and growing. Our heavy portfolio of PC-client and mobile games along with our services and other complementary offerings are faring well with our loyal community base. We continue to expand this audience with a focus on superior quality and innovations, while keeping an eye toward integrations of our PC-client and mobile games and other product and service offerings across our business lines.

This concludes William's comments. I will now provide a review of our third quarter 2015 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit. Gross profit for the third quarter of 2015 was RMB 3.8 billion or $605.6 million compared to RMB 2.8 billion and RMB 2.3 billion for the preceding quarter and the third quarter of 2014 respectively. The year-over-year and quarter-over-quarter increases in online games' gross profit were primarily driven by revenue contributions from our mobile games such as the Fantasy Westward Journey mobile game, and licensed games such as Blizzard Entertainment's Diablo III: Reaper of Souls and Hearthstone: Heroes of Warcraft, as well as our new self-developed PC-client games such as Revelation.

The year-over-year and quarter-over-quarter increases in advertising services gross profit were primarily attributable to strong demand from the automobile, Internet services and food and beverage sectors, and the monetizations of our mobile applications, primarily our Mobile News App.

The year-over-year decrease in e-mail, e-commerce and others, gross profit was primarily due to the temporary suspensions of higher margin e-commerce services related to third-party lottery products since late February 2015, which was partially offset by increased revenue contributions from our other e-commerce platforms which have relatively lower gross profit margins. The quarter-over-quarter decrease was primarily due to the one-off recognitions of expenses related to certain copyrights in the third quarter of 2015.

Our gross profit margin for the online games business for the third quarter of 2015 was 67.9%, compared to 69.3% and 77.2% for the preceding quarter and the third quarter of 2014, respectively. The year-over-year and quarter-over-quarter decreases in gross profit margin were mainly due to increased revenue contributions from mobile games, which have relatively lower gross profit margins as a percentage of our total online games revenues.

Gross profit margin for the advertising services business for the third quarter of 2015 was 67.6%, compared to 68.2% and 65.3% for the preceding quarter and the third quarter of 2014, respectively. Gross profit margin for our e-mail, e-commerce and others business for the third quarter of 2015 was 0.1%, compared to 4.2% and 51.6% for the preceding quarter and the third quarter of 2014, respectively. The year-over-year decrease in gross profit margin was primarily attributable to the temporary suspension of higher margin e-commerce services related to third-party lottery products discussed above, as well as increased revenue contribution from our other e-commerce platforms, which have relatively lower gross profit margins. The quarter-over-quarter decrease was mainly due to the one-off recognition of expenses related to certain copyrights in the third quarter of 2015.

Our total operating expenses for the third quarter of 2015 were RMB 1.8 billion or US$277.1 million, compared to RMB 1.4 billion and RMB 1.1 billion for the preceding quarter and the third quarter of 2014, respectively. The year-over-year and quarter-over-quarter increases in operating expenses were mainly due to increased selling and marketing expenses for mobile and PC-client games, advertising services and other mobile products, and higher staff-related costs resulting from an increase in head count and average compensation.

We recorded a net income tax charge of RMB 399.2 million or US$62.8 million for the third quarter

of 2015 compared to RMB 145.9 million and RMB 197.3 million for the preceding quarter and the third quarter of 2014, respectively. The effective tax rate for the third quarter of 2015 was 17.1%, compared to 9.2% and 14.4% for the preceding quarter and the third quarter of 2014, respectively. The year-over-year increase in the effective tax rate was mainly the result of certain subsidiaries being approved as Key Software Enterprises and subject to a preferential tax rate of 10% for 2014. Those subsidiaries were subject to a tax rate of 15% in 2015. The quarter-over-quarter increase in the effective tax rate was mainly due to the recognitions of certain tax credits in the second quarter of 2015 related to annual tax filing benefits. Most of these credits comprised extra tax deductions for research and development expenses approved by the tax authorities.

In the third quarter of 2015, we had a net foreign exchange gain of RMB 66.5 million or US$10.5 million, compared to a net foreign exchange loss of RMB 21.7 million and a net foreign exchange gain of RMB 2.2 million for the preceding quarter and the third quarter of 2014, respectively. The year-over-year and quarter-over-quarter changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our foreign currency-denominated bank deposits and short-term loan balances, as the exchange rate of the U.S. dollar against the

RMB fluctuated over the periods.

Our net income attributable to the company's shareholders for the third quarter of 2015 totaled RMB 1.9 billion or US$296.1 million, compared to RMB 1.4 billion and RMB 1.2 billion for the preceding quarter and the third quarter of 2014, respectively. Our non-GAAP net income attributable to the company's shareholders for the third quarter of 2015 totaled RMB 2.1 billion or US$322.6 million, compared to RMB 1.6 billion and RMB 1.3 billion for the preceding quarter and the third quarter of 2014, respectively.

Basic and diluted earnings per ADS for the third quarter of 2015 were US$2.25 and US$2.24, respectively. This compares to basic and diluted earnings per ADS of US$1.70 and US$1.69 respectively, for the preceding quarter, and basic and diluted earnings per ADS of US$1.40 and US$1.39, respectively, for the third quarter of 2014. Non-GAAP basic and diluted earnings per ADS were US$2.45 and US$2.44, respectively, for the third quarter of 2015. This compares to non-GAAP basic and diluted earnings per ADS of US$1.90 and US$1.89, respectively, in the preceding quarter, and US$1.51 each for third quarter of 2014.

As of September 30, 2015 our total cash and time deposits balance was RMB 20.4 billion or US$3.2 billion, compared to RMB 21.2 billion as of December 31, 2014. Cash flow generated from operating activities was RMB 2.2 billion or US$346.5 million for the third quarter of 2015, compared to RMB 835.9 million and RMB 1.2 billion for the preceding quarter and the third quarter of 2014, respectively.

As part of our commitment to returning values to our shareholders, we are pleased to announce that our board of directors has approved a dividend of US$0.56 per ADS for the third quarter of 2015. We expect to pay this on December 4, 2015 to shareholders of record as of the close of business on November 27, 2015.

Additionally, on September 1, 2015 we announced that our board of directors approved a new share repurchase program of up to US$500 million of the company's outstanding ADS. As of September 30, 2015, we have repurchased around 0.19 million ADS for approximately US$20.7 million under this program.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you. [Operator Instructions] And our first question comes from Dick Wei with Credit Suisse.

<Q - Dick Wei>: Hi, good morning. Thank you for taking my questions, and congrats on the strong quarter. First question is on the mobile games front. I wonder, in general, how many mid-core mobile games players play at the same time?

<A - William Ding>: So, based on our observations, for the general hardcore players, they would generally focus on playing one game at one time, whereas for the players playing the casual games, usually they would focus to two to three games.

<Q - Dick Wei>: And the second question is maybe on deferred revenue. I think the deferred revenue was around RMB 4.1 billion this quarter versus around RMB 3.8 billion last quarter so the growth is vertically stable. I wonder if any – how should I look at that in relation to the revenue growth as well as I'm not sure, any accounting policy changes for the deferred revenue. Thank you.

<A - Onward Choi>: So with regard to your questions about the deferred revenues, I believe that there has been a very good and positive trend of going up in the third quarter. And basically, this would also be very good reflections on – the positive reflections on – since the launch on the operations of our new mobile games including the Fantasy Westward Journey and also the Westward Journey Online mobile games. And those games have been trending on track, and we are still quite happy to see that the deferred revenues have been going up.

With regard to your point on the accounting policies, I believe that we have been upkeep as a very consistent approach in doing the recognitions of the games' revenues. Basically, if we are referring to the item-based model, then we would amortize those revenues for a period of not more than six months. This has been consistently applied for both the PC-client games and also the mobile games.

<Q - Dick Wei>: Okay. Thank you.

Operator

Thank you. Our next question comes from Alicia Yap with Barclays.

<Q - Alicia Yap>: Hi. Good morning, William and Onward. Congratulations on the strong quarter. Thanks for taking my questions. I have a couple of quick questions. Number one is that can you share with us maybe what are the success factors for your two hit games in a row, Fantasy Westward Journey and Westward Journey II, and mobile? And then can you share with us the user profile for both games, like the similarities and the differences between; for example, like demographic age group, like the first-tier versus lower tier cities. Any skew towards iOS user or android user?

And then, can I also get the percentage of mobile games contribution for the quarter? And I have another question. Thanks.

<A - Onward Choi>: Okay. So basically, with regard to your questions about the success patterns or perhaps the user profile about our mobile games, in particular the FWJ or the WJ Mobile, first of all we do have a very strong development team in the past 10-plus years, cumulative of rich experiences of developing games. And we also got a very good knowledge and experience base to make sure that we can deliver something that would be of very good qualities to our targeted audiences in the market.

And just to recap on what William has previously highlighted in particular to the user base for the FWJ Mobile, basically, about 70% of those would be new users. And we believe that with the higher popularities of the mobile handsets or the mobile smartphones, this would also place a very good trend for people to turn to play the mobile games in that sense. And also, we also observe that in terms of the users for the FWJ Mobile, basically they would be users of the younger age group.

<Q - Alicia Yap>: Okay. Thank you. Thank you, Onward and William. My second question is on Kaola. So, is there any metrics that maybe you can share with us in terms of numbers of orders or maybe active user base? That would be great. If not, what about in terms of most popular products that people attracted to your platform? And then, just overall is that, to conclude, other than competitive pricing and authentic products, what are Kaola's key differentiations between other e-commerce platform or what targets that we try to achieve on differentiation? And Onward, can you also remind us the mobile game percentage contribution? Thanks.

<A - Onward Choi>: Okay. So basically with regard to our strategies on the Kaola business, basically we are using our own resources to do the merchandising or the sourcing of those goods and to making sure that those goods will be authentic in that sense. And if we look to the market for some of the other peers because somehow they would also be using third-party vendors or suppliers in order to source those products and so there would be a risk on the authenticity of the goods.

And, at the same time, there would also be certain pricing issues attached with those products. And the theme or the philosophies for NetEase in getting to this new area is that we would like to make sure that we would provide something that would be value for money, that would be of good value and adds a very good experience to our targeted users on our Kaola.com platform.

And in the past couple of quarters, we also see that the growth in this new business initiatives has been doing very well and we are also looking forward that this would be on track to growth going forward. And this would be the first part response to your questions, and just to supplement, Alicia, on your questions about the mobile games percentages for the third quarter; this has already come up to about 53% for this quarter.

<**Q - Alicia Yap**>: Okay. Thank you, Onward and thank you, William.

Operator

Thank you. Our next question comes from Eddie Leung with Merrill Lynch.

<**Q - Eddie Leung**>: Good morning. Just a question on the Kaola business as well. We have seen the gross margin being close to zero at the moment. So just wondering whether it's more about discounts or it's more about economies of scale, which we should see, as revenue grows, the gross margin will return to positive. Thanks.

<**A - Onward Choi**>: So, Eddie, thank you for your questions. So basically, with regard to the gross margins of our Kaola business, just as what we have mentioned in previous quarter, this will be a low gross margin business, and we do see that in the past couple of months as the scale and the user base has been growing. We do see that this would also be contributing to a relatively lower gross margin in that sense.

But if we look at the business segment as a whole because this would not just be accounting for the performances on just Kaola alone, but there will also be some other initiatives that we have been offering free of charge to our users as well. And so as a whole, you would also see that there has also been a further freeze or a down-trend in terms of the gross margin on these business segments. But as always, we also anticipated that as we grow our scale of this business, and in a much longer-term, we will also try to see how we could better enhance the gross margin for these business initiatives.

<**Q - Eddie Leung**>: Thank you.

Operator

Thank you. Our next question comes from [ph] Jiang Xi (31:37) with Nomura.

<**Q**>: Hi. Good morning, William, Onward and Juliet. Thanks for taking my call. First of all, Onward, can you remind me again the mobile game contribution in Q3? I probably missed it. I have a few follow-ups. Thank you.

<**A - Onward Choi**>: This would be about 53%.

<**Q**>: Okay. Of total gaming revenue?

<**A - Onward Choi**>: Yes. Yes.

<**Q**>: Okay. Thank you. Also, my second question is also about your mobile gaming business. As we know, your top two game IP, i.e. Fantasy Westward Journey and Westward Journey II, have both been converted into mobile games. So I just wonder, what's the company's mobile game strategy going forward, so we may see more of NetEase's mobile games to be ranked among the top ten?

<**A - Onward Choi**>: Thank you, William. So [ph] Jiang (35:15), with regard to your questions on the mobile game strategies for NetEase, so first of all, the company's internal vision is that we would be introducing far more games that can get up the top-five of the top-grossing charts on the iOS China app store. And with the recent success that we have made so far, we are quite confident that we will be able to make it in the foreseeable future. And in doing so, we would also be expanding our product lines into different kinds of game types and genres, so to call. And in terms of the strategies on the game developments, there would be three main ways that we will be achieving that.

First of all, we would also be introducing our self-developed mobile games, of which the IP would be – rest with NetEase. And secondly, we would also be introducing some game titles by licensing the game titles. And one of the recent ones that we have been done would be games like the Chrono Blade. And the third way that we would be targeting ourselves in the mobile game development is that we would be making good use of the IPs from others, whereas the game development would rest with NetEase, where we would be developing something that would be interesting to the market.

And in the upcoming periods, there would also be games that would be following the [ph] Gu Long's (37:00) series, which is the Chinese martial arts story series games. And another one that would also be launched socially will include games like the Kung Fu Panda, where we are in cooperation with the Warner Bros. in that sense. And so, this would basically summarize the company's strategies, both in terms of how we would like to go, and in terms of how we are going to develop our mobile games going forward.

<Q>: Thank you, William, Onward, for that color. My last question is about your e-commerce business. I think you might book the cross-border e-commerce revenue under others on your P&L. So, I just wonder how much of other revenue in Q3 was contributed by Kaola? And on top of the cross-border e-commerce platform Kaola, I understand that it also has some other e-commerce services. So I just wondered if management might give us some colors on those non-Kaola e-commerce services, like what are those services about, and how's their GMV compared to Kaola?

<A - William Ding>: Okay. So, with regard to your questions about the makeup of our first segments, namely the e-mail, e-commerce and others, basically, what I can share with you is that, out of the total revenues in the third quarter, a relatively high portions, more than half of it, would be coming from the e-commerce related businesses. Whereas, we also got some other revenues coming from other business like the online entertainment broadcasting services, and also our traditional e-mail services, and other services including the sales of game accessory items, stuff like that. And right within these segments there would also be some – a very rich array of offerings that we are currently doing as well, including some wealth management products, some friend-making services, and some related to our classrooms for the [indiscernible] (40:05) and stuff like that. And so we do see that there was a lot more that we are offering within this segment.

<Q>: Thank you very much for the color. Can I ask one last follow-up? Do you have any updates so far from the government when the online lottery can be resumed?

<A - William Ding>: By far, we still do not got new updates with regard to the timelines, but we would keep you posted as soon as we get the information.

<Q>: Okay. Thank you, William. I'll get back to the queue.

<A - William Ding>: Thank you.

Operator

Thank you. Our next question comes from Martin Bao with the Bank of China International.

<Q - Martin Bao>: Hi, management. Thank you for taking my question and congratulations on a very good performance during the last quarter. I have a few question regarding the future development of our mobile game portfolio. I'm wondering, besides RPG what are the types of your mobile game that the management think that will become a new focus of the company in 2016. And as a follow up, and recently we have seen some new software and hardware technology related to the online entertainment industry such as the VR/AR technology. I'm wondering what the management's view on this new technology? And does management see this new technology as the potential drivers for the new growth with the online game market?

<A - William Ding>: Okay. So, with regard to your questions, so NetEase is also paying attention, and also closely observing the developments on the new trends with regard to the VR or the AR stuff. But from our view, we believe that this would just be a way to enrich the experiences of the users, and this would also be just another way of presenting the content to our targeted audiences. But rather, we are still emphasizing that, especially when we are doing the gaming business, whether – in particular to the mobile game businesses, we still believe that the content is far more important. But having said that, we would also keep a close eyes on it and see how this new growing trend would be to help out on our growing game business development.

And with regard to your second question about the game types that we would be launching, apart from the RPG. Basically, we would be getting into the all types of games that would be possible to launch on the mobile platforms. And, apart from games that would be following the growing theme, and some would be following the FPS, we also got games following the card strategy games. And just to highlight on, one of those card strategy games would be the Hearthstone: Heroes of Warcraft, that has been developed by the Blizzard Entertainment and being operated by NetEase. And we do see that, with the latest introductions of new contents to the games. This has also got a very positive reception in the market.

And apart from that, we have also seen that with the introductions of other games, which is [ph] called (46:01) the Million Arthur. This has also been proved to be very popular amongst the users, but because the targeted audiences would be of a much smaller group. And so you wouldn't be able to see it very obviously from the chart, but for the game itself, it's still a very good and popular one.

Operator

Thank you. Our next question comes from Tian Hou with T.H. Capital.

<Q - Tian X. Hou>: Hi, William and Onward. I have a couple question. One is related to mobile game. What's the difference – is there a seasonality for mobile game? So is there a difference between seasonality of mobile game and PC game? And also, related to the mobile game, what payment system do you use? William, another question is, recently we saw many Chinese Internet companies start to have a hiring freeze. And I wonder, how do you see that and what could be for NetEase?

<A - Onward Choi>: So Tian, maybe I do a recap on the response that William just answered. So basically, with regard to the seasonality issues about the mobile games, the simple answer to it is that there should be no seasonality as such, because usually, the player will be just [indiscernible] (50:28) times and sparing about three minutes to five minutes per round experience playing those games. Whereas, for the traditional PC game players, because they need to play it physically in front of a computer, and so there kind of a seasonality exists in percent, because especially when we are getting into the summer holidays, when the younger age players, especially the students, can get more time, more idle time, so they can go to the Internet cafes to play those games. And this would be the major differences in terms of the seasonality regarding the mobile and the PC games.

And on your second point regarding the payment system, so if we are using the Apple system, then there will be a proprietary payment system that Apple would be taking the money on behalf of us and do the settlement afterwards. Whereas for the Android platform, the payment system would somehow be more complicated. But having said that, we can assure you that the payment gateways that we have been deployed and being – our operator is very smooth and making sure that the experience is being offered to our [indiscernible] (51:59) players would be good in that sense. And on the third question about the hiring [ph] trend (52:09) or the news that more and more companies would reduce the scale of the intake of employees, what we can share with you is that in this year for NetEase, the new [indiscernible] (52:27) intakes from the university would be the highest from all years. This would be a historic high for NetEase in that sense. And to us, we see that the latest happenings in the market will also prove to be a very good thing for NetEase because this would also mean that this can enable us to a higher – more high [ph] quantities (52:53) and more suitable candidates to join our company.

<Q - Tian X. Hou>: Okay. Thank you.

Operator

Thank you. Due to time constraints, our last question will come from Thomas Chong with Citigroup.

<Q - Thomas Chong>: Hi. Good morning, William and Onward. Yeah. Thanks for taking my questions. I have a couple of questions. The first question is about the mobile games outlook in 2016. So management comments about how we should think about the growth momentum for the industry. And also, how should we think about the [ph] gross billing (53:31) for Fantasy Westward Journey and Westward Journey Online in the fourth quarter? Are we seeing it increasing on a month-on-month basis? And my second question is about your license game Raven. When should we expect it to be launched? Should we expect it to be launched in the fourth quarter? And another question is about your trend in operating expenses, in particular sales and marketing and R&D. And my final question is about the cash flow. Should we expect the change in prepayment to be somewhat stable as we are heading into the fourth quarter?

<A - William Ding>: Okay. Thank you. So with regard to your first two questions, so basically, this is also the company's target to make sure that the – for our popular mobile games like the FWJ or the WJ Online mobile, we will still up keep the growing trend in the fourth quarter. And making sure that the expectations of our players can be met and surpassed. And secondly, with regard to your questions about the expected launch date for the Raven game, this is tentatively scheduled to launch in January next year. And with regard to your third question about the operating expense trend, in particular, to the S&M and as the R&D, I believe that – but now, we haven't given out any specific guidance in terms of the actual dollar values or the percentages of the total revenue spend. You will see that we are also active, and we're at relatively stable levels to grow those expenses in line with our revenue increase.

And this would also be the kind of trend that we're expecting in the year ahead. And with regards to the [indiscernible] (56:46) question about the pre-payments, whether or not it would be to keep stable or not. I mean, basically, as and when the whole businesses like our e-commerce related business is growing, and there would also be a certain room for this to grow. But on the other hand, the companies would also be imposing more stringent controls on making sure that for the increase in those pre-payments, that those would be a good [indiscernible] (57:23) on the business increase in terms of its scale. And at the same time, we do see that the increase in the pre-payments would also include with other things on our payments that are – the revenue sharings that we have to give way to our mobile operators, our mobile distribution channels. And so this would also be quite in line with how our mobile game businesses would be growing in the upcoming periods.

Operator

And thank you. That concludes today's question-and-answer session. At this time, I'll turn the conference back to management for any closing remarks.

Brandi Piacente

Thank you once again for joining us today. If you have further questions, please feel free to contact Juliet Yang, NetEase's IR manager based in Hangzhou, or The Piacante Group Investor Relations. Have a wonderful day.

Operator

This does conclude today's presentation. We thank you for your participation.

Company Name: NetEase Inc
Company Ticker: NTES US
Date: 2015-08-12
Event Description: Q2 2015 Earnings Call

Market Cap: 17,495.92
Current PX: 133.8837
YTD Change($): +34.7437
YTD Change(%): +35.045

Bloomberg Estimates - EPS
Current Quarter: 12.597
Current Year: 48.048
Bloomberg Estimates - Sales
Current Quarter: 5013.500
Current Year: 17983.357

Q2 2015 Earnings Call

Company Participants

- Brandi Piacente
- Onward Choi
- William Ding

Other Participants

- Dick Wei
- Alicia Yap
- Eddie Leung
- Martin Bao
- Thomas Chong
- Hillman Chan
- Tian X. Hou

MANAGEMENT DISCUSSION SECTION

Operator

Please stand by. Good day, and welcome to the NetEase Second Quarter 2015 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente

Thank you, operator. Please note the discussion today will contain forward-looking statements relating to future performance of the company and are intended to qualify for the Safe Harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors.

Some of these risks are beyond the company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion. A general discussion of the risk factors that could affect NetEase's business and financial results are included in certain filings of the company with the Securities and Exchange Commission, including its Annual Report on Form 20-F. The company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and a reconciliation of GAAP to non-GAAP financial measures and results, please see the second quarter financial results news release issued earlier today. As a reminder, this conference is being recorded. In addition, a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the call over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi

Thank you, Brandi. Before I begin, please note that, for the purposes of these discussions, all percentages are based on renminbi. The rapid consumptions of mobile games is driving considerable growth in China's online games industry. With our long history as an Internet innovator and some of the best R&D talent available, our strategy to expand into mobile while still in its early stages is beginning to take shape and contributing to our growth objectives.

Our strong second quarter results reflect this success with growth from both our PC clients and mobile games. In fact, we saw healthy revenue increases across all three of our business segments both sequentially and year-over-year. Compared with the same quarter in 2014, we saw revenue increases of 64.8% from online games, 22.8% from advertising services, and 123.3% from our e-mail, e-commerce and others business segment.

The diligent work we have put into expanding and diversifying our mobile portfolio is becoming more evident. We now operate more than 13 mobile games across a variety of genres to appeal to a broad and growing audience. And we plan to continue to build on this success.

We are delighted with our accomplishments during the second quarter. To name a few, our Fantasy Westward Journey mobile game reached a record peak concurring user level of more than 2 million in May. This game has performed extremely well and has been ranked at the top grossing in the iOS China App Store since its launch in March of this year.

As of July, it was the only mobile game in China with its own customized download page in the iOS App Store. For our PC client games, we were very pleased with the performances of some of our newest games. In particular, Revelation, our 3D oriental fantasy MMORPG, and our 2.5D MMORPG Demon Seals were launched in April. Both of these games have been well received by users with positive feedback.

During the second quarter, we also released expansion packs for New Westward Journey Online II and Ghost II, as well as conducted further beta testing for our 3D warfare MMORPG, Hegemon-King of Western Chu.

Our license games also fared well in the second quarter. We are well excited to be launching Blizzard Entertainment's Diablo III: Reaper of Souls in China through the joint effort of Blizzard and NetEase and with the incredible support of passionate Chinese players. Additionally, the April launch of the mobile phone versions of Blizzard Entertainment's Hearthstone: Heroes of Warcraft helped drive that game's number of active users to a new high.

Lastly, Heroes of the Storm, Blizzard's brand-new free-to-play online team brawler, began open beta testing in late – in Blizzard's brand-new – sorry. Page 2. Sorry...

William Ding

[Inaudible] (5:25)

Onward Choi

No. No. No. This is page 2. Yes. Okay. Brand-new free-to-play online team brawler began open beta testing in late May followed by the game's official launch in early June, which had a promising performance. We continue to work closely with Blizzard to introduce exciting new content to China and are thrilled to have licensed Overwatch, Blizzard's first-ever first-person shooter game.

Our pipeline of PC-client and mobile games is strong and growing. Leveraging our strong research and development program, we plan to continue to introduce new games and content throughout the year. In July, we introduced a new expansion pack for our popular game, Tianxia III, and are targeting a number of new expansion packs later in the third quarter for our self-developed games, including Fantasy Westward Journey II.

At the same time, we are expanding our portfolio of mobile games. Last month, we released several new titles that have been well received by users including Fairy Tales: The World of the Brave, a licensed cartoon-style side-scrolling mobile game. In the coming months, we plan to release more mobile games based on our acclaimed self-developed franchises, including the Westward Journey Online mobile game, The X-World, an action-packed mobile ARPG game from the Tianxia universe, and Fantasy Westward Journey: Warriors, an exciting mobile action adventure game.

We continue to evaluate international markets opportunities and our expansion plans are well underway to broaden our market reach through cross-country partnerships and licensing agreements, as well as independent sales. We have already licensed several of our mobile games to the Southeast Asia market, and our pipeline is focused on building mobile games for Western audience. And the first of our mobile games for North American markets will be an adaptations for local markets of Speedy Ninja.

Turning to our advertising solutions business. This segment continued to perform well in the second quarter, driven by overall market demand and monetization efforts for our Mobile News Applications. The top-performing advertising verticals in the second quarter were the automobile, Internet services, and food and beverage sectors.

Additionally, our cross-border e-commerce platform, Kaola.com, experienced rapid growth in the second quarter and continues to gain user tractions. This platform is still in its early stages and we continue to broaden our capabilities by adding high-quality suppliers, increasing warehouse efficiencies and strengthening our overall brand equity.

We have built our company on innovations and understanding the market with an innate ability to evolve and adapt our technology to address market demands such as increasing mobile accessibility. This flexibility supports our strategies to provide our community with exclusive and diverse products and services that meets their expanding needs.

We will continue to focus on creating top quality new games for both PC clients and mobile users and expanding our loyal user base. Our goal is to achieve balanced growth across our businesses by delivering exceptional products and services to our loyal and growing community.

This concludes William's comments. I will now provide a review of our second quarter 2015 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit.

Total sales tax for the second quarter of 2015 were RMB 265.2 million or $42.8 million compared to RMB 225 million and RMB 184.4 million for the preceding quarter and the second quarter of 2014, respectively. The year-over-year and quarter-over-quarter increases in sales tax were mainly due to the increase in our total revenues. Gross profit for the second quarter of 2015 was RMB 2.8 billion or $439 million compared to RMB 2.5 billion and RMB 2 billion for the preceding quarter and the second quarter of 2014, respectively.

The year-over-year and quarter-over-quarter increases in online games' gross profit were primarily driven by revenue contributions from our mobile games including the Fantasy Westward Journey mobile games and licensed games such as Blizzard Entertainment's Diablo III, Hearthstone: Heroes of Warcraft, and Heroes of the Storm, as well as our new self-developed PC client games such as Revelation and Demon Seals.

The year-over-year increase in advertising services gross profit was primarily attributable to strong demand from the automobile, Internet services, and food and beverage sectors, and the monetizations of our mobile applications, primarily our Mobile News App.

The quarter-over-quarter increase in advertising services revenues and gross profit was primarily due to seasonality. The year-over-year and quarter-over-quarter decreases in e-mail, e-commerce and others gross profit were primarily due to the temporary suspensions of e-commerce services related to third-party lottery products since late February 2015, which was partially offset by increased revenue contributions from our cross-border e-commerce platform, Kaola.com, and e-mail services, which have lower gross profit margins.

Our gross profit margins for the online games business for the second quarter of 2015 was 69.3% compared to 73.1% and 77.6% for the preceding quarter and the second quarter of 2014, respectively. The year-over-year and quarter-over-quarter decreases in gross profit margins were mainly due to increase of revenue contributions from mobile games, which have relatively lower gross profit margins as a percentage of our total online game revenues.

Gross profit margins for the advertising services business for the second quarter of 2015 was 68.2%, compared to 59.2% and 60.9% for the preceding quarter and the second quarter of 2014, respectively. The year-over-year and quarter-over-quarter increases in gross profit margins were mainly due to enhanced economies of scale driven by revenue growth. Gross profit margins for the e-mail, e-commerce and others business for the second quarter of 2015 was 4.2%, compared to 38.9% and 35.7% for the preceding quarter and the second quarter of 2014, respectively.

The year-over-year and quarter-over-quarter decreases in gross profit margins were primarily attributable to the temporary suspensions of e-commerce services related to third-party lottery products discussed above, as well as increased revenue contributions from Kaola.com and our e-mail services, which have relatively lower gross profit margins.

Total operating expenses for the second quarter of 2015 were RMB 1.4 billion or $225 million, compared to RMB 1.2 billion and RMB 823.7 million for the preceding quarter and the second quarter of 2014, respectively. The year-over-year increase in operating expenses was mainly due to increased selling and marketing expenses for mobile and PC client games and increased staff-related research and development costs, resulting from an increase in the number of employees and share-based compensations. The quarter-over-quarter increase in operating expenses was mainly due to increased promotional costs for online games, which was partially offset by decreased promotional costs for the e-mail, e-commerce and others business.

We recorded a net income tax charge of RMB 145.9 million or $23.5 million for the second quarter of 2015, compared to RMB 214.5 million and RMB 97.9 million for the preceding quarter and the second quarter of 2014, respectively.

The effective tax rate for the second quarter of 2015 was 9.2%, compared to 14.1% and 7.4% for the preceding quarter and the second quarter of 2014, respectively. The quarter-over-quarter decrease in the effective tax rate was mainly due to the company recognizing certain tax credits in the second quarter of 2015 related to annual tax filing benefits, most of which comprised extra tax deductions for research and development expenses approved by the tax authorities.

We also had a net foreign exchange loss of RMB 21.7 million or $3.5 million, compared to a net foreign exchange gain of RMB 22.7 million and a net foreign exchange loss of RMB 20.2 million for the preceding quarter and the second quarter of 2014, respectively. The quarter-over-quarter and year-over-year changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our foreign currency denominated bank deposits and certain loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

Our net income attributable to the company's shareholders for the second quarter of 2015 totaled RMB 1.4 billion or $229.7 million compared to RMB 1.3 billion and RMB 1.2 billion for the preceding quarter and the second quarter of 2014, respectively.

Non-GAAP net income attributable to the company's shareholders for the second quarter of 2015 totaled RMB 1.6 billion or $256.4 million compared to RMB 1.4 billion and RMB 1.3 billion for the preceding quarter and the second quarter of 2014, respectively. Basic and diluted earnings per ADS for the second quarter of 2015 were $1.75 and $1.74, respectively. This compares to basic and diluted earnings per ADS of $1.56 and $1.55, respectively, for the preceding quarter, and $1.48 each for the second quarter of 2014.

Non-GAAP basic and diluted earnings per ADS were $1.95 and $1.94, respectively, for the second quarter of 2015. This compares to non-GAAP basic and diluted earnings per ADS of $1.75 and $1.74, respectively, in the preceding quarter, and $1.57 each for the second quarter of 2014.

As of June 30, 2015, our total cash and time deposits balance was RMB 20.7 billion or $3.3 billion, compared with RMB 21.2 billion as of December 31, 2014. Cash flow generated from operating activities was RMB 835.9 million or $134.8 million for the second quarter of 2015, compared to RMB 1.9 billion and RMB 1.2 billion for the preceding quarter and the second quarter of 2014, respectively.

As part of our efforts to return values to our shareholders, we are pleased to announce that, in conjunction with our quarterly dividend policy, our Board of Directors has approved a dividend of $0.44 per ADS for the second quarter of 2015. We expect to pay this on September 4, 2015, to shareholders of record as of the close of business on August 28, 2015.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Q&A

Operator

Thank you. [Operator Instructions] Okay. And our first question comes from Dick Wei with Credit Suisse.

<Q - Dick Wei>: Hi. Good morning. Thank you for taking my questions. I have two questions. First one is, I wonder if William or Onward can talk a little bit more about the life cycle for the Fantasy Westward Journey mobile game user. Given the strong growth in revenue, is it mainly coming still from the old user or are you seeing a lot of the new user coming on to play the games and contribute to revenue? So, that's the first question.

And second question is we see pretty big increase in deferred revenue. I wonder if the management can give like a mix of where the deferred revenue coming from, maybe by PC, mobile or maybe from specific games as well. Thank you.

<A - Onward Choi>: [Foreign Language] (20:13-20:34)

<A - William Ding>: [Foreign Language] (20:39-22:15)

<A - Onward Choi>: [Foreign Language] (22:16) So, with regard to Dick's first question about the life cycles of FWJ mobile, basically, we do see that since we first launched the games dated back in early April, till now, about four months' time, the game itself has been ranked as number one for almost 99% over the time period on the – our apps – China App Store, which is very encouraging. And basically, from the company's perspective, we are quite satisfied with its product performances. And we are still [ph] uphold (22:51) a very confidence mode with regards to its revenue contributions in the upcoming periods.

And based on our market research that has been undertaken so far, we have received very positive user feedback from the market. And we will uphold our business philosophies to deliver the highest qualities of products and the best-ever user experiences to our users by rolling out or launching our mobile games.

And we are also expecting that there will be some newer versions to enrich the contents and features of this game so as to ensure that the user experiences can upkeep to the highest level at all times.

And in terms of the distributions of the user profile, basically around 70% of it would be coming from the new users. The rest of – the 30% would be coming from our existing PC client games users. And we are expecting that for both the new and old users that there would be again a very good experiences of trying out these new mobile games. And this basically finished the first part on William's comments on the first questions.

And with regard to Dick's questions on the deferred revenue, and basically, we do see that it has increased quite a bit in the second quarter. And basically, we do see that there has been a good growth in terms of our mobile games initiatives, which have increased the deferred revenues. And we also see that, for all our other games, there has also been a nice growth in terms of the deferred revenues, too.

<Q - Dick Wei>: Great. Thank you very much, William and Onward.

Operator

Thank you. Our next question comes from Alicia Yap with Barclays.

<Q - Alicia Yap>: Hi. Good morning, William, Onward and Brandi. Congratulations on the solid quarter. Thanks for taking my questions. I actually have a follow-up question from the deferred revenue. So, I understand that it's related to FWJ and other games. Just wanted to know a little bit color how long you would recognize the rest of those revenue? Is it for the following three quarters or for the maximums of 12 months?

And then, can you give a little bit more color on the FWJ trend since the launch in the end of March? Is the gross billing ramped up like month-over-month or is it a big jump in April and then kind of steady and small growth for the month after that?

<A - Onward Choi>: Okay. So perhaps I will just give you a first answer to your first questions about the deferred revenue. Basically, we do see that there has been a good increase in terms of the revenue coming from the mobile front as well as from our PC front. And as long as the – how we – how long we are to recognize the revenue, it would still be – depends on the consumptions of those different items, so to call. But basically, you wouldn't expect that this would not take for a very long time.

And with regard to the second questions about the FWJ mobile trend, basically, so far, we are still seeing that it has been progressing well. And basically, the gross billings has also been [ph] upkeep (26:38), let's say, very healthy levels. And we do see that [ph] – a punch note is (26:43) that since we first launched the mobile games of FWJ in the markets in late March or early April, it has been upkept in the top ranking in the iOS China App Store for that long, which is a very good proof that you will see that the game has been very popular among the users. And we are also still expecting that. Yeah.

<Q - Alicia Yap>: Okay. Okay. I see. And then, in related to that, maybe can you share with us some is there anything you have done differently to the game design and the game play that the FWJ able to achieve such instant success? And given because of relatively shorter life cycle for older mobile games so far in other, like, other companies or other games, what your team is doing to keep the gamers' interest in the game? Any color you could provide would be helpful. Thank you.

<A - Onward Choi>: [Foreign Language] (27:45-28:17)

<A - William Ding>: [Foreign Language] (28:18-29:47)

<A - Onward Choi>: [Foreign Language] (29:48) So, basically, the major highlights is that NetEase always puts the user experiences as the number one task in order to achieve and also to ensure that the users would get a best ever experiences from China with our different game titles. And based on our fruitful experiences in the game developments over the years, especially in the RPG games and also the item-based games, we do see that we have also accumulated a very good experiences to make sure that the development cycle has been going on well and smooth.

And the overall success of the FWJ mobile, we will say that it will not be only lies on the fact that we have a strong IP or just pointing to the fact that we have some good past experiences in terms of the self-developed games or the game operations. But more importantly, we do feel that how we put the attitude towards the product itself and offering the best-ever user experiences to our users is of the most important points.

<Q - Alicia Yap>: Great. Thank you, Onward. [Foreign Language] (31:14), William.

Operator

Thank you. Our next question comes from Eddie Leung with Merrill Lynch.

<Q - Eddie Leung>: Hi. Good morning. Thank you for taking my questions. Two questions. The first one is about your e-commerce business. Just wondering if management can share with us the key differentiation of your platform against a lot of your competitors. So, what could be the advantage of NetEase running this Kaola platform.

And the second is a housekeeping question on balance sheet. We noticed that there's also a [indiscernible] (31:54) in prepayment. So, wondering if Onward could share some color on that. Thanks.

<A - Onward Choi>: Okay. Sure. So, William, [Foreign Language] (32:03-32:15)

<A - William Ding>: [Foreign Language] (32:15-33:33)

<A - Onward Choi>: Okay. So, basically, with regard to our differentiations from our peers in doing the cross-border e-commerce businesses, basically, our Kaola.com business is a cross-border imported goods e-commerce business model. And basically, we are also focusing on our self-merchandising efforts to make sure that the highest qualities and the best stuff would be sourced to our targeted users or consumers in the China market.

And basically, this would be the e-commerce platforms, and one of our major features is that we are promoting the users to complete the transactions using their mobile applications. And in the upcoming periods, we would also be adding in more new features to give a more refreshing feel to our users. And as always, we are putting a very high importance of building up our own brand, and we are also regarding ourselves as having a very strong overseas merchandising capabilities on that front. That differentiates ourselves from our peers.

And with regard to Eddie's second question about the prepayments, the increase in the balance sheet, basically, you can [indiscernible] (35:16) since they generate this year, we have been putting into our new business line, which is the Kaola.com, these cross-border e-commerce businesses, and we are also building up our own inventories to meet the demand of the local markets. And so, one of the major increase in the prepayments and other current assets line items will be contributors from the increased inventory that we have built so far.

Operator

Thank you. Our next question comes from Martin Bao with Bank of China International.

<Q - Martin Bao>: Thank you for taking my question, and I have two questions regarding the mobile games. The first one is how does the management think about the recent trend of the new gamers joining to the whole online game and the mobile game market? How does the company will accommodate to the demand from these new gamers such as younger generation born in 1990s and the female gamers?

The second question is what's the criteria behind – how do we choose the license that games and the external IPs besides our own IPs to develop or to license what [Foreign Language] (36:36-37:07)

<A - William Ding>: [Foreign Language] (37:11-38:50)

<A - Onward Choi>: [Foreign Language] (38:52) So, basically, with regard to our uncertainties in building up our new user base of – on the mobile game fronts, basically, we are also emphasizing the importance of the new user growth coming from the people born after 1990s or the 2000s. And one of the examples is that, for our newly launched games like the FWJ mobile versions, we have also engaged the [indiscernible] (39:27) have to sing the songs for the game titles which also got a very good reception there.

And with regards to the choice of the different new games targeted to perhaps to the female users and the younger generations, we will also be exploring whether there would be some more mature game titles or game stuff that is available for us to roll out.

And on other games that we have lately tried out will be a game called the [indiscernible] (40:04). And with regard to the choice of the games or the licensed games from the overseas markets, one of the points that we put at the highest priority just the qualities of the games and how good those games can fit into the [ph] visual (40:26) and also [ph] how quick (40:28) the play can be picked up by the targeted audiences.

And in the – very soon, we will also be rolling out another game that has been ranked as number one in the Korean market, which is called the Raven. And this is how we have been moving on especially in the mobile game market.

<Q - Martin Bao>: [Foreign Language] (40:51) Thank you, Onward.

Operator

Thank you. Our next question comes from Thomas Chong with Citigroup.

<Q - Thomas Chong>: Hi. Good morning. Thanks for taking my questions. I have a question regarding the online advertising. Can management comment about any impact on the macro headwinds? And on the other hand, any color about the revenue contribution coming from mobile? Thanks.

<A - Onward Choi>: [Foreign Language] (41:24-41:33)

<A - William Ding>: [Foreign Language] (41:34)

<A - Onward Choi>: [Foreign Language] (41:36)

<A - William Ding>: [Foreign Language] (41:38)

<A - Onward Choi>: [Foreign Language] (41:42-41:52)

<A - William Ding>: [Foreign Language] (41:53)

<A - Onward Choi>: So, basically, Thomas, with regard to your questions about how we feel about our online advertising businesses' performances, we do not feel that the latest macro changes or some other methods have got very significant impacts to our business developments.

<Q - Thomas Chong>: Thanks. And another question is about the revenue contribution coming from mobile in online advertising.

<A - Onward Choi>: You mean the revenue contributions of the advertising revenue.

<A - William Ding>: [Foreign Language] (42:35-43:28)

<A - Onward Choi>: So, basically, we have very comprehensive strategies in setting out our mobile strategies. And apart from our Mobile News Applications, we also have a very extensive work on other areas like products like the Cloud Music, our Youdao Dictionary, the Cloudnote, the EaseRead, and also the Lofter and as well as our MailMaster. All of those has been progressing very well and we do see that they have also been – the growth has been growing, and we are anticipated that we – perhaps we can share more colors about the distributions of the revenue coming from the mobile fronts versus the PC in the future period.

Operator

Thank you. Our next question comes from Hillman Chan with Macquarie.

<Q - Hillman Chan>: Hello, William, Onward and Brandi. Congrats on a strong quarter. I have two questions. First one is on your cross-border e-commerce management, give us more color on the growth plan for this business, for example, in terms of the SKUs, product categories and also your logistics deployment? And how should we think about your investment on this business going forward? And I have another question afterwards.

<A - Onward Choi>: [Foreign Language] (44:54-45:05)

<A - William Ding>: [Foreign Language] (45:08-46:29)

<A - Onward Choi>: So, basically, with regard to – Hillman, your first question about our growth trend on our cross-border e-commerce, the Kaola.com businesses. First of all, this would be the imported goods e-commerce platforms. And so basically, unlike the traditional e-commerce counterparts, we would need to put those stuff in a port warehouse or in overseas. And in order to address the warehousing issues, we would buy a warehouse to accommodate those inventories and also rent some warehouse in overseas.

And at the same time, in terms of the SKU developments, we are targeting that the numbers would come up to 10,000 SKUs for this year.

And by the end of this month, which is August, we will also be launching another mobile applications for the Kaola which would give a more refreshing load to our targeted users. And one of the competitive edge of our Kaola or dot-com businesses is that we place a very high importance of giving the good values to our users. And we believe that, by doing so, the [indiscernible] (47:56) would get recognitions from the users in a broader sense.

<Q - Hillman Chan>: Just to quickly follow up on that, how should we think about the marketing dollar spend to promote, for example, a mobile app Kaola and also a webpage and also all these investments around your, like, warehousing, China or renting overseas? And if possible, so some color on profitability will be helpful. Thank you.

<A - Onward Choi>: [Foreign Language] (48:28-48:39)

<A - William Ding>: [Foreign Language] (48:38-49:18)

<A - Onward Choi>: Yes. So, basically, with regard to our anticipation, so expectations of spending on the marketing front, given the fact that NetEase got a very huge user base and given the fact that we are also selling quite a lot of the fast-moving consumables and we are expecting that the marketing dollars that we are spending on difference as compared with our peers in the space would be lower.

And with regards to the potential investments in building up our own warehouse and stuff like that, basically, this would be of a more similar magnitude as to what everybody would be doing in the market. And basically, the imports or the investment in those area would be quite similar.

<Q - Hillman Chan>: Okay. And my second question is on your strategy on licensing overseas games and IP to China. You recently announced that your partnership with NetMarble and Raven and also your Kung Fu Panda IP from DreamWorks. So when it comes to licensing all these overseas mobile games and IP, how should we look at the selection criteria? I think you touched on it previously. Just want to see some more color on how you see fit for Chinese gamers.

And what are the works that you've done afterwards? When did you license them? For example, localization, like renovation in terms of the game play, and also the monetization models. And roughly how much – how long time it takes from signing the deal to launching the games in China? This is my second question. Thank you.

<A - Onward Choi>: [Foreign Language] (50:59-51:40)

<A - William Ding>: [Foreign Language] (51:44-53:24)

<A - Onward Choi>: [Foreign Language] (53:25) So, basically, NetEase has kept active and very close collaborations and relationship with the different game developers on an ongoing basis. And so, given those smooth and close relationship with the different developers and [ph] managers (53:41) also got very high recognitions from them.

And on this front, this can facilitate how we are going to proceed with different licensing arrangements. And whenever we need to consider and select a [indiscernible] (53:57) games to license, definitely, we would also be engaging our own team to perform some analysis of the different game, whether the features and the game content itself can fulfill our expectations. And we would also be considering whether those game would get a potential good response or demand in the China market. And this also reflects our responsible attitudes towards serving our gaming community.

And on the other hand, you would also appreciate that we have also been getting into the game licensing businesses for quite a couple of years since we first get cooperations with Blizzard Entertainment some years before. And basically, we have a very happy and smooth relationship with Blizzard so far, and we also believe that we also possess the experience and the capabilities to make sure that, for whatever new licensed game that we're going to do, the license fees or the royalties would be negotiated on a very competitive terms.

Operator

Thank you. Our next question comes from Tian Hou with T.H. Capital.

<Q - Tian X. Hou>: Hi, William, Onward, and Brandi. I have several questions. Let's go to the first one. It's about your e-commerce. Regarding the e-commerce, so what's the take rate? I think for this business, your recognized revenue [ph] as a GMV (55:53). So, I wonder what the take rate is today and what's the ideal level of take rate for that business. That is the first question.

The second question is related to your – the thought of this business, let's say, is totally different than game business. It's not game business. Game business is what you do really well, William. So now you enter into a totally new business, and previously, we thought that you would enter into e-commerce, and later on, somehow load it into [ph] a daily (56:32) dot-com. They don't do it anymore. So what makes you have such a determination to do this business? That's the first question.

And then I will have a follow-up. William, [Foreign Language] (56:43-57:23)

<A - William Ding>: [Foreign Language] (57:27-59:05)

<A - Onward Choi>: [Foreign Language] (59:06) So, basically, we do regarded that if you look back in the past years on how we have been doing on our virtual products e-commerce businesses like the lottery product sales, we have been doing quite good. And perhaps this would be comparatively much better than our peers like the JD and stuff like that.

And basically, with regard to the cross-border e-commerce businesses, all the goods are located in overseas. And in the past years, we do see that there has been huge numbers of people and huge amounts being spent on that front of procuring the products in overseas.

The reasons behind or the rationale is that the people would believe that the products in those areas would offer much better values for the monies that they are being spent. And so, we do believe that we do have a good relationship especially with some overseas partners in this sense, and on the premise that we are also taking care about the sourcings and merchandisings by ourselves, making sure that the best values and also the highest qualities product would be sourced. We can also stand up a very good competitive edge in doing this new business for ourselves.

Operator

Ladies and gentlemen, due to time constraints, this concludes today's question-and-answer session. At this time, I would like to turn the conference back to management for any additional or closing remarks.

Brandi Piacente

Thank you, once again, for joining us today. If you have any further questions, please feel free to contact Cassia Curran, NetEase's IR Manager, based in Hangzhou or The Piacente Group. Have a wonderful day.

Operator

This concludes today's presentation. We thank you for your participation.

Company Name: Netease
Company Ticker: NTES US
Date: 2015-05-14
Event Description: Q1 2015 Earnings Call

Market Cap: 18403.6633685
Current PX: 140.83
YTD Change($): 41.69
YTD Change(%): 42.052

Bloomberg Estimates - EPS
Current Quarter: 11.153
Current Year: 44.898
Bloomberg Estimates - Sales
Current Quarter: 4148.833
Current Year: 16470.333

Q1 2015 Earnings Call

Company Participants

- Brandi Piacente, IR
- Onward Choi, Acting CFO
- William Ding, CEO

Other Participants

- Jialong Shi, Analyst
- Alicia Yap, Analyst
- Thomas Chong, Analyst
- Vivian Hao, Analyst
- Nick Ning, Analyst
- Tian Hou, Analyst
- Charanjit Singh, Analyst
- Natalie Wu, Analyst

Presentation

Operator

Good day. Welcome to the NetEase First Quarter 2015 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brandi Piacente. Please go ahead.

Brandi Piacente, IR

Thank you, operator. Please note that the discussion today will contain forward-looking statements relating to future performance of the Company and are intended to qualify for the safe harbor from liability as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the Company's control and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect NetEase's business and financial results is included in certain filings of the Company with the Securities and Exchange Commission, including its annual report on Form 20-F. The Company does not undertake any obligation to update this forward-looking information except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures for comparison purposes only. For a definition of non-GAAP financial measures and the reconciliation of GAAP to non-GAAP financial results, please see the First Quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. In addition, a webcast replay of this conference call will be available on the NetEase corporate website at ir.netease.com.

I will now turn the conference over to Mr. Onward Choi, Acting Chief Financial Officer, who will read the prepared remarks on behalf of Mr. William Ding, Chief Executive Officer of NetEase.

Onward Choi, Acting CFO

Thank you, Brandi. Before I begin, please note that for the purposes of this discussion, all percentages are based on Renminbi.

Our First Quarter was driven by advancement in our online PC-client and mobile games and other segments as we introduced new content and services. Total revenues increased by 54.2% year-over-year with growth from each of our business segments. Our online games business continues to thrive with revenues from this segment increasing by 44% in the First Quarter.

Mobile games have become a major driving force in China's online games market and we see substantial opportunities to diversify our gaming user base. We have seen remarkable interest in our self-developed mobile games, particularly for our Battle to the West and The World HD, both of which we introduced in the Fourth Quarter. Moreover, our flagship game, Fantasy Westward Journey, continued to gain in popularity, with the mobile versions of this game reaching Number 1 in the iOS China app store. And setting a record peak concurrent user count of 1.6 million after its introduction in late March. We now offer over 20 mobile games across over a variety of channels and we plan to build on this positive momentum as we deploy more new self-developed and licensed mobile titles in the coming months.

Our self-developed online PC-client games also continued to be well received and there remains a satiable appetite for new games and updated content. During the First Quarter, users gave a warm welcome to the beta tests for one of our games under development, Hegemon-King of Western Chu, our 3D warfare MMORPG. We also saw solid performances from Fantasy Westward Journey II and New Westward Journey Online II.

In 2015, we plan to expand our portfolio with an exciting pipeline that includes a number of new online PC-client and mobile games, as well as new content for our existing games. We are already making progress towards this goal. In April, we commercially launched Demon Seals, a 2.5D MMORPG. And introduced expansion packs for New Westward Journey Online II and Ghost II. We have also received positive feedback from users in the closed beta testings of Revelation, our 3D oriental fantasy MMORPG, which began in January, with open beta testing to follow. We also continue to work closely with Blizzard Entertainment and have been delighted by the success of the open beta testing for the Chinese version of Diablo III: Reaper of Souls. That game sold over 1 million copies within 10 days of its launch in late April, setting the record for fastest-selling PC game in China. We plan to begin open beta testing for Blizzard's Heroes of the Storm in late May.

We are excited to bring our successful games to overseas markets and to expand our global footprints. Later this year, we plan to work with local partners to launch our games in other countries in Asia and North America so that users can enjoy the NetEase gaming experience.

Looking at our advertising services business, this segment remains strong. Our Mobile News Application and the growing online advertising market in China, supported our growth in advertising services revenues which increased by 35.9% compared with the same period last year. Automobile, Internet services. And food and beverage were the top performing advertising verticals in the First Quarter. E-commerce in particular is an area where we see significant growth opportunities. While it is still in the early stages of operation, our self-operated cross border e-commerce platform, Kaola, has performed well so far. We are actively expanding our range of product offerings to service our growing customer base.

Throughout the year, we expect to see continued momentum across our businesses with high demand from the mobile market and stable growth from our PC-client games and services. Our model is designed to build on our strength and lead new trends in China's evolving online market.

Throughout these changes, our strategy will remain focused on diversity, excellence and international expansion to achieve healthy growth across all of our Internet businesses where we can continue to serve our community and our shareholders.

This concludes William's comments. I will now provide a review of our First Quarter 2015 financial results. I will primarily focus on the discussions of margins and expense fluctuations along with net profit. Before I begin, I would like to note that beginning in the First Quarter of 2015, we made a reclassification of certain revenue and cost of revenue from our advertising services segment to our e-mail, e-commerce and others business segment. The reclassification of these segments reflects changes in the way we evaluate our business performance and manage our operations. Reclassification of certain Fourth Quarter 2014 comparative figures in these segments has been changed to conform to the current period presentations.

Total sales taxes for the First Quarter of 2015 were CNY225 million or $36.3 million compared to CNY220.6 million and CNY153.5 million for the preceding quarter and the First Quarter of 2014 respectively. The year-over-year and quarter-over-quarter increases in sales tax were mainly due to the increase in our total revenues.

Gross profit for the First Quarter of 2015 was CNY2.5 billion or $401.5 million compared to CNY2.5 billion and CNY1.7 billion for the preceding quarter and the First Quarter of 2014 respectively.

The year-over-year increase in online games gross profit was primarily driven by the revenue contributions from our self-developed online games, such as New Westward Journey Online II and Fantasy Westward Journey II and licensed games such as Blizzard's World of Warcraft as well as mobile games including Battle to the West, The World HD and the mobile versions of Fantasy Westward Journey. The quarter-over-quarter increase in online games gross profit was primarily driven by increased revenue contributions from our mobile games, Battle to the West, The World HD and mobile versions of Fantasy Westward Journey.

The year-over-year increase in advertising services gross profit was primarily due to strong demand from the automobile, Internet services and food and beverage sectors. And the monetizations of our mobile applications such as our Mobile News Application. The quarter-over-quarter decrease in advertising services revenues and gross profit were primarily due to seasonality.

The year-over-year increase in e-mail, e-commerce and others gross profit was primarily attributable to an increase from e-commerce services related to third-party lottery products. The quarter-over-quarter decrease in e-commerce, e-mail and others gross profit was primarily attributable to the temporary suspension of e-commerce services related to third-party lottery products since late February 2015, which was partially offset by an increase in revenues from our e-mail and others businesses in this segment.

As expected, we saw some gross margin contractions in our online game businesses during the First Quarter as we experienced increased revenue contributions from our mobile games which carry a relatively lower gross profit margins. Gross profit margin for our online games business for the First Quarter of 2015 was 73.1%, compared to 76% and 78.5% for the preceding quarter and the First Quarter of 2014, respectively.

Gross profit margin for our advertising services business for the First Quarter of 2015 was 59.2%, compared to 65.9% and 47.8% for the preceding quarter and the First Quarter of 2014, respectively. The year-over-year increase in gross profit margin was mainly due to enhanced economies of scale driven by revenue growth. The quarter-over-quarter decrease in gross profit margin was mainly due to the decrease of advertising services revenues due to seasonality.

Gross profit margin for our e-mail, e-commerce and others business for the First Quarter of 2015 was 38.9%, compared to 48.2% and 6.7% for the preceding quarter and the First Quarter of 2014, respectively. The year-over-year increase in gross profit margin was mainly due to increased revenue from e-commerce services related to third-party lottery products, which has a relatively higher gross profit margin. The quarter-over-quarter decrease in gross profit margin was primarily attributable to the fact that revenue from third-party lottery products decreased as a percentage of total revenues for this segment due to the temporary suspension I previously mentioned.

Total operating expenses for the First Quarter of 2015 were CNY1.2 billion or $189.3 million compared to CNY1.2 billion and CNY0.6 billion for the preceding quarter and the First Quarter of 2014, respectively. The year-over-year increase in operating expenses was mainly due to increased selling and marketing expenses for online PC-client and mobile games, promotions for our e-mail, e-commerce and others business, as well as the advertising services business. And increased staff-related research and development costs resulting from an increase in the number of employees and average compensation. The quarter-over-quarter decrease in operating expenses was mainly due to decreased promotional costs for our online games and advertising services.

We recorded a net income tax charge of CNY214.5 million or $34.6 million for the First Quarter of 2015, compared to CNY187.9 million and CNY179.6 million for the preceding quarter and the First Quarter of 2014, respectively.

The effective tax rate for the First Quarter of 2015 was 14.1%, compared to 12.8% and 13.8% for the preceding quarter and the First Quarter of 2014, respectively.

We also had a net foreign exchange gain of CNY22.7 million or $3.7 million compared to a net foreign exchange loss of CNY7.1 million and a net foreign exchange gain of CNY7.1 million for the preceding quarter and the First Quarter of 2014, respectively. The quarter-over-quarter and year-over-year changes in foreign exchange gains and losses were mainly due to unrealized exchange gains and losses arising from our foreign currency-denominated bank deposits and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over the periods.

Our net income attributable to shareholders for the First Quarter of 2015 totaled CNY1.3 billion or $204 million compared to CNY1.3 billion and CNY1.1 billion for the preceding quarter and the First Quarter of 2014 respectively. Non-GAAP net income attributable to shareholders which excludes share-based compensation totaled CNY1.4 billion or ($229.9 million), compared to CNY1.4 billion and CNY1.2 billion for the preceding quarter and the First Quarter of 2014, respectively.

Our basic and diluted earnings per ADS were $1.56 and $1.55, respectively, for the First Quarter of 2015. We reported basic and diluted earnings per ADS of $1.57 and $1.56, respectively, for the preceding quarter. And the basic and diluted earnings per ADS of $1.39 each for the First Quarter of 2014. Non-GAAP basic and diluted earnings per ADS was $1.76 and $1.74, respectively, for the First Quarter of 2015, compared to non-GAAP basic and diluted earnings per ADS of $1.72 and $1.71, respectively, for the preceding quarter. And $1.46 each for the First Quarter of 2014.

As of March 31, 2015, our total cash and time deposits balance was CNY22.1 billion or $3.6 billion, compared to CNY21.2 billion as of December 31, 2014. Cash flow generated from operating activities was CNY1.9 billion or $310.6 million for the First Quarter of 2015, compared to CNY1.9 billion and CNY1.7 billion for the preceding quarter and the First Quarter of 2014, respectively.

We continued to return value to our shareholders and are pleased to announce that in line with our quarterly dividend policy, the Board of Directors has approved a dividend of $0.39 per ADS for the First Quarter of 2015. We expect to pay this on June 5, 2015 to shareholders of record as of the close of business on May 27, 2015.

Thank you for your attention. We would now like to open the call to your questions. Operator, please go ahead.

Questions And Answers

Operator

(Operator Instructions) Jialong Shi, Credit Suisse.

Jialong Shi, Analyst

And I have a few questions. The first question is about your advertising business and your Guangzhou advertising revenue growth was much faster than your total peers. So I just wonder how much your ads revenue was contributed by mobile apps and also the same question for your online gaming business and just wonder how much of your gaming revenue was from mobile games in 1Q?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

Jialong, first of all regarding the mobile apps contributions for our advertising businesses, just as what we have mentioned in previous calls, we haven't disclosed exact percentage of this but it has also been come to a double-digit levels and on a quarter-over-quarter basis, we have also seen -- there has been a good growth in terms of this contributions from the mobile front for our advertising businesses.

As for our mobile game revenue contributions, in the last quarter as we mentioned, it has come up to a (level of about 1%) and for this quarter, it has come up to 20% about.

Jialong Shi, Analyst

With a % of your total gaming revenue?

Onward Choi, Acting CFO

Yes.

Jialong Shi, Analyst

So in terms of mobile games, I know you guys have launched mobile blockbuster title Fantasy Westward Journey in Q1. So how much of your mobile game revenue was contributed by mobile Fantasy Westward Journey?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So far as the launch of the mobile versions of Fantasy Westward Journey is concerned because it has been just launched by late of March and we have also seen -- there has been some contributions there. But we haven't been disclosed the percentages of it so far. But -- and so far, if you look back to our performances on the ranking board on the China iOS app store, it has been upkeep as a -- ranked as Number 1 on that chart for already over months and so you will see that its performance has been very encouraging.

Jialong Shi, Analyst

My second question is about how large that cross border e-commerce business and I just wonder what's the (inaudible) you guys have started in Q1. So maybe in Q1 the change was still small. So I just wonder what the (inaudible) and what do you think are your competitive edges in this First Quarter e-commerce business?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

With regard to your questions about our cross-border e-commerce businesses. So far that -- this would be our newly introduced business initiatives and we are still in the early stage of implementing these new business strategies. We are still seeing how it goes down the roads. And so far, we are still quite happy and satisfied with its performance so far and perhaps we will give you more colors to it at a later stage.

Operator

Alicia Yap, Barclays.

Alicia Yap, Analyst

I have two questions. Number one is regarding the Fantasy mobile, Fantasy Westward Journey mobile. So what makes Fantasy mobile so successful, how long do you think the strong franchise interaction to continue? Then given typically mobile games usually have a relatively short life cycle, should we be worried for Fantasy or will this be an exception?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So with regard to your questions about the critical success factors attributing to our business launch on the Fantasy Westward Journey mobile versions, first of all on the IPs of this game itself has already been surpassed 10 years -- more than 10 years in the market. And so far as the project teams is concerned, they have been working very diligently and work hard in order to enrich the game content and the game play and stuff like that in order to make it to be a very good product to our targeted audiences or the players in the market.

And that's why for this mobile version of the Fantasy Westward Journey game, we have do quite a lot of inspirations and new innovations in the way to attract our targeted audiences in this new space. And we have also taken the previous success experiences that we've earned or developed so far in executing or running our own PC-client Fantasy Westward Journey games in the market. And so that's why we believe that we have do a very good job in order to shape a very competitive and good quality products in the marketplace.

And so far as its performance is concerned, we are still quite happy and satisfied with its performance so far. And we are looking forward that we would be working more game titles along these lines to put forward to the market.

Alicia Yap, Analyst

Second question very quickly on the impacts on the lottery suspension. So when do you think the suspension to be lift and after it is lift, how should we think about the revenue trends compared to previously?

Onward Choi, Acting CFO

In terms of the temporary suspension is concerned, I think the companies will not be in the most suitable positions to comment on when this would release or the suspension would be over. But we would consider that and so far as this revenue contribution is concerned, it is still a relatively small part to the overall businesses that we have been doing. And I think this would be the updates that we can share with you for now. And in case we do got more updates about the developments, we'll keep you posted as soon as possible.

Operator

Thomas Chong, Citigroup.

Thomas Chong, Analyst

I have two questions. The first question is about the mobile games market as well as Fantasy Westward Journey. Given we have seen the lifecycle of mobile games in China is somewhat like a year or so. So how should we think about the life cycle for mobile Fantasy Westward Journey? Then I have a follow up.

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So with regard to our expectations on the life cycle for the mobile games or perhaps the Fantasy Westward Journey game titles in particular, basically we have full confidence about developing a long list of mobile games like the Fantasy Westward Journey that was launched recently. And if you look to the market so far, there would be a couple hundred of thousands mobile games in the market and not many of them would be very successful. But given the fact that possibly for NetEase that we are pursuing the highest qualities and the best user experiences in launching and upgrading our various products and sources, we believe that and coupled with our continuing innovation to adding some creative stuffs to our games, we do look upon that and we would be able to run out something that would be of a much longer life cycle.

Thomas Chong, Analyst

And my second question is about the cash, given (Prologis had such a high cash LIFO) management consider increasing the dividend payout ratio or any other areas you would consider doing M&A etcetera?

Onward Choi, Acting CFO

So basically the Company will still be upkeep with our three main directions on the potential utilizations of the cash. First of all, the dividend payout which we already have a very clear quarterly dividend policy that we will be giving about 20% to 25% of the quarterly net income by returning value to our shareholders.

And secondly, hopefully if the conditions or the criteria would be suitable then we would also be considering some potential buyback or stuff like that. And you would also be aware that we have one last program that we announced in last year but unfortunately we haven't been brought out -- bought back any shares upon its expiry in February this year.

And thirdly, of course the Company has also been actively pursuing some investing opportunities in the market and we believe that those will be the three main ways that we will be considering utilizing the cash going forward.

Operator

Vivian Hao, Deutsche Bank.

Vivian Hao, Analyst

I had two questions. First of all, we've seen that the mobile Fantasy Westward Journey has been a great success so far, just trying to understand how cannibalistic is our mobile games to our legacy PC online portfolio under the same IP. For example, like we still have -- we have FWJ and also probably incoming we have the Westward Journey this fall, this is my first question? And second question is regarding can we get a sense to roughly like how much lower is the margins for our mobile games versus PC games that will be very helpful?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So basically William's comments is that and so far as the game is concerned, we do not see that would be a very obvious or significant kind of realization coming up from the launch of the mobile games to our existing PC-client games.

And with regard to your second question about the mobile games gross margins, basically we have previously also highlighted that we are expecting that overall gross margins would be lower than what our existing PC games will be doing, the most obvious fact is that there would be some revenue sharing cost that we will be paying out to the third-party distribution channels. But having said that and so far as the distribution of the mobile games is concerned, we would be implementing an overall strategy by considering what's best in order to put forward to the market. Of course, while we would be using some third-party resources but at the same time we would also be making good use of our own internal resources to distribute our own games titles.

Operator

Nick Ning, 86 Research.

Nick Ning, Analyst

So my question is with the success of Fantasy Westward Journey mobile, are we confident that we can obtain a bigger market share of mobile than PC in the next two years even though we were a bit late in mobile gaming? And how do we see the overall mobile game market despite a relatively short history. Will this become much bigger by size than PC gaming?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So basically with regard to your first question about the -- our win about the market share in the mobile games market, first of all, we have a very strong confidence about making good market share in this part of the new business and a very clear sign that you can make reference to (RS wrecking ball) about the top grossing applications, the Fantasy Westward Journey has been ranking as Number 1 for a very long time and at the same time for the top pay chart. You would also see that our latest launch of mobile games like the (Monthan) has also been ranked as Number 1.

And so far as the overall gaming market is concerned, both the mobile and also the PC-client games markets is concerned, we still believe that the success factors would be attributing to companies that will be able to deliver some highest quality stuff to the market in order to secure their positions in the marketplace.

And at the same time, we do see that with the various new initiatives in terms of the PC-client games that we have been doing, we are also in a very confident position to saying that we will be doing good in the gaming market.

Nick Ning, Analyst

My second question is judging by the current trend of Diablo III, do you see it's possible to become as big or even bigger than World of Warcraft China?

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So far as the launch of Diablo III is concerned with the relatively short launch history of it, it has just launched on the 23rd of April, not a very long time. So far we are still quite happy with its performance. And for PC games like these, which is adopting to a one-time payment model, we do see the upcoming performances would be depending on how the contents will be developing or evolving whether or not we would have richer contents within the games and how the game play would be evolved to make it more attractive to our targeted audiences.

And while we wouldn't be making any specific expectations on how good the game will be doing but we still believe that this would be a very successful PC game in the marketplace.

Operator

Tian Hou, T.H. Capital.

Tian Hou, Analyst

So I have a question related to mobile game. So what's the major channel of your mobile distribution besides the app stores? And how much of the traffic actually comes from your YiChat and do you also take -- use this payment from overseas, it is also in iOS app store? (spoken in foreign language)

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

With regard on to the distribution of our mobile games, basically we would be emphasizing and also placing much effort to make good use of our own internal resources to promote our various game titles. And just now you mentioned about the YiChat and this is not the only way that we will be distributing our own game titles. In fact, we would have also got some other very popular and content-rich mobile applications available on hand including the Mobile news

Application and our dictionary. And definitely this would be -- interactions we would be doing going forward.

And so far as the overseas payments is concerned, this option is already available in the U.S. markets for games like the Fantasy Westward Journey and for players in the overseas market like U.S., the players can make the payments with their credit card. And basically, we are also setting aside our work of -- of working, expanding our footprint outside the China market and with the concurrently doing the localizations of our various games titles, we would be looking for that more and more games would be made available or distributed in overseas markets via the Apple stores or the Google Play.

And for other game title distribution just like Battle to the West, we have also been into operations with a Korean company and also in Taiwan and also Thailand and a company called the (The Lon). And so you will see that in terms of the overall distribution strategies for NetEase, we would be embracing a very wide and extensive and comprehensive solutions in order to put through our various game titles to our targeted audiences in different parts of the world.

Tian Hou, Analyst

This is very helpful. May I ask one more question, this is related to your mobile, BOBO is like a mobile entertainment. So I wonder if you could give you some color on the progress of that? And also in terms of your e-commerce program. So what is your plan for your overseas direct title program. So do you plan to make it a major part of your business or it's just a side business? (spoken in foreign language)

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So with regard to your first question about BOBO, basically this would be our online video entertainment services that have been offered to our targeted users. And in fact -- or so called the Internet interactive communication services. We have two services in particular, one is called the BOBO and the other one is called the CC. The BOBO one is targeted more to the public entertainment needs and the CC is more targeted to the game broadcasting to explain how the games would be doing and to show some of the tournaments or the performances of various games on these channels or the so-called platforms.

And so far we, have also accumulated quite a good user base there, a traffic reach and with our new innovations there and we also see that our targeted users has been expressed a very positive effect to us of using these two different platforms.

And in so far (multiple speakers) -- and one more thing and so far as the cross border e-commerce is concerned, basically we are still looking forward with the launch of our Kaola, cross border e-commerce since the (Generic X). We have been using this brand name to source good values or value for money products over the world in different parts of the world. And you will appreciate that for NetEase. We have been doing very well in particular to on the information services and we are looking upon that as we are entering to new and emerging areas like the cross border e-commerce. We will also be doing a very good on the merchandise service to our targeted customers in China.

And what we have said as our vision is that for the self-operated cross boarder e-commerce platforms, we would like to become one of the Top 3 operators in the marketplace and we also look upon that with this kind of platform services. We would be working out something more meaningful perhaps in a year's time.

Operator

Charanjit Singh, HSBC.

Charanjit Singh, Analyst

I was wondering if you can just give us an update on YiChat. I read in the press that you are sort of launching more features and functionalities. So if you can just give us an update on maybe users, habits, I assume any type of operational update on YiChat would be very helpful. Thanks so much.

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So basically in terms of the newly introduced or implemented functionalities for the YiChat services data pack in the Chinese New Year holidays, we have been launched the free call functions on the YiChat platforms which also prove to be very popular to our targeted users. And we have also seen both the traffic and the activity levels has been rising since then. And we are also quite happy and satisfied with this performance so far and we will update our momentum on our innovative capabilities to roll out something more interesting to the market.

And we do see that what the market or the users has been expecting is a more efficient and easy to use tools to facilitate their communication needs or interaction needs. This is also our long term vision to operate this kind of communication services in the long term with a more successful win.

Operator

Natalie Wu, CICC.

Natalie Wu, Analyst

I have two questions. First, William, you mentioned that you have overseas expansion later this year. Can you give us some extra color on this plan? And you denoted to a mobile game or client base game on this aspect and what's specifically kind of game will it involve? You already have overseas version of Battle to the West. Are you just planning to raise the overseas portfolio in addition to that or you've done it -- take more significant steps and will you recruit more people and open overseas rep office to facilitate better expansion? (spoken in foreign language)

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

Basically (technical difficulty) on the terms that you have just used, basically rather than saying that we are doing expansions some expansion on the gaming business. To be more specific, we are referring to our overseas distribution of the games and basically our targeted products would be focusing on the mobile games.

And so far as the game titles are concerned. So far other than Battle to the West, we have also got other games like The World HD and also the Speedy Ninja that soon go to the overseas market. And basically we would like to further enrich the different types of mobile games that we are going to roll out into overseas market and one way of doing it is that we would be distributing it by ourselves and we would also be considering to get into co-operation with some other parties in the overseas markets.

Natalie Wu, Analyst

So I noticed that Hearthstone iOS and Android version has already been released last month, wondering can we get some revenue sharing from this game and if yes, how much could we get and how much should we allocate to Qihoo 360 as it claims to be the operator on the Android version? (spoken in foreign language)

William Ding, CEO

(spoken in foreign language)

Onward Choi, Acting CFO

So basically you are right in saying that we are distributing the Hearthstone on both the Android and also the iOS platforms and there will be certain stipulated rules on how the revenues will be sharing out on different platforms.

Operator

That concludes today's question-and-answer session. I will turn the conference back to management for any additional or closing remarks.

Brandi Piacente, IR

Thank you, operator. And thanks everyone for joining us today. If you have any further questions, please feel free to contact Cassia Curran, NetEase's IR Manager based in Hangzhou or the Piacente Group Investor Relations. Have a wonderful day. Thank you.

Operator

This concludes today's conference and thank you for your participation.

Company Name: Sea Ltd
Company Ticker: SE US
Date: 2020-05-18
Event Description: Q1 2020 Earnings Call

Market Cap: 31604.6246279
Current PX: 67.8099975586
YTD Change($): 27.5899975586
YTD Change(%): 68.598

Bloomberg Estimates - EPS
Current Quarter: -0.44
Current Year: -1.626
Bloomberg Estimates - Sales
Current Quarter: 887.167
Current Year: 3889.143

Q1 2020 Earnings Call

Company Participants

- Yanjun Wang, Group Chief Corporate Officer
- Forrest Li, Chairman and Group Chief Executive Officer
- Tony Hou, Group Chief Financial Officer

Other Participants

- Miang Chuen Koh, Analyst
- Thomas Chong, Analyst
- Alicia Yap, Analyst
- John Blackledge, Analyst

Presentation

Operator

Good morning and good evening. Welcome to the Sea Limited First Quarter 2020 Results Conference Call. All participants will be in listen-only mode. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded. I would now like to turn the conference over to Ms. Yanjun Wang.Please go ahead.

Yanjun Wang, Group Chief Corporate Officer

Thank you, operator. Good evening and good morning, everyone and welcome to Sea's 2020 first quarter earnings conference call. I am Yanjun Wang, Sea's Group Chief Corporate Officer. Before we continue, I would like to remind you that we may make forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons. As stated in our press release. Also this call includes discussion of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA and net loss, excluding share-based compensation and changes in fair value of the 2017 convertible notes.

We believe these measures can enhance our investors' understandings of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release. I have here with me Sea's Chairman and Group Chief Executive Officer, Forrest Li; and Group Chief Financial Officer, Tony Ho. Forrest and Tony will share strategy and business updates, operating highlights and financial performance for the quarter.

This will be followed by a Q&A session in which we welcome any questions you have. With that, let me turn the call over to Forrest.

Forrest Li, Chairman and Group Chief Executive Officer

Thank you, Yanjun. Hello, everyone, and thank you as always for joining today's call. I hope that you are owing good health and staying safe.On behalf of all of us at Sea, I would like to thank you for your ongoing support during this exceptional period.These are time of significant change and the disruption for communities, economy and businesses around the world. Against this challenging backdrop, we are proud that we have been accelerating growth and we are reporting very strong result, for the first quarter. Our communities are increasingly relying on our platforms during the pandemic. Our user are turning to Garena to enjoy interactive entertainment and socialize with your friends during the social isolation of the lockdown. Shopee is becoming a more integral part of the commercial ecosystem in each of our markets with consumers now relying on our platform, for their staple, daily essentials and other consumption needs.

At the same time, more sellers are migrating to or relying more on Shopee to sell and grow their business. As our economies become more online and contactless, the digital payments and the financial services that SeaMoney provide are becoming an ever more important part of the infrastructure in our region. The Coronavirus crisis is driving at that change in the growth of the digital economy globally particularly in the market and the segments where Sea operates. It has materially accelerated a shift to online lifestyle that is broad, deep and in our view, irreversible. Building on our market leadership in some of the key and the largest segment of the digital economy, we believe we are gaining and will continue to gain a disproportionate share of that growth.

Our growth is also well supported by strong balance sheet and the cash flow from operation and we will continue to invest in a highly prudent way to maximize efficiency. Sea was born in the middle of the global financial crisis. We believe that certain key qualities like humility, focus, commitment, resilience, adaptability, and prudence helped us survive and strive in those difficult days when we first started our business. We believe that this quality still define us today and in fact are more valuable to us in the current climate than ever before. As businesses are stress tested by the crisis, our resilience and capability have enabled us to respond well to search in user demand while we navigate the physical constraint and disruption caused by the Coronavirus crisis. For example in all of Shopee's key market, we have launched and dramatically scaled up our offering of incorporating health and hygiene products and the essential household items in a matter of days. We are also doing everything we can to support economic recovery across our markets.

We launched a region-wise Shopee seller support package to top merchants to get back on their feet. This includes a number of initiatives localized for the specific need of merchants, and on the [ph] ground condition in each of our market.This range from training and support programs to top new sellers move online or assist existing sellers to grow their business for free or discounted accept to our services like advertising and marketing that enable seller attract new customers online.

Furthermore, we are providing fee relief for some of our seller services to ease the financial burden on them during this difficult period. Meanwhile, our derivatives have quickly scaled up our capacity to meet record search in customer demand. We have also worked hard to create new ways for our user to engage online from creating dedicated online esport event so that our communities can interact with each other even as they play hard to using our platform to raise awareness of health and assist in better practices in fun and a creative way.

Our adaptability ensures that our platform can support our customers and ecosystem partner when they need us most. This is helping us build strong bonds of affinity with them that will outlast this crisis. Just as importantly, this ensures that we can continue to grow our businesses and extend our leadership even in the most affecting circumstances. I am equally proud to see how our team have come together to get aid to where it is needed most, across our market we have worked with local authorities to provide financial support as well as essential medical equipment such as ventilators, mask and personal protective equipments to the hospital and the healthcare workers on front-line of the battle against the Coronavirus. This mission is to better the lives of consumers and small businesses through technology and it has never been more important for us to live up to that mission. Let me now turn to our results for the first quarter. On a group level, adjusted revenue grew 58% year-on-year to $913.9 million for the first quarter. Gross profit for the quarter was up 424% year-on-year to reach $206.8 million compared to $39.5 million in the same quarter of 2019.

Adjusted EBITDA was negative $69.9 million, compared to negative $32.0 million in the same period in 2019. Let's look now at our digital entertainment business. Garena once again broke record in the first quarter. Adjusted revenue grew by 30% year-on-year to $512.4 million. This robust top line growth was primarily driven by strong growth in both active user and paying user. In addition, we hit new highs in terms of quarterly active user. We recorded 48% growth year-on-year to 402.1 million quarterly active user while our quarterly paying user grew 73% year-on-year to $35.7 million. The quarterly paying user ratio remained strong at 8.9%. Free Fire saw particular strong growth in the first quarter, and I am pleased to note that the strong growth extended into the second quarter. The game recently hit new record for peak daily active users of 80 million. In April, Free Fire achieved another record high in monthly paying users, which more than doubled year-on-year. In India our monthly paying users as a percentage of monthly active users already exceeded 10% in April. We believe this growth in our user base is attributable both to the macro trends as well as our constant efforts to engage new and existing users with fresh, creative and highly localized content. For example, we introduced a new map called Kalahari. It features a desert theme, with faster, more intense game play. The Kalahari map proved very popular with our users when it was first piloted in select events a few months ago, and has since been made a permanent part of the game. We have also rolled out a number of new features based on feedback from our communities, such as a ranked mode for our popular Clash Squad game mode. The Clash Squad game mode features teams of four competing against each other in intense, best-of-seven matches that last just 1.5 minutes each. It has been a big hit with the community, and the addition of a ranked mode based on their feedback adds a new competitive element, where teams can challenge themselves against the best opponents in their region.

Alongside these global content pushes, our local teams are focused on developing highly localized content for our users. In Indonesia, for example, we have partnered with one of the country's most popular actors and star of Mortal Kombat, Joe Taslim, to create a playable in-game character called Jota, modeled after Joe himself. To promote this, we also worked with one of Indonesia's most popular directors to create a short film with Joe showcasing his famous martial art skills. So far in Indonesia, over half of our users have played as Jota. This initiative highlights how these elements of local flavor really resonate with our users. Similarly, in India, we partnered up with popular actor, Amol Parashar, to produce a series of light-hearted videos highlighting Free Fire's key features.

These videos quickly went viral, and to date have recorded over 37 million views on YouTube. With offline eSports events generally on pause, we have quickly adapted and introduced new ways to sustain our engagement with the Free Fire community. For example, in April, we hosted a special one-off global event called Wonderland Peak. This was a week-long celebration featuring special characters, items, and in-game challenges to excite our community around the world and to reward our most loyal users. It was also Free Fire's largest in-game event of the year so far, and we saw significant user number growth as a result.

Moreover, we are working with local celebrity Free Fire fans to create fun and engaging online competitions that have been very popular with our users. In Brazil, our long-term partner DJ Alok, who is one of Brazil's most popular musical artists, took part in an online competition against some of the best known local Free Fire influencers as a warm-up for a hugely popular live set he performed across local social media channels. Meanwhile in Colombia, two of the country's best-known footballers, James Rodriguez and David Ospina, each captained teams of Free Fire influencers in an online charity tournament that attracted over a million view. In the first quarter, we recorded over 90 million online views for Free Fire's eSports events globally. This is a testament to the growing reach and the popularity of this game across the world. Building on this growing and more engaged user base, we will continue to focus on developing Free Fire into a long-lasting IP and a bigger platform. The larger user base also presents greater monetization opportunities over the longer run. We are therefore fully focused on execution and leveraging Garena's strong momentum to further accelerate its growth globally.

Let's turn now to Shopee. Like Garena, Shopee also recorded stand-out results for the first quarter and into the second quarter. Throughout the quarter and beyond, we have been making every effort to win the hearts and minds of our consumers and merchants during this difficult time for them. We hit a new record high for GMV of $6.2 billion representing year-on-year growth of 74.3%. The year-on-year growth rate increased by almost 10 percentage points compared to 64.8% for the last quarter, despite the disruptions of the Coronavirus crisis. We also recorded strong growth in orders, up 111% year-on-year to $429.8 million. The year-on-year growth rate of gross orders further accelerated to more than 140% in April, as we saw the strong growth momentum on our platform carrying into the second quarter.

In the first quarter, we further extended our market leadership and continued to rank first across Southeast Asia by downloads, monthly active users, and total time in app on Android, according to App Annie. Notably, we were the top ranked app by monthly active users in each of Taiwan, Indonesia, Vietnam, and Malaysia. As we further expanded our user base, Shopee ranked third in the Shopping category globally by downloads across the iOS and Google Play App Stores combined during the first quarter. Adjusted revenue grew strongly to $314.0 million, up 111% year-on-year, and marketplace revenue grew even more quickly to $236.7 million, up 132% year-on-year. We believe this indicates the strength and resilience of our platform despite the macro environment. Merchants are willing to keep investing in Shopee even in these tough times because they recognize the value that we offer, our unrivalled reach to consumers and the return on their investment that Shopee provides. The slight quarter-on-quarter decrease in our overall and marketplace take rates is mainly due to the lockdowns and other movement restrictions in the first quarter. These disruptions had a particularly significant impact on some of our cross-border merchants. As a result, we saw an impact on revenue derived from sales by those merchants. This includes revenue from cross border logistics that is recognized on a gross basis. We also provided fee relief to our cross border merchants who were materially impacted by the Coronavirus crisis. Into the second quarter, we have seen meaningful recovery of cross border transactions on the platform.

Adjusted EBITDA loss per order declined further falling by 48% year-on-year to $0.60 compared to $1.16 for the same period in 2019 and $0.70 last quarter. Our ability to drive sustained improvements in unit economics even in this difficult environment, highlights our focus on scaling with efficiency and our disciplined approach to growing our business. In Indonesia, where Shopee is the largest e-commerce platform by orders, Shopee registered over 185 million orders for the market in the first quarter or a daily average of over 2 million orders. That represents an increase of 123% year-on-year, further extending Shopee's market leadership. Shopee also ranked first in Indonesia by average monthly active users, downloads and the total time spent in app on Android in the Shopping category during the quarter according to App Annie. Our sustained focus on engaging our user continues to be a key driver of platform growth. As our community have build up, we are now able to drive engagement into activities in a much more personalized and targeted way. For example, we launched a membership-based service called Shopee mom [ph] club across our market.

These surveys target mothers who use our platform and enables them to discover a unique selection of highly quality created [ph] product and brand. Some of this product and brand are only available to members. They also enjoy discounts on many common item such as diapers. This targeted group engagement build stronger user stickiness and activity and we are rolling out similar targeted offering in other categories like health and beauty. From 30 [ph] March onwards, government in all our market began to introduce restriction on movement to curb the spread of the Coronavirus.

In response to this, our local team worked extremely hard to quickly launch and scale up our offering of FMCG home and living and other categories of essential and household group. We rolled out a special program called Shopee from home in every market. This program was designed to encourage our user to follow government guideline and stay home by buying their essential needs online. We also onboarded thousands of new merchants to help them migrate their business online during this difficult time and overcome the significant logistical and operational challenges imposed by the lockdown.

As Shopee becomes an increasingly vital part of the retail landscape in our market, more and more of the world's top brand are building up their partnership with us. In early May, we rolled out a region-wide partnership with Procter & Gamble called Show Me My Home. For this innovative campaign, Shopee and P&G collaborated to create dedicated macro site for each Shopee market that feature a curated selection of top P&G brand categorized by different (inaudible).

The campaign aims to give consumers a new, brand and engaging way to find a product that they want from P&G to world famous brand on Shopee. I'm really proud of our team for managing the business through the challenging environment we have faced in recent months. We must increase demand of our consumers and merchant in spite of significant stress test on our business and our ecosystem in whole by the pandemic itself and the various restriction introduced to curb the spread of the virus. We are well positioned to continue capturing the expanded growth opportunity in the sector and further extending our market leadership. We believe that this strong leadership position combined with the resilient commitment and adaptability of our team will drive accelerated long-term growth.

Finally, SeaMoney continue to experience strong growth propelled by increased user demand for digital payment and financial services during the pandemic, accelerated growth of our Shopee platform and the deeper integration of our mobile wallet services with the platform.

In the current climate, the overall digital economy is growing rapidly. In particular, more people are spending more of their time and the money online, and that is driving an increased need for both online payment services and the financial services as well as an increased need for contactless payment option. That in turn means that more people are adopting digital payments and the financial services option as one of their primary channels of choice.

Building on that, we are encouraged by the progress we have made in driving adoption of SeaMoney's offering. In the first quarter, our mobile wallet total payment volume or TPV exceeded $1 billion, a milestone achieved in just about a year after we started to integrate mobile wallet service with our Shopee platform. The quarterly paying user for our mobile wallet services surpassed 10 million. More than 40% of Shopee's gross orders in Indonesia, our largest market for SeaMoney were paid using our mobile wallet services in the month of April. Moreover, we are rapidly expanding third party use cases and the partnership online and offline. In March, 2020, we joined forces with Google to offer our mobile wallet as a payment option for the Google Play Store in Thailand. We see significant growth ahead in the digital payment and the digital financial services segment and we see that growth accelerating as the Coronavirus crisis drives more consumer activity online. We also believe that SeaMoney is in an excellent position to capture this growth as we build out our strategic leadership position in some of the largest use cases in digital payment.

We will continue to focus on scaling SeaMoney effectively and efficiently to reach strong leadership position across our key market. To conclude, we are glad to be reporting strong numbers for the first quarter. This performance demonstrates the fundamental strength and the resilience of this business and our position as the market leader in sectors of the economy that are experiencing the strongest grow. Looking ahead, while we expect to face uncertainty in the near term due to the Coronavirus crisis. We believe that that change in adoption of the digital economy that we have seen in recent months is here to stay and it will experience rapid growth in our market in the years ahead.

More importantly, we believe that the three core businesses as the leader in their sectors will capture an outsized share of that growth. Sea have been stress tested in recent months due to the Coronovirus crisis and our performance under this condition have underlined the fundamental strength and the resilience of our business. This gives us confidence that we are well equipped to manage the current external turbulence and ready to capture the long-term growth opportunities. We will still (inaudible) continue to invest in our future and is focused on winning the heart and the mind of the user across all of our platforms, given the time when they need us most.

We believe that Sea will emerge from the crisis in an even stronger position and better prepared to our long-term growth.

With that I will invite Tony to discuss our financials.

Tony Hou, Group Chief Financial Officer

Thank you, Forrest. And thanks to everyone for joining the call. We have included detailed quarterly financial schedules together with the corresponding management analysis in today's press release, and Forrest has discussed some of our financial highlights. So I will focus my comments on the other key financial metrics. With Sea, overall total adjusted revenue grew by 58% year-on-year to $913.9 million, which was mainly driven by the growth of our digital entertainment business, especially our self developed game Free Fire and our continued monetization efforts in our e-commerce business in the past quarters.

The 30% year-on-year growth in digital entertainment adjusted revenue to $512.4 million was primarily driven by the increase of our active user base and deepened paying user penetration, and in particular, the continued success of Free Fire. Digital entertainment adjusted EBITDA was $298.4 million, an increase of 32% year-on-year, mainly due to strong top line growth in our self developed game accounting for an increased share of revenue.Our e-commerce adjusted revenue of $314 million included marketplace revenue of $236.7 million, up 132% year-on-year and product revenue of $77.3 million, up 64% year-on-year. This growth is a result of our commitment to continue enhancing our service offerings. As we seek to create greater value for our platform users. E-commerce adjusted EBITDA loss was $260 million as we continued our investment to fully capture the market opportunity in the region. We will continue to invest prudently and drive high quality growth by serving the user's needs better in the long run. Digital financial service's adjusted revenue was $10.7 million, an increase of 278% year-on-year from $2.8 million in the first quarter of 2019. Adjusted EBITDA loss was $101.6 million in the first quarter of 2020 compared to a loss of $11.9 million in the same period of 2019.

This was primarily due to our continued efforts to integrate our mobile wallet services with our Shopee platform across different markets. We have also been expanding the use cases of our mobile wallet services outside of Sea's platforms to include other online and offline merchants along with a variety of third-party use cases. Returning to our consolidated numbers, we recognized a net non-operating incomes of $11.2 million in the first quarter of 2020 compared to a net non-operating loss of $442.8 million in the first quarter of 2019.

The net non-operating loss in the first quarter of 2019 was primarily due to a fair value loss of $436.1 million arising from the fair value accounting treatment for the 2017 convertible notes. We have -- we had a net income tax expense of $23.2 million in the first quarter of 2020 which was primarily due to withholding tax and corporate income tax recognized in our digital entertainment business. As a result, net loss, excluding share-based compensation and changes in fair value of the 2017 convertible notes was $239.4 million in the first quarter of 2020 as compared to $237.3 million for the same period in 2019.

From a foreign exchange standpoint, we have seen increased volatility in the exchange rates of some of our local currencies against the US dollar, and that meant for us on a constant currency basis, the top line metrics would have been neutral to modestly better in some of the cases, but we did not assess the differences to be material.

With that, let me turn the call back to Yanjun.

Yanjun Wang, Group Chief Corporate Officer

Thank you, Forrest, and Tony. We're now ready to open the call for question. Operator,

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) The first question comes from Miang Chuen Koh of Goldman Sachs. Please go ahead.

Miang Chuen Koh, Analyst

Thank you. Good evening. Congrats on the results A sets of questions please. Firstly, gaming. Can you talk about what fiscal revenues would have been on an FX-neutral basis, which countries did the growth in active users come from. And why pay ratio fall Q-o-Q?

Secondly on e-commerce, it was mentioned cross border was the reason for the decline and decrease. Can I confirm that this has hit your commission revenues more quarter to quarter than advertising and us [ph] and given merchant supply initiatives in second quarter, will we likely see more revenue decline in that quarter or revenue take rate decline in the quarter. And I confirm that -- can I confirm also FY '20 e-commerce revenue guidance is maintained as well. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thanks, Chuen Koh. And I will address the game question first. As Tony mentioned earlier, there has been some foreign exchange related fluctuations and that means FX-neutral basis, our top-line number, including the game revenue could be slightly better than what we reported. But if you noted that as Tony mentioned that we assess difference not to be material and we will continue to monitor the situation if we think there is need to report more ForEx neutral numbers. We will do so in the future.

In terms of the active user growth, it came from across different markets in Southeast Asia, Latin America, India as well as the other markets in Middle East, Europe, US, Russia. So I think during the COVID time, I think we see more people as they are confined at home in social isolation. They tend to our game, which is highly interactive and social for both entertainment as well as the human interactions with their friends and family and colleagues. And we definitely see both user -- active user increase, pay user increase, sorry play time increase and that we think in the longer run, will continue to drive the longevity of the IP as well as monetization.

As we mentioned in earnings release for Free Fire in April, we saw the pay user more than doubled and at same time for example, another country, India where people usually do not see as a a big eSports market. In fact, it has been one of the biggest market for us for Free Fire and at the same time, we see that in terms of monthly pay user ratio, it has already exceeded 10%. While that is increasing. We also see, average revenue per user increasing in India as well as in all the other markets that. So I think overall for our game side, it's been very positive trend, we're observing. And we hope to outperform our full year target. And if we have more data, we might update the market down the road later. On the e-commerce side, so in terms of the take rate. I think if you look at Q1. Overall, Q1 is traditionally a -- not a shopping season. It is also a shorter quarter compared to Q4. And in fact Q-on-Q our e-commerce continue to grow and growth rate in terms of GMV year-on-year growth rate even accelerated in Q1 by about 10 percentage points compared to Q4, which is very big shopping season for us.

This is despite all the impact that might come from cross border and more of a total lockdown in the Philippines. So this shows how resilient our marketplace is. The strength of the marketplace leadership in the -- in Q1, despite the physical constraints and market turbulences that our region might be facing and in fact, as we look at Q2, we mentioned in the earnings release that our April order actually grew more than 140% year-on-year. So if you look at the different markets, we see this as a step change in terms of adoption rate of e-commerce that is with benefits disproportionate according to us as a strong market leader.

In terms of the take rate, the Q1 take rate drop from Q4 is mainly driven by the value-added services, which is primarily cross border logistics that we recognize on a gross basis -- basis which means if the seller pays us $2 for cross border logistics fees, we pay the third-party logistics providers $2. We recognize this $2 as revenue as well as cost of revenue. So with that, if you look at what happened in Q1, China had a lockdown during that period, which did have impact on the cross border logistics, sorry, both cross border sales volume as well as cross border logistics and that is reflected in the take rate that we are looking at for Q1. Since China has opened up and resumed most of the normal activities, we have seen this has bottomed out in February, and meaningfully recovered by April and we continue to cross border will just uptick in May and onwards.

So we think this one will not -- is not a permanent impact on us, and we expect take rate to gradually right back to the previous level and our revenue is going to be both driven by the right take rate as well as the increase in volume itself. So we are not worried about long-term monetization of e-commerce platform. This does not change our view. In fact, it makes us even more bullish on the e-commerce business as a whole given the step up in the penetration rates.

So if you look at our markets, where the penetration of e-commerce and digital economy as a whole is still relatively low, the COVID situation actually drive a lot of people online as offline shops are closed. And we -- our all operations remain open and we deliver as normal, in most of our markets. So throughout this whole period, this allow us to capture disproportionate amount of growth and also winning the hearts and minds of our users with -- with the quality of the services we provide them as well as assistance we are providing them especially the SME sellers on our platform, who are trying to move their business online. And this will also be reflected in our seller commission relief program, the aid program, as well as the -- the marketing credit that we might get to sellers.

So, short term, we might continue to see take rates being a bit lower than what used to be before COVID situation, but long-term we have that does not change at all our view of the steady state take rate is achievable and the monetization potential of the platform is also throughout drove further our growth as a market leader.

So in terms of guidance for Shopee at this point, we think that as the situation is still evolving daily. While we continue to see strong growth, we think it's -- we would like to update the market if there is more data later. But at this stage, we don't see there is a need to change the guidance.

Operator

In the interest of time, we will take a maximum of two questions at a time from each caller. The next question comes from Thomas Chong of Jefferies. Please go ahead.

Thomas Chong, Analyst

Hi, good evening, thanks management for taking my questions. Given that we have seen Free Fire has reached another milestone in terms of the peak active users. Can you comment about the long-term trend or the stage of lifecycle for Free Fire and we're also seeing that India in terms of their paying ratio is also doing well. How should we think about the longevity of Free Fire In terms of the growth momentum, should we expect it to be a multi-year or 5 to 10 years kind of socially phenomenal game. Any color on that would be great.

And then my second question is back to Shopee, given the fact that we may see some volatility in terms of the take rate in the near term because of the Coronavirus. And as we are seeing the China cross border e-commerce is also coming back. Should we expect take rate to back to year-on-year growth trend back in the second half and on -- on that trend, can you comment about in terms of the impact of Coronavirus in different geographies, i.e. Indonesia, Taiwan, Malaysia, Vietnam, Philippines and Singapore. I just want to get a sense about how the GMV actually is trending because of the Coronavirus and also the pace of recovery in different countries. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. I'll start with Free Fire. I think, we see very positive trend. As you mentioned, we recently hit a peak -- daily active active user of more than 80 million and at the same time we also see pay user increased significantly with ARPPU at pretty steady stage that shows that A, monetization potential of this game is huge and B, we think this also helps with the longevity when you have more players playing this game and more players paying for this game. They tend to stick with the game for longer and also given how social interactive this game is more people play with -- play this game, that also means more of your friends, family, other people are in the game and they talk about it. That's part of your social life and circle, you also stick with the game for longer.

I think that we are trying to really how to focus on managing -- maximizing the upside of the game and building it into a not only a long living classic IP, but also increasingly social platform. As you can see that we introduced the new map, new content in collaboration with other game as well as movie stars, football stars, and we introduced music video into the game as playable characters acting in the music videos. So these are all these features we are introducing that are very welcome and very well received by our users who are engaging with us in the game and also outside of game in online forums, through live streamings and watching the game videos on different platforms. So I think that there is definitely the focus on us to continue to build out this IP under this huge platform with now more than 80 million people interacting with each other daily. So I think that is something that we are very much focused on. And in terms of e-commerce take rates, we're not worried at all about the volatility in the take rate. As mentioned, Q1 volatility is more attributable to cross border logistics, as which is the revenue recognized on gross basis. But as you can -- as we previously mentioned, the majority of our revenue actually came from the high margin revenue, i.e. commissions, handling fees, advertisement et cetera and these continue to be highly resilient during this period. Now we do by choice actively gave seller some relief and assistant packages to help them transition, especially those SME sellers who are more severely affected -- impacted by this COVID situation to transition through this period.

This is something we think, we are very fortunate to be able to do from a position of stress to help our communities of sellers as are the broader communities to help them get on feet -- back on their feet. So this is something that we might continue to do in the near term as they recover. But on the other hand, this is something that we think in the longer run, will help us win the goodwill and build a stronger and deeper bond with our key participants in our platform, and this is very worthwhile investments we're making.

In terms of the different impact in geographies. I think probably in a broad basis three categories, one is markets where the lockdown was -- there wasn't a extended period of very strict or total lockdown. So these are markets like Taiwan and Vietnam. Vietnam did have a lockdown but relatively short and then there are also markets where you see more extensive lockdown that would include Singapore, Malaysia, Thailand, Indonesia and then there is also the Philippines which is that has a lockdown that also for a very short period of time in March that prevents all delivery. We are actually one of the first players to receive exemption from the government to deliver essential goods to our users. And we also start to see the lockdown easing in Philippines over time to allow more categories of goods to be delivered. And then there's also China, where the cross border impact is from. So I think these markets are different in a sense that for the markets that has relatively less impact from the lockdown, we see normal -- more normal growth year-on-year and quarter on quarter like before and we continue to grow very strongly and in markets that are -- have more extended lockdown where our operation still carry on as I would say as much as normal as possible despite the physical constraints our teams faced, which also speak volume about the resilience and execution capabilities of our team, who actually see even more stronger, more profound increase in demand for our services and we have been able to deliver that. And that is the markets that we think the -- to extend the lockdown is still in place. We will continue to see strong demand and in markets where like Philippines that does affect e-commerce logistic and delivery. There is a decrease in the overall volume that can be fulfilled, but again, we start to see that being eased and as a market leader this affects everybody. But as a market leader, I think we are still doing probably better than many other players in this regard.

And for China, I think that as you all know, pretty much the bottom has passed by the end of February and we see recovery in March, April, so the cross border, we think will be -- will be back more quickly.

Operator

In the interest of time, we will take a maximum of two questions at a time from each caller.The next question comes from Alicia Yap of Citigroup. Please go ahead.

Alicia Yap, Analyst

Hi, good evening. Forrest, Tony, Yanjun and other management. Thanks for taking my questions. Very quickly, I know the Free Fire has sustained really strong momentum, but just curious out of this soft economy, do we anticipate the spending behavior will get more cautious as the macro outlook get -- I mean worsens, and also, as we emerge from the lockdown. And then for -- quickly on the Shopee side, any thoughts in terms of the longer-term strategy that we potentially would put more emphasis on building a combinations of the branded flagship store model versus together with the long term merchants. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you, Alicia. In terms of the macro outlook, of course, this is the situation is evolving daily, it will depend on how long the lockdown might be and how well we can address a pandemic and the impact on the economies market by market, but overall, I think, we do see game business generally to be quite counter cyclical even during the -- during economic recession, people still need some form of social engagement and entertainment and what they might pay for game, especially in our market. If you compare to like say a movie ticket or subscription of streaming, streaming services, et cetera it is -- that's the reason we call it micro transaction.

I think this is something that's highly affordable to people's skill [ph]. And also the -- for games where it's not targeting a very -- our game, especially as a large eSports highly social game. We are talking very broad base of consumers and, therefore, having a very large user base and we focus on QAU, QPU daily active users et cetera is very important that gave us much better resilience against any potential downturn and given that our game is not concentrated in any particular market.

In fact, we see in terms of user contribution, as well as revenue contribution increasing balance across different market, including Southeast Asia and Taiwan, LatAm, India as well as other markets that give us, in a way better protection against any particular market downturn. So we think in that way, we are quite fortunate to be in this business at this time. And in terms of longer-term strategy for e-commerce. I think we will continue to grow both. We see very strong growth on Shopee Mall, i.e. the branded merchants on our platform both before the COVID started and as well as during this period as brands also started to look at online commerce as -- not as afterthought or as a good to have alternative now more as a -- probably more of a must-have alternative or even a greater focus, especially when the offline retail is pretty much shut down.

So I think, we are disproportionately benefiting from that migration and we are very focused on serving them well to retain our users and capture that growth and -- but at the same time, we still think our market. There are lot of SME sellers that really can benefit from our marketplace and Shopee as when we design it to be a general merchandise marketplace as opposed to more of a niche kind of marketplace or a lumpy marketplace -- a lumpy kind of a model. It's precisely because we think there are large number of smaller merchants, SME merchants that can grow with our marketplace and our markets.

And we have a unique advantage in our ability to serve millions and tens of millions of them well with very highly localized operations and high quality management of the sellers category by category. This differentiates us from a lot of the existing players and help us grow to the market leaders we are now. So we'll continue to focus on -- focusing on serving them well and make them grow with our platform.

Operator

In the interest of time, we are limiting a maximum of two questions at a time from each caller.The next question comes from John Blackledge of Cowen. Please go ahead.

John Blackledge, Analyst

Great thanks. I'm John (technical difficulty) any particular Shopping categories that drove the (technical issue) growth acceleration (technical issue) further acceleration in April and on April (technical issue) on the 140% growth in April, curious how growth is tracking...

Yanjun Wang, Group Chief Corporate Officer

Sorry, I am going to ask you, can you repeat the question please.

John Blackledge, Analyst

Yeah. Can you hear me?

Yanjun Wang, Group Chief Corporate Officer

Yeah, it's better.

John Blackledge, Analyst

Shopee, any particular Shopping categories that drove the acceleration in 1Q. And the third acceleration in April and then (technical difficulty) that you're seeing, that you may be seeing in May. And then on SeaMoney, how should we think about the long-term opportunity. And also just the near-term trajectory for (technical difficulty) and EBITDA losses which were $50 million higher for Q2 [ph]. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Yeah. Thank you. So in terms of GMV growth. I think if you look at our traditional segment that are -- the categories that are largest in our platform include fashion, health and beauty, home and living, baby products. We see very strong growth -- accelerated growth in -- particularly in home and living, health and beauty, baby products. We also see strong accelerated growth in FMCG, other FMCG goods staple that we are also focusing on now to meet the surges in demand. So we think with the lockdown in place still in most of markets. This will probably continue for a while. After the lockdown, we'll have to observe when life back to normal. How much of that volume will continue to flow to us. But I think what we focus on is at this stage, when the users are being kind of naturally turning to online for -- to fulfill their needs and these users are oftentimes the first time users. If you look at the e-commerce, low e-commerce penetration rate in our markets, we're not talking about alternative wallet of share, we're actually talking about increase in terms of the baseline of new users coming naturally keen to be educated how to use e-commerce, and we are there probably the first impression and providing the first time experience of e-commerce to them. So this is what we focus on whether they want to buy health products or FMCG or staple food. We try to as much as possible serve their needs well, and with our engage -- engaging experience as well as the large assortment of things, we can covert them into more frequent buyers into other products and goods as well.

So, during this period of time, we see increasing active buyer, sellers as well as by frequency, used to be between four and five, we see increase in getting to above five and for some markets, even above six times a month. So all the other categories are also increasing, even for fashion, which people might think as a more discretionary, we still continue to see year-on-year growth in April for fashion order, but I would say the other category, the order, growth probably is more pronounced compared to fashion, as now people don't have to go out as much.

So I think, we will continue to observe going into May. In terms of the long-term opportunities and versus the EBITDA loss, if you look at our adjusted EBITDA loss per order at $0.60, now, which is -- has been increased -- decreasing, year-on-year and Q-on-Q and at same time if you look at our game EBITDA, this is, now, it's meaningfully larger than Shopee EBITDA loss for this quarter, which again as we said many times before that we want to breakeven we can, any time, but we are focused on investing in growth in extending our market leadership that will bring us much better -- retain a longer run and profitability.

We're very much focused on disciplined growth, and efficiency of growth and the same times, our view does not change that the investment in Shopee now is very effective and efficient and it's increasingly covered by our cash generated from both Shopee monetization itself, as well as monetization from the digital entertainment side, which also is enjoying strong growth. So we are in -- we see better than ever position now. And we're very focused on maximizing the upside of being presented to us under the Special Situations, basically we're fast-forwarding into the future.

The reason we focus on digital entertainment, e-commerce and digital financial services as our three core businesses is because our strong conviction in the growth of the digital economy of our region and that these three sectors are the largest opportunities in a digital economy of our region. And with the current situation, we see that the adoption of digital economy as a whole has accelerated and -- and the baseline has increased, and all three segments that we are focused on happen to be the best -- biggest beneficiary.

And we being the market leader in these segments, again, being the biggest beneficiary within these segments. So we are very much focused on investing with discipline to capture that growth for our long-term potential.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Yanjun Wang for any closing remarks.

Yanjun Wang, Group Chief Corporate Officer

Thank you for everyone for joining today's call. We look forward to speaking to you all again next quarter.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: SE US
Date: 2020-03-03
Event Description: Q4 2019 Earnings Call

Market Cap: 23027.8912268
Current PX: 49.7099990845
YTD Change($): 9.48999908447
YTD Change(%): 23.595

Bloomberg Estimates - EPS
Current Quarter: -0.32
Current Year: -0.895
Bloomberg Estimates - Sales
Current Quarter: 899.667
Current Year: 3558.125

Q4 2019 Earnings Call

Company Participants

- Yanjun Wang, Group Chief Corporate Officer
- Forrest Xiaodong Li, Chairman and Group Chief Executive Officer
- Tony Hou, Group Chief Financial Officer

Other Participants

- Alicia Yap, Analyst
- Miang Chuen Koh, Analyst
- Thomas Chong, Analyst
- Mike Olson, Analyst
- John Blackledge, Analyst
- Ranjan Sharma, Analyst
- Varun Ahuja, Analyst

Presentation

Operator

Good morning and good evening. Welcome to the Sea Limited Fourth Quarter and Full Year 2019 Results Conference Call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Ms. Yanjun Wang. Please go ahead.

Yanjun Wang, Group Chief Corporate Officer

Welcome to Sea's 2019 Fourth Quarter and Full Year Earnings Conference Call. I am Yanjun Wang, Sea's Group Chief Corporate Officer. Before we continue, I would like to remind to you that we may make forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes discussions of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA and net loss, excluding share-based compensation and changes in fair values of the 2017 convertible notes.

We believe these measures can enhance our investors' understanding of the actual cash flows of our major businesses, when used as a complement GAAP disclosures. For a discussion of the use of non-GAAP financial measures and a reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

I have here with me Sea's Chairman and Group Chief Executive Officer, Forrest Li; and Group Chief Financial Officer, Tony Hou. Forrest and Tony will share strategy and business updates, operating highlights and financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have.

With that, let me turn the call over to Forrest.

Forrest Xiaodong Li, Chairman and Group Chief Executive Officer

Hello everyone, and thank you as always for joining today's call. 2019 has been an extremely successful year for Sea, and the year when we achieved a number of significant milestones. In particular, we celebrated our 10th anniversary last year. This milestone gave us an opportunity to look back at just how far Sea has come over the last decade.

Our business has grown rapidly, and has been constantly evolving. In just the 10 years, we have grown from being a PC game publisher to a leading games publisher and the developer with a diverse mobile and PC game portfolio. We have evolved from being a game platform to a consumer Internet platform, that covers digital entertainment, e-commerce and digital financial services, and we have expanded from our humble beginnings as a start-up in a small shop housing Singapore to become a regional leader with strong footprint across global high growth markets.

Observers might be surprised by the pace and extent of Sea's growth, and the evolution over the last few years. While we benefit from economic and the technology tailwinds in our markets, we believe the key reason for Sea's success in our firm focus on identifying what we see as the largest opportunities in the consumer Internet industry and our relentless efforts to capture these opportunities with the right business model, timing and execution.

We started our digital entertainment business Garena in 2009, because we passionately believed that gamers in our region deserved a better way to access and enjoy top quality games and the esports. Over the past of 10 years, Garena has evolved from a PC game publisher in Southeast Asia and Taiwan, to a leading global game publisher and developer.

Our first self-developed mobile game Free Fire is a global hit, and was ranked the world's most downloaded mobile game in 2019. The success of Free Fire has significantly expanded our total addressable markets globally. For example, the Latin America or LATAM markets, with their large and the faster growing populations and the faster deepening mobile penetration have become the second largest regional market for our digital entertainment business after Southeast Asia and Taiwan.

Collectively, the LATAM markets and the other faster growing frontier markets such as India, Russia and the Middle East already accounted for about half of our digital entertainment and adjusted revenue for the fourth quarter of 2019.

Our proven capabilities in both game publishing and the development, as well as our strong track record in global growth market which are highly complex and diverse have driven consistent, strong financial performance. In 2019, our digital entertainment adjusted revenue grew by over 167% year-on-year to reach $1.8 billion, while our adjusted EBITDA grew by over 289% to over $1 billion.

More importantly, we believe we have built a very strong foundation and develop the core strengths that position us real well for continued growth globally. Looking to the decade ahead, our focus for Garena is to continue to bring top quality content and the more billion dollar games to our global users, through both our own development capabilities and our stable of top tier publishing partnerships.

We will also focus on strengthening our in-house capabilities with global top talent, through both organic growth and the strategic acquisitions and the partnerships.

Just as Garena's success, was built on addressing the unmet needs of gamers in our markets, Shopee was built on addressing the unmet needs of consumers and the small businesses in our market. Shopee was also able to grow quickly. Thanks to the local operational strengths, we developed through our digital entertainment business. We launched the Shopee in over seven markets in Southeast Asia and the Taiwan, simultaneously in late 2015.

Within a short period of time, Shopee has grown to become the leading e-commerce platform across our region. In 2019, just about four years from its inception, Shopee achieved over $17 billion in GMV with over $1.2 billion orders. It was the world's fifth most downloaded shopping app and it ranked first in key user engagement metrics of monthly active users and the downloads across Google Play and the iOS App Store combined, in both Southeast Asia and Taiwan.

Meanwhile, we have significantly deepened monetization over the last year. In 2019, Shopee generated more than $942.1 million of adjusted revenue representing more than 224% up year-over-year growth. While, adjusted revenue as a percentage of total GMV reached 5.4% benefiting from an increasing economy of scale with growing market leadership. We also saw rapidly improving unit economics for Shopee. For example, adjusted EBITDA loss per order decreased significantly year-on-year, from $1.34 in the fourth quarter of 2018 to $0.70 in the fourth quarter of 2019.

We believe that Shopee's strong track record is attributable to our managerial, organizational and executional capabilities. This strength has enabled us to quickly identify and gain a deep understanding of the emerging trends of social commerce among the mobile native generation, determining the right business model and the timing to enter the right market, build and rapidly scale, a new business across diverse complex markets with high efficiency to achieve market leadership, enjoying strong network effect and economy of scale. And constantly focus on high quality decision making and execution with hyper localized operations.

Looking ahead, we will continue to focus on growing our e-commerce business with efficiency, expanding our market leadership to maximize long-term returns and the deepening monetization over time. More importantly, we believe that the capabilities we have demonstrated in growing Shopee from a standing start to the regional leader will continue to help us to achieve greater success in building up a full ecosystem surrounding our consumer Internet platform. This, in turn, presents huge growth opportunities that we are deeply focused on capturing.

Our third core business in digital financial services, SeaMoney is a key component of this ecosystem and the crucial structure that presents significant long-term growth and the monetization opportunities. We started SeaMoney in 2014 with the firm belief that digital financial services or DFS is a key infrastructure for our consumer Internet ecosystem and represents one of the largest growth opportunities in the digital economy of our region.

Based on our recent Google, Temasek, Bain report, the DFS industry in the six largest economies of Southeast Asia is expected to grow at 22% CAGR between 2019 and the 2025 to reach $38 billion in revenue.

Based on the report, three out of every four adults in Southeast Asia have insufficient access to financial services, and 49% are unbanked. By comparison, just a 7% of people in the United States are unbanked and the 20% in China, according to US government and the World Bank data respectively.

Similarly, the World Bank estimates that just a 5% of adults in Southeast Asia have access to credit cards compared to 66% in the US and 21% in China. This reflects, that the regions have massive untapped opportunities in DFS, and the deep opportunities will only continue to grow as the oral digital economy of this regions expands. And we believe that Sea is very well positioned to capture the most significant portion of this growing pie.

First, we are building on our core strengths in identifying and the capturing market trends and the strong execution. And more importantly, we are the market leader in both e-commerce and digital entertainment, which are two of the largest, fastest growing and highest quality and frequency used cases in the digital economy served by DFX. This is well demonstrated by the rapid growth of our SeaMoney business in 2019.

Our quarterly paying users for our e-wallet services have exceeded 8 million in the fourth quarter, as we deepened integration of our e-wallet with the Shopee platform and further expanded our e-wallet services to third party online and offline merchants and the used cases.

In January 2020, about a year after we started integrating our e-wallet with Shopee in Indonesia, more than 30% of Shopee's gross orders in that market were already paid using our own e-wallet services. Such integration has shown clear benefits in reducing payment friction and improving user experience for consumers on Shopee.

To sum up, we believe that our core businesses of e-commerce, digital entertainment and the digital financial services represents the three largest opportunities in the digital economy of our region. As we begin a new decade, we will continue to focus on strengthening our market leadership and the core competencies across all three segments, to position us well for long-term continued growth and the profitability.

More importantly, our leadership and strengths across these businesses provide us an unparalleled opportunity to develop a comprehensive consumer Internet ecosystem that generate significant value for the consumer and the small businesses on our platforms.

With this reflection on what we have achieved so far in the past decade, and in the path of growth, we will continue to focus on for the future, I will now turn to a more detailed discussion of our strong results for the fourth quarter. Looking first at Garena's performance. In the fourth quarter, we once again hit new high for adjusted revenue and EBITDA, but adjusted revenue was $479.9 million, up 107.4% year-on-year. While adjusted EBITDA was $266.4 million, up 153.2%. This was primarily driven by continued quarterly active user growth and further deepening of paying user penetration.

And in particular, the continued strong performance of our self developed game, Free Fire. Let me highlight some of the key drivers of Free Fire success this quarter. First, our user base continued to grow. I am pleased to note that Free Fire recently set a new historical high with over 60 million peak daily active users.

According to App Annie, in the fourth quarter, Free Fire was ranked among the top 10 games, globally, by monthly active users and was the fourth most downloaded game globally on Google Play.

Second, we continued to deepen engagement with our massive user base. Last November, we held our largest ever esports event for Free Fire. The Free Fire World Series the in Rio. According to esport charts, this event attracted the most concurrent viewers for any mobile esports event in history with over 2 million viewers watching the live streamed panel at the same time, the success of our esports content is reflected in Free Fire's popularity on streaming sites.

Free Fire was the fourth-most watched game on YouTube globally in 2019, behind only Minecraft, Fortnite, and the Grand Theft Auto. It was also the most watched mobile-only game.

Third, as we mentioned before, we are increasingly building Free Fire into a social platform for the hundreds of millions of people around the world, who play Free Fire. It is not simply a game that they play, it has to become a community. Our players meet up with their friends in Free Fire. They watched our esports events and cheered for their favor rate teams. They even enjoy music created just for our players.

For instance, we launched a music video featuring characters from the game in a virtual band performing a song in multiple languages, that we commissioned specifically for Free Fire. To accompany the video, we launched specific in-game events and the promotions as well as special schemes and other in-game items.

The launch was a huge success with our players with the video attracting over 10 million viewers online within a week. Over the last two years, we have developed a unique ability to build and sustain huge and the highly-engaged Free Fire communities across diverse markets, globally. We are also seeing the holders [ph] of other high-quality IP want to work with us to reach these communities. We recently-unveiled a partnership with Gravity, the developers of the classic MMORPG game Ragnarok, to launch a range of exclusive in game content in Free Fire based on Ragnarok's IP.

Generations of gamers across Southeast Asia and the Latin America have a strong affinity with Ragnarok and its characters, and the response to this in-game collaboration has been very encouraging. We will continue to focus on growing the user base and deepening user engagement for Free Fire with an increasing emphasis on building the game into a well-loved and the long lasting IP and the highly active social platform serving hundreds of millions of global users. We believe that this will, in the longer term, translate into sustained strong performance for Free Fire.

Another exciting recent development is our acquisition of Phoenix Labs, one of the top independent game development studios in North America. This brings a team of more than 100 of the best AAA developers in the industry into the Garena family, and significantly enhances our in-house content creation capabilities and our ability to serve diverse markets globally.

The acquisition also underlines how Garena is increasingly being recognized as a leading industry player worldwide, thanks to our strong global footprint.

For Garena, as a whole, we are moving into 2020 in a great position and with exciting plans for growth. Our focus for the year ahead, will be to continue creating captivating content that will help us grow and engage more deeply with our global communities and to continue strengthening our game development capabilities and the publishing network to bring to market, more global hits and the top grossing games. Our digital entertainment guidance for the coming year reflects our confidence in our ability to continue deepening engagement with gamers globally and to build out the momentum that made 2019 a standout year for Garena.

For the full year of 2020, we currently expect adjusted revenue for digital entertainment to be between $1.9 billion and $2.0 billion.

Turning to Shopee. In the fourth quarter, we recorded another impressive set of results. Growth in the e-commerce industry in our region continues to accelerate and the Shopee as the clear market leader is gaining an upside to slice of the pie. Across the region, our order growth is accelerating with gross orders for the quarter, growing about 113% year-on-year to $440.5 million. GMV for the fourth quarter also reached $5.6 billion, an increase of more than 54% year-on-year.

As we continued to expand our market leadership, Shopee saw sustained strong user engagement in both Southeast Asia and in Taiwan. Shopee ranked number one in the Shopping category by average monthly active users across Google Play and the iOS App Store combined in the fourth quarter according to App Annie. By total time spent on app, which App Annie measures on Android phones, Shopee also ranked number one in Southeast Asia as a whole and each of our five largest markets.

In fact, worldwide, Shopee was among the top five most downloaded app in the Shopee Shopping category across Google Play and the iOS App Store combined in both the fourth quarter and the full year of 2019 based on App Annie's estimates.

At the same time, we are seeing that consumers are building an increasing affinity with the Shopee brand. According to YouGov 2019 global brand best ranking, which mirrors the brands with the most best with consumers in different markets around the world, Shopee was the top ranked brand across all categories in each of Indonesia, Thailand and the Malaysia and at the top ranked e-commerce brand in Vietnam.

We are also encouraged to see that Shopee is enjoying strong user retention, as we continue to strengthen our market leadership. Shopee's three-year order retention from January 2017 to December 2019 was close to 70%. With the order retention rate in Indonesia, our largest market, even higher than the group rate for the same period. In Indonesia, Shopee further solidified its market leadership.

In the fourth quarter, we recorded an average of 2 million orders a day, that is more than double the same number, from the same quarter a year ago. In fact, year-on-year growth where Shopee's GMV and orders accelerated each quarter in 2019. Shopee also continued to rank as the top app in the shopping category in Indonesia by monthly active users and the download on Google Play and the iOS App Store, as well time spent in app on Android, in the fourth quarter according to App Annie.

As we continued to benefit from our growing regional leadership and the deepening monetization, we recorded strong growth on the topline and a further improvement in operating efficiency, during the quarter. E-commerce adjusted revenue increased over 182% year-on-year to $358.3 million in Q4 and increase over 224% year-on-year to reach $942.1 million for the full year, which meant that we exceeded the high end of our twice increased guidance for 2019.

And adjusted revenue, as a percentage of GMV reached 6.3% in the fourth quarter, a new high for Shopee. This strong revenue performance is the result of a dedicated focus to enhance the services we offer to our sellers and the buyers and to grow the platform to create more value to them. We also recorded a positive gross profit for the fourth quarter of 2019.

During the quarter, we also continued to drive improvements in cost efficiency and adjusted EBITDA loss per order decreased by 47.8% to $0.70 in the fourth quarter of 2019, compared to $1.34 a year ago and $0.79 in the third quarter.

I'm also pleased to note that Shopee was gross profit positive in the fourth quarter, as we continued to benefit from economies of scale that come with market leadership, as well as our improved operating efficiency. Moreover, in Taiwan, our second largest market, we continued to record a positive quarterly adjusted EBITDA after allocation of the headquarters' common expenses. Adjusted EBITDA margin in Taiwan, before allocation of the headquarters' common expenses already exceeded 20% in the fourth quarter of 2019.

Looking to the year ahead, Shopee is in an ideal position to continue capturing the lion's share of the growth in our region's e-commerce market. We are increasingly benefiting from the scale and the brand recognition we enjoy as the clear industry leader, and we will continue to invest prudently to extend our leadership by continuing to grow our seller and the consumer base and building ever-stronger bonds of affinity with them across the region.

Our e-commerce guidance for 2020 underlines our belief that we will continue to scale the platform with speed and efficiency, while further deepening monetization. For the full year of 2020, we currently expect adjusted revenue for e-commerce to be between $1.7 billion and $1.8 billion.

As I mentioned at the start, 2019 was a year of major success for Sea. We have been fortunate to be in this region at a time when the market has been growing rapidly. We have been in the right place to capture these growth opportunities. But, we also have been highly strategic in the areas we have chosen to focus on. Highly disciplined in how we build and skilled our business and highly skilled in managing their growth.

We see huge growth opportunities ahead in each of our business lines, leveraging our proven capabilities in building and the scaling businesses with efficiency and our ability to achieve strong profitability in diverse growth markets.

We believe, we are in an ideal position to capture this, and other global growth opportunities that may present themselves in the coming years. I'm more excited than ever, as we move into 2020 and would like to close by thanking our investors and partners on behalf of all of us at Sea for your support over the last decade. We have big goals for 2020 and beyond, and we are humbled to have your continued backing.

With that, I will invite Tony to discuss our financials.

Tony Hou, Group Chief Financial Officer

Thank you Forrest. And thanks to everyone for joining the call. We have included detailed quarterly financial schedules, together with the corresponding management analysis in today's press release. So, I will focus my comments on the key financial metrics. For Sea, overall, our fourth quarter total adjusted revenue was $909.1 million, an increase of 124% year-on-year. This was mainly driven by the growth of our digital entertainment business especially our self developed game Free Fire and our continued monetization efforts in our e-commerce business in the past quarters.

Digital entertainment adjusted revenue was $479.9 million, an increase of 107% year-on-year. The growth was primarily driven by the increase of our active used base and the deepened paying user penetration, and in particular, the continued success of our self developed game, Free Fire. Digital entertainment adjusted EBITDA was $266.4 million an increase of 153% year-on-year, mainly due to strong top line growth and our self developed game, accounting for an increased share of revenue.

E-commerce adjusted revenue was $358.3 million, up 182% year-on-year. Within this, marketplace revenue was $283.5 million, up 224% year-on-year, while product revenue was $74.7 million, up 90% year-on-year. This growth is a result of our commitment to continue enhancing our service offerings, as we seek to create greater value for our platform users.

E-commerce adjusted EBITDA loss was $306.2 million, as we continued our investment to fully capture the market opportunity in the region. We will continue to invest prudently and drive high-quality growth by serving the users needs better in the long run. Digital financial services adjusted revenue was $3.6 million, an increase of 18% year-on-year from $3.1 million in the fourth quarter of 2018.

Adjusted EBITDA loss was $49.8 million in the fourth quarter of 2019 compared to a loss of $9.8 million in the same period of 2018. This was primarily due to our continued efforts to integrate our e-wallet services with our Shopee platform across different markets. We have also been expanding the use-cases of our e-wallet services, outside of Sea's platforms to include other online and offline merchants along with a variety of third-party use-cases.

Returning to our consolidated numbers; we recognized a net's non-operating loss of $15.2 million in the fourth quarter of 2019 compared to a net non-operating income of $53 million in the fourth quarter of 2018. This was primarily due to a fair value loss of $6.8 million in the fourth quarter of 2019, as compared to a fair value gain of $61.2 million in the fourth quarter of 2018, arising from the fair value accounting treatment for the 2017 convertible notes.

We had a net income tax expense of $36 million in the fourth quarter of 2019, which was primarily due to withholding tax and corporate income tax recognized in our digital entertainment business. Finally, net loss, excluding share-based compensation and changes in fair value of the 2017 convertible notes was $240.2 million in the fourth quarter of 2019, as compared to $321.2 million for the same period in 2018.

With that, let me turn the call back to Yanjun.

Yanjun Wang, Group Chief Corporate Officer

Thank you Forrest and Tony. We're now ready to open the call for questions. Operator?

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) The first question comes from Alicia Yap from Citigroup. Please go ahead.

Alicia Yap, Analyst

Hi good evening management. Thanks for taking my questions. Congrats on the strong set of results. The first question is on the e-commerce. Can you share with us, currently what is the percentage of the GMV or orders on Shopee that's coming from merchants in China? And have we seen any disruption during this period, given the virus outbreaks?

On the other hand, have you seen increase for the online shopping, in countries such as like Thailand, Singapore or even Indonesia as more people turning to online, given the outbreak? And then the second question is on the growth -- adjusted revenue guidance for the gaming business, is that mainly based on the existing games? And should we expect that it does not include any potential new games contribution? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you Alicia. E-commerce in terms of cross-border business, we do have a very strong cross border business. However, our e-commerce marketplace is primarily local-to-local. In terms -- so we don't give the specific breakdown, but suffice to say, it's in the range of -- overall cost mode of business is in the range of low teens from GMV perspective, and part of it also from other countries within Southeast Asia as well as outside of China, inside Asia and so far we haven't seen much of an impact from the virus situation.

As you can see from our revenue guidance for e-commerce, which we budget for 80% to 90% year-on-year growth still, and of course, if this virus situation become a extended issue that impacts global supply chain or regional economy as a whole, we might become similarly impacted.

On the other hand, we also see that especially in our region, while people are looking for online alternatives and to shop for things, especially in FMCG or cleaning categories and as the market leader, Shopee does take a more of a lion's share in terms of the demand that might come online. So, that could also foster some user habit in purchasing things online.

But, in general, as you can see Shopee has seen very strong year-on-year growth at more than 100% range, and being the market leader, we actually are growing at a faster pace than our peer companies which are significantly smaller than us, in most of the markets that we are big. And that also shows that the growth is very robust and continues to be very strong for Shopee, and that comes from both user number growth, as well as frequency growth.

We mentioned before that Shopee users shopped around three times to four times a month -- our platform, and that number has increased to four times to five times. And in our largest market, Indonesia, that number has exceeded five times. So, that has also been part of the growth driver for our Shopee platform.

So overall, we are very optimistic of the fundamentals and the network effect from the -- our strengthening market leadership over time. In terms of digital entertainment guidance, again to put things into perspective, our adjusted revenue for 2019 has shown a very significant growth from previous years, thanks to our own self-developed game, which not only strengthened our revenue and the revenue generation capabilities for the longer run, but also significantly expanded our global footprint.

As Forrest mentioned earlier, markets outside of Southeast Asia and Taiwan now contribute close to 50% of our revenue and that would include markets like LATAM, as well as new frontier markets like India. We also start to see encouraging growth in markets as diverse as United States. So, this is very encouraging for us, and we -- for this year, we will continue to focus on promoting the user growth for Free Fire and deepening user engagement and monetization over time.

As we mentioned in our earnings, our peak daily active user has reached 60 million globally, and that is, we believe a very impressive number we have achieved for the single game. And we are also increasing EC [ph] -- deepening monetization in large markets like India for example with very high user growth. We also start to see faster growth being pay user ratio while the ARPPU, the average revenue per paying user also continued to increase. So, that is a very good sign for us.

We also see some encouraging signs from diverse market like the United States, of course, with very high ARPPU. So, on all fronts, I think we see 2020 to be continue a year of strong performance for our digital entertainment. Of course, we don't -- as usual, we don't discuss game pipeline specifically. But, as we always assure our investors, everything we do we are focused on building the long-term potential and maximizing our ability and opportunity to create the next billion dollar game.

At the same time, we want to maximize the potential of the existing billion dollar game, we already have.

Operator

The next question comes from Miang Chuen Koh from Goldman Sachs. Please go ahead.

Miang Chuen Koh, Analyst

Hi, thank you for the opportunity. So, the first question is just wondering how we should think about the revenue, as well as the cost impact for the gaming business from integrating Phoenix Labs? And the second question is, how should we think about cash burn for both your e-commerce and payments divisions this year? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you MC. So, Phoenix Lab is a investment we recently made. It's a AAA lab based -- a studio based in Vancouver with also operations in both Canada and the US. They have more than 100 developers with 10, 20 years of experience from creating AAA titles, across different platforms and diverse markets, with a key focus on developed markets. We believe their skillsets and focus and expertise are highly complementary to our existing skillset, and experience across global emerging markets.

And so, the acquisition is more for talent acquisition, and so we look long-term in terms of developing more IP and strengthening our self development capability as opposed to more of a IP acquisition where we just look at a single game.

So, in terms of that, I think it really strengthens our development capabilities in the longer run, as I mentioned that we are looking at the next decade in terms of our development capabilities and generating top IP across the globe.

In terms of our cash burn for e-commerce and DFS; so on the e-commerce side, I think our position has been very consistent. We have strong market leadership and our market leadership has been strengthening over time and for e-commerce, as we all know, it enjoys very strong network effect. And therefore, strong market leadership eventually leads to better profitability and competitive modes in the longer run. So, we will continue to invest to maximize our market leadership and also continue to invest to provide better services to our sellers and buyers to build a better ecosystem, to serve them over time. By that, we generate more value and derive more profitability over the longer run.

So, on that front, I think our investment is highly efficient. If you look at our EBITDA -- adjusted EBITDA loss per order, that's actually being decreasing quite rapidly quarter-on-quarter and we continue to focus on efficiency, efficient growth as well as monetization at same time for our e-commerce business going into 2020 and beyond. In terms of digital financial services, as we mentioned earlier, we believe it is a core infrastructure for our digital ecosystem, as well as a key part of the digital economy of our region, which has a large unbanked, underserved population by financial services, in general, and we see this as one of the largest opportunities in the (inaudible) economy of our region, and a very long-term opportunity.

As always, we oftentimes don't jump onto opportunity without first carefully thinking about the size, the timing, our comparative advantage in running that opportunity and our playbook in executing that, and we always try to maximize the -- in terms of all these features that we closely look at.

So, the same thing applies to digital financial services, that's how we did in game as well as in e-commerce. So, we evaluate the opportunity carefully, we understand the total addressable market there. We understand the timing, and we also understand how we are going to approach it from our core strengths and we believe the fact that we have two of the largest digital entertainment segment, as well as the e-commerce segment, which are two largest digital consumption opportunities in our economy really help to grow the digital financial services on our platforms with the captive user base, high frequency use-case, as well as high quality data that allow us to build out into a bigger platform over the long run, not only serving our users, but also serving third party use cases and the merchants.

And with just one year of integration with Shopee platform, we already see very strong natural adoption rising to more than 30% of gross orders in Indonesia, by January, and that is very encouraging sign of how this is welcomed by our users. And at the same time, we have already achieved more than 8 million quarterly paying users in the fourth quarter of 2019 for our e-wallet services.

Again, we believe that spending is highly efficient, and we will continue to go at that in an efficient manner.

Operator

The next question comes from Thomas Chong from Jefferies. Please go ahead.

Thomas Chong, Analyst

Hi. Thanks to management for taking my questions, and congratulations on a strong set of guidance for Shopee. May I ask about the take rate trend, of course, different geographies such as Indonesia, I think also in Taiwan going into the next couple of years? And on the other hand, going back to the gaming fees in that, can management comment about the performance or Call of Duty, as well as any new titles from Tencent in 2020? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. As we mentioned, we will be deepening monetization on Shopee platform as we continue to grow the platform, and we will continue to raise -- take rates across different markets over time, as we provide more services and enhance our services to our sellers, as well as buyers and grow the platform. While we don't give a specific guidance on the rates, as you can tell from the guidance, we have given on Shopee's full year adjusted revenue that this also incorporates increased -- deepening monetization on the platform.

In terms of digital entertainment, we see very strong performance on Call of Duty mobile, so far, in our region which are also a bright spot among the global region we believe. And it's still at a very early stage since it was launched October last year, and we'll observe how it will continue to perform and work closely with Tencent, Activision to continue to improve the game, and tailor it to our market.

In terms of new titles from Tencent in 2020, of course, under our close partnership with Tencent as well as the Right of First Refusal arrangement, we have full visibility of the pipeline. As usual, we don't specifically talk about any game pipeline, but can rest assure that we will continue to work with Tencent, as well as all our partners to bring the top titles that we think are highly promising to our markets, over time.

Operator

The next question comes from Mike Olson from Piper Sandler. Please go ahead.

Mike Olson, Analyst

Hi, thanks for taking my questions. Just two questions, specifically on competition. On the SeaMoney side, what competitive environment would you describe there relative to the competition that you see in your other core markets of gaming and e-commerce? And then, on the e-commerce side, are you seeing any increased competitiveness or aggressiveness, I should say, from competitors from the standpoint of free or subsidized shipping or other marketing spend? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. In terms of SeaMoney, we think that at this stage the market is still highly underdeveloped and fragmented. We have seen some players in the market, who have spent [ph] to educate the market, grow the pie for all of us which we think will also stand to benefit, as we look to serve more users and use cases, who have already been educated on a digital wallet. Ultimately, we think our core competence and advantages in owning the two of the largest used cases is going to help us drive growth, and also build out a comprehensive digital financial services ecosystem.

And I think, of course, the competitive landscape in e-commerce, for us, is quite different -- we are the market leader and we continue to -- as mentioned, we continue to grow at a faster pace in our markets, despite being larger than our competitors.

As for example Indonesia, we mentioned, our order number actually doubled, more than doubled year-on-year to reach more than 2 million per day, and for some of the competitors who also announced their growth rate, while they are significantly smaller than us, their growth rate is also significantly lower than ours. And, we also start to see some of our peers switching gear towards -- focusing more on profitability and cost cutting over time. I mean, we fully respect our competitors, and I believe they're doing the best for their business.

But -- while we continue to see great potential opportunity for us to maximize our market share as well as increasing the -- building up the full ecosystem under the e-commerce business.

Operator

The next question comes from John Blackledge from Cowen. Please go ahead.

John Blackledge, Analyst

Great. Thank you. On SeaMoney, could you help us think about some key targets or metrics for SeaMoney in 2020, and kind of what should investors be looking for in terms of progress of SeaMoney, as we get through the year? And then on Shopee, I know there's been a couple of questions on cash burn, EBITDA loss, was 2019 the peak EBITDA loss year for the segment? And how should we think about longer-term EBITDA margins for Shopee? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. In terms of SeaMoney, I think we will continue to integrate our e-wallet services with our Shopee platform, across the region, and at the same time with the large captive user base, we already have. We also have been approached by third-party merchants and others partners wanting to work with us and we will continue to expand into other third-party used cases and the merchants.

So, on that, we will continue to focus on building the user base as well as user frequency and quality of used case on the SeaMoney side. And, in terms of e-commerce, as mentioned before, we don't give guidance on adjusted EBITDA loss and we also think it is I guess competitive -- our competitive interest to specific guide on that part, but on the overall as you can see, we have been growing with increasing efficiency and the EBITDA -- adjusted EBITDA loss per order actually being dropping quite rapidly.

And we are very much focused on growth efficiency, as always. And the EBITDA loss from e-commerce is mainly actually covered by our internal cash flow generated from operations. And also, more importantly, if you think about the longer term, we think e-commerce wants to achieve strong market leadership. It brings high profitability. One example we have given is, Taiwan market, where we have achieved a very strong market position quickly, in that market, and as we mentioned in earnings that in the fourth quarter, our adjusted EBITDA before common expense allocation for Taiwan, already exceeded 20%.

We first announced our adjusted EBITDA for Taiwan, excluding common expense, being positive at the beginning of 2019. So, within the course of one year, the margin expansion has been quite rapid and we've continued to grow the Taiwan market and deepening monetization there. The take rate in tele market is actually not significantly above the group level. So, we continue to see strong monetization potential over time and that's a good example of how profitable the business could eventually be, when we turn on the tap.

So, at this time, I would say it's our choice in deciding how fast we can grow the market and of course, always keeping a close tap on the market, natural pace of growth so that we're not going at an inefficient level, but always ahead of the market.

Operator

The next question is from Ranjan Sharma from JPMorgan. Please go ahead.

Ranjan Sharma, Analyst

Hi, good evening. It's Ranjan from JPM. Congratulations on your achievements over the last decade. Maybe I can start the first question with regards to Dauntless and what it means for you. I see that it's a very high spec game, going into a mobile launch, is this game going to be more geared to the developed markets rather than emerging markets like India or Indonesia?

The second question is on the e-commerce business. I know you have shared previously that Brazil is a market which was being targeted more as a bottom up project of your cross border team, but have your aspirations been changing recently because I think you've been hiring more people for Shopee Brazil? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Yes. Thank you. In terms of Dauntless, it's a product by Phoenix Lab, which we recently acquired. And as mentioned, there are AAA studio focused on AAA titles, and developed markets across different platforms and that is why exactly we believe their skillsets are highly complementary to ours, where we have shown very strong track record in global emerging markets.

I think that always possible that we will continue to work with the studio on this and future IP that we collectively might bring to the market across the different markets in the world. And, we believe, that our expertise combined, we can address a wide range of markets, and further expand our global talent. In terms of e-commerce in Brazil, this is a cross-border project and by popular demand of our cross-border sellers, who, of course would always prefer the platform that can offer more markets to them, for the same amount of work they pretty much need to do, integrating with the platform and the fact that we have already operational capabilities from the game side and understanding of the market, give us a competitive advantage in serving them, in this regard. I think our team will continue to -- our sellers as they need us.

Operator

The next question comes from Varun Ahuja from Credit Suisse. Please go ahead.

Varun Ahuja, Analyst

Yes hi, thanks for the opportunity. I've got three questions. First, on the gaming side, so if you look at your EBITDA margin on a sequential basis, it has declined, but it seems to me that Free Fire has been growing, so given it's your self-developed game so just wanted to understand, why there is 5% sequential decline in EBITDA margin on the gaming side, that will be helpful?

Secondly, if you look at, say the, marketing spend as a percentage of GMV has been growing for the last three, four quarters, earlier it was used as a benchmark to show that as you gain and attain scale. You may achieve more toward profitability. So, I wanted to understand the dynamics, how should we think about the sales and marketing spend? Are you spending more to kind of continue to grow the market? So, some color will be helpful.

And lastly, of the three businesses that you have, which opportunity are you more excited about, whether it's gaming, e-commerce or the digital financial services? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. So, in terms of the adjusted EBITDA margin, our Q4 margin is at 155.5% which is very high compared to -- we understand, the industry average and the sequential declines really related to launch of new games such as Call of Duty Mobile, as well as our esports events recently, we had in Brazil, India and across different markets, which as we mentioned in our earnings release as highly successful and making the most viewed game on YouTube for the mobile-only category and with more than 30 billion views, and that allow us to increase our user base as well as engagement with our users, which eventually lead to higher monetization for Free Fire.

I think this is a highly efficient spending for us, and we will continue to look for opportunities, while being highly mindful of our adjusted EBITDA margin, because of course, we run game highly focused on a cash basis view.

In terms of sales and marketing spend as a percentage of GMV, it's been quite stable, I would say across the quarters at around 4.4% to 4.5% range, and even -- but, if you look at our Q4, as we said it is a -- the shopping season -- holiday season was 11/11 and 12/12 and all kinds of events, and we show extremely strong order and GMV growth, as well as revenue growth for the quarter.

So, I would say the spending is highly efficient. Again, I would guide people to look at adjusted EBITDA loss per order. And as we increasingly spend on branding to promote Shopee brand and affinity with the Shopee brand across different markets, we might again make opportunistic spending in terms of our sales and marketing at different times of year, but we're very focused on efficiency of spending, and the result it generates, as you can see from all the rankings, YouGov survey, where Shopee as a rental, the top brand and sometimes the top e-commerce brand and sometimes even beating all the other long-term classic IP brands that are already existing in the country and the buzz, we generate across the world.

For example, our collaboration with Cristiano Ronaldo has created more than 500 million views of the Shopee clip and that is highly efficient for us. So, I think this -- we will continue to be optimistic, while mindful of the efficiency of the spending.

And, in terms of the -- all the three businesses, which we are most excited about. I think these are our three children, and we believe each of them represents a huge opportunity and collectively they represent the biggest opportunities in the digital consumer -- Internet segment of our region, and we are very fortunate to be able to capture those opportunities in a very good position to capture that, and we will continue to execute on it with efficiency and with good execution.

On the gaming side, our focus in the longer run is continue to expand globally and increase our presence in diverse markets, and also strengthen our development capabilities to maximize our opportunity to get the next billion-dollar game, and also highly de-risk the gaming business overall.

And so, if you look at, as I mentioned, our revenue contribution that's being increasingly diverse and outside of just Southeast Asia and Taiwan with new markets like India and Thai markets, contributing significantly to our user base as well as our monetization contribution. And we hope to, with acquisition of AAA titles and studios, as well as experience, we gained in operating game across 130 markets globally, we are able to significantly expand our business and that offers huge upside in terms of monetization and future profitability.

And, in terms of the e-commerce business, we have already achieved very strong market leadership and with the network effect, we can see how things are rolling out in front of eyes, exactly according to the playbook, we told people years back when we started IPO process, and we will continue to execute on this significant opportunity and e-commerce with its own high profitability margin as well as the ancillary opportunity it might bring in building out the entire ecosystem presents huge chance for us to continue to grow our business in this region and even beyond.

At the same time, on digital financial services that links both e-commerce as well as digital entertainment business, enable people to make purchases online and offline. We think, this also remains the one of the largest under tapped opportunities in our region and with us owning the two largest online used cases, we believe that we are in the best position to capture that opportunity and we'll continue to do that to focus on growth and servicing our users in the longer run.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Ms. Yanjun Wang for any closing remarks.

Yanjun Wang, Group Chief Corporate Officer

Thank you operator. Thank you everyone for joining today's call. We look forward to speaking to you all again next quarter.

Forrest Xiaodong Li, Chairman and Group Chief Executive Officer

Thank you.

Operator

This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: SE US
Date: 2019-11-12
Event Description: Q3 2019 Earnings Call

Market Cap: 16290.2807651
Current PX: 36.6100006104
YTD Change($): 25.2900006104
YTD Change(%): 223.41

Bloomberg Estimates - EPS
Current Quarter: -0.492
Current Year: -2.444
Bloomberg Estimates - Sales
Current Quarter: 773
Current Year: 2702

Q3 2019 Earnings Call

Company Participants

- Yanjun Wang, Group Chief Corporate Officer
- Forrest Li, Chairman and Group Chief Executive Officer
- Tony Hou, Group Chief Financial Officer

Other Participants

- Miang Chuen Koh, Analyst
- John Blackledge, Analyst
- Mike Olson, Analyst
- Alicia Yap, Analyst
- Ranjan Sharma, Analyst
- Thomas Chong, Analyst
- Varun Ahuja, Analyst
- Conrad Werner, Analyst
- Mark Goodridge, Analyst

Presentation

Operator

Good morning and good evening. Welcome to the Sea Limited Third Quarter 2019 Results Conference Call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Ms. Yanjun Wang. Please go ahead.

Yanjun Wang, Group Chief Corporate Officer

Thank you. Good evening and good morning, everyone, and welcome to Sea's 2019 third quarter earnings conference call. I am Yanjun Wang, Sea's Group Chief Corporate Officer. Before we continue, I would like to remind you that we may make forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release. Also this call includes discussions of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA and net loss excluding share-based compensation and changes in fair value of the 2017 convertible notes. We believe these measures can enhance our investors' understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

I have here with me Sea's Chairman and Group Chief Executive Officer, Forrest Li; and Group Chief Financial Officer, Tony Hou. Forrest and Tony will share strategy and business updates, operating highlights and financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have.

With that, let me turn the call over to Forrest.

Forrest Li, Chairman and Group Chief Executive Officer

Thank you, Yanjun. Hello, everyone, and thank you as always for joining today's call. We are happy to announce a strong set of results for the third quarter. For Sea as a whole, our adjusted revenue tripled year-on-year to reach $753.3 million. Adjusted EBITDA improved year-on-year to negative $30.8 million, compared to negative $183.8 million, a year ago.

We continue to fund our growth primarily with cash generated through operations and are in a strong position to further capture the significant growth opportunities ahead. As we mentioned before, our strategic goal for 2019 has been to strengthening our leadership across different markets and business lines scaled with increasing [ph] efficiency and deepen user engagement and the monetization. The results we reported today show that we are making excellent progress with this strategy. In view of our encouraging performance in Q3 and our strong outlook for the remainder of 2019, we have decided to once again raise our guidance for our full-year adjusted revenue for both digital entertainment and e-commerce.

For digital entertainment, we now expect full year 2019 adjusted revenue to be between $1.7 billion and $1.8 billion, representing 157.2% to 172.3% growth from 2018. This compares to the previous guidance of between $1.6 billion and $1.7 billion. We are also increasing our guidance for full year adjusted revenue for e-commerce to between $880 million and $920 million, representing 202.7% to 216.5% growth from 2018. This compares to the previously stated guidance of between $780 million and $820 million.

I will turn first to our digital entertainment business. This was another great quarter for Garena led by the sustained success of our global smash hit, Free Fire, which recently joined the billion-dollar club as one of the highest grossing mobile games in the world. Let's look at some of our key metrics for the third quarter. Adjusted revenue for the digital entertainment business grew by 212% year-on-year to $451 million and we continued to deliver an excellent performance on the bottom line with adjusted EBITDA increasing 395% year-on-year to $266 million. The increase in adjusted revenue was mainly driven by an increase in our user numbers and the deepening pay-user penetration. In particular, our quarterly active user numbers or QAU increased by 82% to 321.1 million compared to 176.1 million a year ago. And the pay user ratio, which is quarterly paying users as a percentage of QAU, increased again in the third quarter to 9.1% compared to 4.1%, a year ago.

Turning to our Games portfolio. Free Fire celebrated its second anniversary recently and it continues to be one of the world's most popular mobile battle royale games. According to App Annie, in Q3 it ranked among the Top 5 most downloaded mobile games globally for the third straight quarter and was the highest-grossing mobile game in Latin America and Southeast Asia in the quarter. We believe that Free Fire's continued global popularity also reflects the success of our effort to build a highly engaged global community around the game and keep this community engaged by constantly providing fresh high quality in game content as well as driving an extremely successful global esports program. Sustaining this level of community engagement is an important focus for Garena. We are convinced that the huge popularity of Free Fire worldwide give us an opportunity to build a long-lasting franchise around this IP. Let me share a few recent examples of our initiatives to drive community engagement. In terms of content, we rolled out a number of new experimental modes of play. The response from our community has been overwhelmingly positive. Our Clash Squad mode for example, allow teams of four to compete against each other and proved extremely popular with our players.

As Free Fire has increasingly become a national pastime in Latin America, especially for it's young and social population, we have further extended the games reach into the local communities with our network of followers, influencers, as well as popular icons. For example, we partnered with DJ Alok, Brazil's most popular DJ, and one of the country's best Latin music stars for the game. Alok is now a playable character in our game and will also provide one of his songs for Free Fire and our esports events.

Esports is also a key driver of user engagement and stickiness. Over the past the several weeks, we have been rolling out our largest ever esports event for Free Fire, the Free Fire World Series. In September, we hosted regional qualifiers across all our markets globally for the World Series. This included hugely successful esports event in our newer markets such as India. India's Sports Minister attended our event as our guest of honor. We also partnered on this event with one of the country's largest media powerhouses, India Today.

We are seeing very strong online engagement with these events. The final match of our Brazil qualifiers recorded over 1 million concurrent viewers online. To-date, our World Series events around the globe, has -- have accumulated over 100 million viewers across all platforms. The highly anticipated World Series will conclude at the grand finals in Rio in a few days' time. We are encouraged by the strength, depth and a strong gamer affinity that Free Fire is demonstrating. By combining this with our unique ability to build and deepen engagement with game communities on a hyper-local level in diverse markets globally, we are confident in Free Fire's long-term success for years to come.

Looking at the publishing side of the greener business, we continue to work with the world's top developers to bring the highest quality titles to our markets. In October, we launched Call of Duty Mobile in our core markets in Southeast Asia and Taiwan and the game received an immediate strong reception from our users. It was the most downloaded mobile game on both the Google Play and iOS App Stores in each of our markets for the month of October. For the rest of the year and beyond, we will continue to work closely with Activision and Tencent to enlarge the games' user base and deepen user engagement in our markets.

I'm pleased to note that we are seeing the strong momentum of the third quarter sustaining into Q4. In October, we hit a new record high for monthly digital entertainment adjusted revenue, which was mainly attributable to the continued growth of Free Fire. Our strategic goal for Garena for this year has been to enhance our position as a leading global game developer and publisher, to extend our global footprint and to translate this into sustained business success. Our results for the quarter demonstrate that this strategy is well on track and we believe that Garena is in a stronger position than ever as we head into the fourth quarter and beyond.

Let's look now at e-commerce. In the third quarter, Shopee sustained its strong growth momentum and continued to expand its lead at the forefront of the very promising e-commerce opportunity in Southeast Asia and Taiwan. The recent Google and Temasek report projected that e-commerce GMV in Southeast Asia will grow from $38.2 billion in 2019 to $153 billion by 2025. As the market leader, we believe Shopee is in an ideal position to capture outside [ph] the share of this growth opportunity. And our results for the quarter underline how Shopee's clear leadership is translating into business success.

During the quarter, the pace of growth in total orders further accelerated to a year-on-year rate of 103% to reach 321.4 million orders. Meanwhile, GMV increased to $4.6 billion, up 70% year-on-year. In the third quarter, we also extended our lead as the most popular e-commerce platform in our region. According to App Annie, Shopee was once again the leading e-commerce platform in both Southeast Asia and Taiwan by average monthly active users and the downloads across the Google Play and iOS App Stores combined, and the top ranked app in Southeast Asia as a whole and in each of our five largest markets by total time in app on Android. Shopee is now one of the most popular and the fastest growing e-commerce platform globally.

In the third quarter, it was ranked the fifth most downloaded app in the shopping category worldwide, across both Google Play and iOS App Stores according to App Annie. In our largest market, Indonesia, Shopee continues to solidify its market leadership as the shopping platform of choice. Orders in Indonesia grew 118% year-on-year to 138 million orders in the third quarter, which we believe makes Shopee the clear leader by orders in that market.

That is a daily average of more than 1.5 million orders compared to a daily average of 1.2 million orders in the second quarter. Shopee was also the number 1 ranked app in the shopping category in Indonesia by all key metrics in terms of average monthly active users and the downloads across the Google Play and iOS App Stores combined, as well as in terms of total time in app on Android according to App Annie.

Our leading market position across the region is reflected in our very strong performance during our recent shopping festivals. Building on our successful branding campaign, featuring the football icon, Cristiano Ronaldo, we recorded three times more orders on September night alone than we did a year ago during our double night shopping event. Our Double 11 big sale, which we concluded yesterday was also a huge success with approximately 70 million items sold during the 24 hours of November 11.

We saw very strong user engagement during the Double 11 festival period with our Shopee live streams recording approximately 65 million views during the three weeks of the sales campaign. At the same time, our growing scale and efficiency is translating into improvements in both revenue and our key bottom line metrics. We continue to ramp up monetization during the quarter. In the third quarter, our overall take rate in terms of e-commerce adjusted revenue as a percentage of GMV increased from 2.6% for the same period a year ago to 5.6% with adjusted revenue, rising by 261% year-on-year to $257.2 million. Our overall unit economics for Shopee also improved further this quarter. Adjusted EBITDA loss per order further declined by 41.9% to $0.79 compared to $1.36 in the same period last year.

In Taiwan, we recorded positive adjusted EBITDA even after allocation of the headquarters common expenses in the third quarter. To conclude, Shopee is well on track with our strategy to scale with efficiency, capture increasing market share across our region and the deepen monetization. It is now firmly established as the clear market leader and in a better than ever position to benefit from the rapid growth of e-commerce in our region.

With that, I will invite Tony to discuss our financials.

Tony Hou, Group Chief Financial Officer

Thank you. Forrest, and thanks to everyone for joining the call. We have included detailed quarterly financial schedules together with the corresponding management analysis in today's press release. So I will focus my comments on the key financial metrics. We'll see overall, our third quarter total adjusted revenue was $763.3 million, an increase of 214% year-on-year. This was mainly driven by the growth of our digital entertainment business, especially our self developed game Free Fire and our continuous monetization efforts in our e-commerce business in the past quarters.

Digital entertainment adjusted revenue was $451 million, an increase of 212% year-on-year. The growth was primarily driven by the enlarged paying user base as we continue to improve the monetization of our games, especially Free Fire. Digital entertainment adjusted EBITDA was $266 million, an increase of 395% year-on-year, mainly due to strong top line growth and our self developed game accounting for an increased share of revenue.

The increase was also partially due to the improved operating efficiencies as shown by the lower sales and marketing expenses as a percentage of adjusted revenue as well as G&A expenses as a percentage of adjusted revenue. E-commerce adjusted revenue was $257.2 million up 261% year-on-year. Within this marketplace revenue was $208.1 million up 314% year-on-year, while product revenue was $49.2 million, up 135% year-on-year. E-commerce adjusted EBITDA loss was $253.7 million as we continued our investment to fully capture the market opportunity in the region.

We will continue driving the high quality growth by serving the users needs better and improving operational efficiencies in the long run. Digital financial services adjusted revenue was $2 million, a decrease of 35% year-on-year from $3.1 million in the third quarter of 2018 as we focus our efforts on strengthening the infrastructure to support our existing platforms.

Adjusted EBITDA loss was $33.6 million in the third quarter of 2019, compared to a loss of $7 million in the same period of 2018. This was primarily due to our continued efforts to integrate our AirPay and Shopee platforms. Returning to our consolidated numbers, we recognized a net non-operating income of $9.8 million in the third quarter of 2019 compared to a net non-operating income of $30.9 million in the third quarter of 2018.

We had a net income tax expense of $27.4 million in the third quarter of 2019, which was primarily due to withholding tax and corporate income tax recognized in our digital entertainment business. Finally, net loss excluding share-based compensation and changes in fair value of the 2017 convertible notes was $175.2 million in the third quarter of 2019 as compared to $237.6 million for the same period in 2018.

With that let me turn the call back to Yanjun.

Yanjun Wang, Group Chief Corporate Officer

Thank you, Forrest, and Tony, we're now ready to open the call for questions. Operator?

Questions And Answers

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions) The first question today will come from Miang Chuen Koh of Goldman Sachs. Please go ahead.

Miang Chuen Koh, Analyst

Hi, congratulations on the results. The two questions for me. Firstly, can we get a sense of Free Fire's revenue contribution this quarter? And along that line, your new gaming revenue guidance implies fourth quarter gaming revenues of $430 million at the low-end, $530 million at the high end. Just wondering what are factors, I mean, swing revenues by $100 million or so in a quarter? Is it regarding Free Fire's trends as well that may result in debt. And the second question is more around Latin America. Can we discuss on the gaming side, how Speed Drifter is doing so far? Any likely new titles and also e-commerce in LatAm and the Shopee has started a cross-border business there, can we get clarification on Shopee's ambitions as well in LatAm? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you, MC. So in terms of the Free Fire revenue and the new revenue guidance for our gaming business, the reason we are revising the guidance is because we continue to see strong growth on Free Fire, both in terms of users and pay user penetration. While we continue to focus on user engagement, the monetization just naturally follows, which is a very positive sign for this game that we see as a potential ability to develop this into a long-term franchise and a classic IP.

More importantly, we see this game as increasingly become a platform with hundreds of millions of users playing this game and rapping with each other, building up communities online and offline. And an amount of creativity and the connections coming from this kind of community events and interactions within and outside of game, give us a lot of encouragement and continue to build out the franchise and maximize its long-term potential.

So, for this game, we are not looking at any quarter-on-quarter or month-on-month or even year-on-year short-term performance, but we are really looking to build into a long-term IP franchise. And so therefore I think while we reflect the potential -- monetization potential in the revised gaming revenue guidance, but I would like to ask our investors and committee to re-look at long term for this game and the great potential, whether on the user community building the platform as well as our monetization that we will bring with it.

In terms of LatAm, it's a very exciting market for us. It is -- obviously with more than 600 million population and with our Free Fire in LatAm, we have basically doubled the total addressable market. So if you look at the population size of LatAm, it's about the same as Southeast Asia and also with a very young population and high growth population size and deepening mobile penetration in those markets. So all the market dynamic present great opportunities for us to grow the digital entertainment business there. And after Free Fire, we have now also introduced Speed Drifter, also the game from Tencent into LatAm markets after its success under our publishing arrangement with Tencent in Southeast Asia.

This again is a show of our strength in publishing partnership to extend our footprint globally with the large user base that we now have from the LatAm, America based on the Free Fire success as well as our local operation capability that we are fast building up in the local markets. So we are very optimistic in the long-term prospects of our digital entertainment business in LatAm.

As far as e-commerce is concerned, as we mentioned before, it's an initiative by our cross-border team to cater to the demands of their existing cross-border merchants, who would like to access more markets globally and given that we have the capabilities and our team would like to serve them better, we are, as a group are supportive of such bottom-up initiatives by our team to service their merchants better.

Miang Chuen Koh, Analyst

Just to clarify, are you looking at Shopee's engagement in LatAm in a similar fashion as in Southeast Asia or largely just sort of a bit more peripheral to debt?

Yanjun Wang, Group Chief Corporate Officer

So I think for LatAm Shopee, I think our approach has been just to, as I said before, to serve the cross-border merchants.

Operator

Our next question today will come from John Blackledge of Cowen. Please go ahead.

John Blackledge, Analyst

Great, thank you. Just curious what the key drivers of the order growth acceleration were at Shopee and also the marketplace take rate was better than what we expected. If you can discuss the drivers there and then, also on Shopee, just curious, is 2019 the peak EBITDA loss year? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you for the questions. On the acceleration of Shopee's growth, and I think, as we mentioned earlier, we believe that we have captured the right market at the right time with the right business model and that's very important. With a two-sided marketplace model, we enjoy strong flywheel effect and overall economies of scale as we ascend to market leadership and now further extending our leadership vis-a-vis peers in the markets. So this is actually shown in our results quarter-on-quarter as Shopee continue to accelerate its growth and claim more market share over time. And we think, as we mentioned before, we stand in a very good position to gain from the overall market growth as well.

In terms of the take rate, we've been working with our sellers to improve our services to them, increase their returns, at the same time also growing in the marketplace. And as a result, that is reflected in our gradual deepening our monetization as well and we have rolled out more programs for the sellers to advertise our platform and check more bias to their shops and services for them. As a result, we are also able to touch a higher take rate over time.

As we mentioned before, our investment in the long-term growth of the platform we believe is highly efficient and will eventually generate long-term profitability. And now is -- for us, it's a good time to continue to invest in growing the market, in growing our market leadership and improving in the future our long-term profitability and therefore we will continue to invest in the growth.

Operator

Our next question will come from Mike Olson of Piper Jaffray. Please go ahead.

Mike Olson, Analyst

Thanks for taking my questions. So you mentioned strong downloads of Call of Duty Mobile. Is there anything else you can say about how that game is doing so far and just to what extent the success of that title could be competitive with Free Fire, and I guess potentially cannibalize Free Fire? Do you really see it as just a different player base? And then, for Shopee, what are you seeing competitively right now in the core Southeast Asia e-commerce market, is there any kind of change in marketing trends or other there signs of aggressiveness from other competitors? Thanks.

Yanjun Wang, Group Chief Corporate Officer

Thank you. Yeah. So we are very excited about the strong performance of Call of Duty Mobile so far and received a strong reception in our markets by users, which is within our expectation. And right now, we're continuing to focus on further tailoring the content of our local markets in partnership with Tencent Activision for this game. It's too early to tell the long-term monetization potential for this game at this stage as it was just launched. We will continue to work hard on it and absorb the trends closely.

In terms of our core marketplace competitive landscape, we believe, we continue to extend our market leadership. And ultimately, how fast we can grow is now increasingly depend on how well we serve our users, our merchants, as well as the buyers and scale the marketplace with efficiency, it will increasingly less and less affected by what the other peers might be doing in the market as we extend our market leadership and continue to gain market share. So I will say we don't observe much change in the trend nor does that have much impact on us anymore.

Operator

Our next question will come from Alicia Yap of Citigroup. Please go ahead.

Alicia Yap, Analyst

Hi, good evening, Forrest, Tony, Yanjun and other management. Thanks for taking my questions. Congrats on the very strong number. My first question is related to the Call of Duty and Free Fire. So based on your team experience, what is the expectation for the longevity of Call of Duty Mobile and monetization potential as compared to Free Fire. And then for Latin America, it seems that Free Fire remain very strong, despite the launch of Call of Duty Mobile, could you share with us what is the secret source for Free Fire to remain so resilient and so strong in LatAm?

Second question is on e-commerce. If we take a little bit like three to five year views, longer term, could you share with us on your e-commerce monetization model breakdown, what could be the percentage contribution from -- for example, the advertising revenue versus the commission take rate and versus the logistic delivery and the cross-border fee, given the AOV seems quite stable and if we're assuming annual consumption power, what could be the annual spending per user that you're expecting in three to five years? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you, Alicia. So regarding CODM, in terms of longevity and the monetization potential, again it's a bit too early to tell at this stage, but we see very strong initial trends and we will continue to work hard with the developers to improve the game and further tailor to the markets to continue to improve the games content and also the user base over time. And, of course, we hope to have as (inaudible) game life as possible and deep monetization for this game, given that it has a relatively strong user follower base for this IP as well as traditionally FPS games in our region.

In terms of Free Fire's continued strength in LatAm, as we mentioned before we're not -- to worry about people were wondering about potential cannibalization before we launched CODM. And we always said, we believe these games cater to different crowds and also have a complementary effect to each other within our portfolio, as we are very careful about selecting games within the portfolio and the pipeline. So this has exactly played out as we believe it would.

And Free Fire's continued strength we believe is attributable to, A, the depth of the game itself and the network effect of a game that supports 50 users playing, interacting with each other at same session, same time building a large community online, offline and building more cultural game entertainment, other forms of elements into the game over time. And we are cross learning from -- we are cross learning from other games as well as other forms of entertainment. And of course our own team's efforts and in continuing to build out this game and their creativity and their understanding of the local markets with a large user data we have already for this game. So I think that's why we remain very optimistic about the longevity -- the future monetization of Free Fire over the long run.

In terms of e-commerce revenue breakdown, so the -- we see a pretty significant increase in the take rate quarter-on-quarter and that's largely attributable to the high margin transaction-based fees, commissions, handling fees and advertisement.

We believe that the high margin revenue will continue to grow -- drive the growth of our e-commerce monetization. Of course, the value-added services, including the cost on logistics revenue will continue to grow as we continue to grow the platform and increasingly, however, the revenue growth, as well as in the longer run, the margin expansion we believe will be more driven by the high-margin items within the revenue. Although, it's a bit too early to detail out the exact break down between the different streams of revenue.

And in terms of our spending, on the cost of revenue side, of course, right now, we see that our first party product revenue pretty much very offset the cost of revenue on the cost of goods sold. And also at the same time, the cost of customer [ph] logistics have been offset by the cross-border logistics revenue, as well. So increasingly, we're hoping to cover the cost of revenue as well as R&D, G&A, and of course, the sales marketing cost over time with economy of scale. So we believe that the long-term profitability of the e-commerce model is very clear to us.

Operator

The next question will come from Ranjan Sharma of JPMorgan. Please go ahead.

Ranjan Sharma, Analyst

Hi. Good evening and thank you for the call and for taking my questions. Two questions from my side, both on Gaming. Firstly, on India, it seems that you are -- the Garena brand is growing there. You have partnered with India Today, which is one of the leading magazines in the market. Would you also be looking to establish a presence in India, like, what you have done with Latin America and potentially bring more third-party IP into that market as well?

The second question is on the margins for the Gaming business, it feels that -- increase that software revenues are coming from non-App Store or Google Play Store. So let's say through vouchers. Can you give us a sense on how big that number is, and if that's growing much faster than your revenues on the different App Stores? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Sure. Thank you. In terms of India, we are very encouraged to see the results that India, that recently, especially we now become the top grossing game based on any -- for October in a country. And we have also rolled out lots of esports and community building events. We currently don't have meaningful physical presence locally and -- but like LatAm, we will assess the situation to see if at some point it's appropriate to build up some local team to help with local community building and operational capacity. So on that front, we will remain flexible and assess based on business needs.

And of course we are hopeful of strengthening our global footprint and India is a huge market with great potential. We are seeing very encouraging user growth there and very encouraging pay user growth there. That is a very important, actually, sign for our potential gaming opportunities there. And we do hope to work with global partners to further strengthen the presence in the market and explore the huge market potential in that market. I think we'll continue to innovate. As we've always mentioned, we believe that with that big of a user base and with creativity, we are optimistic that eventually we will be able to make something out of that very big market. And we already start to see the results.

And in terms of the vouchers versus Google Play, App Store, actually, most of our gaming revenue still for mobile game has come from Google Play and App Store. There are some alternative channels in the different markets based on local demands and circumstances, but we won't believe that's a drive -- makes a significant difference at this stage.

Operator

Our next question today will come from Thomas Chong of Jefferies. Please go ahead.

Thomas Chong, Analyst

Hi. Thanks management for taking my questions. May I ask about how many game developers do we have right now in Shanghai versus last quarter and what's our headcount spend for our game development team next year? And my second question is about the revenue mix in Southeast Asia versus LatAm going into 2020, how should we think about also in terms of the paying ratio as well as the ARPU between the two regions? Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. We have more than 300 developers in Shanghai Studio. I think last time, we disclosed was more than 200, about a couple of quarters ago, and we will continue to build out our development capabilities and augment our development teams in Shanghai and also other places where we find great gaming talent. It will be a very important focus for us the coming quarter and going forward as we continue to build out our development capabilities and leveraging the existing user information data and strength we already have in our global footprint for game.

But at the same time, we will be very prudent in developing our team as we pay to people with proven track record, industry veterans and people who are truly passionate about game as their life choice career. And these are the people that we want to bring to our home. And we're focused on looking for such talent globally as opposed to just adding, piling up a number.

So overall, our G&A and R&D expenses have been very efficient, if you look at our margin as well, and we will continue to manage that with a lot of prudence.

In terms of revenue mix, I think we see that LatAm has become increasingly important market for us, as we continue to build out our game presence there. And we also have increased the revenue contribution for the newer markets such as India, Russia and MENA as we mentioned before.

And in terms of pay ratio and ARPPU, we do not see material difference between LatAm and Southeast Asia. I think it's a more of -- more depend on the specific game type, but we think the market potential is there.

And also some times, an example for Indonesia, we may -- traditionally people might think, it's not the most affluent to market in the world, and therefore attribute low pay user ratio or low ARPPU to this market and subsequent low monetization potential, but our game, Free Fire has definitely proven otherwise. We see very high double-digit paying ratio coming from Indonesia market as well as a very good monetization potential.

So we think at the end of the day, it is about knowing the markets, getting the right IP to the right crowd and being able to execute well and accurately. So that you can maximize monetization potential of IP in any particular market, which we think is something that we are super-focused on doing and we already reap the fruits of such effort for several markets already and will continue to expand our presence in the global emerging markets where we have already accumulated so much know-how and operational expertise.

Operator

Our next question today will come from Varun Ahuja of Credit Suisse. Please go ahead.

Varun Ahuja, Analyst

Yeah, hi, good evening. And congrats on a good set of numbers. I've got quick three questions. So the Q4 guidance increase, sorry, the full year guidance increase is do you think -- how much is it from India? Do you think you're seeing after this last few quarters of effort that we've been putting, has it really come to a stage where it will start contributing meaningfully and, 4Q, do you think lot of it is coming from India? That's number one.

Number two, can you give little bit more color on Free Fire? How do you seeing users graduating from free passes to other high margin virtual items purchase, because you still ARPPU continues to go down, but existing users, how much of you seeing upgrade to higher margin products? That's number two.

And number three, if you can give some color on new game launches. I know you're very -- you don't disclose much but any commentary how you are thinking about this landscape and any -- your self developed game, any timeline that you're thinking about it, because it will be almost three years since you launch by next year your own games? So, anything on that front will be helpful. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Thank you. So in terms of the Q4 guidance increase, based on what we're observing, the revenue increase -- we see increasing revenues across different markets in Southeast Asia, LatAm, as well as the new markets including India. So it's not any kind of single market kind of event. It's really more across different -- across the region for us. And for India, we believe that the market potential is huge. And while the -- in terms of the pay ratio, it's still below the average for us in Southeast Asia and LatAm, but the increase in the paying user is very encouraging, which is fueled by both the increase in the user base as well as increase in the pay user ratio.

So I think we will continue to experiment with different things such as the Elite passes which has been quite effective in helping converting free user to pay user for some of our markets over time. And also some of the air drop packages, for example, we have personalized attractive items grouped into packages with personalized prices targeting different users to convert them into a paying user. So we are continuing to innovate with different features in the game to help deepen monetization with -- at the same time, we want to keep building out the user base, and we are very encouraged by the signs we're seeing in India, as well as the different markets we are operating in.

In terms of the Fire Pass or Elite Pass as mentioned, we believe that tool has stuff that its intended purposes of creating a free user to paying user. At the same time increasing user stickiness as well as engagement level based on the data we have. So we will continue to deploy that from time to time. And of course, we will come up with new innovation for example bundling themed passes, et cetera to further explore the potential -- its potential.

And in terms of new game launches, as always, for commercial reasons, we don't discuss game pipeline for confidentiality. But again, you can trust that, that's the number one priority that we are focused on is, in the longer run, continue to bring top IP to our world users. And as a game developer and a publisher, we are well blessed by the -- our stress in both development, self development as well as our partnership with global developers that stand us very well to hopefully capture any opportunities and new creativity rising in the world gaming communities and bring that whether through our own development capabilities or publishing arrangement to our users.

And again let's not forget, right of first refusal, we also have with Tencent which is -- was one of the largest gaming company. And we continue to see strong pipeline and we will of course select potential IP based on the appropriateness of our market and our assessment of the -- our own portfolio.

Operator

Our next question today will come from Conrad Werner of Macquarie. Please go ahead.

Conrad Werner, Analyst

Hi, thanks a lot for taking my question. The first one is just maybe since the last quarter's update. Have you been able to or felt it was appropriate to introduce kind of either new or higher commissions in any of the markets for e-commerce? That's the first question. And then also kind of related to the whole kind of competition question, maybe putting into -- looking at it the other way. I mean, are you almost kind of at the point now where you're sort of seeing less competition in your chosen categories because you've kind of achieved sort of a multiple in terms of scale versus the nearest competitors and perhaps maybe in some of the markets even in Indonesia, we're seeing people kind of drawing back and not maybe wanting to compete generally, but compete more on their chosen categories and that kind of makes life a little easier for you in your categories? Is that something you might be seeing? Those are my two questions.

Yanjun Wang, Group Chief Corporate Officer

Yes. Got it. Thank you. In terms of the commissions, and we continue to gradually ramp up commission in different markets over time. Of course, it is something that we may do from time to time based on local market conditions and our assessment of the appropriateness of different levels of commissions and seasonal also taking into account the seasonal effects. So more recently, for example, we increased the normal seller commission for Taiwan slightly. And also the seller commission for (inaudible) Indonesia. So these are some of the measures that we are taking to hope to further differentiate the best performing merchants. And also with more resources to be invested into the ecosystem to serve our merchants that is to help them grow even faster. So it's a kind of win-win situation between the platform and the merchants and eventually benefit our buyers.

So in terms of competitive landscape, we always take competition very seriously. But at the end, regardless of what the competitors do, we always have our clear playbook in terms of grow the marketplace model, focusing on core categories that we have always focused on from a better beginning and continue to capture the market share and also serve our users better. Eventually, we think that will lead us to very strong market leadership position and we are well on path to doing that. And I think you're right to -- in a way that our hands are increasing -- our destiny is increasing our own hands. It's less relevant to us what our competitor is doing day-to-day, but increasing is more about how we can serve our users better.

Operator

Our next question will come from Mark Goodridge of Morgan Stanley. Please go ahead.

Mark Goodridge, Analyst

Hi guys, just a quick question from me, on the gaming business, it looks like the average revenue per paying users fell in Q3. Specifically, was that just due to the mix shift to the lower paying markets or was that more due to some of the promotional activity that you had for Free Fire's anniversary, during the quarter? Thanks.

Yanjun Wang, Group Chief Corporate Officer

Yeah. Thanks, Mark. So ARPPU decreased little bit mainly due to two factors; one is increasing revenue mix attributable to Free Fire with its strong growth and as we mentioned before ARPPU sometime is genre specific. For Free Fire type of genre where you are targeting mass audience with hundreds of millions of active users, you tend to see lower ARPPU compared to some of the mid-core games such as for example Speed, where you see, you will see higher ARPPU. So I think it's generally natural based on the game revenue mix.

And second, we also introduced the -- for example, the air drop packages and other Elite Passes etcetera to continue to grow our pay user ratio in the region, because we believe that with a larger user base and a larger pay user base will lead to a longevity of the game and be better monetization over the longer run. And this in fact is playing out as we believed. And as far as mentioned earlier that we see a new record high in monetization based on our results in October so far. And that we believe is a positive effect coming from our expansion of the pay user program to attract more paying user and increasing game stickiness. So I think this overall is a strategy that's well played out for us. But if -- also if you look at revenue per user, which is stable at $1.4 that shows that while we are expanding our pay user base and further strengthen our long-term monetization potential, we're not sacrificing our immediate monetization opportunity either.

Operator

Ladies and gentlemen, this will conclude our question-and-answer session. At this time, I'd like to turn the conference back over to Yanjun Wang for any closing remarks.

Yanjun Wang, Group Chief Corporate Officer

Thank you, operator. Thank you everyone for joining today's call. We look forward to speaking to you all again next quarter.

Operator

Ladies and gentlemen, the conference has now concluded and we thank you for attending today's presentation. You may now disconnect your lines.

Company Name: Sea Ltd
Company Ticker: SE US
Date: 2019-08-20
Event Description: Q2 2019 Earnings Call

Market Cap: 14683.945815
Current PX: 33
YTD Change($): 21.68
YTD Change(%): 191.519

Bloomberg Estimates - EPS
Current Quarter: -0.514
Current Year: -2.387
Bloomberg Estimates - Sales
Current Quarter: 665.2
Current Year: 2364.857

Q2 2019 Earnings Call

Company Participants

- Yanjun Wang
- Forrest Xiaodong Li, Founder, Chairman & Group CEO
- Tony Hou, Group Chief Financial Officer

Other Participants

- Miang Chuen Koh, Analyst
- Mike Olson, Analyst
- John Ryan Blackledge, Analyst
- Ranjan Sharma, Analyst
- Conrad Werner, Analyst

Presentation

Operator

Good day, and welcome to the Sea Limited Second Quarter 2019 Results Conference Call. (Operator Instructions) I would now like to turn the conference over to Yanjun Wang. Ms. Wang, please go ahead.

Yanjun Wang

Thank you, operator. Good evening and good morning everyone and welcome to Sea's 2019 second quarter earnings conference call. I am Yanjun Wang, Sea's Group Chief Corporate Officer. Before we continue, I would like to remind you that we may make forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release. Also this call includes discussions of certain non-GAAP financial measures such as adjusted revenue and adjusted EBITDA. We believe these measures can enhance our investors' understanding of the actual cash flow of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on Non-GAAP Financial Measures in our press release. On the call with me are Sea's Chairman and Group Chief Executive Officer, Forrest Li; and Group Chief Financial Officer, Tony Hou. Forrest and Tony will share strategy and business updates, operating highlights, and financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have. With that, let me turn the call over to Forrest.

Forrest Xiaodong Li, Founder, Chairman & Group CEO

Thanks, Yanjun. Hello, everyone and thank you as always for joining today's call. I'm really pleased to report that we had another great quarter. Across the business, we saw sustained strong growth and further improvement on the top and bottom lines. For Sea as a whole, our adjusted revenue tripled year-on-year to reach $665.4 million and our adjusted EBITDA improved once again to negative $11 million. Our results for the quarter show that we continued to drive revenue growth and improved efficiencies across our business. We're increasingly able to fuel our growth with cash generated through operations, which we believe positions us well to continue driving long-term sustainable growth. As you know, at the start of the year, we set ourselves some very ambitious targets for adjusted revenue growth in 2019.

With our very strong performance in the first half of the year, we have decided to raise our guidance for our full year adjusted revenue for both digital entertainment and e-commerce. For digital entertainment, we now expect full year 2019 adjusted revenue to be between $1.6 billion and $1.7 billion, representing 142.0% to 157.2% growth from 2018. This compares to the previous guidance of between $1.2 billion and $1.3 billion, representing 81.5% to 96.7% year-on-year growth. We are also increasing our guidance for full year adjusted revenue for e-commerce to between $780 million and $220 [ph] million, which represents 168.3% to 182.1% growth from 2018. This compares to the previously stated guidance of between $630 million and $660 million, representing 116.7% to 127.0% year-on-year growth. Our increased full year targets reflect our confidence in both the growth opportunities ahead and in our ability to execute our strategies to capture those opportunities.

Let me start with Garena, where we saw healthy growth across key metrics in the second quarter. On the top line, adjusted revenue for the digital entertainment business more than tripled year-on-year to $443.2 million. In terms of the bottom line, adjusted EBITDA for digital entertainment was up 443% year-on-year to $263.8 million. Adjusted EBITDA margins further increased to 59.5% for the second quarter of 2019 from 34.9% for the second quarter of 2018. Our quarterly active user numbers, or QAU, almost doubled from a year ago to reach more than 310.5 million. The paid user ratio which is quarterly paying users as a percentage of QAUs more than doubled from 4.1% a year ago to 8.4% in the second quarter.

There are three key highlights to Garena's success this quarter. First, we continued to drive strong organic growth in active users globally. In particular, Free Fire, our self-developed smash hit game was the third most downloaded mobile game and the most downloaded battle royale game globally across the Google Play and the iOS App Store in the second quarter according to App Annie. We are excited to see continued user growth across our core markets of Southeast Asia and Latin America, as well as in other growth markets like India, Russia, Turkey, and the Middle East. Second, we are strengthening our foothold in Latin America. As we mentioned in previous quarters, the huge success of Free Fire in Latin America is opening up opportunities for Garena in this high-growth market of more than 600 million people. I'm pleased to report that in late July, we launched the Garena Speed Drifters across Latin America. This is the first third-party licensed game that we are publishing in Latin America and it is an important step forward in expanding our footprint in this very exciting market. Finally, we continue to deepen our engagement with our gamers while driving monetization across our game portfolio. For example, throughout June, we ran a series of themed competitions in Free Fire and offered a wide range of in-game items based on campaign themes, which were very popular with our gamers. This translated into both user number and revenue growth for the game.

At the same time, our eSports and community building efforts are also enhancing engagement across our titles. In Brazil, for example, we hosted our largest ever eSports tournament for Free Fire in that market in July, which attracted over 12 million views online. During the grand final of the tournament, the peak concurrent views on YouTube alone exceeded 800,000. In June and July, we also hosted Arena of Valor World Championship in Vietnam. This was the first time that this global tournament was held in Southeast Asia and it was a huge success. We recorded cumulative online views of over 74 million with over 850,000 concurrent views at the peak. We believe that this showcases Arena of Valor's popularity as one of the region's top mobile MOBA games. Looking to the quarters ahead, our pipeline remains strong. For example, we recently launched pre-registration for Call of Duty: Mobile in our core markets in Southeast Asia. We also see plenty of headroom for our existing titles to continue growing. In particular, as we further deepen engagement with Free Fire's growing global user base, we believe that this game and the battle royale genre in general are still young and evolving. For the upcoming quarters, we believe that Garena is in a great position for long-term growth. This is also reflected in our decision to raise the full year outlook for the digital entertainment business.

Turning to Shopee, in the second quarter, we continued to deliver on our strategy to scale with efficiency to capture market share and deepen monetization. Looking first at growth, Shopee further strengthened its market leadership. In the second quarter, it ranked the highest in the Shopping category by both average monthly active users, and by app downloads across the Google Play and iOS App Stores, in both Southeast Asia and Taiwan, and ranked the third in app downloads in the same category globally according to App Annie. Gross orders for the quarter increased more than 90% year-on-year to 246.3 million, and GMV for the quarter increased 72.3% year-on-year to $3.8 billion. These data points underline our success in building and sustaining a strong and engaged user base across the region and continuing to capture market share. As we scale, we also continue to improve on growth efficiency. Shopee's adjusted EBITDA loss per order decreased by $0.46, or 31.3%, compared to the same period in 2018. More importantly, we continue to see sustained improvements in monetization and take rate and adjusted revenue more than tripled year-on-year to $177.4 million dollars. Adjusted revenue as a percentage of total GMV increased to 4.6% in the second quarter, up from 2.6% for the same period a year ago. And adjusted marketplace revenue as a percentage of total GMV reached 3.6% in the quarter. Indonesia, the biggest e-commerce market in Southeast Asia and also Shopee's biggest market, our growth accelerated in the second quarter as we further extended our market leadership. We reached over 110 million orders for the quarter, which represents a daily average of over 1.2 million orders.

In Taiwan, Shopee continued to record a positive quarterly adjusted EBITDA before allocation of the headquarters' common expenses for the second quarter. This is a powerful demonstration of the long-term profit potential of our e-commerce model. Our focus for Shopee is not only on the quantity of growth, but also on quality. We believe that long-term success for Shopee is based on capturing the hearts and minds of shoppers in our region, and translating that into deep and sustained user engagement. That's why one metric that we track closely is Total Time In App, which we believe is a measure of our ability to attract, and deepen engagement with our users. By this metric, Shopee was once again number one in the second quarter in Southeast Asia as a whole and in each of our five biggest markets on Android, according to App Annie. From the beginning, we designed the Shopee experience to be highly engaging and social, by pioneering in-app live chats, games and social features in our region. And we are constantly working on new ways to enhance the user experience. For instance, we rolled out our new live streaming feature across all of our markets by the second quarter. This feature offers a new and powerful way for consumers to engage with our platform, brands and sellers through live video streams created by Shopee or by the sellers themselves. As consumers discover new products through this feature, they can make immediate purchases without leaving the stream. We also employed AI and AR technologies to further enhance consumer experience on our platform. For example, our new AI and AR powered tools, which were introduced in partnership with L'Oreal, enable our users to try different shades of make-up or get personalized, professional skincare advice in the Shopee app.

In addition, we leveraged our unique strengths in both digital entertainment and social commerce by introducing esports streaming on the Shopee platform. This has helped us attract and better engage with an even broader audience across market segments. And just last week, we announced the world-famous footballer Cristiano Ronaldo as Shopee's new brand ambassador in Southeast Asia and Taiwan. Ronaldo is one of the world's best known athletes and an icon across our region. We are confident that our partnership with him will resonate with consumers and deepen their engagement with the Shopee brand. We believe that our focus on keeping our users engaged and entertained gives Shopee unique strengths in better attracting and retaining users. It also offers us numerous opportunities to better understand our users' needs and preferences to help them discover more new products on our platform.

To conclude, looking to the second half of the year, we believe we are in a great position to drive sustained growth across both e-commerce and digital entertainment, and to do so with increasing efficiency. That said, we are still very much in growth mode across our businesses. We have a great opportunity ahead of us to grow our markets over the long term and we are very well placed to capture the largest slice of this growing pie. As we have always said, we believe scale and strong market leadership will translate into long-term profitability. Our results for the second quarter demonstrate that our businesses become increasingly efficient as we scale, and we are committed to continuing scaling up to maximize those efficiencies. With that, I will invite Tony to share more about the financials.

Tony Hou, Group Chief Financial Officer

Thank you, Forrest, and thanks to everyone for joining the call. We have included detailed quarterly financial schedules together with the corresponding management analysis in today's press release. So, I will focus my comments on the key financial metrics. For Sea overall, our second quarter total adjusted revenue was $665.4 million, an increase of 203% year-on-year. This was mainly driven by the growth of our digital entertainment business, especially our self-developed game Free Fire and our continuous monetization efforts in our e-commerce business in the past quarters. Digital entertainment adjusted revenue was $443.2 million, an increase of 219% year-on-year. The growth was primarily driven by the enlarged paying user base as we continue to improve the monetization of our games, especially Free Fire. Digital entertainment adjusted EBITDA was $263.8 million, an increase of 443% year-on-year mainly due to strong top line growth and our self-developed game accounting for an increased share of revenue. The increase was also partially due to the improved operating efficiencies as shown by the lower sales and marketing expenses, as well as general and administrative expenses as a percentage of adjusted revenue. E-commerce adjusted revenue was $177.4 million, up 202% year-on-year. Within this, marketplace revenue was $137.8 million, up 269% year-on-year, while product revenue was $39.7 million, up 85% year-on-year. E-commerce adjusted EBITDA loss was $248.3 million as we continued our investment to fully capture the market opportunity in the region. We will continue driving the high quality growth by serving the users' needs better and improving operational efficiencies in the long run.

Digital financial services adjusted revenue was $2.8 million, a decrease of 18% year-on-year from $3.4 million in the second quarter of 2018 as we focused our efforts on strengthening the infrastructure to support our existing platforms. Adjusted EBITDA loss was $18.1 million in the second quarter of 2019 compared to a loss of $6.8 million in the same period of 2018. This was primarily due to our continued efforts to integrate our AirPay and Shopee platforms. Returning to our consolidated numbers, we recognized a net non-operating loss of $29.2 million in the second quarter of 2019 compared to a net non-operating loss of $30.8 million in the second quarter of 2018. We had a net income tax expense of $15.3 million in the second quarter of 2019, which was primarily due to withholding tax and corporate income tax recognized in our digital entertainment segment. Finally, net loss excluding share-based compensation and changes in fair value of the 2017 convertible notes, was $215.1 million in the second quarter of 2019 as compared to $198.7 million for the same period in 2018. With that, let me turn the call back to Yanjun.

Yanjun Wang

Thank you, Forrest and Tony. We're now ready to open the call for questions. Operator?

Questions And Answers

Operator

(Operator Instructions) Our first question today comes from Miang Chuen Koh with Goldman Sachs. Please go ahead.

Miang Chuen Koh, Analyst

Hi. Thank you for the opportunity. On the gaming business, it appears that the average revenue per paying user fell quite a bit quarter-to-quarter. I recognized, there may be some dilution for more Free Fire paid users but then again the paying users increased even more Q-on-Q in the first Q and the ARPU did not fall as much then on a sequential basis. So just wondering, what drove sort of the larger-than-usual decline in ARPU? And secondly, Free Fire revenues in the quarter, is it possible to give us some indications? And then thirdly, on your expansion plans globally especially in places like LatAm, can you give us a sense of whether we should be expecting a lot more headcount increases in some of these regions and how that would affect your OpEx structure in the second half of this year? And then, if I may as well on the e-commerce side a couple of questions as well. One, the take rate increased 70 basis points Q-o-Q, which is quite high. Can we have a sense of how much of this 70 basis points increase was from value-added service and how much was from commissions and advertising? And finally, Indonesia, will Sea start to charge Star Sellers obviously on the C2C marketplace side in July? What exactly do you see from the industry perspective that gives you confidence in that and what does it mean for other markets? Sorry that's quite a handful of questions. But thank you.

Yanjun Wang

Thank you, MC. Happy to answer your questions. Regarding the ARPPU trends, I think as we discussed before when we look at esports title that has a large user base and long game life, we tend to focus on different things and different phase. It usually starts with growing the user base, and then gradually ramping up monetization deepen the pay user ratio and then optimize for ARPPU. So, for Free Fire in particular as you can see we have seen very strong growth both on the user side as well as on the pay user penetration quarter-on-quarter. And this is contributing significantly to the revenue increase as well. And in terms of ARPPU, it is not currently the focus for us for Free Fire. We believe the game is still very young, and has a long runway and we are focusing on broadening the user base as well as continue to deepen the pay user penetration. For example, one tool that we find pretty helpful in bringing more pay users to our game would be the Elite Pass or the Fire Pass. Although, it has a lower ticket size at $5 a month, but it's a very effective in converting free user to pay user over time and for that, we've been focusing on promoting more of a Fire Pass user engagement over the period. So as you can see overall our revenue trend has been very positive and the margin has increased also over time even though we already started with very high margin compared to the game industry as a whole. So we think this is a positive trend and shouldn't be of any concern. And we think in the longer run, there will be growth potential on the revenue as well as ARPPU side both for the game business and for Free Fire in particular.

In terms of Free Fire revenue outlook, as mentioned earlier we think the game is still young and evolving and we're very focused on bringing new contents into the game. We have more than 300 developers in our studio now and about half of them are devoted to creating new content, new innovations for the game to engage the user better and more recently we have offered themed competitions and themed virtual items that have been very effective to attract new users. This is a new mode of play that we have introduced. So we are quite confident about Free Fire's revenue and the trend going forward. As you can see in our revised guidance that we basically are guiding towards a more than 140% to more than 150% year-on-year growth in our game revenue and that is largely attributable to the strength in the Free Fire game performance over the longer run. And also over all our other existing games so we continue to see pretty stable performance. So we are confident of our longer-term game performance in the markets. In terms of LatAm expansion, we have set up small operations locally in Brazil and Mexico and we are quite careful in expanding into new markets. These teams are focused on local operations being with payment partners and organizing local esports events and community building, as well as local customer services. So our focus will be to gradually ramp up operations, but as you can see from our past practices and track record, our gaming operation has been highly efficient in terms of G&A spending has been fairly low and that gives rise to the high EBITDA margin in our gaming business compared to the industry standard.

Now turning to e-commerce, yes, as you've observed our take rate continued to rise and this is basic to us, it's a clear sign that as we scale and continue to gain market leadership and market share across various markets, we are also able to ramp up monetization while we continue to grow. And in terms of the up-tick in the take rate, the vast majority of that is from the high-margin type of parts of the revenue; i.e. the commission, handling fee, and advertisement income. So we think we're on a very healthy growth path over time to monetize over the e-commerce platform. However at this stage, we are very much focused on growing the platform and attracting more users, more sellers as well as building up our assortments and services to the sellers. We are not worried about the potential to monetize it as we have shown. This has a huge runway to go. And at this time we are focused on building up our market leadership across the markets, which is showing in all of the various; for example, we're the top ranked app in terms of downloads, user time spent, monthly active users in the Shopping category in our region. And these are also important indicators of the growth of the platform and the solid leadership it is able to command across the market.

And in terms of the star seller as you correctly pointed out, we have started to charge a commission on the star sellers in Indonesia. Again, we see very robust growth in Indonesia for our e-commerce platform as we continue to extend our market leadership. In Q2 our daily order volume has exceeded 1.2 million and accelerated growth from quarter-to-quarter. And even though Indonesia is while -- actually our largest market, it is also enjoying of the highest growth rates across different markets. So as a result we are also providing more services and returning greater value to our sellers as they derive the most sales volume and income from our platform and they are happy to pay the rate because they see the value in working with us, in providing them the access to the vast user base, the services, the integrated logistics and payment services we provide them as well as the other services. And therefore we believe over the long run, we can gradually ramp up -- continue to ramp up monetization across different markets including

Indonesia our biggest market where we are commanding an even stronger leadership now. And we are confident about that approach.

Miang Chuen Koh, Analyst

Got it. Thank you.

Operator

The next question comes from Mike Olson with Piper Jaffray. Please go ahead.

Mike Olson, Analyst

Hey, thanks for taking my questions. So as you just talked about Latin America has been a surprisingly strong region. But outside of Latin America, do you believe there's a significant opportunity in some of these other regions that you mentioned like Eastern Europe, India, Middle East, etc.? And will you focus on building out those regions with Free Fire first or with other third-party games? And then just overall, you've mentioned continued opportunities for growth broadly for the business across both major segments. What do you expect your key areas of investment across the company will be in the next few quarters? Will it be new game development or new content for existing games or marketing or subsidies or what kinds of things will you be specifically investing in for growth? Thanks.

Yanjun Wang

Thank you. In terms of expansion into the other high-growth market, we have mentioned before that we see very strong user growth in markets like India, Russia, Turkey, the Middle East for our self-developed game Free Fire. And we believe that with the wealth of user data and deepening user understanding over time, we acquire from this global hit game we are very well positioned to introduce and continue to build upon the success of that game to deepen monetization as well as potentially introducing new content and even new IP, whether it's self-developed or third-party to these markets; just like what we did in LatAm. We started with Free Fire, our self-developed game, grow the user base there, monetize over time. And now we are reaping the fruits of that efforts. And in addition, we have recently rolled out a second game, which is a third-party licensed game from Tencent Speed Drifters in the market. We believe this approach can also potentially work in the other high-growth markets. And I think given that our unique advantage in being able to operate well and deeply in so many complex diverse, but high-growth young markets across the globe, we are very well positioned to capitalize on the new opportunities in these emerging markets with the rise of mobile technologies. That enables a lot more new content to be introduced to our users across the world.

And in terms of key areas of investments, we are very much focused on the gaming side, both deepening our development capabilities as well as global expansion. On the other hand, if you take a look at our gaming performance so far, we enjoy very high growth at the very high EBITDA margin. That doesn't mean that we're not investing in games. We're actually investing heavily in terms of human capital. This business we believe is a creativity-based business. It's not about just dumping money to buy growth. It is about deepening understanding of the user making good use of the wealth of user data we have and leverage the experience and understanding of our complex diverse markets to build up content development capabilities and that is very much talent-driven as well as knowledge-driven. So to that thought, we devote a lot of time and resources in terms of the management timing and management focus continue to develop our game businesses and also in understanding our global markets better to introduce more content globally. On the e-commerce side, as we mentioned, we're in a better-than-ever position to build up our e-commerce ecosystem as our platform continue to scale. As you can see, we're enjoying increasing efficiency. In terms of EBITDA loss per order, this continues to decline over time. And our sales marketing has been fairly stable as a percentage of GMV. But as we mentioned before, shipping subsidy is increasingly a minor part of the sales and marketing.

The majority of the sales market spending is now discretionary brand marketing. For example, our partnership with Mr. Cristiano Ronaldo and our sponsorship of Liga 1 in Indonesia, which is the most popular football event nationally. These are very efficient marketing activities delivering high ROI for us and promoting our brand awareness across the region as well as globally. So we will continue to be opportunistic about it and leverage good marketing opportunities to further promote our brand as we become a go-to marketplace in our region.

Mike Olson, Analyst

Thank you.

Operator

Next question comes from John Blackledge with Cowen. Please go ahead.

John Ryan Blackledge, Analyst

Hi, great. Thanks. A couple of questions on Shopee and one on Garena. How should we think about the -- for Shopee the GMV trajectory in the back half of the year? And if you can talk about kind of market share positioning and any update on the competitive environment across the different markets? And then second on Shopee. The second quarter growth was really strong, obviously particularly order growth. But the AOV was a little lower than we thought. Just any color on what drove the lower AOV and how we should think about that going forward? And then on Garena, just any color on the Free Fire Pass and what's the monetization around that and what that looks like going forward? Thank you.

Yanjun Wang

Thank you. In terms of the Shopee, GMV trajectory, as we continue to scale the platform across different markets for Q2 we have more than 70% year-on-year growth in GMV and more than 90% year-on-year growth in order. And the GMV growth is slightly lower than order growth is as you mentioned relating to the average order value. And to that, we do have a view on what will be a optimal value or range of optimal value for our markets in building out a general merchandise marketplace e-commerce. If you look at some of the large e-commerce, general merchandise e-commerce platform such as Taobao, we understand their basket size is also around the mid-teens range. We think that's a good range to have for building a e-commerce platform in all markets as well with the focus on the key categories of fashion, health and beauty, home and living as well as baby products. These are the high-margin now standardized products that lend themselves very well to build up a large diverse seller base and buyer base and eventually the largest e-commerce marketplace in China.

So we believe we will focus on building out these core categories and drive user base as well as drive frequency while maintaining a healthy range of order value. So in particular relating to the Q-on-Q fluctuation, for example there are different reasons the intrinsic factor that could affect the period-to-period average order value. During the Ramadan season for example, we see higher demand in the fashion category, which tend to have a smaller basket size and therefore could affect the order value as a whole. So these are the intrinsic factors we think as far as we maintain a healthy mix of in terms of the GMV of different categories for our marketplace ecosystem. We are on track to continue to grow the marketplace and extend our leadership further. So that falls to the next question regarding competition. Now, I think obviously we take competition very seriously and have a deep respect for our peers in the market. But some context I think it's important to note that none of the competition we currently see is new to us. Our peers have been longer established have been in the market for many years before we even started the e-commerce business. And yet, we managed to grow from zero to market leadership with more than 15 billion of annualized GMV and a Q2 4.6%

of take rate in less than four years' time over such diverse complex markets. None of them are in all the markets that we are in.

So we have local competition, but we don't even have competition across all these markets. So I think our track record has shown that we have been very effective in competition. And we believe we will continue to be so because our competitive advantages are in our understanding of the right timing, right model and right market for the e-commerce marketplace business as well as our ability to execute very well in highly diverse complex markets, with highly localized operations and adapt our business strategies over time based on our deep understanding of local users as well as market conditions in addition to our deep understanding of the efforts of marketplace e-commerce that business model. So I think these competitive advantages remain. And we now have additional advantage of being the market leader across markets in e-commerce. And as you can see some of our peers are now following our footsteps in some of their operations. For example, focusing more on mobile, switching from 1P to a marketplace model, and focusing more on the social aspects of it or even in charging student take rates, etc. We have a lot of respect for our peers and their efforts in this regard, and we believe that collectively all these industry players including us growing the pie for all of us as a whole. Given the low penetration rate of online retail currently in our region, we believe there's a huge potential opportunity for all of us to tap. And being the market leader with existing scale and given our growth rate, we believe we have the best opportunity to tap the largest -- to take the largest share of the growing pie over time.

And in terms of Free Fire monetization and outlook, as mentioned before, we believe this Free Fire is a battle royale game. It has a lot of depth in it. It's very young and still evolving. And we're constantly building new content, new modes of playing into this game. And we believe that as we continue to see organic user growth across markets including our core market in Southeast Asia, Taiwan, in Latin America as well as the new frontier markets in India, Russia, Middle East, Turkey we believe the game has a huge potential and a long runway, and we are now still focusing on continuing to grow the user base as well as deepen the user penetration.

John Ryan Blackledge, Analyst

Thank you.

Operator

Next question comes from Ranjan Sharma with JP Morgan. Please go ahead.

Ranjan Sharma, Analyst

Hi. It's Ranjan from JPMorgan. Thank you for the call. Two questions for my side. Firstly, on the gaming side, you of course had a very strong second quarter, but if I look at this -- if I look at the top end of your gamings revenues guidance, it feels like you don't -- you're not expecting any further growth in quarterly revenues in the third and fourth quarter of this year, despite having two strong launches in Speed Drifters and in Call of Duty. If you can share your thoughts around -- on how you get to this guidance. ARE you expecting any kind of maturity in Free Fire coming through? So that's the first question. Secondly, in terms of Indonesia, we have seen LinkAja, a local payment business getting access to a number of platforms across the marketplaces. I don't think it's part of Shopee yet. If you can share like if you're looking to add them as well or if you're looking to grow your own Shopee pay business. Thank you.

Yanjun Wang

Sure. So if you look at our guidance, it is based on the year-on-year growth. It is a very high rate at 142% to 157%. And if you look at our EBITDA -- adjusted EBITDA for this quarter, I believe it's higher than our adjusted EBITDA for last year the entire year. So we are continuing to see very strong growth in our game -- on the games side, and as usual we hope to be able to deliver beyond expectations. And for the new games, we have launched or start pre-registration for including Speed Drifters in the LatAm market as well as Call of Duty: Mobile in Southeast Asia and Taiwan as mentioned our focus would initially still be on growing the user base, understanding the user preferences for this new genre. In the case of Drifter, a racing game for the LatAm users. And in case of CODM, a mobile FPS game with a very big IP, but also being newly introduced to our region as being a free to play kind of mode. So there are a lot for us to work on to -- with in collaboration with the developers and to understand our markets better, understand the user preferences, grow the user base before we gradually ramp up monetization.

So in terms of payment, we obviously don't discuss any specific commercial arrangement, but we've been supporting our Shopee platform also with our own payment app and with the integration of our own self-owned e-wallet with the Shopee app over time. We've seen user adoption very encouraging signs of user adoption. And we believe that to show financial services will be one of the largest opportunities in the digital economy of our region, and we stand very well positioned to benefit from the growth of that given our own capabilities track record in that front in building up the e-payment as an infrastructure for our Shopee as well as Garena businesses as well as further growing DFS overall.

Ranjan Sharma, Analyst

Thank you for that. Maybe just one quick follow-up. So in terms of Speed Drifters, are you saying that you have not rolled out monetization for the game in Latin America right now?

Yanjun Wang

Yes. So we haven't been focusing on monetization yet.

Ranjan Sharma, Analyst

Okay. Thank you.

Operator

The next question comes from Conrad Warner with Macquarie. Please go ahead.

Conrad Werner, Analyst

Hey. Thanks a lot. Maybe just a first question on the e-commerce side of the business. The take rates are continuing to show good momentum. You are -- it sounds like you're starting to track some more commissions. Can that trend continue? In other words, I guess, we can assume that take rates should continue to rise in the second half of the year. And if that is the case what's going to drive that? Are you able to put some more commissions into the market given your scale right now? Then one other question on the e-commerce side of the business, was there any impact on FX from exchange rates on your GMV? In other words, might your GMV have been slightly understated due to exchange rate impacts? Just thinking about the average order value stuff we were talking about before.

And then just last question on the e-commerce. When you say you're leaders in all your markets what metric is that on? Is it on GMV or is it on orders or something else? Then maybe just on the digital entertainment side of the business. In the past, you gave a range for what percentage Free Fire was of the total revenues. It was 50% to 60% in the first quarter. Could we just have an update on that? And then also could we get an update on how much of free -- sorry how much of the games business the digital entertainment business was ex-Southeast Asia? And then maybe just as a last question on the digital entertainment, Beyond Call of Duty and Speed Drifters, I guess, which is a reasonably new title relatively speaking, any other games in the pipeline that we should be looking out for? And are you monetizing Speed

Drifters in Southeast Asia to a good degree right now? And then sorry, I know I'm asking a lot of questions here but the last one is just on a group level I know that you're still in investment mode, etc., but the margins in the digital entertainment are very good. As you say you're starting to fund the business with internal cash. Could we see group level profitability before the end of the year? Thank you, on an EBITDA basis? Thanks.

Yanjun Wang

Thank you. So, on the first question regarding the take rate trends, we will continue to gradually ramp-up monetization over time. That is going to be driven by first the scale of our platform as we continue to grow engage with a larger user base, larger seller base and the sellers platform derive more income from the platform. And with their margin with the right mix of categories and focus we believe that there continues to be a very good potential to gradually ramp up monetization. And in terms of the composition of the take rate, we believe that one there is potential for higher commission, as well as the handling fees, as well as advertisement income. And at the same time, we are rolling out the full spectrum of services that seller will be very happy to utilize and pay for. So if you look at Taiwan market for example, okay, this is the first market that we have achieved positive adjusted EBITDA without common expense allocation. And this is a market where we start monetizing first a couple of years ago with advertisement and then followed by the full spectrum of commissions, handling fees, as well as VAS, Value-Added Services.

By now, we have rolled out commissions for all sellers be it mall sellers, preferred sellers or other sellers across border and of course different rates based on the types of sellers and based on the categories in that market. And that has helped to increase the monetization for us. And at the same time that platform in Taiwan continues to grow at a very healthy rate. And this is what we ideally would like to see gradually roll out in all other markets as well. So by now, we have rolled out commission and handling fee for the mall sellers in all our markets. And more recently, we have rolled out the commission for star sellers in Indonesia and increased the rate for some of the mall sellers in Thailand, for example. So we believe this trend will continue. And the reason we are able to do that is the value we're delivering to our sellers and buyers in our markets for the infrastructure for e-commerce online retail tends to be underdeveloped. That also gives us more opportunities and more touchpoints with our sellers and buyers to serve them better. And that means, we also have more opportunities to charge a higher take rate over time. So that is what we believe will gradually roll out. And in terms of Forex question, I'll invite our CFO, Tony, to answer that.

Tony Hou, Group Chief Financial Officer

Yeah, sure. So we constantly monitor the constant currency key metrics like GMV and revenue growth. And then actually due to the appreciation of US dollar against some of our region's currencies like Indonesian Rupiah and Taiwan dollars, the growth profile had we choose to present using constant currency would be better than using the actual exchange rate. And having said that, we will continue monitoring the gap and we'll choose to present the constant currency, if the gap is becoming larger.

Yanjun Wang

Okay. Regarding the -- in terms of the metrics we use to measure market leadership, now we use -- we look at array of metrics to see how well our e-commerce business is growing. In some of the market, obviously our leadership is so clear, so strong that whatever metrics you use pretty much, we are the clear leader. In other metrics, there might be -- people might say this market has a different kind of GMV metrics et cetera. Now the reason we look at the range of metrics based on the disclosure in our PR including the order number, the download, the active user, time spent, in app, etc., is because looking at GMV alone can be misleading for the business as a whole. So if we tell our people to just look at GMV, the outcome might not be ideal in growing the e-commerce business, because the team will be trying to focus on growing the basket size with the higher ticket items in those more standardized goods, the lower-margin, lower-competitive modes categories such as virtual goods, electronics or even wholesale stuff.

These are easy to grow GMV. And -- but they don't lead to a healthy e-commerce platform with the core category of focus that we mentioned again and again. These are fashion, health and beauty, home and living and baby products. That's why when we look at GMV or the size of GMV, we have to ask the next-level question. What's the basket size? And what's the order number? Are you growing the GMV by growing the basket size and skewing towards the different categories of goods versus the core e-commerce marketplace categories? Or are you truly growing the order? And these orders are sustainable, high-value, high-margin orders that are real and will come back again. So, these are the categories we focus on and we look at actual orders that we believe are recurring and then can allow us to charge a high take rate, allow us to build a healthy e-commerce platform with diverse seller and user base and eventually an ecosystem around it. So that's why we look at an array of different things. Another example will be time spent in app. We focus on that because we have a deep understanding of our young users in our region. These are social-community-based native generation, native to the mobile technologies. And they like to socialize and they like to talk to each other, engage with each other and that's how they express themselves, live their lives and also do their shopping transactions.

So, on that front we have built in a lot of social gamification features, live streaming, AR features, even esports stream for example, leveraging our strength in the esports front to engage our users and build a community and follow in that. That also helps to retain users better as well as lower our user acquisition costs and make our scaling much more efficient over time. So therefore, when we look at the market leadership, we look at a host of metrics together and the healthiness -- health of the ecosystem as a whole. By that, we have disclosed consistently that we are the market leader. And for example in Indonesia, we have mentioned that we are the market leader by order for several quarters already and with a specific order number being disclosed. Going back to digital entertainment. As you can probably imagine, Free Fire continue to be a large part of the revenue although we don't specifically disclose percentage. But it's been an increasing contribution from Free Fire in the revenue mix. And in terms of region outside of Southeast Asia also without disclosing the specific percentage of -- for competitive reason, this is increasingly a significant part of our revenue as we diversify our game businesses.

Again as we mentioned, if you look at the -- our core market now just not just including Southeast Asia and Taiwan, we also refer to LatAm as part of our core market collectively there are about 1.2 billion to 1.3 billion population. That's almost the size of population of China, but with even younger population profile and higher population growth. So it's a very attractive demographic feature. And we're probably the best stand in the best position given our track record in capitalizing on such high growth, but highly diverse and complex emerging markets. In terms of our pipeline, again for competitive reasons we don't disclose specifics about pipeline. But as you can imagine, while we said that, we devote half our studio to building on Free Fire, the remaining half we devote to building up our self-development pipeline in small teams. Actually, it doesn't take a lot of people to come up with a prototype of a new game. When we built up Free Fire initially, there was a team of four or five people. And so we continue to work with all the game talent, we can find in the market and build up that team and let them run with their creativity and come up with all kinds of potential ideas that we could build into our game portfolio. And at the same time we work with top studios in the world. If you look at our track record we pretty much work with everybody in the U.S., Japan, Korea as well as China. And we I think given our wealth of user data from all the emerging markets globally with the hugely successful Free Fire game, I think we are very well-positioned to introduce new content into those markets, whether it's self-developed or licensed from third parties.

And in terms of the group level EBITDA as you rightly pointed out, we are seeing increasingly less loss in adjusted EBITDA and increasingly we are funding growth with internal cash generated. Obviously, do we -- if we want to breakeven, can we? Yeah, we can, right? As I said before, it's not the focus of the business as we are in a better than ever position to grow our ecosystem of digital economy of consumer Internet platform with some of the largest opportunities that we ever see in the region and beyond in digital entertainment, in e-commerce additional financial services. And you don't have these kinds of opportunities coming along that easily for many generations. There maybe one-time we believe that you're in the historical moment where we can capture that growth in the right region where there is still low penetration, but high growth potential. And we believe given our strong cash position, given our cash also from the game business that it can fill our internal investments, we believe we want to invest in the long-term growth of our ecosystem and will not trade that for short-term profitability. And in the longer run, when we do achieve clear leadership and build out the entire ecosystem that we envision for ourselves, for our employees, and all the stakeholders we believe it's a much more valuable business.

Operator

This concludes our question-and-answer session. I would now like to turn the conference back over to Yanjun Wang for any closing remarks.

Yanjun Wang

Thank you for joining the call today and we're happy to keep talking with our investors, analysts in case you have any further questions. And we look forward to speaking to you all again next quarter.

Operator

This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2019-05-22
Event Description: Q1 2019 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q1 2019 Earnings Call

Company Participants

- Yanjun Wang, Group Chief Corporate Officer
- Forrest Li, Chairman and Group Chief Executive Officer
- Tony Hou, Chief Financial Officer

Other Participants

- Miang Chuen Koh, Analyst
- John Blackledge, Analyst
- Conrad Werner, Analyst
- Nelson Cheung, Analyst
- Mark Goodridge, Analyst
- Varun Ahuja, Analyst

Presentation

Operator

Hello, and welcome to the Sea Limited First Quarter 2019 Results Conference Call. (Operator Instructions) Please note this event is being recorded.

I now will turn the call over to your host today, Yanjun Wang, Group Chief Corporate Officer. Please go ahead ma'am.

Yanjun Wang, Group Chief Corporate Officer

Thank you. Good morning, good evening, everyone and welcome to Sea's 2019 First Quarter Earnings Conference Call. I'm Yanjun Wang, Sea's Group Chief Corporate Officer and General Counsel.

Before we continue, I would like to remind you that we may make forward looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release. Also, this call includes discussions of certain non-GAAP financial measures such as adjusted revenue and adjusted EBITDA. We believe these measures can enhance our investors' understanding of the actual cash flows of our major businesses, when used as a complement to our GAAP disclosures. For a discussion on the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

I have here with me Sea's Chairman and Group Chief Executive Officer, Forrest Li and Group Chief Financial Officer, Tony Hou. Forrest and Tony will share strategy and business updates, operating highlights and financial performance for the quarter. This will be followed by Q&A session, in which we welcome any questions you may have. With that let me turn the call over to Forrest.

Forrest Li, Chairman and Group Chief Executive Officer

Thanks, Yanjun. Hello everyone, and thank you as always for joining today's call. Building on our very strong performance in 2018, we have kicked off 2019 on an even stronger note, with very healthy growth across our businesses. For Sea as a whole, our adjusted revenue for the quarter was $578.8 million, almost triple that of the same quarter last year. It is mainly attributable to a strong revenue growth of both our digital entertainment and e-commerce businesses. Moreover we saw significant improvement on the bottom line this quarter. Total adjusted EBITDA was negative $32 million, which improved from negative $144.7 million for the first quarter of 2018 and negative $203.6 million for the fourth quarter of 2018. We believe this is a strong indication of the potential profitability of our Group businesses.

Let's look first at Garena. Garena had a standout quarter. Adjusted revenue for the digital entertainment business grew 169% year-on-year and 70% quarter-on-quarter to $393.3 million. Adjusted EBITDA increased 311% year-on-year and 115% quarter-on-quarter to $225.8 million. In addition adjusted EBITDA margin increased to 57.4% from 37.7% for the first quarter of 2018 and 45.5% for the fourth quarter of 2018.

The strong results are mainly attributable to the following.

First, strong user growth. The number of quarterly active users reached 271.6 million, an increase of 114.4% year-on-year and 25.6% quarter-on-quarter.

Second, deepening paying user penetration with sustained strong average revenue per paying user. Our pay ratio reached 7.6% for the first quarter compared to 5.7% for the same period a year ago and 5.5% for the previous quarter.

Third, continued outstanding operating and financial performance of our first self-developed game Free Fire. It contributed significantly to the margin improvement as no developer royalty is a payable by us for the title. We are particularly pleased to see that the key metrics for the Digital Entertainment Business showed healthy growth and the improvement in the quarter. We believe this is the result of first, our proven strategy of pushing -- (technical difficulty)

Yanjun Wang, Group Chief Corporate Officer

Hello, operator?

Operator

Yeah, I am here.

Yanjun Wang, Group Chief Corporate Officer

We hear music.

Forrest Li, Chairman and Group Chief Executive Officer

(Technical Difficulty)

Yanjun Wang, Group Chief Corporate Officer

Hello, are we back online?

Operator

Yes, you are back online, yes, we have isolated disturbance.

Forrest Li, Chairman and Group Chief Executive Officer

Sorry, guys. We just have some music in the background just now. Sorry for the interruption. We are particularly pleased to see that the key metrics for the Digital Entertainment business showed healthy growth and improvement in the quarter. We believe this is a result of first, our proven strategies of pushing further into self-development and new markets globally. Second, our relentless efforts to keep bringing new and engaging content to our users. Third, our constant focus on enhancing games and monetization features, based on a deep understanding of local preferences and conditions. And last, but not least, our strong efforts in eSports and community building.

Free Fire is a great example. This smash hit is our first self-developed title. It recently surpassed 450 million registered users and 50 million peak daily active users in over 130 markets globally, making it one of the most popular mobile games in the world. It was also the second most downloaded mobile game globally across the Apple app store and Google Play Store combined in the first quarter, according to App Annie. Moreover, we have been working hard to enhance monetization of the game. We further localized our offerings and pricing to appeal to users of different markets and introduced new content that incentivizes users to convert to paying users through personalized discounts and rewards.

On the eSports front, we held our first Free Fire World Cup and recorded over 27 million online views in total. At its peak, we had more than 1 million people globally watching the competitions online at the same time. For the rest of the year and beyond, we will continue to focus on growing this first self-developed title of ours into a top-ranking and long-living global franchise.

At the same time, we are highly focused on bringing high quality games from top global developers to our users, which also further strengthen our game portfolio and pipeline. For example, Speed Drifters, the first game we launched early this year under our right-of-first-refusal arrangement with Tencent, has quickly become one of the best performing games in some of our key markets, in terms of both user growth and financial performance. Our efforts in this car racing game delivered meaningful contributions to Garena's strong results for the quarter, and helped us gain further experience and expertise in more casual genre. This can, in turn, help us further broaden our game portfolio over the long run.

Speed Drifters' success is a great example of why global top IP holders choose to work with Garena because they recognize that we deliver top results. On that note, in April, we announced that Garena is partnering with Tencent and Activision to publish Call of Duty Mobile in our core markets in Southeast Asia and Taiwan. Call of Duty Mobile brings the classic characters and game play of this much-loved FPS series to mobile for the first time. We will share more information on this game in due course.

Looking to the rest of the year, I believe Garena is in a strong position with an excellent stable of games, as well as lots of opportunities for growth for the top games in our portfolio and pipeline. Last quarter, we provided adjusted revenue guidance for our digital entertainment business of $1.2 billion to $1.3 billion for the full year of 2019. This represents 81.5% to 96.7% growth year-on-year, which is a highly ambitious goal for the size of our business by any measure. Still, we are confident that we are wellplaced to meet or even beat this ambitious target. We may choose to revise our full-year Digital Entertainment guidance upwards next quarter when we have more data.

Now we turn to Shopee. At the end of 2018, we outlined some very clear objectives for 2019; to continue to capture the growth opportunity ahead, ramp up our monetization efforts, and do so with growing efficiency. And I'm pleased to say that in the first quarter we have delivered across all three fronts.

In terms of continuing growth, despite Q1 being a traditionally low season, we recorded a very strong GMV of $3.5 billion. Compared to the same period a year ago, that represents close to 82% growth. We also recorded strong order numbers of 204 million, an increase of 83% year-on-year. Moreover, in Q1, Shopee was the Number One app by downloads in the Shopping category across Southeast Asia and Taiwan, according to App Annie. As the market leader, we believe Shopee is capturing an outsized proportion of the market growth.

Turning to monetization, we are making excellent progress with our efforts to grow Shopee's revenue. In the first quarter, adjusted revenue increased 342% year-on-year to $149.2 million. Of this, $102.0 million was of marketplace revenue, which was up 363% year-on-year and 16% quarter-on-quarter. This reflects the development in each of our marketplace revenue streams transaction-based fees, advertising, and value-added services. The increase in revenue is a result of our platform growth as well as the increasing value of our services to better meet the evolving needs of our users.

And finally, let's look at our growth efficiency. Sales and marketing expenses as a percentage of GMV declined once again to 4.2% in the first quarter. Moreover, sales and marketing expenses in absolute dollar terms declined quarter-on-quarter for the first time in Q1, even as we continued to experience strong growth across the platform. As we have noted in previous quarters, we are benefiting from ever-improving economies of scale as we extend our leadership position.

All of the above is well reflected in our solid bottom line performance. Adjusted EBITDA for e-commerce improved by more than $42 million quarter-on-quarter to negative $235.3 million, compared to negative $277.5 million in Q4. I am also pleased to note that in Taiwan, Shopee was EBITDA positive before allocating headquarters costs for this quarter. Therefore, we believe Shopee is off to a great start this year, and will continue to focus on successfully executing on our stated strategies for e-commerce.

In summary, while we are very encouraged by our results for the first quarter, we believe we still have a lot of work ahead to further enrich and enhance our services to users, and we continue to see significant opportunities to capture an outsized share of the biggest growth opportunities in our region's digital economy. Therefore, while our strong results for the first quarter demonstrated our potential profitability, we will continue to focus on investing prudently and efficiently in growth. Moreover, when we make such investment decisions, we will continue to prioritize sustainable growth and long-term market leadership considerations, as opposed to short-term profitability. This is because, particularly for the e-commerce business, we believe scale and strong market leadership will translate into long-term profitability.

Finally, please allow me to take this opportunity to say a few words about our company's 10th anniversary, which we celebrated just on May 8. On behalf of the entire Sea team, I would like to thank our customers, investors, partners and friends for all your support and contributions to this young company's growth over the last decade. We began with very humble roots in a shop house in Singapore. When we started each of our core businesses, we had no prior experience and had to compete head on with many much longer established, bigger and better funded players. Our teams persevered with passion and conviction. We pursued our own path. And we have become the market leader in the areas we chose to focus on.

Looking to the decades ahead, we will continue to be humble, to serve our customers, investors and partners to the very best of our ability, and we will strive always to deliver beyond expectations. And I hope we can continue to count on your valued support in the years to come.

With that, I will invite Tony to share more about the financials.

Tony Hou, Chief Financial Officer

Thank you, Forrest. And thanks to everyone for joining the call. We have included detailed quarterly financial schedules together with corresponding management analysis in today's press release. So I'll focus my comments on the key financial metrics.

For Sea overall, our first quarter total adjusted revenue was $578.8 million, an increase of 194% year-on-year and 49% quarter-on-quarter. This was mainly driven by the growth of our Digital Entertainment business, especially our self-developed game, Free Fire and our continuous monetization efforts in our E-commerce business in the past quarters.

Digital Entertainment adjusted revenue was $393.3 million, an increase of 169% year-on-year and 70% quarter-on-quarter. The growth was primarily driven by the enlarged paying user base as we continue to improve the monetization of our games, especially Free Fire. Digital Entertainment adjusted EBITDA was $225.8 million, an increase of 311% year-on-year and 115% quarter-on-quarter, thanks to the strong topline growth and our self-developed game, accounting for an increased share of revenue. The increase was also partially due to the improved operating efficiencies as shown by the lower sales and marketing expenses as well as general and administrative expenses as a percentage of adjusted revenue.

E-commerce adjusted revenue was $149.2 million, up 342% year-on-year and 18% quarter-on-quarter. Of this $149.2 million in adjusted revenue marketplace revenue was $102 million, up 363% year-on-year and 16% quarter-on-quarter, while product revenue was $47.2 million, up 304% year-on-year and 20% quarter-on-quarter. As highlighted by Forrest earlier E-commerce adjusted EBITDA loss narrowed to $235.3 million this quarter. We will continue driving high quality growth by serving users' needs better and focusing on operational efficiencies.

Digital Financial services adjusted revenue was $2.8 million, a decrease of 28% year-on-year from $3.9 million in the first quarter of 2018, as we focus our efforts on strengthening the infrastructure to support our existing platforms. Adjusted EBITDA loss was $11.9 million in the first quarter of 2019 compared to a loss of $8.6 million in the same period of 2018. This was primarily due to our continued efforts to integrate our AirPay and Shopee platforms. Returning to our consolidated numbers we recognized a net non-operating loss of $442.8 million in the first quarter of 2019. This was primarily due to the fair value loss of $436.1 million on 2017 convertible notes, as our share price during the quarter significantly exceeded the conversion prices of these notes.

We had a net income tax expense of $7.2 million in the first quarter of 2019, which was primarily due to withholding tax and corporate income tax recognized in our digital entertainment segment. Finally net loss, excluding share based compensation and change in fair value of the 2017 convertible notes was $237.3 million in the first quarter of 2019 as compared to $186.7 million for the same period in 2018.

With that let me turn the call back to Yanjun.

Yanjun Wang, Group Chief Corporate Officer

Thank you, Tony and Forrest. We're now ready to open the call for questions. Operator.

Questions And Answers

Operator

(Operator Instructions) And the first question is from Miang Chuen Koh with Goldman Sachs.

Miang Chuen Koh, Analyst

Hi, good morning. Congratulations on this strong set of numbers. A few questions for me. Firstly can you give us a sense of Free Fire revenues for this quarter and how are you increasing monetization for this game, since paid user of this went up significantly quarter-on-quarter. Secondly Free Fire dollars appears to be stabilizing last few months. Will we also expect revenues from Free Fire to be increasingly stable in coming quarters as well, versus what we've seen in first Q. And besides Call of Duty, would it be possible to give a bit more color on the pipeline of new games for the remainder of this year. Thirdly E-commerce, the cost of sales went up significantly Q-o-Q. Can we get more color on the cost of components that drove up this increase. And lastly you know for E-commerce as well, cash burn trends in coming quarters, if we could get some guidance in terms of what to expect. Should we be thinking it would -- it should continuously come down Q-o-Q or should we look at it more of a Y-o-Y, because I believe previous guidance is that we should see E-commerce cash burn being lower this year versus last year. Are we still I guess on track? Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Sure. Thanks for -- let me talk about the Free Fire first and we are very happy with the Free Fire results, and as you can tell from our this quarter's result and we see significant improvement in terms of the monetization of the game. I think like -- well I think this is mainly reflect our effort to continually finding better ways to engage our gamers and to understand them and understand what they want. I think there is -- across the quarter we have different ways to try out the monetization mechanism, and some work very, very well, some may not work very, very well. So -- but overall like we feel very confident and we kind of like already got a strong sense okay, what is ideal way to monetize this game like. But at the same time we believe we'll be overall cautious to make sure whatever the monetization we have we will make sure the communities are healthy and that the engagement level we serve with the gamers is high and the gamers' satisfaction is high. So in a way it's like we're happy to see our monetization is improving and at the same time the engagement level of the gamers is improving as well.

In terms of the user growth, and actually we see across the market, we still see very strong growth like of our new users. Right. So as we talk about just now, right for this recent quarter we had more than 50 million daily active users. That is still a significant increase from the previous quarter and specifically we see some accelerating growth for some new market, which we may not really focused on previously. So as we talked about in the previous earning calls, so we see tremendous users coming from Southeast Asia and Latin America. Actually recently we started to see some new pickup in some exciting markets such as India, Russia and Turkey and we are seeing those market actually their user growth rate is accelerating.

In terms of the new game, yeah, so at this moment, yeah, as we just talk about we were going to launch Call of Duty Mobile and we are -- we have a very high expectation of this game like this is a very, very high quality game. I think like in the next couple of months what we're going to focus on is how to make sure we find a better way to position the game in our respective markets and how to make sure we optimize the local operations. We're very confident of the quality of the game and content and so we believe we're going to see a very good result from the launch of the game.

And for other games for competitive reasons we are probably not able to talk too much at this moment. But in general as we mentioned, so we are pretty happy with the potential pipeline for the rest of the year. I think like in terms of the big directional ones, best opportunity, we are very excited about these because of Free Fire now doing very, very well in Latin America. And this generate a lot of interest from global developer community and which they never really launched their games in Latin America and they see our success. They come to us and we have multiple discussions with the global game developers to potentially launch their portfolios in Latin America like -- so with us. So we see this could tremendously increase our addressable market beyond Southeast Asia. So we're very excited about this opportunity.

Tony Hou, Chief Financial Officer

I'll take the cost of E-commerce question. So the major cost elements are the costs of logistic services, bank transaction fees, server and hosting expenses, staff costs as well as some warehousing costs. And the cost is relatively stable compared to last quarter despite some slight increase which is mainly due to the server hosting and staff expenses. And because our monetization improved this quarter, our gross profit actually improved quite significantly compared to last quarter.

Yanjun Wang, Group Chief Corporate Officer

Right. And in terms of the Shopee overall cash burn, while we don't give guidance on this, as you can see that we see a very strong quarter in terms of the bottom line as well not only sales marketing as a percentage of GMV but in absolute dollar terms also dropped quarter-on-quarter. Obviously there is seasonality to E-commerce and we do time our marketing spend in accordance to seasonality to achieve maximum efficiency. In terms of the sales and marketing spends going forward, there could be fluctuations as we capture growth opportunities in the market. We believe e-commerce is still at a very nascent stage in our region and we stand very well to gain an outsized benefit of the fast growth of the E-commerce as a whole in the region, given our market leadership position.

And therefore while we continue to aim to grow very efficiently and invest prudently on long term sustained growth, we won't be able to guide on the exact dollar spend quarter-on-quarter. We want to retain some flexibility. For example in terms of marketing spend most recently we announced the appointment of Shopee as a title sponsor of Indonesian Premium Football League, Liga 1. And it is -- as part of the sponsorship package Shopee has launched a new logo branding based on Shopee's orange, distinctive orange color. And this sponsorship has allowed Shopee to reach the general public across the market, especially our targets of young consumers. So these are one off examples of good marketing opportunities that we might take advantage of from time-to-time as we consolidate our leadership position across the market and further promote the brand awareness. So on that front while we are very encouraged by the results and we continue to want to grow very efficiently, we do think there could be fluctuations in the overall plan. But on the other hand in terms of group bottom line, while we don't give any guidance we think reasonably likely will be better than the current market consensus.

Miang Chuen Koh, Analyst

Understood. Thank you very much.

Operator

Thank you. And the next question comes from John Blackledge with Cowen and Company.

John Blackledge, Analyst

Great. Thank you. Just a couple questions, on the Digital Entertainment side, with the big increase in margins what's a good way to think about the margin profile for digital entertainment you know kind of over time, just given expected growth of self-developed games?

And then on Shopee you seem to imply that market share gains are rising obviously with the great results again this quarter. Can you just talk about how Shopee is doing relative to competitors and any general color on the competitive environment within the E-commerce in Southeast Asia? Thank you.

Tony Hou, Chief Financial Officer

Sure. Thanks for the question. I will talk about the game EBITDA part and then Yanjun Wang will comment on the Shopee questions. And for Garena EBITDA margin trend, so our -- as we talk about and during the call just now our adjusted EBITDA margin in this quarter was very high, above what we believe is overall industry average. So our EBITDA margin is mainly affected by the mix of revenue contributions from self-developed games and the licensed games, spending on sales and marketing and R&D among other things. So as mentioned before our strategies for the game business are continuing to bring top quality content to our users whether it is a self-developed or licensed to further strengthening our game development capability to extend the globally beyond our core markets. So we may continue to introduce third party IP, so we may also spend more on marketing as we bring new games to market and further growing our developer team are now expanding into markets outside our core region. So as we successfully executed our growth strategies, our adjusted EBITDA margin for the game business could fluctuate.

Yanjun Wang, Group Chief Corporate Officer

In terms of the competitive environment of Shopee, we continue to see Shopee extending its leadership position especially in the core categories and the key markets. As we mentioned before we believe Shopee is the market leader in all of our markets, with perhaps the exception of Singapore, which is relatively a smaller market that we haven't been strongly focused on yet. And in terms of the market leadership position, we think, we're multiple times larger than our next competitor in Taiwan for example. And as we mentioned in the earnings release that for Q1 2019, we already achieved adjusted EBITDA positive before HQ cost allocation in Taiwan. And this is an example where we believe that we have successfully monetized on the platform and continue to do so, as we achieved a strong leadership position to further grow the platform environment. We believe the positive dynamics will play out in all the other markets that we are currently operating in. For example in the largest market Indonesia, we recorded a daily order of 0.9 million again this quarter for -- sorry Q1, which is again extending our leadership further in the market. And in other markets, for example, EBITDA we also believe we're about two times larger than our next competitor in Thailand and Philippines and Malaysia. We've also become the market leader. So all these markets as we gradually further certify our leadership position we believe the positive dynamics that we are seeing in Taiwan will start to generally play out in those other markets as well.

John Blackledge, Analyst

Thank you.

Operator

Thank you. And the next question comes from Conrad Werner with Macquarie.

Conrad Werner, Analyst

Hi there. Thank you for the comments on the competitive landscape. Could I just maybe also see when you talk about the market leadership. What metric are you generally homing in on? Is it orders? Is it the GMV itself? You know when you talk about being two times the size of the next competitor in Vietnam for example, what metric are you generally looking at? That's the first question. And then a second question on the E-commerce costs. In the previous quarter you had talked about the shipping subsidies declining in absolute terms in the fourth quarter. Has that trend continued in the first quarter? Are we getting away from shipping subsidies, as kind of one of your key marketing tools in favor of other forms of expenditure? And could you maybe provide some color on that? And then just maybe on Call of Duty itself, what quarter do you expect that to be launched? Presumably it may not be launched in all markets at once. But when does that kind of come out in a few markets I guess. You talked about a few months before but is it kind of Q2, Q3, Q4? Thanks.

Forrest Li, Chairman and Group Chief Executive Officer

Sure. Okay. So let me start, and Yanjun please feel free to add on. And for Call of Duty, we may, based on that we are still working with the Tencent, Activision to figure out what is the best time to launch it. But looking at the current schedule it probably will be in the late Q2 or early Q3. So that's the timeline we're looking at. So we want to capture the opportunity during the quarter for the summer break of schools. And so for Shopee for E-commerce and the key metrics we look at is quite straightforward, is the orders and GMV. And on top of that -- and we are also specifically looking at this category by category. So we are very focused on the key categories. We have been really pushing. So like a fashion, like home and living and health and beauty. So this is the key categories. I think like, so in those key categories and our leadership position is even stronger. And beyond that, I think in terms of the operations and we do care about in terms of -- because we are mainly we focused on the mobile users, right. So we're very focused on our traffic engagement, on our Shopee mobile app. So in that sense like the daily active user is much more active users and the time spent are the key metrics we look at.

Yanjun Wang, Group Chief Corporate Officer

In terms of shipping subsidies, yes. It's declined quarter-on-quarter in Q1 again. But overall you know Q1 is a lower season, so I wouldn't take that to be a promise that it will continue to always decline Q-o-Q. Thinking about shipping subsidy, I think it's important to highlight that it continues to be a effective marketing message. In fact we have less than a quarter of people getting free shipping in our largest markets while the market take the free shipping to be a very strong marketing message from Shopee. So we are spending very efficiently on that. And overall it's more of a new user acquisition tool as our social sellers bring their followers onto our platform to encourage them to place orders through Shopee as opposed to some other social websites. This is a strong message that the buyers get the direct benefit that they can easily understand. So overall we think the shipping subsidies tend to stabilize in the longer-run but there might be fluctuations in the short to medium-term.

Conrad Werner, Analyst

Thank you so much and I'm going to be rude and just maybe ask one more. Could you maybe talk a bit about how much digital entertainment revenue came from outside southeast Asia? It's a metric you provided over the last two quarters. Do you have an update -- I think it was 28% in the fourth quarter, what about first quarter 2019?

Yanjun Wang, Group Chief Corporate Officer

Yeah, we didn't specifically discuss that number but suffice to say that it continued to grow. And as far as I also mentioned earlier we are very focused on growing our markets outside of Southeast Asia now given our self-development capabilities with Free Fire having reached a global audience and being one of the largest Battle Royale games as well as mobile games globally. We do hope to expand further expand into the emerging markets beyond our core markets as well as the other markets that we currently see very strong growth. I think in terms of the specific numbers it's already one-third. So we are seeing very strong growth on that front as well.

Conrad Werner, Analyst

Thank you so much.

Operator

Thank you. And the next question comes from Nelson Cheung with Citi.

Nelson Cheung, Analyst

Hi, management, thanks for taking my question and congratulations on the solid results. I have a question on E-commerce. Given that we noticed that the E-commerce monetization rate is very high at 4.2% in first quarter 2019 we would like to ask whether this monetization rate is a normalized or sustainable monetization rate for E-commerce in long run. And can management elaborate more on what actually contribute to the strong improvement in terms of monetization rates? And maybe can management can provide more color in terms of ranking by monetization contribution and what's the growth rate by each type of E-commerce revenue stream? And a quick question on Speed Drifter. Can management provide some more color on revenue contribution of Speed Drifter and the comment on life cycle of this game would be great as well. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Sure. In terms of the monetization rate, in the longer run obviously E-commerce is still at a very early stage, as part of the digital economy of our region and we believe it's the biggest opportunity actually in that part. We believe in the longer run, we hope to see a monetization take rate that is close to our global peers for marketplace, e-commerce. Of course there is a path to get there and we see very positive directions, we're moving in this front.

And in terms of overall contribution from the different streams of revenue we see positive trends in every type of monetization avenue we have. Especially on the marketplace front, we see very encouraging signs in terms of the uptick in transaction-based fees as well as advertising and VAS upfront. More recently as we gained strong market leadership positions across the region and as we focus on further promoting the healthy growth of the ecosystem for our e-commerce platform, we have rolled out more transaction-based fees across platforms to help the sellers grow better and distinguish the better seller and bigger seller from the crowd. So that they are more incentivized to serve the buyers better.

By monetization, we not only just focus on getting money from them, we are very much focused on providing them better, more services that they would desire. On that front, we are very confident of our ability to keep raising the monetization rate over time. We don't specifically disclose the each stream of monetization or strategies quarter-on-quarter for competitive reasons but as mentioned earlier, we think the market place take rate contributes quite significantly to the overall take rate increase in this quarter.

In terms of the Speed Drifter it is very successfully launched in Q1 in most of our markets and we see a very strong performance in terms of both user adoption, paid user ratio as well as monetization overall and it did contribute meaningfully to the uptick in our adjusted revenue. And we think it's one of the top four games in our portfolio now.

Nelson Cheung, Analyst

Thank you very much.

Operator

Thank you. And the next question comes from Mark Goodridge with Morgan Stanley.

Mark Goodridge, Analyst

Hi, guys I just have two questions. One on Call of Duty, just after -- can you just give us a bit of strategies around how you guys are going to manage any potential cannibalization of Free Fire when that game launches? And then secondly just on E-commerce, we saw you introduce some monetization like Q4, which obviously we have seen the results here in Q1, but specifically could you tell us what has been the reaction of your competitors in Thailand and Indonesia and Vietnam where you've introduced the monetization? Have we seen the competitors follow suit and introduce exactly the same measures in those markets. Thanks.

Yanjun Wang, Group Chief Corporate Officer

In terms of Call of Duty, obviously it is a very well-known franchise, very big IP with its core followers in the West and we're very excited about bringing in to our region. We believe the experience, although we're still working on with the developer about the exact content that's tailored for our region, but overall experience will be more of a classic FPS action based kind of game.

I think that differentiates itself from Free Fire, which is a more Hybrid Battle Royale game with fantasy elements, imaginative content. So on that front we're not too worried about cannibalization. When we take on any new content we would carefully analyze its interaction with our existing portfolio. So we are often -- we are of course very careful about that as well.

In terms of monetization and the competitive behavior of our competitors so we don't comment on our competitors or other players in the market. We think overall our monetization ability is -- was affected, mostly dependent on our ability to serve our sellers as well as the return the value adding the sellers derive from the platform as opposed to what the competitors are doing. So we're not really that much influenced by their behavior.

Mark Goodridge, Analyst

But we've clearly seen that Lazada have followed. They've introduced commissions similar to your commissions in Vietnam. But are you able to make a comment to say whether or not they've done the same thing in Indonesia.

Yanjun Wang, Group Chief Corporate Officer

I think in Lazada, we haven't seen they have a touch higher commission in Indonesia. But again I think they do that in historical periods. All other players have done different things. They may or may not charge commission, they may increase or decrease commissions as we continue to grow and extend our market leadership positions. And so there hasn't really been any great impact on our business or how we think about our own monetization strategies.

Mark Goodridge, Analyst

Okay. Thank you.

Operator

Thank you. And the last question comes from Varun Ahuja with Credit Suisse.

Varun Ahuja, Analyst

Yeah. Hi, good money management and congrats on a good set of numbers. First on online games a few questions on Free Fire, can you comment how do you see this game life? Because obviously this game has done really well. Looks like 2019 will be strong for you because of Free Fire. But beyond that generally when you have discussions, what do you see of this Battle Royal genre, which is going still strong. How much as an investor we should view this game life over the two to three years period.

Secondly on self-developed, can you give as the last few quarters you have given how much of revenue is being contributed by self-developed game and what percentage of revenue came from mobile for this quarter? Thirdly if you can elaborate any other self-developed games that you're looking at in terms of genre, in order to increase that component that would be helpful.

And lastly as you briefly mentioned you may look at the Latin American market. So how should we look at this space? Are you in any advanced stages of discussions or is it a 12 to 18 months where you away [ph] from looking at that space? Are you looking any -- have you started making some investments? Those colors would be helpful. On e-commerce, I know you don't break it up that revenue by various market place by various components. But is it fair enough to say that value added services still remains the largest contribution of realization rate or take rate purely from a marketplace perspective excluding the product revenue those will be helpful. Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Sure let me start and Tony and Yanjun feel free to add on. And for Free Fire, actually like we are pretty happy about what we have seen in terms of the trend. And to be honest because this is a very new genre and there is not -- for the industry there is not much historical data we can look at, in this specific genre in terms of the life cycle.

So we have several quarters ago we may have shared a similar -- like we have the similar questions you ask. But like looking at a trend now we are pretty happy and we feel very optimistic, that the reason is that we see that the gamers engagement level is increasing right in terms of how often they come to play the game and how much right and in terms of every game play session how long they play the game. And we believe -- we see that still there is a lot like enthusiasm about the genre specifically on Free Fire as well in the gamer community.

And as I mentioned just now we even see accelerating user growth in certain new market. So if we do feel there is a still a -- we do still feel there is a long way to go. And for Free Fire and specifically I think also for the Battle Royale for the genre itself we believe this genre suggests that their starting page right under is compared to MMORPG game compared to like mobile or FPS game, so this genre is just at the very beginning. So the genre itself will continually evolve and we believe this is going to provide a huge opportunities for other like game studios players, specifically they want to focus on this genre.

Of course because of the success of Free Fire we think we are very, very well positioned as the game studio, so in this genre to tap on this opportunity because we have learned a lot through the Free Fire development and we have a lot of like a real-time user data, we understand that the gamers of the genre behavior, their preference pretty well. I think we have a lot of insight on that. In that sense we are very confident.

So we are going to continually invest in the development and adding the content and the different ways to monetize the game and the social features, community features and even the live streaming features, all those type of things into the game. And so in terms of the -- I think you asked about what is the percentage of our Garena revenue for the sub developed game. I would say that, at this moment it's a pretty -- pretty much -- accounts for 50% to 60% of our total game revenue from -- for our self-developed games.

We do have several like development in our like a new title development in the process. I think it's still too early to specifically talk about any individual of those -- those games, but we remain a very kind of like a fast execution approach. Really we have -- just have a very small team probably five to six people and to build our idea and to start to build up the prototype.

And when we have the prototype and we quickly launched in certain market without mentioning Garena brand. And we want to see how -- we want to collect the initial set of the data from the users especially on the retention rate and the organic growth, user growth rate and that is the key metric when we evaluate, we want to continually develop the game or potentially launch the game, or we just think, well this is -- probably this idea doesn't work. We want to just focus on -- shift our focus to some other projects. So -- and I think this is kind of like a very dynamic evaluating process and that could be a very time efficient and cost efficient way to develop the game.

And in terms of the Latin America, we are very excited about the opportunity we have observed there. So Free Fire is doing very, very well. And so I think like that the gamers there, like they are equally enthusiastic about the games compared to our core market in Southeast Asia. So we have several discussion leads with the multiple game developers like for specifically for that region. And we also -- we all see the good opportunity there. Specifically I think we mentioned this before.

So we are in the discussion with Tencent to potentially launch Speed Drifter in Latin America as well. So the game performed very, very well in Southeast Asia. So we are happy about the result we have seen and the potential of the game in other market. And we think it's a kind of a global popular a topic right among gamers and the general audience. So we think we may see good potential there as well. But at this moment because this is a kind of like a new game, we still want to test out.

So we want to -- before we make the decision to launch the game we want to make sure, okay, in terms of the specific game graphics of Speed Drifter, the gameplay, is it like a really kind of like a suitable for the Latin America gamers? Do we need to make any adjustment before launching the game. So we are closely working with Tencent on that.

Yanjun Wang, Group Chief Corporate Officer

Right, in terms of the components of the take rate, as you mentioned, VAS is a large part of the marketplace take rate simply because it's recognized growth level for us, based on our business model as we charge the fees to the sellers, and then outsource the logistics to third party logistics services provider, somewhat like a China [ph] model. On that front, overall we think we're close to break even for the logistics part and but important to note that sales, sorry the transaction based fees, as well as advertising is a significant part of our market place take rate. And more importantly that the increase we're looking at in the marketplace takeaway is largely attributable to the increase in a tax rate based on transaction based fees as well as advertising.

Varun Ahuja, Analyst

Thank you, that's helpful. Just couple of more things. PUBG lite was launched last quarter, so just wanted to understand how much it has helped. And you didn't give the indication of what percentage of revenue is coming from mobile. That would be helpful. And lastly on Latin America, given you're looking at launching potentially the Speed Drifter, how should we look at the investment in Latin American market. Will you be at similar scale as the new core market? Do you need a physical presence? Or still want to do it from here? Any commentary on that will be helpful. Thank you.

Yanjun Wang, Group Chief Corporate Officer

Yeah. So I think -- as we're getting close to our time, I'll take these questions and if there's any further discussions we can continue another call later. So in terms of PUBG lite, we have published in most of our core markets. We haven't stopped monetizing it yet. And the performance is as expected. In terms of percentage of revenue from mobile and LATAM, sorry is that the question you just asked?

Varun Ahuja, Analyst

Yes. Percentage of revenue from mobile, gaming revenue from mobile.

Yanjun Wang, Group Chief Corporate Officer

Okay. So percentage of revenue from mobile continued to increase. And we think overall mobile is the largest opportunity in terms of digital entertainment segment, while we continue to see a strong core base for our PC users, the overall percentage of mobile will become a very significant part of our business overall. So yeah, it continues to increase from last quarter.

Varun Ahuja, Analyst

Thank you.

Operator

And this is all the time we have for questions right now. So I would like to return the floor to management for any closing comments.

Yanjun Wang, Group Chief Corporate Officer

Great, thank you operator. Thank you everyone for joining today's call. We look forward to speaking to you all again next quarter.

Forrest Li, Chairman and Group Chief Executive Officer

Thank you.

Tony Hou, Chief Financial Officer

Thank you.

Operator

Thank you. The conference call has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2019-02-26
Event Description: Q4 2018 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q4 2018 Earnings Call

Company Participants

- Howard Soh
- Forrest Xiaodong Li
- Tian Yu Hou

Other Participants

- Miang Chuen Koh
- Alicia Yap
- Mike Olson
- Varun Ahuja
- Conrad Werner
- Andrew J. Orchard

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone, and welcome to the Sea Limited Fourth Quarter and Full Year 2018 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] And please note that today's event is being recorded.

And I would now like to turn the conference over to Howard Soh. Please go ahead.

Howard Soh

Thank you very much. Good morning and good evening, everyone, and welcome to Sea's 2018 fourth quarter and full year earnings conference call. I'm Howard Soh, Director of Corporate Development and Strategy at Sea. Before we continue, I'd like to remind you that we may make forward-looking statements which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes a discussion of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA and adjusted net loss. We believe these measures can enhance our investors' understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

Let me begin by introducing the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; our Group Chief Financial Officer, Tony Hou; and our Group General Counsel, Yanjun Wang.

Forrest and Tony will share strategy and business updates, operating highlights and the financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have.

With that, let me turn the call over to Forrest.

Forrest Xiaodong Li

Thanks, Howard. Hello, everyone, and thank you for joining today's call. I'm very pleased to announce that we closed out 2018 well ahead of our ambitious target. Building on our strong results in the fourth quarter, we exceeded the high end of each of the projections we provided in our latest guidance last year.

Let me start by calling out Garena's success. Our digital entertainment adjusted revenue for the full year of 2018 reached $661 million, exceeding the high end of our guidance by $41 million. In the fourth quarter, we recorded adjusted revenue of $231.4 million, up 60% from the third quarter and it is expected to show further robust growth in the first quarter of 2019. And our adjusted EBITDA margin for the quarter rose to 45.5% compared with 37.2% for the previous quarter. It is expected to improve further in the first quarter of 2019.

We believe Garena's sustained strong performance underlines our success in executing our core strategy to materially expand our digital entertainment business from being a PC-focused regional publisher to a global developer and a publisher, with core strength in mobile games and a key focus on emerging markets which greatly expands our total addressable market guide.

Free Fire is now one of the most popular battle royale games in the world. We recently hit a new record high of more than 350 million registered users and more than 40 million peak daily active users. According to App Annie, for the full year of 2018, Free Fire was the fourth most downloaded mobile game in the world across the Apple App Store and Google Play Store combined. It has also hit the milestone of recording more than 100 million monthly active users. Importantly, we are also making excellent progress on monetizing Free Fire's massive and highly active user base and this is reflected in our adjusted revenue growth and EBITDA margin improvement.

One of the crucial factors in Free Fire growth is the fast-growing and engaged global community of players. Building on this strong community sentiment from late 2018, we have been rolling out the Free Fire World Cup, a global eSports tournament. We believe this global tournament will help to drive sustained excitement and solidify Free Fire's position as one of the leading games in the [indiscernible] (00:04:39) globally.

As Free Fire success has demonstrated, we believe that Garena has built a unique set of capabilities in developing and publishing global hit games that also address the needs of gamers in fast-growth emerging market. We have a deep understanding of the unique profiles and the needs of gamers in such market and unrivalled access to data and insights about these gamers because of our huge user base. We are also deeply rooted in this market with strong local operation capabilities and not only in our core market but also in other major markets like Latin America.

More importantly, with our strong technology and execution capabilities, we are able to quickly identify and take advantage of market opportunities. We now have a strong and growing game development team with more than 200 developers in our game studio in Shanghai who are working on enhancing Free Fire and are building out our self-developed games pipeline. Free Fire is a great example of how quickly we are able to identify and tap into new market opportunities. It was one of the first mobile battle royale games to come to market.

At the same time, our game publishing business continues to grow from strength to strength as global IP holders recognized our unrivalled ability to tap into the fast-growing game communities in our region. For instance, we have begun loading out Speed Drifters as the first game that we are publishing under our right of first refusal arrangement with Tencent that we announced last quarter. And I'm pleased to say that we have agreed with PUBG Corporation to bring into our key market in Southeast Asia PUBG LITE, a PC game adapt from their global hit game, PUBG, tailored for our region.

Looking to the year ahead, we intend to continue to drive growth in our digital entertainment business as we continue to build out a world-class in-house game development arm and strengthening our publishing capabilities.

Turning to e-commerce. Our goals for Shopee in 2018 was to continue to strengthen its market leadership position across its key markets with increasing efficiency and to ramp up monetization and I'm pleased to say that we have delivered on all front. E-commerce GMV for the fourth quarter was $3.4 billion, representing 27% growth on the $2.7 billion in the third quarter.

During the quarter, we recorded 206.9 million orders, up 31% from the third quarter. Meanwhile, during the 24 hours of our 11.11 sale in 2018, we see the new record for Shopee of over 11 million orders in a single day. And just one month later, during our 12.12 sale, we broke that again, recording over 12 million orders in 24 hours on December 12. Out of those 12 million orders, approximately 5.4 million came from our largest market, Indonesia.

Shopee's continuing certification of leadership in Indonesia is a powerful demonstration of the strong flywheel effect it enjoys. In the fourth quarter, Shopee recorded total orders of 83.8 million or a daily average of 0.9 million in Indonesia, further extending its leadership as the largest e-commerce platform there.

For the full year of 2018, Shopee achieved $10.3 billion in GMV, which was above the high end of the [ph] released guidance (00:08:51) of $9.7 billion we provided in the third quarter. Reaching $10 billion in annual GMV was an important milestone for Shopee and an impressive achievement for platform that is just three years old.

You can see the sustained improvement in the efficiency of our sales and marketing spend. In the fourth quarter, sales and marketing expenses as a percentage of GMV fell once again to 5.4%, down from 5.7% last quarter and 8.5% for the same period a year ago. In fact, shipping subsidies declined in absolute dollar terms in the fourth quarter compared to the third quarter.

It is important to note that Shopee achieved this sustained improvement in marketing efficiency while its GMV grew by 27% and orders grew by 31% quarter-on-quarter, demonstrating that we are able to both grow our platform while increasing efficiency at the same time. We are able to do this because of the durable leadership position we have achieved.

We expect the sales and the marketing expenses to start trending down in absolute dollar terms this year as we continue to scale with greater efficiency, benefit from strong organic user growth and solidify our market leadership in the region.

On the monetization front, e-commerce adjusted revenue grew over 16 times year-on-year to $290.7 million for 2018 as we ramp up our monetization efforts during the year. And in the fourth quarter, adjusted revenue grew more than 78% compared to the third quarter to $126.9 million. Moreover, we expect Shopee to record a positive quarterly adjusted EBITDA before allocation of the headquarters' common expenses for the first time in the first quarter of 2019 in Taiwan.

We see the same dynamics around network effects that [ph] accrued to clear leader (00:11:13) in a two-sided marketplace model starting to play out in our other markets. Shopee's ability to grow rapidly over a short period of time to achieve regional market leadership is a testament to its successful strategy and ability to execute that strategy efficiently and effectively. Shopee has been focusing on building a mobile-centric socially engaging marketplace with an emphasis on high margin products from a highly diverse seller base.

In addition to that, Shopee has also combined its marketplace offering with integrated payments logistics instructor and the comprehensive seller services. And then looking to the year ahead, we believe the strategic focus and our proven track record of successfully executing on our strategies will continue to drive growth at Shopee. In 2019, we intend to focus on growing with efficiency while looking to further ramp up monetization through deeper engagement with our sellers and buyers.

To sum up, I'm very proud of our performance in the fourth quarter and the full year of 2018. Across the business, 2018 was a transformative year as Shopee extended its lead in e-commerce and Garena emerged as a leading global game developer and publisher. We enter into 2019 in a stronger position than ever before, poised for growth on all front. We are hugely excited for the year ahead and have once again set ambitious growth targets for ourselves as reflected in our guidance for 2019.

With that, I will invite Tony to share more about the financials.

Tian Yu Hou

Thank you, Forrest, and thanks to everyone for joining the call. We have included detailed quarterly financial schedules together with a corresponding Management Analysis in today's press release so I'll focus my comments on the key financial metrics.

We'll see overall our fourth quarter total adjusted revenue was $389.3 million, an increase of 137% year- on-year and 60% quarter-on-quarter. This was mainly driven by the growth of our digital entertainment business, especially for our self-developed game, Free Fire, and our continuous monetization efforts in our e-commerce business in the past quarters.

Digital entertainment adjusted revenue was $231.4 million, an increase of 63% year-on-year and 60% quarter-on-quarter. The growth was primarily driven by the enlarged user base and the improvement in the monetization of our portfolio games, especially Free Fire. Digital entertainment adjusted EBITDA was $105.2 million, doubled year-on-year and an increase of 96% quarter-on-quarter, thanks to the strong top line growth and our self-developed game accounting for an increased share of revenue.

E-commerce adjusted revenue was $126.9 million, up 78% quarter-on-quarter from the third quarter of 2018. Of this $126.9 million in adjusted revenue, marketplace revenue was $87.6 million, up 884% year-on-year and 74% quarter-on-quarter while product revenue was $39.3 million, up 9,725% year-on-year and 88% quarter-on-quarter.

E-commerce adjusted EBITDA loss was $277.5 million as we continued our investment to fully capture the market opportunity in the region. We will continue driving the high quality growth by serving users' needs better and improving the operational efficiency.

Digital financial services adjusted revenue was $3.1 million, a decrease of 25% year-on-year from $4.1 million in the fourth quarter of last year as we focused our efforts on strengthening the infrastructure to support our existing platforms. Adjusted EBITDA loss was $9.8 million in the fourth quarter of 2018 compared to a loss of $7.6 million in the same period of 2017.

Returning to our consolidated numbers, we recognized a net non-operating income of $53 million in the fourth quarter of 2018. This was primarily due to a fair value accounting-driven valuation gain of $61.2 million from the convertible notes we issued before our IPO.

We had a net income tax expense of $3 million in the fourth quarter of 2018, which was primarily due to corporate income tax and withholding tax recognized in our digital entertainment segment. Finally, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses and a fair value change for the three IPO convertible notes was $321.2 million in the fourth quarter of 2018 as compared to $199.6 million for the same period in 2017.

I will conclude with our guidance for the full year of 2019. We currently expect digital entertainment adjusted revenue to be between $1.2 billion to $1.3 billion, representing year-on-year growth of 82% to 97%. In addition, we expect e-commerce adjusted revenue for the full year of 2019 to be between $630 million and $660 million, representing year-on-year growth of 117% to 127%.

With that, let me turn the call back to Howard.

Howard Soh

Thank you, Forrest and Tony. We are now ready to open the call for questions. Operator, please proceed.

Q&A

Operator

Thank you and we will now begin the question-and-answer session. [Operator Instructions] And the first questioner today will be Miang Chuen Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Hi. Good morning. Congrats on the strong results. A few question for me. For games, the [ph] pay (00:18:04) ratio was up significantly Q-over-Q. I presume this is mainly Free Fire but has the monetization started already at the end of second quarter? Why is there such a big jump, I guess, in fourth Q?

And for games as well in terms of your FY 2019 revenue guidance, is the expected growth just coming from Free Fire and Speed Drifters or does it include other new games from Tencent or even your own?

And then a couple question after your comments, if I may...

<A>: Sure.

<Q - Miang Chuen Koh>: ...as well. Sorry. Now, the cost of services for e-commerce continues to rise quite a bit more than revenues. I know there are some explanation in the press release on the cost items that contribute to that. However, could there be more color on that? A bit more specifics on either perhaps cost increases that – or cost buckets that we should be aware of? And when can we see revenues tread more in line with the increase in cost of services as well?

And then finally, on the e-commerce revenue guidance for FY 2019, is the Y-o-Y growth expected to come more from higher [ph] take rates (00:19:20) or from GMV increase? Thank you.

<A - Howard Soh>: Sure. Great. [indiscernible] (00:19:25) all your questions. Let me start from the first one, on the Garena side of things. So, you talked about overall [ph] pay (00:19:32) ratio for – has blended upward? That's right. Yes, it is actually a reflection of the fact that the [ph] pay (00:19:38) ratio for Free Fire has gone up. You're right that we have been monetizing the game a bit earlier on, but recall that during the previous call, I actually mentioned that whenever we had a high potential game, our first protocol of duty is really to make sure there as many people as possible are playing the game. Now that we have the numbers and as far as share, more than 350 million registered users, over 100 million MAUs and peak DAUs of over 40 million. Now that we're in that position, we think that we are able to turn on the monetization levers a bit more strongly.

So what you've seen is there are a lot of efforts. In terms of our fourth quarter, it's really been focused in terms of converting free users to becoming paying users. As a result, that has affected the pay ratio and subsequently, the adjusted revenues for the fourth quarter.

If we think about the 2019 guidance on the Garena side of things, yes, it's true. It's actually quite robust in terms of where we think we're going to land in terms of the overall guidance being $1.2 billion to $1.3 billion in adjusted revenue for digital entertainment for 2019. It is coming off the back of a couple of things. You mentioned like Free Fire as well as some of our new titles like Speed Drifters, but it's really a reflection of – and we are reaping the dividend of a shift in our overall strategy.

When we set out several years ago, we were primarily a PC-based pure publisher focused on [indiscernible] (00:21:00) in Taiwan and now, we successfully made a transition towards being a lot more mobile-centric from being a pure publisher to going into self-development. And of course, with the success of Free Fire, that's really given us a passport to spread our wings beyond Southeast Asia and Taiwan to a lot of global emerging markets; so access to places like Latin America where Free Fire was top rank game in Brazil in 2018 by MAUs, downloads and consumer spend; and a top five for each of these categories in Mexico and Argentina. Needless to say, that really has great implications in terms of our total addressable market for the future.

I'll let Tony weigh in in terms of the questions with regard to Shopee on the cost of services.

<A - Tian Yu Hou>: Yeah. For the cost of services, yes, you're right. It's mainly the volume-driven thing. If you look at the core component, mainly our bank transaction fees and also the cost of value added services like logistic services and as the volume ramping up, the cost of sales is also ramping up as well.

<A - Howard Soh>: [indiscernible] (00:22:06), sorry, [ph] MC (00:22:07). Do you mind running us through that last question again [ph] I saw (00:22:09) in terms of like [ph] EC (00:22:10) revenue guidance?

<Q - Miang Chuen Koh>: Yes. So I'm just wondering whether the Y-o-Y growth in [ph] EC (00:22:17) revenues. Is it coming more from higher take rates that you expect or more from GMV increase Y-o-Y?

<A - Howard Soh>: Yeah. Yeah. So we actually think that it's going to be a combination of both. With GMV, it's still going to continue to grow very, very robustly. At the same time, we've also indicated that once we gain a good measure in terms of being the market leader, we can also look -- it is within our ability to start looking at monetization a bit more deeply and that's something that we've started to do already in the first quarter and you see it continue to echo out throughout 2019. They'll come from a combination of commissions as well as advertising as well as value-added services.

<Q - Miang Chuen Koh>: Got it. Thank you.

<A - Howard Soh>: Thank you.

Operator

And our next questioner today will be Alicia Yap with Citigroup. Please go ahead.

<Q - Alicia Yap>: Hi. Good morning, Forrest, Tony, Howard. Congratulation on a strong quarter and also the strong guidance. I have some follow-up questions on the digital entertainment regarding the fourth quarter and also the guidance. On the fourth quarter, can you share with us outside of the Southeast Asia regions, how much is the Free Fire now contribute?

And then regarding in terms of the guidance, I think how confident are you and then what sort of scenario that you are baking in to come up with the guidance? In more detail, what I mean is can you share with us is this coming from the gross billing and obviously, the deferred that you have and then also you assuming Free Fire will continue to improve, right, on the user front and also the monetization? And then also, if you can give some color on the QQ Speed, that will be helpful.

Then second question is on e-commerce, also wanted to follow-up. Realized that this time, you guys are giving the adjusted revenue guidance rather than the GMV, which I think is indicative of your much more confidence in terms of the monetization. But then could you share with us maybe the implied GMV guidance from the net revenue guidance that you have? And also, if you can also give a little bit color in terms of, let's say, the growth rate on revenue on e-commerce. If we were to rank by country as they come from, let's say, Indonesia or other country, if you can kind of give us some color in terms of the ranking and in terms of the growth rate, that will be helpful. Thank you.

<A - Howard Soh>: Okay. Thank you, Alicia. So, let's start on the digital entertainment thing. So, I'll say of the core market [indiscernible] (00:25:16) in Taiwan, we actually disclosed that in terms of like our revenue -- adjusted revenue coming in from global emerging market. So, meaning outside of that core region. It was 28% in the fourth quarter.

So – and then when you're talking about things such as the overall scenarios that we mapped out in terms of the revised – in terms of the new guidance for 2019, it comes down to a combination of factors. First of all, in terms of continuing success on the Free Fire front, I think that is true. We have already started very successfully converting a lot of the free users [ph] to become (00:25:54) paying users. By the same time that we believe that there is also some optimization work that can happen in terms of trying to upscale the amount of ARPPU or the average revenue per paying user on the Free Fire front.

At the same time, keep in mind that our publishing efforts continue to be very robust and that has materialized most recently in terms of PUBG LITE. At the same time, we also have a very strong pipeline of games coming in from our right of first refusal arrangement with Tencent, again, culminating in Speed Drifters.

I would say that in combination to all of these different growth factors, we also have our own self-development studio. In terms of 200 developers that we have in our studio, all of them are continuing to work not just in terms of building new content for Free Fire, but also they are experimenting with new genres, new features, new game titles. So, we are quite optimistic about the fact that we continue to have a very robust pipeline that will fuel growth looking forward.

If we think about – shifting gears with the e-commerce side of things, implied GMV guidance will probably – you're right that in terms of the way how we've chosen to guide in 2019, we are focusing very much in terms of adjusted revenues and we paint a picture of landing within $630 million to $660 million for the year. We believe that that's a pretty direct indicator of overall performance of e-commerce businesses.

As a result, we've chosen to guide on that. We probably won't provide guidance in regard to GMV

per se, but we continue to report it just as we have during this quarter. Unfortunately, I can't dive too much into the specific nuances of each market but suffice to say, we are seeing continued strong robust results in terms of Indonesia.

We actually, on previous call, you might recall that we claimed that we believed we were the market leader in Indonesia by virtue of our 700,000 orders per day on average and what we've done since then is we've looked on that leadership position and closed in at 83.8 million orders in the fourth quarter or an average of 900,000 orders per day.

For 12.12, during the December 12 festival, we actually saw 5.4 million orders coming in from Indonesia alone in that single day. So I think it's pretty safe to say and we hope you agree that not only are we a leader in Indonesia, but we've also built on that lead quite substantially.

<Q - Alicia Yap>: That's very helpful. Can I follow-up just quickly on the digital entertainment guidance? So is that fair to interpret correctly from your comment just now that you have baked in PUBG LITE and also some new games that you are planning in the rest of the year from the Tencent portfolio? Thank you.

<A - Howard Soh>: That is correct, Alicia. It's pretty much a holistic view of the performance of our digital entertainment efforts.

<Q - Alicia Yap>: Okay. Thank you. Congrats again.

<A - Howard Soh>: Thank you.

Operator

And our next questioner today will be Mike Olson with Piper Jaffray. Please go ahead.

<Q - Mike Olson>: Hey, good morning. I was wondering if there are any additional details you can share about 2019 profitability expectations, for example, just from a high level, are your early thoughts on EBITDA for the year -- for the EBITDA loss to improve or worsen in 2019 compared to 2018? And then when could we potentially expect additional self-developed titles? I'm sure you're really focusing resources on Free Fire at this point, but can you provide any thoughts on the pipeline for self-developed titles like will we potentially see one new self-developed title in 2019 or is that more of a 2020 event? Thanks.

<A - Howard Soh>: Great. Thanks for your question. So let's discuss first in terms of profitability about 2019. So what we have observed is really that on terms of the Shopee front of things, sales and marketing has really declined like coming in from like 8.5% as a percentage of GMV a year ago to 5.7% in the third quarter of 2018 to 5.4% most recently in the fourth quarter of 2018.

At the same time, we see the twin effect. On the other side of things, we've seen adjusted revenues as a percentage of GMV really rose to 3.7% in the fourth quarter. So we're seeing a narrowing in terms of both lines coming to intersect and while we can't paint a picture with regards to precisely when the Shopee business will achieve breakeven, I think Taiwan case study actually paints a pretty good picture.

When we said that you can see the results really in terms of our Taiwan, the successful execution of the Shopee strategy in Taiwan, specifically when it was the first market where we started to monetize about two years ago. And when we mentioned earlier that we expect Shopee to record a positive quarterly adjusted EBITDA before the allocation of [indiscernible] (00:31:00), for the first time in the first quarter of 2019. So we do believe that the greater trends of deeper monetization, lowering of such shipping subsidies and sales and marketing expenses that we are witnessing in Taiwan, we're actually seeing a lot of that echo out into the other markets as well. So we're quite pleased and positive about that.

In terms of shifting gears to Garena in terms of self-developed titles, it's pretty early to tell and we don't disclose our game pipeline for competitive reasons but needless to say, you can be assured that we are hard at work in terms of trying to develop new genres, new titles and new features for the future.

<Q - Mike Olson>: Thank you.

Operator

And our next questioner today will be Varun Ahuja with Credit Suisse Singapore. Please go ahead.

<Q - Varun Ahuja>: Yeah, hi. Good morning, everyone, and congrats on a great set of numbers. First, I just want to -- on the digital entertainment, can you provide a little bit color on the margin front because the fourth quarter looks pretty strong on margin. In the first quarter, you were guiding for a much better margin than the fourth quarter. So, for full year, how should we think about because your revenue guidance on digital entertainment is very strong, so how should we think about the margin profile? Any color will be helpful.

Secondly, in terms of guidance for e-commerce, can you just provide a little bit color how much is product revenue, how much is market-based revenue that you're looking at in the guidance for the revenue for the e-commerce business?

And if you look at your sales and marketing, you had mentioned that the absolute amount for the shipping subsidies have come up for the fourth quarter, but if you look at on a quarter-on-quarter basis, the sales and marketing has increased. So it means you are spending it somewhere else, some other promotions and stuff. So, I just wanted to understand how much of the sales and marketing in fourth quarter is free shipping or the subsidies on shipping front. As a percentage, is it coming off while the other expenses are going up? So, wanted to understand that type – that thing.

Then number four is can you talk about a little bit about the fund raising, if you may have to put in for Shopee? I understand they were last year comments being made that you may look at raising at the Shopee level so given you're burning -- not burning, you're investing cash every quarter, which may not last beyond 2019, so any plans on that front will be helpful. Thank you.

<A - Howard Soh>: Thanks, Varun. Good to speak again with you. So let's take it from the top. In terms of your first question on margins, so yes, you are right. In terms of the EBITDA margins on the digital entertainment side of things, third quarter, we had 37.2%. That has improved pretty substantially to 45.5% in the fourth quarter.

In terms of just giving more color there, it's really a combination of, we would say, three factors. First of all, just overall strong top line growth coming in from Free Fire as well as some of the other game titles. There is also the fact that our sub-developed games, so in this case, Free Fire accounted for a greater share of revenue and that has led to an improvement in terms of EBITDA margins. And of course, we've also seen greater efficiency in terms of our marketing efforts and that helps just to stretch the dollar. That's, for me, the color that we can provide in terms of EBITDA margins.

In terms of e-commerce guidance, unfortunately, we probably cannot break down a little into any more granularity with regard to the guidance in terms of marketplace product -- versus product revenue. But that's something that we disclosed in our earnings. So if we look at the composition of the fourth quarter particularly, if we look at where we ended with $126.9 million, roughly $87.6 million was marketplace and [indiscernible] (00:35:07) roughly 39.3% (sic) [$39.3 million] (00:35:07) was product.

In terms of the sales and marketing, let me try to contextualize and frame your question. So, if we look at it from a big picture kind of view, sales and marketing overall as a percentage of GMV fell from 5.7% in the previous quarter to 5.4% in the fourth quarter. And something else that we said was that sales and marketing, in terms of absolute dollars, we expect that to trend down this year. And part of our ability to do that really stems from the fact that we are now the market leader. We are continuing to get outside benefits from the flywheel effects where more and more buyers and sellers flock to the Shopee ecosystem. What this means essentially is that we get a lot in terms of organic user growth. So we don't actually need to continue to invest as much in terms of sales and marketing in order to [ph] impose (00:35:58) very robust growth rates.

One thing that you pointed out, particularly on this question, was the shipping subsidies. What we'll say here is that shipping subsidies have really fallen in terms of absolute dollar terms if we look at the fourth quarter relative to the third quarter. But keep in mind that although we've pulled that back, at the same time, GMV grew by 27% quarter-on-quarter and orders grew by 31% quarter-on-quarter. This really proves that we can grow with increasing efficiency.

And you're right. We have redeployed some of that budget towards more discretionary type of marketing activities but over time, what we've found is that initially, when buyers are a bit well-acquainted with any particular e-commerce platform, perhaps free shipping or subsidized shipping becomes an important tool for them to try out the platform for the first time. But when you are in a position where Shopee is where people are very familiar with you, then other factors become very important, things like product assortment, ease of discovery, deeper engagement and very high quality fulfillment [ph] at (00:37:07) customer service; all of which are pretty much hallmarks of the Shopee experience.

And then finally, in terms of your question on fundraising, as of the end of the fourth quarter, we have over $1 billion in cash and cash equivalents. We're very encouraged by our most recent results in terms of Shopee. At the same time, we also have Garena. It continues to exceed our expectations. We have great accomplishments on the adjusted revenue front with over $661 million in 2018.

We think all of these puts us in a very, very strong position. At the same time, as a management team, we are very committed to growing our business and market leadership in what we think is a very large and attractive market opportunity. To that end, we will continue to evaluate our fundraising options and may access the capital markets as appropriate.

<Q - Varun Ahuja>: Okay. Thank you.

Operator

And our next questioner today will be Conrad Werner with Macquarie. Please go ahead.

<Q - Conrad Werner>: Hi, there. Thanks. It's Conrad from Macquarie. First question is just in the past, and I'm sorry if you already disclosed this, you also mentioned what percentage of adjusted revenues in the games business was directly coming from Free Fire. So I'm wondering if you could provide that again.

And then just a follow-up on some of the previous questions. I mean, everything in the results looks great. I think the market would just still have that one outstanding question around the cadence of EBITDA losses in the e-commerce business. Would it be fair to say that the fourth quarter EBITDA loss might represent a high watermark going forward on a quarterly basis? Given all of the positive revenue trends that you're calling for plus some of the efficiency that we're seeing on the sales and marketing side, at least in terms of the shipping subsidies, I think any color around that would be very useful.

And tied to that, is there any seasonality to expect in the business? I mean, you had a couple of big sales events in the fourth quarter for the e-commerce business. They were very successful. Does that sort of impact the quarter-over-quarter trends in the first quarter for e-commerce? And then just lastly, on the shareholders' equity, is there a plan or a need from your perspective to move that more into a positive number over the course of 2019 and how would you do that? Thank you.

<A - Howard Soh>: Okay. Conrad, thanks for your question. So, your first question is on the percentage of adjusted revenue from Free Fire. Yes, we did disclose this. We said that for the fourth quarter, it accounted for 44.5% of adjusted revenue.

<Q - Conrad Werner>: Sorry, missed that. Thanks.

<A - Howard Soh>: Yeah. Yeah, it's okay. So, the second one is in terms of the cadence of EBITDA losses. Would it be fair to say fourth quarter EBITDA losses represents a warm-up in terms of EBITDA losses? I think that it's fair to characterize it that way. If we think about what we've disclosed, we kind of fit that – we expect overall sales and marketing in terms of absolute dollars to continue to trend down starting from this year. So, I think that that characterization is accurate.

The third question on seasonality, I think that's true. We have seen quite an outsized response in terms of great consumer demand leading in from our 10.10, 11.11 and 12.12 festivals, and so like there is some implied seasonality in the e-commerce business, just as there is as well for the games business. [ph] Then for the (00:40:49) shareholder equity question, perhaps I'll let Tony weigh in on this.

<A - Tian Yu Hou>: Yeah. So, you're well pointing it out and as shared by Howard earlier, we have $1 billion on the balance sheet in cash and we have seen very strong performance in our game business and also a strong pickup in our e-commerce business as well. And meanwhile, as we shared, we're open-minded about the option and closely monitoring the market positions.

<Q - Conrad Werner>: Thanks for that. Maybe just to follow-up on the seasonality question, I mean, given the strong just organic growth in this business even with the seasonality, should we still expect the revenue metrics to be up sequentially in the first quarter just by not as much or is there a chance that we could see them come down sequentially before they start rising again over the course of 2019? Thank you.

<A - Tian Yu Hou>: The expectation is that it will rise. And that is...

<Q - Conrad Werner>: Thank you.

<A - Tian Yu Hou>: ...also reflected in our adjusted revenue guidance for the year.

<Q - Conrad Werner>: And that applies to the first quarter as well?

<A - Tian Yu Hou>: That's right.

<Q - Conrad Werner>: Thank you so much.

<A - Howard Soh>: Thank you.

Operator

[Operator Instructions] Our next questioner will be John Blackledge with Cowen. Please go ahead.

<Q>: Hi, this is [ph] Bill (00:42:12) on for John. Congrats on a strong quarter and thanks for the questions. I had a couple, if I could. Could you just tell us a little bit more about what you see as the drivers of GMV and monetization in the first quarter? And then just a little bit more color on the logistics services and value-added services, how have those performed versus your expectations and what do you kind of see as the long-term view for those businesses over the next few years? Thank you.

<A - Howard Soh>: Hey, [ph] Bill (00:42:48), thanks for your question. So in terms of the e-commerce [indiscernible] (00:42:52) drivers of GMV and monetization, a couple things to say here. I think that when I was asked on the previous call what accounted for the great GMV acceleration in the third quarter, I kind of said that Shopee is really coming to its own. I think number one e-commerce platform in the region and I think that is more true today.

Even as short as three months ago, if we just look at the facts moving from $0 of GMV to over $10 billion of GMV in a three-year timeframe, our success in terms of Indonesia where we have 900,000 orders per day. And when App Annie says and has declared that we were the most downloaded app in the shopping category in Southeast Asia and Taiwan for the entire of 2018, I think all of these provides really strong evidence that we are the number one player in Indonesia, in Taiwan and the region as a whole.

If we think about our ability to continue to monetize, there are a number of key drivers behind this growth. First of all, Shopee continues to the experience robust platform growth and we've extended our leadership position across the region and market by market.

Secondly, we are observing a deepening of user engagement on the platform as we continue to enhance our service offerings to both buyers and sellers, be it through a wide assortment of service offerings as well as innovative gamification elements, seller tools and value-added services.

Thirdly, we began rolling out a fuller spectrum of monetization avenues since January this year and we plan to continue rolling out even more of the – over the course of 2019. For example, we recently rolled out commissions for more sellers in Thailand and Indonesia, and we've ruled out handling fees across multiple markets.

So, looking ahead, we continue to grow – focus on growing with efficiency on the e-commerce front. We will leverage our organic user acquisition opportunities and we'll wrap up monetization as we deepen our engagement with both buyers and sellers.

In terms of your question on VAS, it's pretty much performing in line with our expectations. As you can imagine, it is – we are really solving a fundamental need [indiscernible] (00:45:05) has been unaddressed by largely – unaddressed by any sort of player in our region. So you can imagine that there's been outside demand coming in for those value-added services that we provide.

<Q>: Okay. great. Thank you so much.

Operator

[Operator Instructions] And our next questioner will be Andrew Orchard with Nomura. Please go ahead.

<Q - Andrew J. Orchard>: Hi, guys. Thanks for taking my question. Question on e-commerce. Can you give us some color on what percentage of the orders is from organic lead generation and how much is coming from affiliate websites such as [indiscernible] (00:45:56) or other websites?

And then on the gaming front, can you give us some color on where you expect the split between self-developed and non-self-developed games to be eventually? Maybe not necessarily for this year, [indiscernible] (00:46:11) at some point. These are my two questions. Thanks.

<A - Howard Soh>: Great. Thanks, Andrew. So, we probably can't provide more color in terms of the exact split in terms of orders. For gross sales, we've got – we're very pleased in terms of the overall trajectory of our orders. We've seen acceleration in terms of orders and growing from 0 to more than 600 million orders in a timeframe of three years, we think, is a pretty remarkable accomplishment.

On the other hand, when we talk about the split between self-developed and non-self-developed games, recall during one of the previous calls, we actually did paint a picture where we said about 50% of that is going to come in from self-developed games and 50% of that is going to be published. What we've seen on the Free Fire front particularly is that now, Free Fire already accounts for 44.5% of – for the assets for the fourth quarter. So, we are well on our way to hit those targets.

<Q - Andrew J. Orchard>: Do you think that it might exceed that more significantly as you get to stage 1 will be 60/40 or 65/35?

<A - Howard Soh>: We do think that's possible and we wouldn't necessarily say that that's a negative thing given the fact that it is our self-developed title, it does lead to better EBITDA margins for the business. And we've seen how that has been a real – has really resonated with a global audience. We're seeing how it's done really well not just in our core markets but also across all sorts of different markets such as India where it can lead to get a very strong user base.

<Q - Andrew J. Orchard>: Okay. Thank you.

Operator

And our next questioner today will be Conrad Werner with Macquarie. Please go ahead.

<Q - Conrad Werner>: Hey. Sorry for the follow-up but just to follow-up on that previous question around the additional color around the monetization in e-commerce, is it fair to say that the guidance for 2019 still does not assume much in terms of commissions outside of the mall business? In other words, the commissions for more, though, of the marketplace business would be sort of something that happens in 2020 and beyond or are you already assuming some of that in 2019?

<A - Howard Soh>: Yeah. Thanks, Conrad. So we are assuming some of that occurring. So it will be different levers that we activate in different markets. We have to almost take it on a market by market basis. But what you're seeing in terms of the guidance for 2019 adjusted revenues for e-commerce, that's an all-in holistic view in terms of all the different monetization levers that we will pursue for the year.

<Q - Conrad Werner>: Okay. Thanks. And sorry, again, if I missed this before, was there a split provided between PC and mobile adjusted revenues in the release or is it possible to get that on this call?

<A - Howard Soh>: Yes. It was provided. So...

<Q - Conrad Werner>: Okay. I'll look it up then.

<A - Howard Soh>: Yeah. It was just 85.1%, just for your quick reference.

<Q - Conrad Werner>: Thanks. Thanks. Sorry, okay. I was late to look at the release. Thanks.

<A>: [indiscernible] (00:49:29).

Operator

And our next questioner today will be Miang Chuen Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Hi. A couple of follow-up as well. On Free Fire, can you elaborate a bit more on what's the monetization tools you actually deployed in fourth quarter and how should we think about those monetization tools this year? So I know you mentioned, of course, deepening that but I just would like some specifics.

And as you go into orders or see great success in all these global markets, Latin America, et cetera, would you be expanding or adding head count in those areas as well and are there other geographies that you see similar opportunities besides Latin America? And then finally, should we expect a few more games from Tencent, I guess, this year as well? Thank you.

<A - Howard Soh>: All right. Great. Thanks, [ph] MC. (00:50:27) So, first question in terms of monetization tools deployed in the fourth quarter on the Free Fire front, recall that one of the most effective tools in terms of us converting free users [indiscernible] (00:50:40) paying users has really been the subscription passes that we pushed out. So these subscription passes, they are very affordable and in terms of like the transition from being a free user to becoming a paying user is very, very low ticket, being about an average of $5 per month. It beats the low repeat behavior in terms of being a subscription type of tool and it gives you [indiscernible] (00:51:06) access to a whole host of content that you would otherwise get as a free user. So that's been a very attractive tool and once individual start investing in the game, then there's a higher propensity for them to participate in other avenues such as buying costumes and skins and so on.

One thing that I will mention is that the subscription passes are also team-based. So we tend to push out monthly sort of teams around the subscription passes and that leads to a lot of opportunities for people, localization and engagement with users.

In terms of success in global markets and we are seeing [indiscernible] (00:51:45). I think questions – your next couple of questions are kind of interrelated. So we will say that we've seen lots of great success in terms of our initial foray into Latin America. But at the same time, we are seeing great user traction and growth numbers in markets like India, Russia, and Turkey.

According to App Annie, throughout the month of January, Free Fire was consistently ranked as the top three grossing action game on the Google Play Store in India and Russia, and within the top six grossing action game on the Google Play Store in Turkey. So, we believe that Free Fire's unique position as a premium battle royale title, which is optimized for emerging market users, has allowed the game to achieve popularity and success in other global markets as well.

Does this lead to an investment in terms of on-the-ground infrastructure and personnel? Sure, we will make those investments in order to make sure that we have delivered the best game experience to our users.

<Q - Miang Chuen Koh>: Yes. And then will we expect more Tencent games as well besides Speed Drifters for the remainder of the year?

<A - Howard Soh>: Sure. So I think the short answer is you stay tuned in terms of our announcements. We obviously can't speak about our game pipeline but well, we're quite excited about what we see when we look across the Tencent portfolio.

<Q - Miang Chuen Koh>: Got it. Thank you very much.

<A - Howard Soh>: Thank you.

Operator

And this will conclude our question-and-answer session. I would now like to turn the conference back over to Howard Soh for any closing remarks.

Howard Soh

Well, thank you very much, everyone, for your time. We look forward to speaking with you again on the next call.

Operator

The conference is now concluded. Thank you for attending today's presentation and you may now disconnect your lines.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2018-11-20
Event Description: Q3 2018 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q3 2018 Earnings Call

Company Participants

- Howard Soh
- Forrest Xiaodong Li
- Tian Yu Hou
- Yanjun Wang

Other Participants

- Miang Chuen Koh
- John Blackledge
- Alicia Yap
- Michael Olson
- Andrew J. Orchard
- Varun Ahuja
- Mark Goodridge
- Conrad Werner

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to the Sea Limited Third Quarter 2018 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Howard Soh, Director of Corporate Development and Strategy, please go ahead.

Howard Soh

Thank you. Good morning and good evening, everyone, and welcome to Sea's 2018 third quarter earnings conference call. I'm Howard Soh, Director of Corporate Development and Strategy at Sea. Before we continue, I would like to remind you that we may make forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes discussion of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA, and adjusted net loss. We believe these measures can enhance our investor's understanding of actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For discussion on the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

Let me begin by introducing the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li. We have our Group Chief Financial Officer, Tony Hou; and our Group General Counsel, Yanjun Wang.

Forrest and Tony will share strategy and business updates, operating highlights, and financial performance for the quarter. This will be followed by Q&A session in which we welcome any questions you have.

With that, let me turn the call over to Forrest.

Forrest Xiaodong Li

Thank you, Howard. Thank you for joining today's call. I'm very pleased to announce that Sea continued to deliver strong results this quarter. The robust momentum across our e-commerce and the digital entertainment businesses is also reflected in our revised full-year outlook, which Tony will discuss in more detail shortly.

In the third quarter, Shopee expanded its market leadership. Our intense focus on operations and excellence in execution allowed us to capture more consumer transactions and to deepen customer engagement and loyalty. GMV continued to grow at a robust pace, reaching $2.7 billion in the third quarter, an increase of more than 100% year-on-year. We were very pleased to have seen an acceleration in GMV growth from 14% quarter-on-quarter in the second quarter to 21% quarter-on-quarter in the third quarter.

The highly successful Shopee 11.11 Big Sale is a great example of how Shopee is becoming an increasingly important part of the retail experience for consumers in our region. This year we saw a new record of Shopee of over 11 million orders recorded over the 24 hours of November 11. That is around 4.5 times the number of orders recorded on the same date last year. Our strong and the growing engagement with consumers is mirrored in our deepening relationships with our sellers. E-commerce at adjusted revenue grew strongly to $71.2 million, up 21% quarter-on-quarter from the second quarter of 2018 as sellers invested more in our value-added services to reach and to service our large and growing base of active consumers.

As buyers and sellers become increasingly loyal to Shopee, they become more invested in our platform, enabling us to become more and more efficient in our promotional programs. Sales and marketing, as a percentage of GMV, fell further by 50 basis points quarter-on-quarter from 6.2% in the second quarter to 5.7% in the third quarter.

In Indonesia, Shopee's largest market, we recorded 63.7 million orders during the quarter or a daily average of 0.7 million orders, which we believe made Shopee the largest e-commerce platform in Indonesia. Sales and marketing, as a percentage of GMV, for Indonesia was even lower than the ratio for Shopee as a whole, demonstrating higher marketing efficiency in its largest market.

Moreover, many of you will be aware of the recently released Google-Temasek e-Conomy SEA 2018 report, in which the authors estimate Southeast Asia's e-commerce market size to reach over $23 billion in GMV in 2018, representing growth of 114% from 2017's market size and to further reach over $100 billion by 2025.

We believe that our growing and highly engaged user base, increasing marketing efficiencies and steadily expanding market leadership underline how Shopee is cementing its position at the forefront of our region's e-commerce industry. Therefore, we believe Shopee is in a great position to enjoy an outside benefit from the rapid growth of e-commerce in our region.

With Garena, we are also going through an exciting period of growth as we build out our success in adapting our game offerings to meet evolving needs of users in our region. In the third quarter, Garena delivered adjusted revenue of $144.6 million, up 7% year-on-year; and adjusted EBITDA of $53.7 million, up 19% year-on-year.

Quarterly active users, or QAUs, grew 155% year-on-year and 10% quarter-on-quarter to 176 million. Quarterly paying users, or QPUs, also increased to 7.2 million from 6.6 million for the second quarter of 2018.

The encouraging quarter-on-quarter increase in QPUs will primarily attribute to the monetization efforts we recently started for our self-developed game, Free Fire. We are particularly pleased with the global success of Free Fire, which is growing from strength-to-strength. Free Fire recently achieved over 200 million registered users, as well as over 27 million daily active users, a significant increase compared to its previously disclosed peak of over 16 million daily active users.

In the third quarter, approximately 22% of our adjusted revenue for digital entertainment was generated by our self-developed game and approximately 13% was derived from outside the seven core markets in our region. Throughout the month of October, Free Fire was consistently the highest grossing game in Brazil, Argentina and Mexico. And in late October, Free Fire became the highest grossing game on the Google Play Store in our traditional core market of Indonesia. We believe that this is a very strong demonstration of our ongoing success in executing Garena's strategy to expand into game development and to extend our global footprint.

Alongside the success of our game development efforts, I'm excited to note an important new partnership that will further enhance the portfolio of top quality games that we offer in our region. As we announced earlier this week, Garena has signed a binding letter of intent with Tencent to grant us a right of first refusal to publish its mobile and PC games in Indonesia, Taiwan, Thailand, the Philippines, Malaysia and Singapore.

This further strengthens our long-standing, strategic partnership with Tencent. As you know, we already work together to publish a number of the most successful games from Tencent's portfolio including Arena of Valor and the League of Legends. It is also a powerful testament to Garena's unrivaled understanding of the dynamics and the nuances of our region and our reach to the games communities in these high-potential markets.

With that, I will pass on to Tony to talk more about the financials.

Tian Yu Hou

Thank you, Forrest, and thanks to everyone for joining the call. Same as previous quarters, we have included detailed quarterly financial schedules together with the corresponding management analysis in today's press release. So I will focus my comments on the key financial metrics.

For Sea overall, our third quarter total adjusted revenue was our highest ever at $242.8 million, an increase of 60% year-on-year and 11% quarter-on-quarter. This was primarily driven by our continuous monetization efforts in our e-commerce business in the past quarters and the growth of our digital entertainment business, especially for our self-developed game, Free Fire.

Digital entertainment adjusted revenue was $144.6 million, an increase of 7% year-on-year and 4% quarter-on-quarter. The growth was primarily driven by the increased user base and enhanced user engagement, as well as the improvement in the monetization of our existing games and the launch of new games.

Digital entertainment adjusted EBITDA was $53.7 million, an increase of 19% year-on-year and 11% quarter-on-quarter, thanks to the top line growth and the increase of share from our self-developed game.

E-commerce adjusted revenue was $71.2 million, up 21% quarter-on-quarter from the second quarter of 2018. Of this $71.2 million in adjusted revenue, marketplace revenue was $50.3 million while product revenue was $20.9 million. Adjusted EBITDA loss widens to $214.9 million as we continued our investment to fully capture the market opportunity in the region.

Digital financial service adjusted revenue was $3.1 million, a decrease of 35% year-on-year from $4.8 million in the third quarter of 2017 as we focus our efforts on strengthening the infrastructure to support our existing platforms. Adjusted EBITDA loss was $7 million in the third quarter of 2018 compared to a loss of a $8.2 million in the same period of 2017.

Returning to our consolidated numbers, we recognized a net non-operating income of $30.9 million in the third quarter of 2018. This was primarily due to a fair value accounting-driven valuation gain of $36 million from the convertible debts we issued before our IPO. We had a net income tax expense of $2 million in the third quarter of 2018, which was primarily due to corporate income tax and withholding tax recognized in our digital entertainment segment.

Finally, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses and the fair value change for the pre-IPO convertible debt, was $237.6 million in the third quarter of 2018 as compared to $127.1

million for the same period in 2017.

I will conclude with our revised guidance for this year. For the full year of 2018, we now expect total adjusted revenue to be between $930 million to $970 million, representing year-on-year growth of 68% to 75%. This compares to the previously disclosed guidance of $780 million to $820 million. We expect adjusted revenue for digital entertainment for the full-year of 2018 to be between $600 million and $620 million, representing year-on-year growth of 21% to 25%.

We are also revising our e-commerce GMV guidance. We now expect GMV to be between $9.2 billion to $9.7 billion for the full-year of 2018, representing year-on-year growth of 124% to 136%. This compared to the previously disclosed guidance of between $8.2 billion to $8.7 billion.

With that, let me turn the call back to Forrest.

Forrest Xiaodong Li

Thanks, Tony. Finally, I'd like to address the two management changes we announced earlier today. At Garena, Terry Zhao, who currently heads our games studio in Shanghai, has been promoted to the position of President of Garena. Terry has been with us since our earliest days in 2009, and as a Garena veteran he has deep experience in almost all of our core markets and the milestone projects. He has also been instrumental in our push into self-developed games and in addressing the huge and growing mobile games market globally. I'm delighted that he will be leading the Garena team to drive our digital entertainment business forward.

On behalf of our company, I would also like to sincerely thank Alan for his service and wish him well in his future endeavors. As we noted in our release, Alan's responsibilities have been assumed by our Corporate Development and the Strategy team under the oversight of our Group General Counsel, Yanjun Wang. In addition to the legal function, Yanjun now also oversees the corporate development, investor relations, public policy, and the public relations functions for Sea. Since joining Sea in 2014, Yanjun has been working very closely with me on all key strategic and corporate matters of our company. In this expanded law, I'm certain that she will bring invaluable experience and expertise to these important corporate functions.

At this point, I'd like to invite Yanjun to say a few words.

Yanjun Wang

Thank you, Forrest. Good morning and good evening, everyone. I'm excited to take on this expanded role to facilitate a further growth on our company and a better understanding of our businesses and strategies for our stakeholders. I look forward to working more closely with you all in the years ahead.

Howard Soh

Thank you, Forrest, Tony, and Yanjun. We shall now open the call for questions.

Q&A

Operator

[Operator Instructions] And our first question today will come from Miang Chuen Koh with Goldman Sachs, please go ahead.

<Q - Miang Chuen Koh>: Hi, Forrest and team, congrats on the results. Three questions. Firstly, can the team elaborate a bit more on the benefits of this new arrangement with Tencent compared to the previous arrangement, and how does this impact your self-development strategy?

And secondly on e-commerce, the Q-on-Q GMV growth was strong. Is it possible to share more about the growth from individual geographies and whether there is any noticeable change in GMV trends since Shopee reduced some of the shipping subsidies since August this year? And then lastly, would appreciate any update on your latest thoughts around funding for Shopee. Thank you.

<A - Howard Soh>: All right Great. Thanks, MC for your questions. Let me kick it off. So, if we talk about the benefits of the Tencent arrangement, just as a little bit of background. In terms of how games were negotiated and discussed in the past, previously it used to be on a title-by-title basis. And effectively, that would take away a lot of time from Forrest and Senior Management in terms of negotiating and discussing the details of how to launch the games. What happens is that this deeper arrangement that we've announced, the partnership actually allows us to come up with a framework, and you can think of it almost as a green lane in terms of accelerating and bringing games more quickly to our region. So, that's the first one in terms of the Tencent partnership.

You asked about the e-commerce as well, correct?

<Q - Miang Chuen Koh>: I guess...

<A - Howard Soh>: Can you please repeat...

<Q - Miang Chuen Koh>: Yes. Sure. Maybe just to – the second part of the games question was, does this, in any way, impact your self-development strategy on games?

<A - Howard Soh>: All right. So, no, it doesn't. In fact, we do see a good deepening in terms of just how well we're doing with Free Fire, and we're continuing to invest resources in order to make sure that our self-development efforts are very robust.

So to your second question in terms of like GMV in individual markets, so one thing that we've call out particularly with the new revised guidance is that in Indonesia, in particular, what we've seen is that we have clocked in 63.7 million orders for the quarter, which averages out to be about 700,000 orders per day. And that really gives us confidence that we are the largest player, not just in Southeast Asia and the region as a whole, but particularly in Indonesia. So to answer your question, we are seeing good, strong momentum all across the board and, in particular, in Indonesia.

Finally, in terms of update on funding, we did discuss this previously. In terms of the various avenues that we have, we remain quite open-minded. We do have $1.2 billion in cash as of the end of third quarter of 2018. So we are well-funded and there's no urgent need for us to tap the market. Having said that, we remain very open-minded and we are very much focused in terms of maximizing shareholder value.

<Q - Miang Chuen Koh>: Got it. So there was actually a sort of a second part to the e-commerce questions. Just wondering whether there was any noticeable change in the GMV trends because we did notice that Shopee changed some of the shipping subsidies or the shipping promotions since August this year.

<A - Howard Soh>: Yeah. Actually, we haven't seen any sort of slowdown in terms of our GMV cost trajectory. In fact, we brought up guidance in terms of what we previously said was going to be – wherever we're going to land for GMV for the year, we said between $8.2 billion to $8.7 billion. We brought that up by a full billion to $9.2 billion to $9.7 billion for the year.

So, yes, we brought down some of that subsidies, and that is reflected in the lowering of the S&M percentage as a percentage of GMV. But, really, there hasn't been any slowdown at all in terms of our GMV trajectory.

<Q - Miang Chuen Koh>: Got it. Thank you, Howard.

Operator

Your next question comes from John Blackledge with Cowen. Please go ahead.

<Q - John Blackledge>: Great. Thanks. Just a couple questions on the guidance. So it was pretty strong. Just wondering if you can discuss, on digital entertainment guidance, it calls for accelerating growth versus the kind of 7% year-over-year growth in 3Q. The implied 4Q guide calls for accelerating growth even at the low end. Could you just discuss kind of the puts and takes that would land you either at the low-end in the fourth quarter for digital entertainment or the high-end?

And then, the follow-up would be, on Shopee, the full-year guide at the high end implies about $2.8 billion in GMV, something like that, or about $150 million Q-over-Q increase. Last year, GMV increased about $500 million Q-over-Q from 3Q to 4Q. So just curious if the GMV guide for Shopee is somewhat conservative or if the impact from the GMV on November 11 kind of played into the guide. Thank you.

<A - Howard Soh>: Great. Thanks for your question. So let me start off by talking about the digital entertainment side of things. So, yes, we've disclosed actually our digital entertainment adjusted revenue forecast in terms of revised guidance. And we've laid out we think that we're going to land between $600 million to $620 million. That overall represents a21% to 25% year-on-year growth.

And what really gives us confidence about this is the general performance across all of our games, but in particular Free Fire. Now, Free Fire has done really well. You saw the stats which Forrest which mentioned earlier in terms of over 200 million registered users globally. We've hit a new peak in terms of daily active user count of 27 million. And that compares very favorably to the previous high that we disclosed in terms of DAU count of 16 million.

And if you look at the App Annie data, it's really coming to its own right? In terms of being the highest grossing game as of late last month, it became the highest grossing game in Indonesia. It was also consistently the highest grossing game for the month of October for Brazil, Mexico and Argentina. And all of this gives us confidence about our ability to achieve these numbers on digital entertainment front.

Shifting gears a little bit to the e-commerce side of things. If we think about how we've managed to bring this up, really, we are seeing lots and lots of good momentum in terms of Shopee's numbers. If we think about our performance in particular for the 11/11, so like on the November 11 itself, we recorded over 11 million orders on that day. And that's an uplift of above 4.5 times compared to the same day last year. And if you look in terms of just the overall market, that is actually growing very rapidly.

What we've seen from the recently released Google-Temasek e-Conomy report is that they believe that the market side is going to reach over $23 billion in GMV for this year, which represents more than a doubling of what we believe was the 2017 GMV market size. And they predict that's going to accelerate even further to over $100 billion by 2025.

So, we're seeing good momentum in terms of our Shopee business. At the same time, we also see a lot of tailwinds in terms of just how quickly the market is growing.

<Q - John Blackledge>: Okay. Great. Thank you.

<A - Howard Soh>: Thanks.

Operator

The next question comes from Alicia Yap with Citigroup, please go ahead.

<Q - Alicia Yap>: Hi. Good morning, management. Thanks for taking my questions. Congrats on the solid results. I have two questions. First is that, wanted to follow-up on the Tencent binding letter. Wanted to know, is that mean all Tencent in-house developed games that it has global rights that it now can license to you? And then related to games, can you remind us on the transition stage for this Vietnam telco top-up card issues that we experienced in the past few months? Has that been resolved? Is that also a recent contributor to potentially accelerate the growth in the fourth quarter?

And then the second question is on the Shopee business. I think if I hear it correctly, you mentioned this third-party survey quoted $23 billion GMV in 2018 for the region. So since it could suggest Shopee is actually able to capture about or slightly more than 40% market share, is that sound right? And then on e-commerce, can you remind us in the regions what are the current return rate in those orders? Thank you.

<A - Howard Soh>: All right, great. Thanks for your questions, Alicia. Let me try to [indiscernible] (00:26:06) here first. So, first of all, on the Tencent arrangement, broadly speaking, the arrangement focuses on future games in Tencent's portfolio, all right? And it includes pretty much accessibility towards the entirety of Tencent's portfolio except for studios where there's certain operational independence as agreed with Tencent. And we can imagine how this will actually strengthen our long-term game publishing pipeline. Tencent's portfolio obviously has some of the world's most popular and engaging titles. What we look forward to very much is we're working together with Tencent in order to bring these high-quality games to our region.

In terms of the Vietnam situation, if we think about the moratorium that's currently in place, yes, that is still in place. From our understanding, actually a lot of ministries and agencies are going to be involved in establishing guidelines for this, which is why the entire unwinding of the moratorium is taking a bit longer than originally expected. At the same time, what has happened is that we have taken it upon ourselves to really reengage and reactivate alternative top-up channels, and we've seen some movement towards that as well. So, all in all, it's pretty much us taking a view that the government has a long-term – has already indicated that they're going to lift the ban but it's taking a bit longer than expected.

Shifting gears to e-commerce, you're right that the Temasek survey did point out that they expect GMV for the region to hit $23 billion. And you can read from our numbers in terms of our growth – of our GMV performance as well as our GMV projections for the year what our implied market share is. And I think that the range that you mentioned is probably somewhere in the correct vicinity.

And then finally in terms of your question in terms of the return rates, actually the return rates, particularly for Shopee, has been very, very low. And the reason for that is because a lot of the questions upfront with regards to the product and the procedures involved have been resolved through chat that we make available onto the platforms. So, as a whole, we would say that our return rates are actually very, very strong.

<Q - Alicia Yap>: Okay. Thank you.

Operator

The next question comes from Mike Olson with Piper Jaffray, please go ahead.

<Q - Michael Olson>: Great. Thanks and good morning. Just a couple of questions. Number one, what will be the focus monetization tactics for Shopee in the coming quarters? Will it be primarily charging a take rate on new countries where there is minimal or no take rate currently charged, or will it be any increase in value-added services or an increase in advertising or something else? I'm just wondering what will be kind of – I know you're doing all those things, but wondering what kind of the biggest focus will be.

And then second, do you believe Shopee and Garena are businesses that need to be tied together over the long-term or would it potentially make sense to split Shopee or Garena out as a separate entity? Thank you.

<A - Howard Soh>: Great. Thanks for your question. So, let me just walk through the various monetization streams in the market. So, first of all, we have commissions, right? And, as you know, we've actually rolled out commissions to sellers in Taiwan as well as on all cross-border sellers. We do charge commissions via the Shopee Mall as well in Taiwan. The second lever that we look at is advertising. And in terms of advertising, we've rolled that out to all the markets as well. And then finally, in terms of value-added services, we have rolled that out across the markets.

So if we think about the current composition, we actually don't provide much quite much guidance around that. But you can imagine that in terms of value-added services for the time being we are actually filling a very important gap in the market where sellers are unable to actually access these kind of services such as virtual warehousing and these kind of services from anywhere else except for Shopee. And for that reason, it would not be surprising to think that VAS constitutes a larger proportion of the revenue stream at this point in time for the marketplace. But having said that, in the longer term, we do think that perhaps commissions will be a bit more pronounced versus ads and logistics and VAS. So, that's on your first question.

On second question in terms of the Shopee-Garena dynamic, actually, they do enjoy a good amount of synergies existing under the Sea umbrella. We really view it as a single business, and the two – the e-commerce and digital entertainment businesses, although they flourish in their own right in terms of going after very distinct opportunities, at the same time they do have benefits in terms of being under the same umbrella.

<Q - Michael Olson>: Thank you.

Operator

And our next question comes from Andrew Orchard with Nomura, please go ahead.

<Q - Andrew J. Orchard>: Hi. Good morning, everyone. So, a question on the monetization specifically on Free Fire. Any specific metrics that you can give us in terms of paying ratios of Free Fire or the ARPU of Free Fire relative to the broader game portfolio? Also, given that Free Fire seems to be growing faster than the overall business, is there any color that you can give us into your margin profile for the gaming in 4Q 2018? Thanks.

<A - Howard Soh>: Hey, Andrew. So, yes, sure. So, happy to elaborate on Free Fire. If we look at the way in which we've really approached the monetization in terms of Free Fire, whenever we launch a new game, our key priority is to make sure that as many people as possible are playing it. So, there's a lot of mobilization phase and then we start looking at monetization a bit more deeply. We're very much at the early stage in terms of monetizing gamers on Free Fire. As a result of that, we've seen some good initial success. But at the same time, as you can see, comparing up from the data, in terms of just the number of users and the growth that we've seen in Free Fire, the number of paying users as a percentage of that is still in its early stages. So, we think that there's opportunity to deepen that both from a ARPU perspective as well as in terms of the number of paying users.

How that blend into the mix is that obviously you're going to see a bit of a flat/blending downwards of the overall ARPU. But overall, Free Fire and just in terms of the momentum that we've seen, we have disclosed that approximately 22% of our adjusted revenue for digital entertainment was generated by our self-developed game and approximately 13% was derived from outside of the seven core markets in our region. That kind of gives you a sense beyond the App Annie data that we've shared about the tremendous monetization potential that we have experienced with Free Fire. And that all lends us confidence about its future prospects as well.

Operator

And our next question comes from Varun Ahuja with Credit Suisse, please go ahead.

<Q - Varun Ahuja>: Yeah. Hi. Good morning, management. Thanks for the opportunity. So, firstly, if you look at – as you mentioned 22% of your revenue in this quarter came from self-developed games, so that means your remaining games are witnessing a decline. Is it fair enough to say that the other games has eased the stage of maturity or – primarily AOV, and it seems like LoL is on a decline. So, can you potentially comment more on the games how they are performing?

Second is a little bit more clarity on the future game pipeline, which you can share. How many games are you looking to launch? And how has the FIFA 3 progression been because it was talked about as one of the drivers of games for this year, but it doesn't look like it has done much in this year despite being a FIFA year? So that's number two.

Number three on gaming, if you can provide a little bit of color how much is now mobile games as a percentage of total gaming revenue? On the e-commerce side, your losses – obviously, as you're gaining a lot more GMV – is kind of increasing every quarter and quarter. So is there anything that you can share, how should we think about the EBITDA losses? Is there any timeframe where we should expect the losses to start narrowing down? Any color on EBITDA for the e-commerce business will be really helpful.

And lastly, if you can provide a little bit more color on, as you mentioned, the Indonesia orders. So how should we look at the quadruple value? Is it AOV? Is it in similar range what we can see across the market or is it pretty lower than that? Thank you.

<A - Howard Soh>: All right. Thanks for your question, Varun. Let me take it from the top. So in terms of overall games business, right, so what we do is we actually manage the games business on an overall basis, both PC as well as mobile, right? And, yes, we're seeing a good take-up in terms of just the mobile game experience for individuals in Southeast Asia. And we've managed to seize on that opportunity largely through Free Fire.

Now, in terms of AOV specifically, we actually continue to observe good, strong user traction for AOV in the third quarter. At the same time, we actually believe that it's still reasonably young in terms of its monetization life cycle. It's still one of the top mobile games, so [indiscernible] (00:36:19) online battle arena games. In many of our key markets and across the world, we can see that AOV and these types of genres are actually gaining momentum in the e-sport scene.

For example, the AOV World Championships held in Los Angeles attracted over 33 million online views across all the streaming platforms in our markets. And the final was held actually in the end of July. So very, very good momentum from AOV and other titles stable.

Your next question is on the game pipeline. So we don't disclose our game pipeline for competitive reasons. But as you can imagine, with the deepening partnership with Tencent, actually we're going to be able to enjoy the fruits of that deeper, greater partnership with Tencent moving forward.

In terms of FIFA Online 3 to FIFA Online 4, yes, the transition is actually underway. So what happened is that we have already launched FIFA Online 4 in both Vietnam as well as Thailand, and we have plans to actually launch FIFA Online 4 in other markets in the quarters ahead. What you can see is that we're actually running in parallel. So it's not unusual to see both FIFA Online 3 and FIFA Online 4 available in certain markets. We're actually doing this migration quite gradually. And then, eventually, we intend to actually migrate a good portion of those over to FIFA Online 4.

In terms of shifting over to e-commerce, you're quite right that our GMV trajectory is continuing to grow very, very robustly. And your question is mostly along the lines of how do we think about the EBITDA. So there's really two parts to this, right? On one hand, we think we can talk about the sales and marketing expense; on the other hand, we can talk about the monetization. So we're very encouraged by ongoing monetization efforts, and we're very pleased with the quarter-on-quarter decline in S&M as a percentage of GMV.

If we look at the previous quarter, it was 6.2%. We've brought that down to 5.7% as a percentage of GMV for this quarter. And looking ahead, we want to make sure that we can continue to invest to support strong growth of GMV in the fourth quarter. What that means effectively is that, yes, we're going to continue to invest, but we want to make sure that we do it in a very efficient manner. So that's as much guidance as we can probably give in terms of the monetization and S&M looking forward.

<Q - Varun Ahuja>: Thanks, Howard. Now, I just want to go back again, as I mentioned, if I assume 22% of your revenue came from self-developed game, that means the other core revenue is declining. If AOV is doing well, so some of the games are not kind of doing that well. So is it fair enough to say that some of the games are on a declining phase, that is LoL or stuff, PC games? And can you provide a little bit color? Go ahead.

<A - Howard Soh>: Sure. Thanks, Varun. So just as a follow-up to that, we have to bear in mind that a bit of our performance on the digital entertainment is somewhat dampened by the Vietnam issue. So insofar that that has affected it, that's why you're seeing perhaps a bit of a deceleration, if you look at it from a general perspective. But if we're looking at our key game titles, it continues to grow from strength to strength.

I actually did note down an additional question on your front, which talked about the Indonesia specific in terms of Shopee. If we think about the average order value, it's largely in line with the averages that you can work out, trending perhaps slightly smaller on the smaller side of things, and that's really reflective of the composition of types of products that we sell on Shopee, which is primarily long tail, a bit more fashion, cosmetics, home and living focused.

<Q - Varun Ahuja>: Okay. Thank you. Just two for me. Can you provide how much is mobile in terms of gaming, total mobile contribution, any color? Last quarter, you did provide something for the June month. And Vietnam was not included in the Tencent agreement. Is it because of VNG investment that Tencent has? Any color on that, any commentary on that? Thank you.

<A - Howard Soh>: Sure. So in terms of the mobile as percentage of overall, we actually don't disclose that [indiscernible] (00:40:45) regular basis. What we can say is that reading in on all of the information that we shared on Free Fire, it's not surprising that mobile continues to be a very important part of our overall revenue composition.

In terms of the Tencent agreement, you're right that Vietnam is not part of the agreement. That doesn't mean that it's completely out of the picture. It just means that any sort of game titles that we want to discuss for the Vietnam market will be discussed on a title-by-title basis.

<Q - Varun Ahuja>: Okay. Thank you very much.

Operator

The next question will come from Mark Goodridge with Morgan Stanley, please go ahead.

<Q - Mark Goodridge>: Hi, guys. Just wanted to have a quick question on regulation. So, we've seen a lot of the anti-addiction measures go into China. So, I just wanted to ask, are you seeing or having any discussions in any of your other markets about any of these potential anti-addiction measures coming through?

And then second question along with that, are you able to share the percentage of your gamers on your platform that are below the age of 12 years? Cheers.

<A - Howard Soh>: Great. Thanks for your question. So, in terms of your question around gaming addiction, actually, our experience has been that most of the governments in our jurisdictions are very supportive of gaming as a sport. They actually really are attracted by the community-building aspect of e-sports and the legitimate competition that it enables. And so, they actually see it as a good way to engage with youth as well as families.

So one example that I can call in particular is that the Thai government has moved towards recognizing e-sports as an official sport last year. And we're also very excited that League of Legends and AOV were both featured at the 2018 Asian Games in Jakarta as demonstration sports. So, we obviously continue to work very closely with local regulators to ensure healthy growth of games as well as e-sports across the markets.

To your second question, actually, we don't disclose details with regards to our gamer composition and demographics. So, we leave it at that.

<Q - Mark Goodridge>: Cheers.

Operator

And the next question comes from Conrad Werner with Macquarie, please go ahead.

<Q - Conrad Werner>: Hi there. Thanks. I mean, most of my questions have already been answered, but maybe just three additional ones. Could you just maybe comment, even if it's at a high level, on where you're seeing the most competition in the e-commerce space in any of your markets and any trends to note of change in the pace of competition in any of the markets?

Secondly, just getting back to the question on the cadence of the EBITDA losses going forward, clearly, it's a good time to be backing your e-commerce business as suggested by the increased guidance. It's a great opportunity. But I'm just looking at the balance sheet and I'm wondering if the losses continue, then the equity position on the balance sheet does look like it's going to go negative. Is that something you're comfortable with or do you have any plans to keep it positive?

And then, last question, you talked about one of the strengths in e-commerce being the engagement on Shopee. And do you have any stats that just kind of show how much time people are spending on the Shopee platform through its various engagement things like that chat, et cetera, like things like that and maybe where that stacks up versus the rest of the market?

<A - Howard Soh>: Great. So, Conrad, thanks for the questions. Let me take it from the top. So, in terms of the competition that we're seeing high level commentary around e-commerce, no surprise that Indonesia continues to be – to receive a lot of attention, right, with various players out there, with different takes in terms of their strategy. We are actually very confident with the growth that we're seeing in the market, our positioning as a primarily marketplace model focused on long-tail categories will lead to the greatest success in e-commerce in terms of catering to the consumers on the ground.

And just in terms of like what we're seeing as well, we did disclosed that we see about 700,000 orders a day in Indonesia specifically. We actually think that that really lends us a lot of confidence in terms of being the leading player in Indonesia.

Shifting gears to the EBITDA losses, perhaps Tony will weigh in on this but what we will say is that at the end of the third quarter of 2018, we still do have a healthy amount of cash and cash equivalents on our balance sheet. And that puts us in a very robust position moving forward.

Let me tackle the third question first before – perhaps Tony weigh in on your question. In terms of the engagement levels with Shopee, yes, actually, if you do look at some of the third-party data providers out there, particularly App Annie, what you will see is that, over time and particularly now, if we look at the time spent, total time spent in app and total time spent by active user in the shopping category, Shopee is by far and ahead; head and shoulders, way, way ahead of everyone else particularly in Indonesia. And you will see that manifest in the data through time and throughout the shopping festivals that we've had as well in addition, leading up to the current period.

<A - Tian Yu Hou>: Yeah. So, about the balance sheet, so we have very stringent plans quarter-over-quarter. And our team actually closely follow the operating plans and we have – we keep closely monitoring our budget planning and also our balance sheet positions. And the previous round of convertible bonds provided us a robust cash flow as of now. So, you probably noticed $1.2 billion as of third quarter end. But at the meantime, that doesn't rule out that, as previously shared, we're open-minded on the opportunities, and bear in mind our operating plans and also our objective of maximizing the shareholder values.

<Q - Conrad Werner>: Thank you.

Operator

And this concludes our question-and-answer session. I would like to turn the call back to Howard Soh for any closing remarks.

Howard Soh

Great. Thank you very much. I think this concludes our conference call. As always, we remain available and committed to getting any questions that you, the investors and analysts, have. I will serve as a first point of contact if I can ever be of service. I look very much to continuing to liaise with you throughout the quarter and I look forward to our next earnings call. Thank you very much.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2018-08-21
Event Description: Q2 2018 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
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Q2 2018 Earnings Call

Company Participants

- Alan Hellawell
- Forrest Xiaodong Li
- Tian Yu Hou

Other Participants

- Miang Chuen Koh
- Michael J. Olson
- John Blackledge
- Alicia Yap
- Conrad Werner
- Varun Ahuja
- Andrew J. Orchard
- Mark Goodridge

MANAGEMENT DISCUSSION SECTION

Operator

Hello and welcome to the Sea Limited Second Quarter 2018 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

Now, I will turn the conference over to Alan Hellawell, Group Chief Strategy Officer. Please go ahead, sir.

Alan Hellawell

Thank you, Keith. Good morning and good evening, everyone, and welcome to Sea's 2018 second quarter earnings conference call. I'm Alan Hellawell, Sea's Group Chief Strategy Officer. Before we continue, I'd like to remind you that we might be making forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes discussion of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA, and adjusted net loss. We believe these measures can enhance investors' understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosure.

For discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on Non-GAAP Financial Measures in our press release.

Let me begin by introducing the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; and our Group Chief Financial Officer, Tony Hou. Forrest, Tony, and myself will share strategy and business updates, operating highlights and financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have.

With that, let's begin with Forrest for our key strategic highlight.

Forrest Xiaodong Li

Thank you, Alan. Good morning and good evening, everyone. Thank you for joining today's call. I'm very pleased that we are reporting a strong set of results for this quarter. Shopee continues to cement its position as our region's most popular e-commerce platform, and Garena continues to deliver results from its strategy to capture new growth opportunities.

Looking first at e-commerce, this was another very strong quarter for Shopee. Our strategy for Shopee is clear, we intend to continue building our position as the regional leader by providing the most innovative and engaging e-commerce experience for buyers and sellers in our markets while driving our greater efficiency improvements as we rapidly scale up.

In the second quarter, we delivered on both fronts. E-commerce GMV reached $2.2 billion, almost triple that of the second quarter of 2017. Our ability to engage buyers with a huge range of products and a superior shopping experience increasingly makes Shopee the online shopping destination of choice for consumers across the region.

A great example of how successful we have been in making Shopee the platform of choice is our Big Ramadan Sale in Indonesia. This year's sale, which runs through May and June, saw orders and GMV dramatically increased compared to last year's sale. This is a peak shopping season in Indonesia and our success in capturing consumers during this busy period really shows how important Shopee is for the online retail experience.

We are also seeing very strong growth in marketplace revenue as more merchants made use of our value-added services to better engage with their consumers. Alongside this success in building engagement with buyers and sellers, we continue to drive the efficiencies across the business. Our ever-growing scale enables us to consistently drive down costs in areas such as shipping and logistics.

At the same time, as we continue to enhance the user experience and build stronger loyalty with both buyers and sellers, we are able to achieve significantly greater efficiencies in our promotional programs. Sales and marketing as a percentage of GMV, for example, fell 40 basis points quarter-on-quarter from 6.6% in the fourth quarter to 6.2% in the second quarter.

As Shopee goes from strength to strength, I'm pleased to say that Garena, too, is moving quickly to take advantage of growth opportunities in our industry. Garena delivered an adjusted revenue of $139.1 million and adjusted EBITDA of $48.6 million in the second quarter, up 19% and 21%, respectively year-on-year.

In particular, as many of you will know, we have been focused on three key strategic areas for Garena: one, moving from PC-only to mobile-first; two, moving from pure publishing to a mix of game publishing and development; and, three, moving from a regional footprint to a global presence. Across all three areas, we are making encouraging progress.

In terms of mobile games, we are very pleased with how Garena has led the region in the development of the mobile space. And we are particularly encouraged by the strong performance of Arena of Valor and Free Fire, both of which are building huge and engaged mobile user base around the region.

In the month of June, about 73% of our adjusted revenue for digital entertainment came from mobile games, which is a dramatic and a positive change in a short space of time. This speaks to our ability to understand the habits and the preferences of gamers in our region, and adapt quickly and effectively to suit their needs.

In terms of moving into game development, we view the successful launch of our first fully self-developed game, Free Fire, as the first step in our expansion into game development as a key growth strategy. We continue to leverage our traditional strength in publishing, while exploring strategic opportunities upstream and downstream. In the month of June, self-developed game revenue accounted for approximately 13% of our adjusted digital entertainment revenue. This is a record high driven by the breakout success of Free Fire.

The various monetization features we developed for Free Fire such as the season pass concept have led to encouraging monetizing results. Moreover, the game has most recently achieved a record-high DAU count of more than 16 million.

Looking upstream, we will continue to devote resources to enhance our in-house development capabilities. Having already established a development studio in China, we intend to grow that team while tapping into other talent pools in our region and the rest of the world. We also seek to expand partnerships with independent studios capable of developing promising titles. Strong game development capabilities will serve as a springboard for Garena to build up a global presence in the long run.

In terms of the downstream value chain, we continue to explore new opportunities in esports and game streaming in order to deepen user engagement. Our region continues to deliver one of the world's fastest growth rates in terms of organized esports, and that there are still many opportunities for us as the first-mover in our region.

We will continue to build on our strength in esports streaming and look forward to developing this aspect of the business further. Southeast Asia is a relatively underdeveloped market and the history of growth in more maturing gaming markets suggests that there is a huge untapped opportunity here.

Finally, I have already briefly mentioned our expanding global presence. We are hugely encouraged by Free Fire's success. And if you walk down the street today in São Paulo or Mexico City, you are just as likely to see someone playing a Garena game as you would in Bangkok or Ho Chi Minh City. According to App Annie, in July 2018, Free Fire was ranked in the top 10 in terms of games downloads worldwide across both the App Store and the Google Play Store.

What we have seen from this global success is that many of the factors that drive a game's success in our core market in Southeast Asia are the same as those in other parts of the world. I truly believe that Garena can play an important role in helping to build and develop gaming communities in many fast-developing markets globally, leveraging our success and experience in Southeast Asia.

A great example of this is Brazil, which is one of the fastest-growing mobile markets globally. According to Sensor Tower, Brazil ranked third behind the U.S. and India in terms of the total number of downloads on the App Store and the Google Play store in the second quarter.

Brazil is also one of the most exciting markets for Free Fire. According to App Annie, Free Fire has consistently been the top grossing Android app in Brazil across all categories since late June. This is an exciting and important period for Garena, and I will personally be playing an active role as we continue to push forward with these initiatives.

I intend to work closely with our management team to ensure that even as we broaden our geographic footprint and grow our ambitions, we continue to deliver the same level of executional excellence that has driven our success to-date.

As we push forward with these initiatives, we will periodically review our existing business to make sure we are allocating resources to where we can generate the best returns. This may mean some fluctuations from quarter-to-quarter as we continually optimize our game portfolio for future growth. As we move into the second half of 2018, we plan to launch new and highly anticipated titles across different genres in order to meet the evolving preferences of gamers in our region.

In summary, I'm very proud of the growth that we have achieved in the second quarter of 2018, and I look forward to a sustained growth for the second half of 2018. With that, let me hand the call back over to Alan.

Alan Hellawell

Thank you, Forrest. With regards to e-commerce, the markets in our region continue to grow at a healthy rate. Frost & Sullivan recently released its quarterly e-commerce report, which estimated that 2Q 2018 GMV for the markets we operate in grew by 45% year-on-year to $10.7 billion. Based on their analysis, Shopee is still the largest e-commerce platform in the region by orders with an estimated regional market share by orders of between 22% to 24%.

E-commerce monetization, meanwhile, continues to rise encouragingly. Our take rate, excluding product revenue, rose to 1.7% in the second quarter from 1.1% in the first quarter. Marketplace revenue surged 69% quarter-on-quarter as all major components – advertising, commissions, fulfillment and logistics – grew nicely quarter-on-quarter, and all grew markedly faster than GMV. The second quarter improvement across all service lines of our e-commerce platform is indicative of our ability to steadily improve our value proposition to our user base. We are confident that we can continue to drive the take rate upward as we share a steady stream of innovation and efficiency improvements with buyers and sellers.

Turning to Garena. In the second quarter, quarterly active users, or QAUs, grew 150% year-on-year and 27% quarter-on-quarter to 160.6 million. We deepened market penetration as new games continue to grow, while existing key franchises continued to deliver solid results. Quarterly paying users, or QPUs, in the quarter declined to 6.6 million from 7.2 million for the first quarter of 2018. The quarter-on-quarter drop was primarily attributable to the decrease in the number of paying users in Vietnam due to measures launched in April by Vietnam's leading mobile operators to restrict the use of prepaid telco cards for online game top-ops. We are now actively strengthening alternative top-up channels to assist our paying users in this market. It is still too early to predict how quickly the market will recover as we develop these new sales channels.

However, we believe that fundamental demand for our games remained strong. In fact, across our titles, QAUs in Vietnam continued to grow to record highs in the second quarter. We are also encouraged to see growth in the number of paying users again in the past few weeks as users adapt to the new environment.

And finally, with regards to our digital financial services business, I'm pleased to tell you that earlier this month, we obtained the e-money license in Indonesia. We are still in the early stages of planning for the types of services that AirPay will provide with the license. So, obviously, we see this as a significant opportunity to further strengthen our digital financial services infrastructure to support both Shopee and Garena in Indonesia.

We are indeed excited about the future of online financial services in Southeast Asia. During this period of rapid evolution in the value proposition of AirPay, we've realized that there is a need to update the legacy metrics that we have been sharing with you. This will, in fact, be the last quarter that we disclosed GTV in its current form. We aim to return in the future with disclosure that better captures the rapid adoption of e-money and other online financial services across our markets after we have further implemented our services in connection with the recent developments.

With that, I will pass on to Tony to talk more about the financials.

Tian Yu Hou

Thank you, Alan, and thanks to everyone for joining the call. Same as the previous quarters, we have included detailed quarterly financial schedules together with the corresponding management analysis in today's press release. So, I will focus my comments on the key financial metrics.

For Sea overall, our second quarter total adjusted revenue was our highest at $219.6 million, an increase of 71% year-on-year and 11% quarter-on-quarter. This was mainly driven by our continuous monetization efforts in our e-commerce business in the past quarters and the growth of our digital entertainment business year-on-year.

Digital entertainment adjusted revenue was $139.1 million, an increase of 19% year-on-year, and a decrease of 5% quarter-on-quarter. The year-on-year growth was primarily due to the improvement in monetization of our existing games and the launch of new games. For the sequential decline in revenue and QPUs, Alan has already discussed the telco cards top-up restrictions in Vietnam as the main reason. Digital entertainment adjusted EBITDA was $48.6 million, an increase of 21% year-on-year and a decrease of 12% quarter-on-quarter.

E-commerce adjusted revenue was $58.8 million, up 74% quarter-on-quarter from the first quarter of 2018. Of this $58.8 million in adjusted revenue, marketplace revenue was $37.3 million, while product revenue was $21.5 million.

Adjusted EBITDA loss widened slightly to $188.3 million despite the increase in marketing efficiency compared to the first quarter of 2018 as we continued our investment to fully capture the market opportunity in the region. We will stick to our strategy to grow our Shopee platform and strengthen our market leadership position, especially in our focus categories. We expect our investment in sales and marketing to continue throughout 2018, as both our GMV and gross orders continue to grow.

Digital financial services adjusted revenue was $3.4 million, a decrease of 36% year-on-year from $5.3 million in the second quarter of 2017 as we focused our efforts on strengthening the infrastructure to support our existing platforms. Digital financial services adjusted EBITDA loss was $6.8 million in the second quarter of 2018 compared to a loss of $11 million in the same period of 2017.

Returning to our consolidated numbers, we recognized a net non-operating loss of $30.8 million in the second quarter of 2018. This was primarily due to the fair value loss of $37.2 million arising from the fair value accounting of the convertible bonds we raised before our IPO. We had a net income tax benefit of $0.2 million in the second quarter of 2018, which was primarily due to the deferred tax assets we recognized in our digital entertainment segment.

Finally, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses and the fair value change for the pre-IPO convertible debt, was $198.7 million in the second quarter of 2018, as compared to $86.9 million for the same period of 2017.

Alan Hellawell

Thank you, Tony. We shall now open the call for questions. Keith?

Q&A

Operator

Yes. Thank you. We will now begin the question-and-answer session. [Operator Instructions] And the first question comes from Miang Chuen Koh of Goldman Sachs.

<Q - Miang Chuen Koh>: Hi, Forrest, Alan, and Tony. Good morning to you. For the games business, can you perhaps elaborate a bit more on how you're strengthening the alternative top-up channels from Vietnam? And you also mentioned some improvement in paying users that you've seen in July. Can you also talk about how large the improvement was?

And on the games side as well, as you talk about going more global and more self-development, can you also talk about whether or not there could be any impact on your relationship with Tencent? Thank you.

<A - Alan Hellawell>: Sure. This is Alan. Let me take that first question about strengthening alternative top-up channels. We're doing a number of things from further pushing our own branded top-up cards in the existing channels that we've worked with historically. I'm not sure, MC, if you've noticed over the past few days, but it's extremely encouraging to see that the Acting Minister for Information and Communications indicating that the Ministry intends to introduce processes that should enable companies to recommence offering telco top-up cards for digital services in the coming weeks.

I think the reality is this is an extremely valuable channel for the telcos. It's obviously a popular means of gamers to play our games. And in some, there are a lot of constituents who want to see the restoration of that channel. But we are confident that growth will return. As Forrest just pointed out, there's been very strong growth in our key titles. And so, we would think with time things will come back to normal.

<A - Forrest Xiaodong Li>: Yeah. And, yeah, I'm happy to answer the second question. Yeah. So I think, like, we have a lot of discussion with the Tencent Games leadership team. Our interest is fully aligned. I think that both company have the strong interest and intention to explore international global opportunities, and there's a lot of areas we can collaborate and we can learn the best practice and compare notes together.

Specifically, I think for certain areas because our – it is related to our increasing, like, capability in terms of the game development and we work together to like explore some co-development opportunities for the global market. I think an early example of that is the co-development of Arena of Valor, and we expect to do more with Tencent on that front in future as well.

<Q - Miang Chuen Koh>: Great. If I may ask one additional question, just curious, post a recent fundraising exercise, could you just talk about whether or not you are now fully comfortable with your, like, financial position now as you expand more to the e-commerce space?

<A - Alan Hellawell>: Yeah, this is Alan. I'll take that question. We're generally very comfortable with our cash balance. I think you referenced the $575 million we raised through a previous CB. And as we've discussed on previous earnings calls, we moreover have multiple alternatives to raise money should we so desire. And we indeed remain very open-minded about which option, if any, to proceed with. Clearly and invariably maximizing shareholder value is our most important consideration.

So we're still evaluating indications of interest from potential strategic partners and members of the financial community. I would also add that we're very pleased with the valuations we're seeing amongst smaller e-commerce players of recent in the region. And so, we're very comfortable both with our position cash-wise right now and the options we have going forward.

<Q - Miang Chuen Koh>: Great. Thank you.

Operator

Thank you. And the next question comes from Mike Olson with Piper Jaffray.

<Q - Michael J. Olson>: All right. Thanks and good morning. Two questions. First, regarding the go-forward outlook, if there is one, maybe I missed it in the press release or elsewhere, but are you providing a go-forward outlook? Is it a reiteration of the existing full-year guidance that you've given? And then I have one follow-up as well, please.

<A - Alan Hellawell>: Yeah. Hey, Mike. So we would definitely maintain our full-year 2018 revenue and GMV guidance. We're comfortable with that. As of this second quarter, if the question is whether we have rolled out 2019 guidance, we have not done that yet. We'll do it at one of these upcoming quarters.

<Q - Michael J. Olson>: Okay. Thanks. And then are there any more details that you can provide on the new internally developed title that will be coming to Garena in the second half of the year? I guess, specifically, are these games in a similar genre to Free Fire or are they in other genres, and how many titles could we expect? Thank you.

<A - Forrest Xiaodong Li>: Sure. At this moment, yeah, we are still very focused on the future development of Free Fire, and we believe this is just the beginning of the battle royale genre. And the genre itself is still rapidly evolving and that will present a lot of, like, opportunities down the road. And even like for Free Fire itself, the user base is growing quickly and also like we still see a very promising monetization opportunity for that game.

So at this moment, we have, like, about half of our studio employees working on Free Fire. We have another half is pretty much focused on exploring the prototype of some new games. This is across a quite big range of genre, including MMORPG, including SLG and including the card game. But I think all of them is still at very early stage and we are not like have a clear plan, so what is going to be the launch plan for our next game from the studio, but we are actively working on that. So we will let you know when we have a more concrete update on that part.

<Q - Michael J. Olson>: All right. Thank you.

Operator

Thank you. And the next question comes from John Blackledge with Cowen.

<Q - John Blackledge>: Great. Thank you. A couple questions on Shopee. So the GMV was better than expected in the second quarter. I'm just wondering if you could talk about the drivers. Any key verticals driving that growth?

And then on the monetization side, if you could discuss the value-added services in some more detail, kind of the key drivers of the value-added services monetization in 2Q, which markets you're seeing the most penetration?

And then, lastly, on the monetization side, any color on the marketplace revenue, the split between the commissions and advertising and value-added services? Thank you.

<A - Alan Hellawell>: Sure. This is Alan. So with regard to your first question about GMV, I'll state probably something that's very obvious. We saw generally strong sequential growth across all seven markets.

In terms of the actual drivers, generally speaking, we continue to draw the majority of our growth from new customers. Most of the other inputs to the equation are relatively stable, average basket size, frequency, et cetera. And so, yeah, it's characteristic of a market going from 2% to 3% to 4%. It's really user growth that's driving that.

With regard to your second question, Shopee monetization, as I mentioned in my prepared remarks, the very nice thing is that every flavor of monetization, if we think about it as a take rate, actually increased quarter-on-quarter. So adoption of advertising continues to grow. We're seeing very healthy growth in the actual number of sellers using advertising.

Some of the other aspects to VAS such as logistics, we saw very appreciable growth in the number of sellers who adopted our SLS and other solutions. And so, penetration is generally is spreading. And this is at least across advertising and VAS across almost all of our markets. As you know, commissions are still significantly a Taiwan-based game.

In terms of marketplace revenues, again, advertising and commissions, both nicely outgrowing GMV. But VAS, in turn, given that it's a relatively new service, is growing faster than those two. I can try to give you some more color offline. But, generally, again, very encouraging uptake of all of our marketplace-based services.

<Q - John Blackledge>: Great. Thank you. Great quarter there.

<A - Alan Hellawell>: Thanks.

Operator

Thank you. And the next question comes from Alicia Yap with Citigroup.

<Q - Alicia Yap>: Hi. Good morning, Forrest, Alan, and Tony, and management team. Thanks for taking my questions and congrats on the solid results. I have some follow-up on the situations in Vietnam. So, what is the current status now? I understand we're trying to smooth it out gradually. And if we can get some color, for example, what was the percentage of revenue come from this mobile operator, and is this just one operator or multi operators, and why are they suddenly decided to do that? And would there be any resell also happening to other countries in the region?

And then just quickly a follow-up on the Shopee business. I understand one part of the main driver for the revenue uptake could be related to the logistics and the fulfillment. Any other value-added service that you plan to rollout into the second half? Thank you.

<A - Alan Hellawell>: Great. This is Alan. With regard to your first question on Vietnam, we don't actually breakout our gross billings by channel. But suffice it to say, telephone mobile telco top-ups have historically been a pretty sizable channel. And the impact of this, I can say if this did not happen, we would have seen a sequential growth in our mobile gross bookings. So, that gives you a sense as to how it impacted our Vietnam business and also overall.

You asked about the reasons behind this decision. The telcos I think wanted to ensure that this application of top-up was being used for all the right reasons. And obviously, gaming is one of those right reasons and legit applications. I think there were probably some other more untoward uses, and they found it best to kind of summarily discontinue that.

But as I mentioned earlier, they actually do look to top-ups and the top-ups for entertainment for a lot of revenues and profits. And I think this is probably one of the reasons the government has now made such committal remarks in the press. I wouldn't want to handicap when exactly things will be brought back on stream, but you can find it in the media that there's reference to likely a number of weeks before it comes back on stream. So, we're cautiously optimistic there.

Your third question was whether the Vietnam situation could happen in other regions. We have actually no reason to believe that there – this would happen in any other market, not even a whisper. I think it is very isolated and one-off.

And then your final question, Shopee monetization, any other value-added services that we intend to roll out, the answer is yes. That said, we're generally pretty conservative about signaling to the market what tools we have planned, but they will be part of our drive to continue to drive up take rate, and we'll do our very best to profile any new tools that we announce as soon as they are released.

<Q - Alicia Yap>: Okay. Thank you.

Operator

Thank you. And the next question comes from Conrad Werner of Macquarie.

<Q - Conrad Werner>: Hey there. Thank you so much for taking the call. First, just a couple of questions on the e-commerce business. You mentioned the successful Ramadan sale, which really helped boost the GMV through June. Is there any risk that as we head into the third and fourth quarters that that creates a sort of a more tricky sequential comp or are we still growing at a healthy rate where we still can expect sequential growth kind of through the remaining two quarters of the year?

The second question, just on the e-commerce, I tend to look at the sales incentives net-off item as a sort of a proxy for commissions. I'm not sure if that's still correct or not because that was kind of down sequentially from $6.4 million in the first quarter to $4.16 million in the second quarter, and I know there are some accounting quirks that go with that. But are commissions growing sequentially? Your comments seem to suggest that they still were.

Then maybe just on the games, talking about maybe some of the third-party games. Can you tease any titles into the second half? Can we expect any new titles in the second half to kind of boost the games portfolio?

And then just lastly on the balance sheet, the shareholders' equity right now stands at just above $200 million. And given that we're still in investment mode and kind of losses are in and around that kind of ballpark, is there a risk of the company kind of tipping into a negative shareholders' equity position any time this year? Is that something we should be concerned about? Are there solutions to that? Those are my three areas of questions. Thank you.

<A - Alan Hellawell>: Sure. Thanks. So, with regard to your first question, you made reference to the Ramadan sale and the strength that we saw and the impact on the third and fourth quarters. We envisioned no negative impact. We saw very appreciable sequential growth in the second quarter. Obviously, we speak now as of August 22. We're generally very pleased with the third quarter. So, I don't think you would see what has happened in some other markets in which events become so so all-consuming that they conceivably [ph] stop (00:36:06) GMV from prior and subsequent quarters where we're generally seeing good sequential growth.

<A - Tian Yu Hou>: So, with your second question on sales incentives net-off under GAAP is decreasing compared to Q1. So, actually, we net-off on broader basis, and that's another angle to look at it as we continuously driving down the per order subsidies over the quarters.

And for the fourth question about the balance sheet, well, so the main reason is that we had two rounds of convertibles raised pre-IPO and recently. So, if you are looking at the pre-IPO convertibles, the conversion price is around $13 to $14. We're pretty much in the money at this moment. So, not really worry on that part. And for the CBs, we raised recently the conversion price is $19.8 and we are quite confident that with the time being down the road that our share price would be higher than that and we're not quite concerned at this moment

<A - Forrest Xiaodong Li>: Okay. And then regarding the second half 2018, the game pipeline. So, in general, we are conservative to mention any game titles, which not like 100% in the launch pipeline yet. But like what we have launched in early August is Contra: Return, which is a mobile game developed by Tencent with the very famous Japanese IP, Contra, and it's still like it's only have been like almost three weeks. It's still too early to judge the potential of the monetization of this game. But, in general, we are pretty happy with the result we are seeing for the first three weeks. And we just launched the game in Taiwan, so in August, and we plan to launch the rest of our market in September.

So, for the other games, like, probably we're going to have another two games will be launched on the regional level, so across most of our market in the second half of this year. So, we'll let you know when we have a more concrete launch plan of those games in the future.

<Q - Conrad Werner>: Thanks so much. And maybe just the last follow-up. Sorry to take up all this time. But there was some news out of China talking about delays in game licenses in Tencent and other game publishers – developers being impacted by this. Does that trickle down to your sales? Has that delayed any of the launches that you had planned for the second half in collaboration with developers or not?

<A - Forrest Xiaodong Li>: Like, number one, there is a – I think it's like a quite isolated China-ish – China industry issue. Market-wise, this has nothing to do with our market. And actually, so if you ask me to make a summation, it's maybe a slightly positive trend for us because like things like the China market, it's a little bit like slowed down for whatever reasons and there is more and more developers start to put their eyes on the international market. And we have seen increasing interest like from the Chinese developers to try to work with us to launch their games out of China.

<Q - Conrad Werner>: Perfect. Thank you so much.

Operator

Thank you. And the next question comes from Varun Ahuja with Credit Suisse.

<Q - Varun Ahuja>: Yeah. Hi. Good morning, everyone. I've got a few questions. First, on the gaming side, can you tell us how the FIFA launch has been for you and how is it ramping up over the last few months since you have launched? That will be number one.

Number two, you mentioned that your self-developed games are increasingly taking higher contribution of adjusted revenue. But if you look at your gross profit margin for this quarter, it was around 51%, down from 52% previous quarter. So, I just wanted to understand, is there any other cost elements, because my belief is that increasing contribution from self-developed games should at least help in your margin side? So, that's number two.

Number three, on the – yeah, you mentioned that Brazil and Mexico has seen decent take-up of Free Fire. Is there any chance, given you've seen that these markets are exciting, that you may also consider similar arrangement with Tencent or other developers to push your games in these two markets? Are you looking at Brazil and Mexico as another extension of your Southeast Asian market, which have similar kind of attributes? So, that's number three.

And lastly, on e-commerce side, this product revenue, can you just provide more clarity in which markets are these primarily? Are they largely in Indonesia and Taiwan? That would be helpful. Thank you.

<A - Forrest Xiaodong Li>: Okay. Thank you. And I think, like, regarding, like, FIFA Online 4, and we launched the game right before the World Cup. And I think like, at this moment, we consider this game is still in the transition period from the previous like version of FIFA Online 3. And we see a pretty good pickup like from the new launch for FIFA Online 4, both in terms of the user base and the revenue side. But we're still seeing a lot of – lot of gamers are still continually playing FIFA Online 3 at this moment.

And we recently – so we recent – I think this is kind of like it's another – this is planned because we really want gamers to have a transition, migration period of time and let them slowly migrate to the new version. We believe is a much better version of FIFA Online 4. But we don't want to force gamers to do that. That's why we plan a pretty like decent transition period. And I think that is the best from the gamer's perspective. And, of course, this, at this moment, may limit the monetization capability and growth capability for FIFA Online 4.

And recently, we make the official announcement to the gamer community. So soon we are going to close FIFA Online 3. And in a way, this is a push to gamers to migrate to new versions as quickly as possible. I think like when we finish this migration process, that is the time like we probably have a better sense of the user base and the monetization potential of FIFA Online 4. Yeah, so I think at this moment, because of the migration situation it's still a bit early to tell.

And regarding your question about South America, yeah, definitely, I think we are very excited to see the potential in those markets. And as I mentioned just now, so we do see a lot of common success factors between South American market and the Southeast Asia, which we are very familiar with. At this moment, we are really, really focused to make sure like Free Fire continually being very successful game in those market. And we travel there frequently and we engage with the local communities. We are going to join a big game show in Brazil in October.

And I think like through all those effort and like where we get a chance to continually building up our local operation and publishing capability, I think like when we have those capability build up and that may be the chance for us to talk to some third-party game developers to launch their games in South America, which is very similar to what we have done with game developers in Southeast Asia.

But, increasingly, we do already have some incoming like request for us, if we are interested in launching like their games from like a third-party game developers in South America. So these could be potential growth opportunities for us down the road. But at this moment, we still really, really focus on to continuing to make Free Fire a very, very successful game in South America.

<A - Tian Yu Hou>: So I'll take your question on gross profit margin for the games side. So, basically, under GAAP, we only defer the revenue and channel cost, but not the rest of the cost. Say, for the revenue share part, it has to be on the cash basis. So that naturally creates a disparity sometimes over the quarter that cause the GP margin to fluctuate. But if you only look at the cash term, it's pretty stable.

<A - Alan Hellawell>: Maybe I'll take your last question on e-commerce product revenue. We don't disclose by market, but I can say just more maybe qualitatively, we've seen very encouraging uptake in market such as Taiwan and Indonesia. And we are obviously continuously rolling out these capabilities across all of our markets. But, yeah, I would say the most encouraging results happen to be our two largest markets.

<Q - Varun Ahuja>: Yeah. Thanks, everyone. Just two follow-ups. On Free Fire, how do you see the impact of Fortnite being launched on the Android platform in these markets? So that's number one.

And secondly, PUBG is – I don't think Tencent does really focus on monetizing PUBG in the market. So how do you see it increasing Tencent looking at international games? So will that impact Free Fire monetization potential? So increasingly more battle royale genre games coming in, especially Fortnite on mobile. How do you see that may impact Free Fire monetization in the next 12 months or so? That's number one.

And number two, the gross profit margin that I was talking about was on cash basis only, so it's 51% compared to 51.6% or 52% in the previous two quarters, so, I've adjusted for the accounting thing. Thank you.

<A - Forrest Xiaodong Li>: Sure. And specifically, for Free Fire, looking at the monetization trend and what we have done within our plans, so I'm very optimistic about the monetization capability of Free Fire. I think like – but the others, there is some similar type of game in the market, as you mentioned Fortnite and the PUBG MOBILE. I think like those games already existed there for quite some time. So it's like – definitely this is like – even just from the competition perspective, this is just not a new competition.

And specifically for Fortnite and, as you mentioned, we remain to see what is the potential of this game on Android. I think there are some factors like we are looking at, and I think like we don't think this is a big threat or concern for us, number one. So, in general, I think like Fortnite is much more popular in Western markets than in some emerging markets and especially like Southeast Asia or even South America.

And the second is like recently we heard – and the games are not going to distributed through Google Play, and we do know. So we remain cautious to see what that impact in terms of the accessibility of Android version of Fortnite.

And then the third is like even just considering across the globe, the market, and I think that the game itself is probably more popular on the console rather than on smartphone. But if you look at Free Fire, so our focus is very, very clear. So number one is to optimize for the smartphone users and specifically like optimize for the like Android users and with a relatively lower-spec phones, right?

And second is we have been really focused on the – focused on some emerging market, where all of the market, where, like, Free Fire is doing very well are the emerging market. And the third one is, at this moment, we already have a decent, very large user base with 16 million daily active users. And we continually enlarge the user base at the same time. So, over the years, we have accumulated a lot of good experience through our publishing capability how to retain users, how to build the community among the user base and how to run all the top-ups like game events, including esports events, for those users to make sure they stay with that game. And actually, that is our strength, like, traditionally.

So, in a way, we are very confident about the prospect of Free Fire. But increasingly, on top of that, I think, like, we closely monitor – so, we learn from the best practice of some game. In general, we learn a lot in terms of the monetization from Fortnite, from PUBG MOBILE. For some best practice, we may implement them into Free Fire, which offer Free Fire a higher, a better prospect in terms of the monetization.

<A - Tian Yu Hou>: So, for your follow-up question on GP, I guess you add up the change in deferred revenue and the deferred channel cost and derived the percentage. So, that's similar in terms of cash term. So, the main reason is we have some fixed costs like depreciation, like human resource costs. Naturally, compared quarter-to-quarter, the revenue or the gross billing dropped a bit. So, that part contributes to the margin drop slightly.

<Q - Varun Ahuja>: Thank you. Thank you, everyone.

Operator

Thank you. And the next question comes from Andrew Orchard with Nomura.

<Q - Andrew J. Orchard>: Hi, guys. Thanks for taking my question. Firstly on the e-commerce advertising, obviously, that's quite a big jump in the quarter. Just trying to understand where in specific the advertising growth is coming from. Are you putting in more ad loads or is your per ad price going up?

And then also on Free Fire, just trying to understand what's the relative size of the game in your entire gaming portfolio right now. And can you also give us a sense of how monetization is trending relative to what you've seen in your previous games in the past? Thanks.

<A - Alan Hellawell>: Yeah. So, with regard to sources of advertising growth, I think I mentioned in the past saying a growth in overall number of advertisers, and I think that that's one of the biggest, if not the largest, basic driver. We generally don't disclose ad rates, but generally, they've been rising gradually. We obviously want to ensure this important stage that sellers identify very persuasive ROI. And so, you obviously, as you well know, you expand inventory to, among other things, relieve pressure on pricing. And so, we're kind of in that mode. But I think the most important thing and the ones – the thing that we do, we work toward is to educate advertisers and grow that number, and I think we've been very successful in that regard.

<A - Forrest Xiaodong Li>: Yeah. And regarding your question, the relative size of Free Fire in our game portfolio, I think as we reported and if you look at our June revenue, right, actually June is the first full month and we start to focus on monetization of Free Fire. And if you remember, like our last earning call, so in mid-May, we mentioned that, okay, we're going to have like update, a patch in late May, and that is the kind of the first patch we start to focus on monetization effort.

And so, the June is the first full month of that effort. And so, if we look at the June number, Free Fire has already account for 13% of our entire game revenue. And so, this is very promising. And you can expect for the next couple of months, this percentage number will increase. And that give you a sense of the size of the – in terms of the revenue contribution of Free Fire in our entire game portfolio.

I think in terms of the monetization, like a sense of monetization relatively to other games and – I think it's relatively early to judge. And because this is a new genre, right, it's very different from some, like, MMORPG or like even mobile or FPS game, which is a very mature genre, and even the monetization, too, is a pretty – like, in a way, it's pretty standard but like for Free Fire, for Battle Royale as the new genre. So, every quarter, every month, we may see some new idea in terms of the monetization. And definitely, this reflect there is a good potential.

And I think if you just look at our number now, and based on existing monetization tools, I think is we're quite happy with the – in general, about this genre in terms of the monetization capability. It may not be as good as some mobile game like Arena of Valor, but definitely, it's better than a lot of other games in our portfolio. Yeah.

<Q - Andrew J. Orchard>: Thank you.

Operator

Thank you. And the next question comes from Mark Goodridge with Morgan Stanley.

<Q - Mark Goodridge>: Hi, guys. I just had a couple of questions on the e-commerce business. Firstly, just on the competitive environment with Lazada, we've seen them introduce free commissions for the merchants in Malaysia, Thailand and Singapore since July. I just want to see, has there been any impact on your business, any slowdown in any form, whatsoever?

And then, secondly, last week in Indonesia, we did see that the Indonesian government introduced some import taxes. So, I just wanted to see would there be any effect on your business in Indonesia on that. Cheers.

<A - Alan Hellawell>: Sure. This is Alan. I'll take those questions. So, with regard to Lazada having introduced a 0% commission, we simply have not seen any impact on Shopee and we don't expect to see any material impact. We've historically not seen such measures as having really had any relevance on our growth trajectory.

I mean, I may be stating the obvious here and, as you know, we went from a 1.1% to 1.7% take rate. Our general working assumption is that as the market consolidates and matures, we should be rolling out more and more monetization tools. And so, that's the direction we're headed into it and we would be very firmly committed to pushing up our take rate going forward.

<A - Forrest Xiaodong Li>: I'll take your second question on Indonesia import tax or duties. So, the impact would be minimal because at this moment, the cross-border transactions are not substantial for Indonesian market. And meanwhile, we're closely monitoring the progress and the details on how the government may operate such rules or tax laws, and we'll see and we will actively seek for the consultant's opinions on how to cope with it and to make sure we're fully compliant of the new regulation.

<Q - Mark Goodridge>: Do you, with your expectation on that Indonesian change, be more affecting people in the market or your competitors in the market who have a higher proportion of 3 Cs being sold through their product mix?

<A - Forrest Xiaodong Li>: Well, my opinion, reasonably expected, yes, because pretty much naturally, you're going to pay more, right, as a local consumer so that would be expected. Yeah.

<Q - Mark Goodridge>: Thanks, guys.

Operator

Thank you. And then next question is a follow-up from Miang Chuen Koh with Goldman Sachs.

<Q - Miang Chuen Koh>: Yes. Hi. Just an additional follow-up on the e-commerce business. Just wondering what's the percentage of GMV now that is from B2C and also from cross-border. And also, just wondering when – in Taiwan, Shopee Mall has already started charging commission to [indiscernible] (00:58:32) for some time. Just wondering whether other regions are in the works of seeing the same change or the same monetization, or there would still be some time down the road? Thank you.

<A - Alan Hellawell>: Yeah. This is Alan. With regard to your first question, percentage of GMV coming from B2C and cross-border, I'm sorry, when you say B2C, are you talking about direct sales?

<Q - Miang Chuen Koh>: So, it includes also obviously merchants listing products – the big merchants listing products in their marketplace as well?

<A - Alan Hellawell>: Right. Right. Okay. Well, so, if it's Shopee Mall, that continues to grow as a percentage of GMV. I don't have a material update for you right now. I think we mentioned in the past that the percentage across most of our markets begins in very high single digits and moves into the mid to high teens. And cross-border, I believe, would be still in the mid to slightly higher single digits, but no major change there.

And then, you had another question about introducing mall commissions for other regions?

<Q - Miang Chuen Koh>: Yes.

<A - Alan Hellawell>: And the time line, I think, notionally speaking, to the extent that Shopee Mall commissions are, by and large, being paid by multinationals and large domestic brands, basically few constituents that have a tradition of paying commissions whether it's in China or Latin America or Japan, we structurally don't see ourselves as any different.

With regard to timeline, unfortunately, we can't really give you much detail there for competitive signaling reasons and other reasons. But we have shared with you in the past, MC, that one of the big triggers in our mind is achieving a level of category dominance. And with this last quarter, we feel like, across all of our markets, we've moved closer to that. So, I would continue to focus that as a potential catalyst.

<Q - Miang Chuen Koh>: Got it. Thank you.

Alan Hellawell

And I think, sorry, we're going to – need to wrap up right now. I just wanted to thank all of you for joining today. And for all of us around the table, I think I speak for the entire management team, we very much look forward to seeing you at many of the upcoming corporate access events over the next few weeks. And we remain totally committed to fielding any other questions you might have subsequent to this call. But I trust you all have a good day, evening and morning. Thank you very much.

Operator

Thank you. The conference has now concluded. Thank you for attending today's presentation. You many now disconnect your lines.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2018-05-15
Event Description: Q1 2018 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q1 2018 Earnings Call

Company Participants

- Alan Hellawell, Group Chief Strategy Officer
- Forrest Li, Chairman and Group Chief Executive Officer
- Tony Hou, Group Chief Financial Officer

Other Participants

- Miang Chuen Koh, Analyst
- Michael Olson, Analyst
- Alicia Yap, Analyst
- Andrew Orchard, Analyst
- Mark Goodridge, Analyst
- John Blackledge, Analyst
- Varun Ahuja, Analyst
- Archana Parekh, Analyst
- Harry Whelpton, Analyst

Presentation

Operator

Good day and welcome to the Sea Limited First Quarter 2018 Results Conference Call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Alan Hellawell, Group Chief Strategy Officer. Please go ahead.

Alan Hellawell, Group Chief Strategy Officer

Thank you. Good morning and good evening, everyone, and welcome to Sea's 2018 first quarter earnings conference call. I am Alan Hellawell, Sea's Group Chief Strategy Officer.

Before we continue, I'd like to remind you that we might be making forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes discussion of certain non-GAAP financial measures, such as adjusted revenue, adjusted EBITDA and adjusted net loss. We believe these measures can enhance our investors' understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

Let me begin by introducing the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; and our Group Chief Financial Officer, Tony Hou. Forrest, Tony and myself, we share strategy and business update, operating highlights and financial performance for the quarter, this will be followed by a Q&A session, in which we welcome any questions you have.

With that, let's begin with Forrest for our key strategic highlights.

Forrest Li, Chairman and Group Chief Executive Officer

Thanks, Alan. Thank you for joining today's call. In the first quarter of 2018, we once again enjoyed robust growth across all of our businesses. I would like to start by highlighting that our digital entertainment business, Garena, returned its number one position in our region for the full year of 2017 based on a combined assessment conducted by Niko and Newzoo recently of the online gaming market in our region.

Looking at the first quarter of 2018, Garena delivered adjusted revenue of $146 million, up 43% year-on-year, and adjusted EBITDA of $55 million, an increase of 49% year-on-year.

We are also pleased to share with you that our first self-developed mobile title Free Fire recently achieved 13 million DAUs. Free Fire's continued growth give us confidence that the title has great potential going forward. Free Fire remains in the early stages of monetization as we focus on building up a critical mass of users. We will look to focus more on monetization as Free Fire's user base continues to expand.

We continue to grow eSports offering to achieve even greater dominance in our region. Our annual flagship event, Garena World had an attendance of approximately 240,000 and attracted over 10.6 million views online. Over 11,000 teams competed in various tournaments leading up to the event in Bangkok. We are confident that our eSports franchise will drive user/gamer engagement and extends the life cycle of our games.

We also have a strong pipeline of highly anticipated titles for 2018 across both classic and new franchisees, and we are excited about their upcoming launches.

Let's move on to the e-commerce. Shopee continued to enjoy rapid growth and ever-improving economics. I am pleased to report that e-commerce GMV reached $1.9 billion in the fourth quarter of 2018, almost triple that for the fourth quarter of 2017.

As mentioned previously, we continue to expand support to our sellers through value-added services. Our service by Shopee offerings include inventory management, online store operations and the fulfillment services. We also provide Shopee Logistics Service for cross-border sellers with complex logistical requirements. On top of that, we may conduct direct sales on behalf of key brands and sellers. We enable sellers to mix and match the different services based on their needs and preferences.

Both service by Shopee and Shopee Logistics Service serve as natural extensions of our business as we expand our partnership with brands. At the same time, we also deepen our relationship with sellers who have outgrown their capacity to cope with the increased demand or have more complex needs. We are committed to the success of our sellers and we will continue to find ways to improve the online selling experience. We expect these services to strengthen our long-term relationships with our sellers. With this additional services, we are able to improve the product assortment, stock availability and the pricing for our buyers.

In summary, I am very proud of the growth that we have achieved in the first quarter of 2018 and I look forward to a strong growth trend for the rest of 2018.

With that, let me hand it over to Alan.

Alan Hellawell, Group Chief Strategy Officer

Thank you, Forrest. Within digital entertainment, we continue to strengthen our market leadership, Forrest has outlined adjusted revenue and adjusted EBITDA results. Garena continues to deliver significant free cash flow. Our digital entertainment adjusted EBITDA margin rose to 38% in the first quarter of 2018 compared to 36% in the same period in 2017, revealing further margin leverage as Garena benefits from greater scale.

I would like to share with you one more facet of Garena's expanding role in the mobile age. As smartphones continue to improve access to gaming, a greater number of people are gaining access to better forms of entertainment. This will lead to an increase in demand from mobile gamers for high-quality content and as a result, we expect to see sustained growth in the popularity of leading multi-year mobile game franchises, similar to what we've seen for PC.

And as the game franchises grow, their ancillary ecosystem start to develop as well, which will in turn spark greater demand from increasingly sophisticated mobile gamers for better on-the-ground game services and community building. Given our position as the leading gaming platform, our geographic reach, our long running on-the-ground presence in these markets and our track record of success, we believe that Garena is well positioned to provide such services.

These factors are also key enablers to our dominance in eSports. We have become one of the region's most fully integrated eSports operator since our inception in 2009. Critical to our success is the extensive network of community leaders we've attracted across various markets. We work closely with them to run thousands of local eSports events. On top of this infrastructure, we have a suite of capabilities supporting eSports content production, particularly in our largest markets.

We are particularly excited about the rapid expansion in eSports activities around Arena of Valor, which with Honor of Kings constituted the world's largest grossing gaming franchise based on the latest data available. We also expect the inclusion of League of Legends and AOV as eSports at the Asian Games in Jakarta to generate additional enthusiasm and gameplay around these titles.

In terms of operational results, quarterly active users or QAU, meanwhile grew 125% year-on-year and 44% quarter-on-quarter to 126.7 million, largely driven by existing games such as Arena of Valor and Free Fire. Meanwhile, average revenue per user or ARPU came in at $1.20 compared to $1.80 for the first quarter of 2017 and $1.60 for the fourth quarter of 2017. The easing in ARPU was mainly due to rapid user growth around Free Fire, which resulted in faster QAU growth compared to quarterly paying users or QPUs. QPUs remain stable at 7.2 million in the first quarter of 2018.

As Forrest has mentioned, our focus for Free Fire right now is to build up a pool of long-term gamers. We are indeed experimenting with different monetization tools in parallel, albeit at a gradual pace.

With regards to e-commerce, the markets in our region continue to grow strongly. For (inaudible), for instance, just released its quarterly e-commerce report, which estimated that first quarter 2018 GMV for Southeast Asia and Taiwan grew 45% year-on-year to $10 billion. Based on their analysis of our region, Shopee is the largest e-commerce platform by orders in all markets other than Singapore. Once again, Shopee had an outstanding quarter with GMV reaching $1.9 billion almost triple the GMV for the first quarter of 2017 and representing quarter-on-quarter growth of 23%. Shopee's gross orders reached 111.4 million, which more than tripled year-on-year. Our ability to grow at such a rapid pace in an increasingly competitive market is testament to the Shopee management team's outstanding execution. In fact, Shopee's pace of growth is ahead of our already ambitious expectations and as we disclosed in our release, we have adjusted our revenue and GMV guidance for the full year of 2018 to reflect our confidence and sustaining the strong momentum.

Our sales and marketing expenses declined in absolute terms from a $135 million in the fourth quarter of 2017 to a $127 million in the first quarter of 2018, reflecting how well we are managing our spending while still driving strong GMV growth. S&M as a percentage of GMV declined from 8.5% in the fourth quarter to 6.6% in the first quarter.

In addition, we are pleased to share with you that this quarter we have value-added services contributing to our e-commerce adjusted revenue. Forrest touched on these offerings and Tony will go into greater detail around these items in his remarks. Our ability to offer such value-added services is in many ways driven by, one, the unique characteristics of the markets we serve. Two, the less developed e-commerce value chain found in our region. And three, our unique and growing skill set and servicing sellers. We expect these value-added services to grow and the business model to improve with the rise in scale, efficiency and constant service improvement.

We also continue to cultivate our direct sales business, which has contributed to growth in product revenue. As we have referenced on previous calls, we have begun to offer direct sales service to select sellers, particularly larger brands. We view these services as an effective strategy to improve many aspects of our marketplace. They are, for instance, ideal for fast-moving SKUs with demanding fulfillment needs.

With regards to our digital financial services business, we continue to focus our efforts on strengthening our infrastructure to support our existing platforms.

With that, I will pass on to Tony to talk more about the financials.

Tony Hou, Group Chief Financial Officer

Thank you, Alan, and thanks to everyone for joining the call. First, I would like to talk about some changes in this quarter's release. For our e-commerce segment, we have made additional revenue disclosures on marketplace revenue and product revenue to help you better understand Shopee's vision as the business model evolves. Marketplace revenue consist of commission and advertising income as we have disclosed in the previous quarters, and revenue generated from Service by Shopee, Shopee Logistics Service, as well as other value-added services, as we continue to broaden our service offerings. While product revenue mainly consist of revenue from direct sales.

We have included detailed quarterly financial schedules together with corresponding management analysis in today's press release. So rather than taking you through our disclosures line by line, I will focus my comments on some key financial metrics. So that we have more time for Q&A later.

For Sea overall, our first quarter total adjusted revenue was our highest ever at $197 million, an increase of 81% year-on-year and 20% quarter-on-quarter. This was primarily driven by the continued growth of our digital entertainment business and the monetization efforts of our e-commerce business. Digital entertainment adjusted revenue was $146 million, an increase of 43% year-on-year and 3% quarter-on-quarter, primarily due to the growth of our QAUs as we launched new games, expanded our existing games into new markets and grew our existing major games in the core markets. Adjusted EBITDA was $55 million, an increase of 49% year-on-year and 5% on quarter-on-quarter as we improved our operational efficiencies.

E-commerce adjusted revenue was $33.7 million, up 262% quarter-on-quarter from the fourth quarter of 2017. Of this $33.7 million adjusted revenue, marketplace revenue was $22 million, while product revenue was $11.7 million. Adjusted EBITDA loss widened slightly to negative $179.6 million as we continue to -- our investment to fully capture the market opportunity in the region. We will stick to our strategy to grow our Shopee platform and strengthen our market leadership position, especially in our focus categories. We expect our investment in sales and marketing to continue throughout 2018 as both our GMV and gross orders to grow.

Digital financial services adjusted revenue was $3.9 million, up 93% year-on-year from $2.0 million in the first quarter of 2017. Adjusted EBITDA loss was $8.6 million in the first quarter of 2018 compared to a loss of $9.9 million in the same period of 2017.

We had a net non-operating loss of $18.2 million recognized in the first quarter of 2018. This was primarily due to the fair value loss of $18.8 million arising from the fair value accounting of the convertible promissory note and the interest expenses accrued on these same notes, partially offset by an investment gain arising from the disposal of an equity security investments.

We had a net income tax benefit of $0.8 million in the first quarter of 2018, which was primarily due to the change in statutory tax rate in one of our markets we operate in and the increase in deferred revenue from our digital entertainment segment in the first quarter of 2018.

Finally, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses was $205.5 million in the first quarter of 2018 as compared to $67 million for the same period of 2017.

I will conclude with our revised guidance for this year. For the full year of 2018, we now expect total adjusted revenue to be between $780 million to $820 million, representing year-on-year growth of 41% to 48%. This compares to the previously disclosed guidance of $730 million to $770 million.

We are also revising our e-commerce GMV guidance. We now expect the GMV to be between $8.2 billion to $8.7 billion for the full year of 2018, representing year-on-year growth of 99% to 112%. This compares to the previously disclosed guidance of between $7.5 billion to $8.0 billion.

Alan Hellawell, Group Chief Strategy Officer

Thank you, Tony. Austin, we shall now open the call for questions.

Questions And Answers

Operator

(Operator Instructions) And our first question will come from Miang Chuen Koh of Goldman Sachs. Please go ahead.

Miang Chuen Koh, Analyst

Thank you. Congratulations on the good results. Three questions, please. Firstly, can we ask more color on the path towards monetizing Free Fire more significantly and when it could have a meaningful impact as well on paid users?

Secondly is that, we understand Sea's balance sheet, of course, do look very strong. However, considering more Shopee spent -- Shopee-related spending is needed ahead [ph]. Can we also get an update on any potential fundraising plans?

And thirdly for e-commerce revenues, can you elaborate on the country breakdown and whether we should expect product revenues to also grow exponentially in coming quarters? Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Okay. Thank you. This is Forrest. I will talk about the Free Fire monetization question and then I will pass to Alan for the rest of the questions. And for Free Fire, we are very excited and we are very encouraged by seeing the rapid growth of our user base and so, in the last quarter annual release we report and we have 6 million daily active users and after three months like this quarter, so now the number is growing to 13 million, it's more than doubled in terms of DAU. And especially like we achieved this tremendous growth with the contacts that actually some competing games was launched aggressively globally and actually very interestingly like during that period of time when the competing game was launched and actually the growth -- the user number of Free Fire, the growth of that actually accelerated.

And regarding your question in terms of the monetization of our Free Fire, and that has been -- we have been like shifting our focus from just really, really just focus on growing the user base now to a more balanced approach, which like we start to really spend a lot of effort to think hard on how to monetize the game and we have started all the -- like a similar general games in terms of how they monetize the user base for -- by total (inaudible) games.

And we have been -- have some good ideas and we see some successful examples from other similar type of games. For example, like we have been quite impressed by the monetization of Four Knights [ph] and we believe that is a very good path for us to explore as well. And so, we have been starting this effort, like in the past, the one to two months and we are going to release a new version, an updated version later this month, probably either later this week or next week and from that version, we are going to start to see the -- our effort in terms of monetization, we're going to see that from the revenue results.

I'm pretty confident, I think probably three months later when we are back to this earning release and we're going to have a release some very encouraging monetizations number to share with you related to Free Fire.

Alan Hellawell, Group Chief Strategy Officer

Great. Thanks, Forrest. I'll answer your second question, which is, I recall, was about Shopee-related spending and fundraising plans. As you've observed, MC, we very much have a healthy cash balance. When we look at the longer-term, there are many options for us to strengthen our balance sheet and much more importantly unlock greater value for our shareholders. These could include raising money at the Shopee level. We believe that Shopee is being significantly undervalued. One only need to look at recent transactions to support this view. Flipkart, for instance, was acquired at, I think, 2.8 times GMV for their March year for more than $20 billion valuation. I think, as I recall, the company's GMV grew about 50% year-on-year during this period. Meanwhile, Shopee's GMV growth, as we know, was about 4 times faster than that of Flipkart for the same period. And I think our GMV was roughly 70% that of Flipkart. So we remain totally open-minded about fundraising and we're very lucky to have various and sundry options there.

With regard to direct sales and product revenue, again, just a little context. This has started to evolve, largely driven by sellers needs and preferences. We will continue to add kind of a growing tool kit to help sellers manage inventory and fulfill orders from warehouses. And we have started leasing warehouses, as you all know, several months ago. We can also help operate their stores on our platform and we may even purchase products from brands for resale on our platform. That part of the business we don't expect to form a significant part of GMV for their foreseeable future, direct sales that is. As we're in kind of early stages, rolling out these services, it would be premature to compare margin profiles, but we wouldn't expect it to be very dissimilar from our peers.

Miang Chuen Koh, Analyst

Sure. And regarding the marketplace revenues, is it possible to share a bit of the country breakdown, is it -- meaning, is it fairly broad base you are talking about or is it more Taiwan focus now?

Alan Hellawell, Group Chief Strategy Officer

I think there are still, for obvious reasons, an outsized presence from Taiwan, largely because that was kind of a first mover market, it was the first market in which we rolled out all forms of commission taking. We do, however, have a growing number of monetization tools across other markets related to some of these new revenue line items. And so, this kind of matrix of country versus form of monetization, we're gradually filling in. But with time, we can safely say that markets outside of Taiwan will grow to be a number of larger percentage of revenue.

Miang Chuen Koh, Analyst

Great. Thank you both for your answers.

Operator

The next question comes from Mike Olson with Piper Jaffray. Please go ahead.

Michael Olson, Analyst

Thanks a lot for taking my question. I had a couple related to gaming specifically, when you look at the battle royale genre and the success that you've had with Free Fire, is the intention at this point to continue to focus on that game singularly or is there any reason to look at potentially additional games within that genre or does that potentially, I guess, dilute Free Fire?

And then secondly on eSports specifically, do you guys view that as a potential real kind of revenue standalone business or do you view it as more of a kind of marketing halo that helps with engagement of the titles? Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Sure. Thank you for the question. And the first question like in terms of like Free Fire and the more genre, the battle royale genre and at this moment, and we are like just we think it's a genre, we are pretty focused on Free Fire. And as we just discussed, and we see a tremendous growth of our user base. And I think like in terms of user base, Free Fire is already probably one of the largest game worldwide in that specific genre.

I think like at this moment, but in generally, we still believe for the whole genre, it still at very beginning stage. And there is going to be continuous evolvement of the genre, which means probably there is going to have a more like a different type of playability and there is going to be have a more features of this genre.

So, I think like based on the deep user base of our Free Fire, this is offer us a very good foundation to continually explore this genre, and also probably with some like our self-innovated approach, right, in terms of the playability and in terms of feature of the game, actually we are keep trying that. And so, that's our -- that's the main task of our Shanghai Studio. So basically, like number one is, pretty much focused on the monetization of the existing user base, and the second is like, we believe, okay, we expect to see like a more growth of this genre moving forward.

So, we want to capture the wave and we continually explore different type of gameplays and we interact, communicate with community frequently and we ask what more they want from this game and what is some other innovative ideas around these genre.

So, at this moment, I don't think like we need just another battle royale game like to capture the wave of the growth of the genre and we just need to focus on what we already have built, and continually grow Free Fire. And -- but at the same time, we remain where we are open-minded and we keep closely monitor worldwide how the genre is developed, we have some of our own ideas, but we also love to learn the best practice from some other like peer studios worldwide. And there could be the chance, right, for certain games like we may collaborate with them for our core market like Southeast Asia and Taiwan.

And so, I think that is -- and at the same time, like other than the battle royale genre, I think like we continually have a very balanced approach and we have a several very highly anticipated game titles in our pipeline to launch this year from our like developer or partners. And we have a, like, I think we have a pretty, like high confidence about the performance of those games. I hope, like, I can come back with a very -- some very encouraging results in three months.

And in terms of the eSports, that really we believe this is a very important trend. And this is how gamers spend their time, not just in the game, but also out of the game, and this is a good way to enhance the engagement -- the gamers engagement and also increase the life cycle of the games. And definitely at this moment, I think -- there is two steps for our approach. Number one is that, we are just going to focus on offer the wonderful eSports experience for our existing user base, right. And luckily there is a big percentage of our games in our pipeline, in our existing portfolio, our eSports-related games and this has been the genre we have been focused on since day one.

So we have a lot of good experience of that, and I think like, you know, so there is a strong need from gamers in terms of those eSports experience, we want to fulfill that need first. And at the same time, we have been very motivated and encouraged to see in some other markets like China and there is a strong monetization of eSports-related products and services as well. And I think like where we continually to learn from those more advanced market and hopefully we're going to apply it to our market as well. I think, we are well positioned to capture the revenue potential of eSports in our key markets.

Michael Olson, Analyst

Thank you very much.

Operator

Our next question comes from Alicia Yap with Citigroup. Please go ahead.

Alicia Yap, Analyst

Hi. Thank you. Good morning, Forrest, Tony, Alan. Congrats on the good results and thanks for taking my questions. I have some follow-up questions on the e-commerce. I wanted to get a sense of this direct sales of this some -- for some of the seller. Could you give us some color like which categories are these products and in which countries? And are we taking the inventory risk on these or more on the consignment model? And what will be our strategy of the overall mix of this 3P versus 1P going forward? And also within the marketplace going forward mix of the C2C versus the B2C?

And second question is regarding the revised guidance. Should we assume most of the increase is mainly attributed to the better e-commerce revenue or should we also assume the digital entertainment revenue will be also some upside with the revised guidance?

And lastly, on the sales and marketing spend for the e-commerce as a percentage of the GMV ratio going forward, what would be kind of the expense ratio that we should be thinking about for the rest of this year? Thank you.

Alan Hellawell, Group Chief Strategy Officer

Sure. Alicia, I'll start off with some of the answers. I think your first question was about direct sales for sellers, which categories and which countries. The more prominent categories would be FMCG. We would also do some amount of 3C-related direct sales. We are generally seeing -- we're rolling it out in markets ranging from Taiwan to Indonesia. Although, we would expect other markets to follow suit.

I would just pause here to just remind you that it's actually a very, very small part of GMV. And we are really just kind of taking it quarter-by-quarter with these key customers. But we will make sure that we keep you apprised around the growth rate of that.

With regard to direct or consignment, actually it's a mix. We want to be as flexible as possible, and it may relate to the attributes of the product or the needs of the seller. But again, early to give you a sense as to what the breakdown would be between direct and consignment.

I think your next question was around 3P versus 1P. Again, the vast bulk of our value proposition from day one and through to today is marketplace. And we'll continue to embrace that as our main mode of business. We will do, again, 1P much more opportunistically. So I would not expect that 1P mix to rise significantly as a percentage.

I think you also had a question about C2C and B2C. Are you basically talking about Shopee and Shopee Mall?

Alicia Yap, Analyst

That's right.

Alan Hellawell, Group Chief Strategy Officer

Yeah. So, I would say, I think I'm correct in saying that across almost every market Shopee Mall is growing quite a bit faster than our incumbency, the Shopee business. And so, that's obviously very encouraging for us. And the reason why it's a regional trend for us is, we're often finding leading brands such as NIVEA recently who inked a multi-market distribution arrangement with us. There might be one other platform that has regional reach and is very strong in certain areas, but our demographic being largely female focused, I think puts us in very good stead to build that part of the business, not just in the Taiwan, not just in the Indonesia but regionally.

And so, with regard to the guidance, yeah, it's by and large relating to these new revenue streams that we're cultivating in e-commerce. I think it steady as she goes around the gaming business. Although, obviously, as a veteran analyst in that area, we may have updates over the next couple of quarters, particularly as we start delivering games from our pipeline.

And then sales and marketing as a percentage of GMV. I would say, generally speaking, we're very much in a phase where we're both pushing greater efficiencies out of the incremental GMV we create. And then we're also, we have a very natural tailwind by growing so much faster than our underlying markets. And those end up being better volume based discounts from our ecosystem of partners. So we're very much focused on continuously driving down sales and marketing as a percentage of GMV.

Alicia Yap, Analyst

Okay. Great. Thank you.

Alan Hellawell, Group Chief Strategy Officer

Sure.

Operator

Our next question is from Andrew Orchard with Nomura. Please go ahead.

Andrew Orchard, Analyst

Hi, guys. Good morning. Thanks for taking my question. Couple of questions. Number one, I think, Alan, you just mentioned that some brands that look at your regional reach and I think that's a benefit. How common is your sentiment? Because I think the thoughts behind e-commerce is, obviously, is that, it's a very fragmented and you look at individual market separately. So our brands coming around to looking at the region as a whole, and does that like you say, drive a lot more benefit going forward.

The other question is, again, on the top-up in the revenue guidance. How much of that within the revenue guidance is increase in 1P sales from e-commerce? Or did your original guidance already include some of this 1P product sales and this increase in the revenue guidance is basically just coming from a lot more GMV growth? So if you answers those two questions that would be great. Thanks.

Alan Hellawell, Group Chief Strategy Officer

Yeah. So with regard to your first question, brands coming around to look at the region. My understanding is, we have all forms and factors of partner on that front. We may have one brand that simply wants to establish a beachhead in one of the larger markets such as Taiwan or Indonesia and it's mission accomplished. And that may also relate to the fact that to your point, there are different buying behaviors and preferences mark-to-market. But one thing that we're seeing increasingly is our brand achieving a lot of success as -- working with (inaudible) partner. Maybe it is in Taiwan or Indonesia and deciding to roll out regionally. So we are finding that there is a lot of brands that use us in one or two markets as a test bed and with satisfactory results come back to us and say, we'd like to explore new markets.

But I think it's a fascinating engagement, these guys have very exacting expectations, they've been distributing on other e-commerce platforms around the world and we usually, frankly, have to spend maybe a good year with them to ensure the level of service that they expect. And interestingly, we're kind of making that one year lap with a lot of these brands. And so, we're quite excited about the second half of this year as we get approved as a partner for a lot of these names.

Do you want to answer the guidance question?

Tony Hou, Group Chief Financial Officer

Sure. So for the guidance, as we mentioned, we are broadening our service offerings for Shopee, including the Service by Shopee, Shopee Logistics and other value-added services. And, of course, that is part of the direct sales. So the increment comes from the broad spectrum of all these additional services we offer to the market, not only from the direct sales part.

Andrew Orchard, Analyst

Okay. Thank you.

Operator

Our next question is from Mark Goodridge with Morgan Stanley. Please go ahead.

Mark Goodridge, Analyst

Hey, guys. Just two questions on the e-commerce business. Firstly in Indonesia, can you just give us an estimate on what you guys think your market share is in that market, is it 20%, is it 30%, is it 40%? The guidance would be very helpful for the first quarter.

And then second question is just on Taiwan. Obviously, that is your most mature market with regards to e-commerce. When specifically do you think you'll be breakeven in that market? Is that six months away? Is it a year away? How close are we. Cheers.

Alan Hellawell, Group Chief Strategy Officer

Sure. I'll take that first question. It's -- I have a kind of a secondary career in trying to measure these markets and understand them. It is a bit tricky when -- across most of our markets, we're the only entity producing numbers. But if you look at a sampling of what we've been able to gather, our general market share tends to be kind of 25% to 30%. These would be by and large surveys done by third parties and the sample sets tend to be between 1,000 and 7,000 respondents. And it reflects, in many cases, the entirety of Indonesia. And so, as I think, we've discussed before, one of the benefits of the marketplace is, obviously, its ability to address not just the urban centers but other parts of the market. So that's kind of the best I can get you in terms of our estimates in the lack of any other data.

What is the questions? So the other -- sorry. Can you repeat your second question?

Mark Goodridge, Analyst

Yeah. Just on Taiwan. So, most mature market there with regards to the e-commerce. When do you think that that will be breakeven? Is it six months away, three months away, a year? Any color would be very helpful?

Alan Hellawell, Group Chief Strategy Officer

Yeah. We're probably not in the position to give that kind of granular guidance. I would say that, A, there is a couple of very favorable factors, as you know, Mark. We have a full commission schedule and have -- since maybe the middle of last year. Within that commission schedule, we are seeing a growing bias towards the higher commission rate forms of GMV, which in our case are Shopee Mall and cross-border.

And then to Tony's earlier point, these value-added services that we're rolling out have seen really good traction in Taiwan. So that's kind of the revenue take rate part. I would say on the sales and marketing to GMV side, we have succeeded in driving that down and we're confident that we'll continue to drive it down further. So, the two lines are definitely are coming closer together. We'll do our best to give you an update as we get closer to free cash flow breakeven, but I would say, particularly on the take rate component, we're obviously, climbing faster than we would have expected before we rolled out these value-added services.

Mark Goodridge, Analyst

Thanks, guys.

Operator

Our next question is from John Blackledge with Cowen. Please go ahead.

John Blackledge, Analyst

Great. Thank you. Two questions on e-commerce. So the GMV was better-than-expected and the guidance was raised. If you could provide any more color on kind of the key markets and/or key verticals driving the better-than-expected growth?

And then the second question on e-commerce would be, the marketplace revenue was also better-than-expected. Just wondering, if you could quantify marketplace revenue from commissions and advertising, and marketplace revenue from the value-added services in 1Q '18? And how we should think about the run rate for those two segments within marketplace revenue for the remainder of the year? Thank you.

Alan Hellawell, Group Chief Strategy Officer

Sure. So with regard to what might have driven stronger than anticipated GMV. Frankly, it seems to be quite broad-based across country and category. We thought generally very strong growth in our largest markets of Taiwan and Indonesia. Taiwan being a little more mature is, obviously, not growing as fast as the overall region. But Indonesia very much is. And in terms of the kind of Tier 2 markets, if you will, we saw Vietnam and Thailand inch up a little bit in terms of their contribution to orders in GMV. So generally, again, pretty broad-based.

With regard to category mix, it was actually very stable. You'll recall that in our long tail focus, fashion ends up being one of our -- is our largest category followed by health and beauty, home and living and then baby products. 3C remain a pretty small minority of our GMV, but again very few changes in the fourth quarter, again suggesting broad-based growth by category.

John Blackledge, Analyst

And then the marketplace (Technical Difficulty)

Alan Hellawell, Group Chief Strategy Officer

Exactly. Okay. So, I think you can probably gain a sense as to what our commission contribution is by looking at the GAAP and the non-GAAP numbers, because as you recall, GAAP guidelines force us to net out commission against sales and marketing. So, I'll leave it to you to kind of do that math.

VAS would be -- basically a -- would represent a significant part of the delta that you would have assumed for first quarter in your own numbers. Collectively, they're still a relatively small part. As they grow, we'll be able to give you more color. But again, it's fulfillment and logistics that contribute to VAS. And we've seen good adoption of both fulfillment and logistics in our largest markets.

John Blackledge, Analyst

Great. Thanks so much. Thank you.

Operator

Our next question comes from Varun Ahuja with Credit Suisse Singapore. Please go ahead.

Varun Ahuja, Analyst

Yes. Thank you, everyone, and congrats on a good set of numbers. First question is on the gaming business. It's expected to have a decent strong rather growth for the Sea on the revenue side. If you can provide some colors on the margins also, how should we look at the margins for the year, would there be any compression? Because '17 seems to have benefited from AOV. As you launch other pipeline games and other stuff, do you think the growth will be there but the margin, let's say, little bit of compression? That will be helpful, any color on that?

Secondly, again on the gaming side, you launched Free Fire in your own game -- in your markets plus Tencent has launched this PUBG mobile in your markets. So how do you see this evolving in terms of relationship and it's on the battle royale genre? But given Tencent is your kind of a larger shareholder and also kind of a main provider of the games to you in terms of the reselling. So how that this relationship of competition evolve over you and Tencent, that would be -- any color that would be helpful? Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Sure. Thanks for the questions. And for -- in terms of like our game business, Garena's margin, I would expect the margin will be pretty stable I think like in our Q4, like a 38% margin, and I don't see the margin will go up or go down like significantly for the rest of the year. And so, it's a pretty stable. As you mentioned, okay, so last year our margin, like, has improved because of like Arena of Valor. Actually, if you are looking at our -- this year, I think probably Arena of Valor is continually contribute very positively on our margins as well because the games are still growing very, very nicely.

And for some other like new games are going to launch in our pipeline because the things we don't expect that going to, like hit our margins like significantly because anyway, like, by being the largest game platform in the region, already have a huge user game -- user base and for the game like we were going to launch like this already really, really highly anticipated. So we don't expect we're going to need to spend aggressively on user acquisition for those new titles. Yeah. So, which is probably the new release is the major like spending with regarding that the new game launch.

Yeah. I think for the second question, like, PUBG in terms of our, like relationship like with Tencent, which -- related of the PUBG mobile. I think, like, if I remember correctly, probably I gave some thoughts, like, in our last earnings -- our earning release that we have been discussing, we have always have very open discussion with Tencent. We have a pretty good visibility about the Tecent's game pipeline as well. So like a regularly discuss with Tencent what is the best approach for each of the games in their pipeline and what is our view of the game in the market and what is the best way to launch it.

I think specifically for battle royale genre and things like, so we already have the Free Fire and Free Fire is specifically developed for Southeast Asia gamers and say for example, like, we have some very specific features, we have been very focused on to meet the needs of Southeast Asia gamers. Number one say, we are very, like, cautious and a very sensitive in terms of per game session and we relatively get an understanding from other our games like -- so in generally, like, gamers prefers like a shorter game session probably 10 minutes, 15 minutes per game session, they can enjoy a gameplay rather than spend like 20 minutes to 30 minutes on one game session. So we specifically developed the -- for Free Fire, for example, like you stand up like with 100 people to play the game together, we make it to be like a 50 people together with the game with the smaller maps, so which -- so the per game session is shortened. And I think it's very welcomed by gamers in our core market.

And another example is in terms of the sensitivity of the smartphone spec, so we have been try to optimize the game experience for Free Fire on the -- towards the lower end, like specs phones, reaches the majority of gamers like the pace -- like the phone they have right in our market. So there is a -- in a way, we have been very confident in terms of the potential and outlook of our Free Fire. And considering our resources and also like to encourage like our internal studio development and so we decided we just focus on one game rather than just have like a multiple games in our portfolio. And yeah.

So that is -- I think this is probably also in the best interest of Tencent and -- right because like, if you think about it like they give the game to us, they may say, okay, how you are going to -- sounds like there is a conflict of interest like how you are going to balance the two games when you allocate your resources.

I think, like, looking a little bit long-term, so we have very strong relationship, like a very strong trust and the collaboration with Tencent and for some games in our pipeline for the launch this year, that is a Tencent's game and there is highly anticipated game as well. And I would say, like, I don't just want to generalize the relationship by one or two cases. I think it's a pretty much, it's a game by game discussion. And by the end of day, so whatever is the best overall for the game rather than just, okay, so, yeah, so this is just a one party interest.

So I think looking forward, you may expect, okay, you will still see, we are going to have pretty high-quality games from Tencent in our pipeline, and also not be surprised if Tencent to launch one or two games by themselves in our region as well.

Varun Ahuja, Analyst

Thank you. Thank you for this detailed explanation. Just one more I want to sneak in. The quarterly average user that you disclose is little bit distorted, given Free Fire has been launched outside of your core market. Can you give color how much of that quarterly average user in your seven core markets, what is outside if you an disclose that? Thank you.

Forrest Li, Chairman and Group Chief Executive Officer

Well, I think like -- we probably like -- don't want to like a breakdown to that details, but I think like a still majority of our user base is coming from our core markets.

Varun Ahuja, Analyst

Okay. Thank you.

Operator

Our next question comes from Archana Parekh with SeaTown. Please go ahead.

Archana Parekh, Analyst

Hi, Forrest, Alan, Tony, congrats on a good set of numbers. I wanted to ask a question, Alan, I think brought up the comparison to the Walmart, Flipkart transaction and mentioned that you may consider something at the Shopee level. Could you elaborate a little bit more on that? And also share with us sort of how similar/different are Flipkart and Shopee, as well as the potential that Shopee has to attract interest in a similar sort of way?

Alan Hellawell, Group Chief Strategy Officer

Yeah. Hi, Archana. I guess, our -- one of our central modus operandi is, obviously, to create value for shareholders. That's probably the unifying thing that drives our meetings day to day and our activities. And it's actually not just Flipkart, but there are some other very, very encouraging examples of transactions that suggest people put a lot of value in a leading e-commerce platform, and frankly it was effectively the most important component on my decision to exit after almost 20 years of equity research and that is what I was seeing with Shopee in Southeast Asia.

And so, at our current share price, I don't think I'm saying anything controversial by saying that it probably is not capturing the dimensions of a platform that has achieved so much in so little time and that frankly, I think has a tremendous opportunity going forward. And so, we -- I wouldn't want to focus exclusively on that. I guess, the real message here is that, we remain entirely open-minded and opportunistic around realizing value for shareholders. But again, I think that we are very confident, quarter-after-quarter we will deliver on our business plan at Shopee and we're hopeful that people will ascribe increasing value to that.

Again, we may offer this very rare opportunity to invest directly in this once in the generation opportunity, we may forge another path. But again we're very much -- we're very keen on making sure that a shareholder realizes as much value across our business units as possible. We remain singularly focused on seizing some of the largest parts of the Southeast Asian Internet economy and we want to share that success with our investors.

Archana Parekh, Analyst

Thank you. That's clear.

Operator

And our next question --

Alan Hellawell, Group Chief Strategy Officer

Yeah. We'll -- sorry, Austin, we'll take one more question. Thanks.

Operator

Thank you, sir. Our last question today will come from Harry Whelpton with Arisaig Partners. Please go ahead.

Harry Whelpton, Analyst

Hi, there. I wanted to see if you could give a bit more disclosure on the stay of shipping subsidies, especially in Indonesia and kind of how much of that -- how much orders are being subsidized?

Alan Hellawell, Group Chief Strategy Officer

I would say, generally speaking, we are not unlike any other market succeeding in driving down shipping subsidies as a percentage of GMV. There is no real black magic there. It's just kind of growing scale economies. You will find that as a shopper with time by and large and because you're not looking for free shipping you're looking more for selection, you are looking more for pricing on the platform, you maybe focused much more on the user experience. We have means of kind of gradually withdrawing that subsidy level.

We're not in a position to give you an exact percentage of how many of our customers get any subsidies. But I would just say that, we have a confidence that is supported by a lots of precedence around the world markets going through consolidation that we will continue to succeed in driving sales and marketing to GMV down in markets not just like Indonesia, but hopefully all of our markets.

Great. Austin, with that, I think we'll wrap up. As always, we very much appreciate you guys joining. Welcome any questions you might have. We happen to be joining some of the bigger conferences in the region over the next couple of weeks. If we don't meet you there, we look forward to hearing from you directly or through the analysts. But thanks again for joining, and thank you, Austin.

Operator

And thank you, sir. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2018-05-15
Event Description: Q1 2018 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q1 2018 Earnings Call

Company Participants

- Alan Hellawell
- Forrest Xiaodong Li
- Tian Yu Hou

Other Participants

- Miang Chuen Koh
- Michael J. Olson
- Alicia Yap
- Andrew J. Orchard
- Mark Goodridge
- John Blackledge
- Varun Ahuja
- Archana Parekh

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Sea Limited First Quarter 2018 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Alan Hellawell, Group Chief Strategy Officer. Please go ahead.

Alan Hellawell

Thank you. Good morning and good evening, everyone, and welcome to Sea's 2018 first quarter earnings conference call. I am Alan Hellawell, Sea's Group Chief Strategy Officer. Before we continue, I'd like to remind you that we might be making forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release.

Also, this call includes discussion of certain non-GAAP financial measures, such as adjusted revenue, adjusted EBITDA and adjusted net loss. We believe these measures can enhance our investors understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on Non-GAAP Financial Measures in our press release.

Let me begin by introducing the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; and our Group Chief Financial Officer, Tony Hou. Forrest, Tony and myself will share strategy and business updates, operating highlights and financial performance for the quarter. This will be followed by a Q&A session in which we welcome any questions you have.

With that, let's begin with Forrest for our key strategic highlights.

Forrest Xiaodong Li

Thanks, Alan. Thank you for joining today's call. In the first quarter of 2018, we once again enjoyed robust growth across all of our businesses. I would like to start by highlighting that our digital entertainment business, Garena, returned its number one position in our region for the full year of 2017, based on a combined assessment conducted by Niko and the Newzoo recently of the online gaming market in our region.

Looking at the fourth quarter of 2018, Garena delivered adjusted revenue of $146 million, up 43% year-on-year, and adjusted EBITDA of $55 million, a increase of 49% year-on-year. We are also pleased to share with you that our first self-developed mobile title, Free Fire, recently achieved 13 million DAUs. Free Fire's continued growth give us confidence that the title has great potential going forward. Free Fire remains in the early stages of monetization as we focus on building up a critical mass of users. We will look to focus more on monetization as Free Fire's user base continues to expand.

We continue to grow our eSports offering to achieve even greater dominance in our region. Our annual flagship event, Garena World, had attendance of approximately 240,000 and attracted over 10.6 million views online. Over 11,000 teams competed in various tournaments leading up to the event in Bangkok. We are confident that our eSports franchise will drive user gamer engagement and extend the lifecycle of our games.

We also have a strong pipeline of highly anticipated titles for 2018 across both classic and the new franchises. And we are excited about their upcoming launches.

Let's move on to e-commerce. Shopee continued to enjoy rapid growth and ever improving economics. I'm pleased to report that e-commerce GMV reached $1.9 billion in the fourth quarter of 2018, almost triple that for the fourth quarter of 2017. As mentioned previously, we continue to expand support to our sellers through value-added services.

Our Service by Shopee offerings include inventory management, online store operations, and the fulfillment services. We also provide Shopee Logistics Service for cross-border sellers with complex logistical requirements. On top of that, we may conduct direct sales on behalf of key brands and sellers. We enable sellers to mix and match the different services based on their needs and their preferences.

Both Service by Shopee and the Shopee Logistics Service serve as natural expansions of our business as we expand our partnership with brands. At the same time, we also deepen our relationship with sellers who have outgrown their capacity to cope with the increased demand who have more complex needs. We are committed to the success of our sellers and will continue to find ways to improve the online selling experience.

We expect these services to strengthen our long-term relationships with our sellers. With these additional services, we are able to improve the product assortment, stock availability, and the pricing for our buyers.

In summary, I'm very proud of the growth that we have achieved in the first quarter of 2018, and I look forward to a strong growth trend for the rest of 2018.

With that, let me hand it over to Alan.

Alan Hellawell

Thank you, Forrest. Within digital entertainment, we continue to strengthen our market leadership. Forrest has outlined adjusted revenue and adjusted EBITDA results. Garena continues to deliver significant free cash flow. Our digital entertainment adjusted EBITDA [ph] margin rose (00:06:10) to 38% in the first quarter of 2018 compared to 36% in the same period in 2017, revealing further margin leverage of Garena benefits from greater scale.

I would like to share with you one more facet of Garena's expanding role in the mobile edge and smartphones continue to improve access to gaming, a greater number of people are gaining access to better forms of entertainment. This will lead to an increase in demand for mobile gamers for high-quality content. And as a result, we expect to see sustained growth in the popularity of leading multi-year mobile game franchises, similar to what we've seen for PC. And as the game franchises grow, their ancillary ecosystem start to develop as well, which will intensify greater demand from increasingly sophisticated mobile gamers for better on-the-ground game services and community building.

Given our position as the leading gaming platform, our geographic reach, our long running on-the-ground presence in these markets, and our track record of success, we believe that Garena is well positioned to provide such services. These factors are also key enablers to our dominance in eSports. We have become one of the regions' most fully integrated eSports operators since our inception in 2009. Critical to our success is the extensive network of community leaders we've attracted across various markets.

We work closely with them to run thousands of local eSports events. On top of this infrastructure, we have a suite of capabilities supporting eSports' content production, particularly in our largest markets. We're particularly excited about the rapid expansion in eSports activities around Arena of Valor, which with Honour of Kings constituted the world's largest [ph] grossing (00:07:58) gaming franchise based on the latest data available. We also expect the inclusion of League of Legends and AOV as eSports at the Asian Games in Jakarta to generate additional enthusiasm in gameplay around these titles.

In terms of operational results, quarterly active users or QAU, meanwhile grew 125% year-on-year and 44% quarter-on-quarter to $126.7 million, largely driven by existing games such as Arena of Valor and Free Fire. Meanwhile, average revenue per user or ARPU came in at $1.20 compared to $1.80 for the first quarter of 2017 and $1.60 for the fourth quarter of 2017. The easing in ARPU is mainly due to rapid user growth around Free Fire, which resulted in faster QAU growth compared to quarterly paying users or QPUs.

QPUs remain stable at $7.2 million in the first quarter of 2018. As Forrest has mentioned, our focus for Free Fire right now is to build up a pool of long-term gamers. We are indeed experimenting with different monetization tools in parallel, albeit at a gradual pace.

With regards to e-commerce, the markets in our region continue to grow strongly. Frost & Sullivan for instance just released its quarterly e-commerce report, which estimated that first quarter 2018 GMV for Southeast Asia and Taiwan grew 45% year-on-year to $10 billion. Based on their analysis of our region, Shopee is the largest e-commerce platform by orders in all markets other than Singapore.

Once again, Shopee had an outstanding quarter with GMV reaching $1.9 billion, almost triple the GMV for the first quarter of 2017 and representing quarter-on-quarter growth of 23%. Shopee's gross orders reached $111.4 million, which more than tripled year-on-year. Our ability to grow at such a rapid pace in an increasingly competitive market is testament to the Shopee Management Team's outstanding execution. In fact, Shopee's pace of growth is ahead of our already ambitious expectations. And as we disclosed in our release, we've adjusted our revenue and GMV guidance for the full year of 2018 to reflect our confidence and sustaining the strong momentum.

Our sales and marketing expenses declined in absolute terms from $135 million in the fourth quarter of 2017 to $127 million in the first quarter of 2018, reflecting how well we are managing our spending, but still driving strong GMV growth. S&M as a percentage of GMV declined from 8.5% in the fourth quarter to 6.6% in the first quarter.

In addition, we are pleased to share with you that this quarter we have value-added services contributing to our e-commerce adjusted revenue. Forrest touched on these offerings and Tony will go into greater detail around these items in his remarks. Our ability to offer such value-added services is in many ways driven by, one, the unique characteristics of the markets we serve; two, the less developed e-commerce value chains found in our region; and three, our unique and growing skillset in servicing sellers.

We expect these value-added services to grow and the business model to improve with rise in scale, efficiency, and constant service improvement. We also continue to cultivate our direct sales business, which has contributed to growth in product revenue. As we have referenced on previous calls, we have begun to offer direct sales service to select sellers, particularly larger brands. We view these services as an effective strategy to improve many aspects of our marketplace.

They are, for instance, ideal for fast-moving SKUs with demand in fulfillment needs. With regards to our digital financial services business, we continue to focus our efforts on strengthening our infrastructure to support our existing platforms.

With that, I will pass on to Tony to talk more about the financials.

Tian Yu Hou

Thank you, Alan, and thank you, everyone, for joining the call. First, I would like to talk about some changes in this quarter's release. For our e-commerce segment, we have made additional revenue disclosures on marketplace revenue and product revenue to help you better understand Shopee's operations as the business model evolves.

Marketplace revenue consist of commission and advertising income as we have disclosed in the previous quarters, and revenue generated from Service by Shopee, Shopee Logistics Service, as well as other value-added services, as we continue to broaden our service offerings, while product revenue mainly consist of revenue from direct sales. We have included detailed quarterly financials guidance together with corresponding management analysis in today's press release. So, rather than taking you through our disclosures line by line, I will focus my comments on some key financial metrics so that we have more time for Q&A later.

For Sea overall, our first quarter total adjusted revenue was our highest ever at $197 million, an increase of 81% year-on-year and 20% quarter-on-quarter. This was primarily driven by the continued growth of our digital entertainment business and the monetization efforts of our e-commerce business. Digital entertainment adjusted revenue was $146 million, an increase of 43% year-on-year and 3% quarter-on-quarter, primarily due to the growth of our QAUs as we launched new games, expanded our existing games into new markets, and grew our existing major games in the core markets.

Adjusted EBITDA was $55 million, an increase of 49% year-on-year and 5% quarter-on-quarter, as we improve our operational efficiencies. E-commerce adjusted revenue was $33.7 million, up 262% quarter-on-quarter from the first quarter of 2017. Of this $33.7 million adjusted revenue, marketplace revenue was $22 million while product revenue was $11.7 million.

Adjusted EBITDA loss [indiscernible] (00:14:16) slightly to negative $179.6 million, as we continued our investment to fully capture the market opportunity in the region. We will stick to our strategy to grow our Shopee platform and strengthen our market leadership position, especially in our focused categories.

We expect our investment in sales and marketing to continue throughout 2018, as both our GMV and gross orders to grow. Digital financial services' adjusted revenue was $3.9 million, up 93% year-on-year from $2.0 million in the first quarter of 2017. Adjusted EBITDA loss was $8.6 million in the first quarter of 2018 compared to a loss of $9.9 million in the same period of 2017.

We had a net non-operating loss of $18.2 million recognized in the first quarter of 2018. This was primarily due to the fair value loss of $18.8 million arising from the fair value accounting of the convertible promissory notes and the interest expenses accrued on these same notes, partially offset by an investment gain arising from the disposal of an equity security investment.

We had a net income tax benefit of $0.8 million in the first quarter of 2018, which was primarily due to the change in statutory tax rate in one of our markets we operate in and the increase in deferred revenue from our digital entertainment segment in the first quarter of 2018. Finally, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses, was $205.5 million in the first quarter of 2018 as compared to $67 million for the same period of 2017.

I will conclude with our revised guidance for this year. For the full year of 2018, we now expect total adjusted revenue to be between $780 million to $820 million, representing year-on-year growth of 41% to 48%. This compares to the previously disclosed guidance of $730 million to $770 million. We are also revising our e-commerce GMV guidance.

We now expect the GMV to be between $8.2 billion to $8.7 billion for the full year of 2018, representing year-on-year growth of 99% to 112%. This compares to the previously disclosed guidance of between $7.5 billion to $8.0 billion.

Alan Hellawell

Thank you, Tony. Austin, we shall now open the call for questions.

Q&A

Operator

[Operator Instructions] And our first question will come from Miang Chuen Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Thank you. Congratulations on the good results. Three questions, please. Firstly, can we have more color on the part with monetizing Free Fire more significantly and when it could have a meaningful impact as well on paying users?

Secondly is that we understand [ph] same (00:17:51) balance sheet, of course, do look very strong. I will continue more Shopee-related spending [ph] as needed (00:17:58). Can we also have an [ph] upgrade (00:18:00) on any potential fundraising plans?

And thirdly, for e-commerce revenues, can you elaborate on the country breakdown and whether we should expect product revenues to also grow exponentially in coming quarters? Thank you.

<A - Forrest Xiaodong Li>: Okay. Thank you. This is Forrest. I will talk about the Free Fire monetization question and then I will pass to Alan for the rest of the question. And for Free Fire, we are very excited and we are very encouraged by seeing the rapid growth of our user base. And so in the last quarter [ph] release we (00:18:38) report and we have 6 million daily active users.

And after three months like this quarter, so now the number is growing to 13 million. It's more than doubled in terms of DAU. And especially like we achieved this tremendous growth with the contacts that actually some competing games was launched aggressively globally. And actually very interestingly, like, during that period of time when the competing game was launched and actually the user number of Free Fire – the growth of that actually has accelerated.

And regarding your question in terms of the monetization for Free Fire and that has been – we have been like shifting our focus from just – really, really just a focus on [ph] growing (00:19:32) the user base now to a more balanced approach, which likely we start to really spend a lot of effort to think hard on how to monetize a game where we have studied all the – like a similar general games in terms of how they monetize the user base for battle royale games. And we have been – have some good ideas and we see some successful examples from other similar type of games. For example, like we have been quite impressed by the monetization of [indiscernible] (00:20:01). And we believe that is a very good path for us to explore as well.

And – so, we have been starting this effort like in the past one to two months and we're going to release a new version – updated version later this month, probably either later this week or next week. And from that version, we are going to start to see the – our effort like in terms of monetization. We're going to see that from the – like from the revenue result. I'm pretty confident I think probably three months later when we are back to this earning release and we are going to have a very – some very encouraging monetization number to share with you related to Free Fire.

<A - Alan Hellawell>: Great. Thanks, Forrest. I'll answer your second question, which as I recall, was about Shopee-related spending and fundraising plans. As you've observed and see, we very much have a healthy cash balance. When we look at the longer term, there are many options for us to strengthen our balance sheet, and much more importantly, unlock greater value for our shareholders. This could include raising money at the Shopee level. We believe that Shopee is being significantly undervalued. One only need to look at recent transactions to support this view.

Flipkart, for instance, was acquired at, I think, 2.8 times GMV for the March year, for more than $20 billion valuation. I think, as I recall, the company's GMV grew about 50% year-on-year during this period. Meanwhile, Shopee's GMV growth, as we know, was about 4 times faster than that of Flipkart for the same period. And I think our GMV was roughly 70% that of Flipkart. So, we remain totally open minded about the fundraising and we're very lucky to have various [indiscernible] (00:22:01) options there.

With regard to direct sales and product revenue, again, just a little context, this has started to evolve, largely driven by seller's needs and preferences. We will continue to add kind of a growing toolkit to help sellers manage inventory and fulfill orders from warehouses. And we have started leasing warehouses, as you all know, several months ago.

We can also help operate their stores on our platform and we may even purchase products from brands for resell on our platform. That part of the business we don't expect to form a significant part of GMV for the foreseeable future, direct sales that is. As we're in kind of early stages, rolling out these services, it would be premature to compare margin profiles, but we wouldn't expect it to be very dissimilar from our peers.

<Q - Miang Chuen Koh>: Sure. And regarding the marketplace revenues, is it possible to share a bit of the country's breakdown? Is it – meaning is [indiscernible] (00:23:11) broad based you're talking about? Is it more Taiwan focused now, yeah?

<A - Alan Hellawell>: I think there's still for obvious reasons an [ph] outside (00:23:20) presence from Taiwan, largely because it was kind of a first mover market. It was the first market in which we rolled out all forms of commission taking. We do, however, have a growing number of monetization tools across other markets related to some of these new revenue line items.

And so, this kind of matrix of country versus the form of monetization were gradually filling in, but with time, we can safely say that market outside of Taiwan will grow to be an ever larger percentage of revenue.

<Q - Miang Chuen Koh>: Great. Thank you both for your answers.

[indiscernible] (00:24:02).

Operator

Our next question comes from Mike Olson with Piper Jaffray. Please go ahead.

<Q - Michael J. Olson>: Thanks a lot for taking my question. I had a couple related to gaming specifically. When you look at the battle royale genre and the success that you've had with Free Fire, is the intention at this point to continue to focus on that game singularly or is there any reason to look at potentially additional games within that genre or does that potentially, I guess, dilute Free Fire?

And then, secondly, on eSports specifically, do you guys view that as a potential real kind of revenue standalone business or do you view it as more of a kind of marketing halo that helps with engagement of the title? Thank you.

<A - Forrest Xiaodong Li>: Sure. Thank you for the question and first question like in terms of like Free Fire and the more general the battle royale genre, and at this moment, we are like just [indiscernible] (00:25:09) genre, we are [ph] pre-focused (00:25:11) on Free Fire and as we just discussed and we see a tremendous growth of our user base and I think like in terms of the user base, Free Fire is already probably one of the largest game worldwide in that specific genre. I think like at this moment, in generally, we still believe [indiscernible] (00:25:33) at very beginning stage and that there is going to be continuous [ph] movement (00:25:38) of the genre, which means probably there's going to have a more like a different type of playability and there is going to be have more features of this genre.

So, I think like based on the user base of Free Fire, this offer us a very good foundation to continually explore this genre, and also probably with some like our self-innovated approach, right, in terms of the playability and in terms of [ph] feature (00:26:08) of the game. Actually, we're keep trying that. So, that's the main task of our Shanghai Studio.

So, basically, like number one is pretty much focused on the monetization of the existing user base, and second is like we believe, okay, we expect to see like a more growth of this genre moving forward. So, we want to capture the wave, and we continually explore different type of gameplays, and we interact, communicate with community frequently, and we ask, so what more they want from this game and what is some other innovative ideas around this genre. So, at this moment, I don't think like we needed just another battle royale game like to capture the wave of the growth of the genre, and we just need to focus on what we already have built and continually grow Free Fire.

But at the same time, we remain very open minded and we keep – closely monitor worldwide how the genre is developed. We have some of our own ideas, but we also love to learn the best practice from some other, like peer studios worldwide. And there could be the challenge, right, for certain games like we may collaborate with them for our core market like Southeast Asia and Taiwan.

And as I think that is – and at the same time like other than the battle royale genre, I think like we continue to have a very balanced approach and we have several very highly anticipated game titles, pipeline to launch this year from our – like [ph] developer partners (00:27:49). And we have a like – I think we have a pretty like high confidence about the performance of those games. And I hope like I can come back with a very – some very encouraging result [indiscernible] (00:28:04).

And in terms of the eSports, definitely, they would believe this is a very important trend and this is how gamers spend their time, not just in the game, but also out of the game. And this is a good way to enhance the engagement – the gamers' engagement and also increase the life cycle of the games. And definitely, at this moment, I think there's two steps needed for our approach. Number one is like we're just going to focus on [indiscernible] (00:28:36) for the eSports experience for our existing user base. And, luckily, like there is a big percentage of our games in our pipeline, in our existing portfolio or eSports-related games, and this has been the genre we have been focused on since day one.

So, we have a lot of good experience of that. And I think, likely [indiscernible] (00:28:58) so there is a strong need from gamers in terms of those eSports experience. We want to fulfill that need first. And at the same time, we have been very like motivated and encouraged to see some other market like China and there is a strong monetization of eSports-related products and services as well. And I think like [ph] we continue (00:29:20) to learn from those [indiscernible] (00:29:23) market, and hopefully, we're going to apply to our market as well. I think we are well positioned to capture the revenue potential of eSports in our key markets.

<Q - Michael J. Olson>: Thank you very much.

Operator

Our next question comes from Alicia Yap with Citigroup. Please go ahead.

<Q - Alicia Yap>: Hi. Thank you. Good morning, Forrest, Tony, Alan. Congrats on the good results and thanks for taking my questions. I have some follow-up questions on the e-commerce. Wanted to get a sense of these direct sales of these – for some of the seller. Could you give us some color like which categories are these product and in which countries? And are we taking the inventory risk on these or more on the consignment model? And what would be our strategy of the overall mix of this 3P versus 1P going forward, and also within the marketplace the going forward mix of the C2C versus the B2C?

And second question is regarding the revised guidance. Should we assume most of the increase is mainly attributed to the better e-commerce revenue or should we also assume that digital entertainment revenue will be also some upside with the revised guidance?

And lastly, on the sales and marketing spend for the e-commerce as a percentage of the [ph] G&P (00:30:54) ratio going forward, what would be [ph] high off (00:30:57) the expense ratio that we should be thinking about for the rest of this year? Thank you.

<A - Alan Hellawell>: Sure. Alicia, I'll start up with the – some of the answers. I think your first question was about direct sales for sellers, which categories and which countries. The more prominent categories would be FMCG. We would also do some amount of [ph] 3C-related (00:31:28) direct sales. We're generally seeing – we're rolling it out in markets ranging from Taiwan to Indonesia, although we would expect other markets to follow [indiscernible] (00:31:46).

I would just pause here to just remind you that it's actually a very, very small part of GMV, and we are really just kind of taking it quarter-by-quarter with these key customers. But we will make sure that we keep you apprised around the growth rate of that. With regard to direct or consignment, that's actually it's a mix. We want to be as flexible as possible and that may relate to the attributes of the product or the needs of the seller, but, again, early to give you a sense as to what the breakdown would be between direct and consignment.

I think your next question was around 3P versus 1P. Again, the vast bulk of our value proposition from day one and until to today is marketplace. And I will continue to embrace that as our main mode of our business. We will do, again, 1P much more opportunistically. So, I would not expect that 1P mix to rise significantly as a percentage.

I think you also had a question about C2C and B2C. Are you basically talking about Shopee and Shopee Mall?

<Q - Alicia Yap>: That's right. That's right.

<A - Alan Hellawell>: Yeah. So, I would say – I think I'm correct in saying that across almost every market, Shopee Mall is growing quite a bit faster than our incumbent B2B Shopee business. And so that's obviously very encouraging for us. And the reason why it's a regional trend for us is we're often finding leading brands, such as NIVEA, recently who [ph] inked (00:33:37) a multi-market distribution arrangement with us. There might be one other platform that has regional reach and is very strong in certain areas, but our demographic being largely female focused, I think puts us in very good stead to build that part of the business, not just in the Taiwan, not just in an Indonesia, but regionally.

And so, with regard to the guidance, yeah, it's by and large relating to these new revenue streams that we're cultivating in e-commerce. I think it's steady as [ph] she (00:34:15) goes around the gaming business, although obviously, as a veteran analyst in that area, we may have updates over the next couple of quarters, particularly as we start delivering games from our pipeline.

And then, sales and marketing as a percentage of GMV, I would say, generally speaking, we're very much in a phase where we're both pushing greater efficiencies out of the incremental GMV we create and then also we have a very natural tailwind by growing so much faster than our underlying markets. And those end up being better volume-based discounts from our ecosystem of partners. So, we're very much focused on continuously driving down sales and marketing as a percentage of GMV.

<Q - Alicia Yap>: Okay. Great. Thank you.

<A - Alan Hellawell>: Sure.

Operator

Our next question is from Andrew Orchard with Nomura. Please go ahead.

<Q - Andrew J. Orchard>: Hi, guys. Good morning. Thanks for taking my question. A couple of questions. Number one, I think Ali just mentioned that you have some brands that look at your regional reach and take that to benefit. How common is this sentiment, right? Because I think the thoughts behind e-commerce in Southeast Asia is that [indiscernible] (00:35:37) fragment and you look at individual markets separately. So, are brands coming around to looking at the region as a whole and does that, like you say, drive a lot more benefit going forward?

The other question is, again, on the top up in the revenue guidance, how much of that within the revenue guidance is increased in 1P sales from e-commerce or did your original guidance already include some of this 1P product sales and this increase in the revenue guidance is basically just coming from a lot more GMV growth? So, if you answer those two questions, that would be great. Thanks.

<A - Alan Hellawell>: Yeah. So, with regard to your first question, brands coming around to look at the region. My understanding is we have all forms and factors of a partner on that front. We may have one brand that simply wants to establish a beachhead in one of the larger markets, such as Taiwan or Indonesia, and its mission accomplished. And that may also relate to the fact that to your point, there are different buying behaviors and preferences mark-to-market, but one thing that we're seeing increasingly is our brand achieving a lot of success working with us as a partner, maybe it is in Taiwan or Indonesia and deciding to roll out regionally.

So, we're finding if there's a lot of brands that use us in one or two markets as a test bed and with satisfactory results come back to us and say, we'd like to explore new markets. But I think it's a fascinating engagement. These guys have very exacting expectations. They've been distributing on other e-commerce platforms around the world. And we usually, frankly, have to spend maybe a good year with them to ensure the level of service that they expect. And interestingly, we're kind of making that one year lap with a lot of these brands. And so, we're quite excited about the second half of this year as we get approved as a partner for a lot of these names. Do you want to answer the guidance [ph] question (00:37:51)?

<A - Tian Yu Hou>: Sure. So for the guidance, as we mentioned regarding our service offerings for Shopee, including the Service by Shopee, Shopee Logistics, and other value-added service, and of course, there is a part of the direct sales. So, the increment comes from the broad spectrum of all these additional services we offer to the market, not only from the direct sales part.

<Q - Andrew J. Orchard>: Okay. Thank you.

Operator

Our next question is from Mark Goodridge with Morgan Stanley. Please go ahead.

<Q - Mark Goodridge>: Hey, guys. Just two questions on the e-commerce business. Firstly, in Indonesia, can you just give us an estimate on what you guys think your market share is in that market? Is it 20%? Is it 30%? Is it 40%? The guidance would be very helpful for the first quarter.

And then, second question just on Taiwan. Obviously, that is your most mature market with regards to e-commerce. When specifically do you think you will be breakeven at market? At 6 months away? Is it a year away? How close are we? Cheers.

<A - Alan Hellawell>: Sure. I'll take that first question. It's – I have a kind of a secondary career in trying to measure these markets and understand them. It is a bit tricky one. Across most of our markets, we're the only entity-producing numbers. But if you look at a sampling of what we've been able to gather, our general market share tends to be kind of 25% to 30%.

These would be by and large surveys done by third-parties and the sample sets tend to be between 1,000 and 7,000 respondents. And it reflects, in many cases, the entirety of Indonesia. And so, as I think we've discussed before, I think one of the benefits of a marketplace is obviously its ability to address on not just the urban centers, but other parts of the market. So, that's kind of the best I can get you in terms of our estimates and the lack of any other data.

What are the questions? So, the other – sorry, can you repeat your second question?

<Q - Mark Goodridge>: Yeah. Just on Taiwan. [indiscernible] (00:40:30) on the e-commerce, when do you think that that will be breakeven, six months away, three months away, a year? Any color would be very helpful.

<A - Alan Hellawell>: Yeah. We're probably not in a position to give that kind of granular guidance. I would say that, A, there is a couple of very favorable factors. As you know, Mark, we have a full commission schedule and have – since maybe the middle of last year, within that commission schedule, we are seeing a growing bias towards the higher commission rate forms of GMV, which in our case are Shopee Mall and cross-border. And then to Tony's earlier points, these value-added services that we're rolling out have seen really good traction in Taiwan. So, that's kind of the revenue take rate part.

I would say on the sales and marketing and GMV side, we have succeeded in driving that down, and we're confident that we'll continue to drive it down further. So, the two lines, they are definitely coming closer together. We'll do our best to give you an update as we get closer free cash flow breakeven, but I would say, particularly on the take rate component, we're obviously climbing faster than we would have expected before we rolled out these value-added services.

<Q - Mark Goodridge>: Thanks, guys.

Operator

Our next question is from John Blackledge with Cowen. Please go ahead.

<Q - John Blackledge>: Great. Thank you. Two questions on e-commerce. So, the GMV was better than expected and the guidance was raised. If you could provide any more color on kind of the key markets and/or key verticals driving the better than expected growth?

And then, the second question on e-commerce would be the marketplace revenue was also better than expected. I'm just wondering if you could quantify marketplace revenue from commissions in advertising, then marketplace revenue from the value-added services in 1Q 2018, and how we should think about the run rate for those two segments of the marketplace revenue for the remainder of the year? Thank you.

<A - Alan Hellawell>: Sure. So, with regard to what might have driven stronger than anticipated GMV, frankly, it seems to be quite broad-based across country and category. We saw generally very strong growth in our largest markets of Taiwan and Indonesia. Taiwan being a little more mature is obviously not growing as fast as the overall region, but Indonesia very much is. And in terms of the kind of Tier 2 markets, if you will, we saw Vietnam and Thailand inch up a little bit in terms of their contribution to orders in GMV.

So, generally, again, pretty broad-based. With regard to category mix, it was actually very stable. You'll recall that in our long-tail focus, fashion ends up being one of our – is our largest category, followed by health & beauty, home & living and then baby products to receive – remain a pretty small minority of our GMV, but again, very few changes in the fourth quarter, again suggesting broad-based growth by category.

<Q - John Blackledge>: And [indiscernible] (00:44:24).

<A - Alan Hellawell>: Exactly. Okay. So, I think you can probably gain a sense as to what our commission contribution is by looking at the GAAP and the non-GAAP numbers. Because as you recall, GAAP guidelines force us to net out commission against sales and marketing. So, I'll leave it to you to kind of do that math.

VAS would be basically a – would represent a significant part of the delta that you would have assumed for first quarter in your own numbers. Collectively, there's still a relatively small part. As they grow, we'll be able to give you more color. But again, it's fulfillment and logistics that contribute to VAS. And we've seen good adoption of both fulfillment and logistics in our largest market.

<Q - John Blackledge>: Great. Thanks so much. Thank you.

Operator

Our next question comes from Varun Ahuja with Credit Suisse, Singapore. Please go ahead.

<Q - Varun Ahuja>: Yeah. Thank you, everyone, and congrats on a good set of numbers. First question is on the gaming business. It's expected to have a decent strong [ph] outlook (00:45:51) growth for this year on the revenue side. If you can provide some colors on the margins also, how should we look at the margins for the year? Will there be any compression because 2017 seems to have benefited from AOV? As you launch other pipeline games and [indiscernible] (00:46:06) stuff, do you think the growth will be there, but the margin will see a little bit of compression? That will be helpful. Any color on that.

Secondly, again on the gaming side, you launched Free Fire in – your own game in your market plus Tencent has launched this PUBG Mobile in your market. So, how do you see this evolving in terms of relationship? And it's in the battle royale genre, but given Tencent is your kind of largest shareholder and also kind of a main provider of games to you in terms of [ph] E-Selling (00:46:38). So, how that this relationship of competition evolve over you and Tencent? Any color that would be helpful. Thank you.

<A - Forrest Xiaodong Li>: Sure. Thanks for the questions. And in terms of like our game business Garena's margin, I would expect like the margin would be pretty stable. I think like in our Q4, we have like 38% margin. And I don't see the margin will go up or go down like significantly for the rest of the year. And it's pretty stable.

As you mentioned, okay, so last year, our margin like is improved because of like Arena of Valor. Actually, if you're looking at this year, like probably Arena of Valor is continually contribute very positively on margin as well because the game is still growing very, very nicely. And for some other like a new game, which are going to launch in our pipeline, [indiscernible] (00:47:42) things we don't expect that's going to like hit our margin like significantly, because, anyway, like by being the largest game platform in the region, we already have a huge, huge user base. And for the game like we are going to launch like this already are really, really highly anticipated, so we don't expect we're going to need to spend aggressively on user acquisition for those new titles. Yeah, so – which is probably the [ph] new release (00:48:13) is the major like spending regarding the new game launch. Yeah.

I think for the second question like a PUBG in terms of our – like a relationship, like, which is the Tencent, which is related of the PUBG Mobile and things like – if I remember correctly, probably I gave some thought likely in our last earning release that we've been discussing – we always have very open discussion with Tencent, okay, among. We have a pretty good visibility about the Tencent's game pipeline as well. So, [indiscernible] (00:48:47) discussed with the Tencent what is the best approach for each of the games in their pipeline and what is our view of the game in the market and what is the best way to launch it.

I think specifically for battle royale genre and the things like – so we already have the Free Fire and the Free Fire is specifically developed for Southeast Asia gamers and we – see, for example, like [indiscernible] (00:49:15) very specific features, we have been very focused on to meet the needs of Southeast Asian gamers. Number one, say, we are very like cautious and very sensitive in terms of per game session. And we relatively get understanding from other our games like – so, in generally, like gamers prefer like a shorter game session, probably 10 minutes, 15 minutes per game session. They can enjoy a gameplay rather than spend like 20 minutes to 30 minutes on one game session.

So, we specifically developed for Free Fire to [indiscernible] (00:49:49) like with 100 people to play the game together, we make it to be like 50 people together with the game with a smaller map, so which – so the per game session is shortened. And I think we're welcomed by gamers in our core markets.

And another example is in terms of the sensitivity of the smartphone specs. So, we have been try to optimize the game experience for Free Fire on the – towards a lower end like [ph] spec phones (00:50:20), which is the majority of gamers like [indiscernible] (00:50:26) like the phone they have right in our market.

So, there is a – in a way, so we've been very confident in terms of the potential and outlook of Free Fire and considering our resources and also like to encourage like our internal studios development and [indiscernible] (00:50:47) we just focus on one game rather than just have like a multiple games in our portfolio and – yeah. So, that is – I think this is probably also in the best interest of Tencent and [indiscernible] (00:51:05) think about it like they give the game to us, they may say, okay, how are you going to – it sounds like there's a conflict of interest like how [ph] are we (00:51:12) going to balance the two games, where you allocate your resources.

I think like looking a little bit long term, so we have a very strong relationship, like a very strong trust and the collaboration with Tencent. And for some games in our pipeline for the launch this year, that is a Tencent's game and there is highly anticipated game as well. And I would say like I don't just want to generalize the relationship by one or two cases. I think it's pretty much is a game-by-game discussion. And by the end of the day, so whatever is the best overall for the game rather than just – okay, so – yeah, so this is just a one party interest.

So, I think looking forward, you may expect, okay, [ph] that we will still see (00:51:53) – we're going to have pretty high-quality games from Tencent in our pipeline. And I will also not be surprised if Tencent to launch one or two games by themselves in our region as well.

<Q - Varun Ahuja>: Thank you. Thank you for this detailed explanation. Just one more one I want to sneak in. The quarterly average user that you disclosed is a little bit distorted given probably Free Fire has been launched outside of your core market. Can you give color how much of that quarterly average user in your [ph] seven (00:52:25) core markets versus outside if you can disclose that? Thank you.

<A - Forrest Xiaodong Li>: Well, I think like – we probably like – don't want to like breakdown to that details, but I think like still majority of our user base is coming from our core markets.

<Q - Varun Ahuja>: Thank you.

Operator

Our next question comes from Archana Parekh with SeaTown. Please go ahead.

<Q - Archana Parekh>: Hi, Forrest, Alan, Tony. Congrats on a good set of numbers. I wanted to ask a question. Alan, I think, brought up the comparison to the Walmart-Flipkart transaction and mentioned that you may consider something of a Shopee level. Could you elaborate a little bit more on that, and also share with us sort of how similar or different are Flipkart and Shopee, as well as the potential that Shopee has to attract interest in a similar sort of way?

<A - Alan Hellawell>: Yeah. Hi, Archana. I guess, our – one of our central modus operandi is obviously to create value for shareholders. That's probably the unifying thing that drives our meetings day to day and our activity. And it's actually not just Flipkart, but there are some other very, very encouraging examples of transactions that suggest people put a lot of value in a leading e-commerce platform. And, frankly, it was effectively the most important component of my decision to exit after almost 20 years of equity research, and that is what I was seeing with Shopee in Southeast Asia.

And so, at our current share price, I don't think I'm saying anything controversial by saying that it probably is not capturing the dimensions of a platform that has achieved so much in so little time and that, frankly, I think has a tremendous opportunity going forward. And so, I wouldn't want to focus exclusively on that. I guess the real message here is that we remain entirely open minded and opportunistic around realizing value for shareholders.

But, again, I think that we're very confident quarter after quarter, we will deliver on our business plan at Shopee. And we're hopeful that people will ascribe increasing value to that. Again, we may offer this very rare opportunity to invest directly in this [indiscernible] (00:55:17) generation opportunity. We may forge another path. But, again, we're very much – we're very keen on making sure that a shareholder realizes as much value across our business units as possible. We remain singularly focused on seizing some of the largest parts of the Southeast Asian Internet economy, and we want to share that success with our investors.

<Q - Archana Parekh>: Thank you. That's clear.

Operator

Our next question...

<A - Alan Hellawell>: Yeah. We'll – sorry, Austin. We'll take one more question. Thanks.

Operator

Thank you, sir. Our last question today will come from [ph] Harry Walton with RSR Partners (00:56:02). Please go ahead.

<Q>: Hi, there. I wanted to see if you can give a bit more disclosure on the safe shipping subsidies, especially in Indonesia and kind of how much of that – how much orders are being subsidized at the moment?

<A - Alan Hellawell>: I would say, generally speaking, we are not unlike any other market, succeeding in driving down shipping subsidies as a percentage of GMV. There's no real black magic there. It's just kind of a growing scale economies. You will find that as a shopper, with time, by and large, and because you're not looking for free shipping, you're looking more for selection, you're looking more for pricing on the platform, you may be focused much more on the user experience. We have means of kind of gradually withdrawing that subsidy level.

We're not in a position to give you an exact percentage of how many of our customers get any subsidies, but I would just say that we have a confidence that is supported by lots of [ph] precedence (00:57:21) around the world. Markets going through consolidation that we will continue to succeed in driving sales and marketing to GMV down in markets, not just like Indonesia, but hopefully all of our markets.

Alan Hellawell

Great. Austin, with that, I'll think we'll wrap up. As always, we very much appreciate you guys joining. Welcome any questions you might have. We happen to be joining some of the bigger conferences in the region over the next couple of weeks. If we don't meet you there, we look forward to hearing from you directly through the analyst, but thanks again for joining. And thank you, Austin.

Operator

And thank you, sir. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2018-02-27
Event Description: Q4 2017 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q4 2017 Earnings Call

Company Participants

- Alan Hellawell
- Forrest Xiaodong Li
- Tian Yu Hou
- Nicholas A. Nash

Other Participants

- Miang Chuen Koh
- Alicia Yap
- Mike J. Olson
- Scott William Devitt
- John Blackledge
- Andrew J. Orchard
- Varun Ahuja

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone, and welcome to the Sea Limited Fourth Quarter and Full Year 2017 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note that this event is being recorded.

I would now like to turn the conference over to Alan Hellawell, Group Chief Strategy Officer. Please go ahead.

Alan Hellawell

Good morning and good evening, everyone, and welcome to Sea's 2017 fourth quarter earnings conference call. I'm indeed Alan Hellawell, Sea's Group Chief Strategy Officer. Before we continue, I would like to remind you that we might be making forward-looking statements, which are inherently subject to risks and uncertainties and may not be realized in the future for various reasons as stated in our press release. Also, this call includes discussion of certain non-GAAP financial measures such as adjusted revenue, adjusted EBITDA, and adjusted net loss. We believe these measures can enhance our investors understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures and reconciliation with the closest GAAP measures, please refer to the section on non-GAAP financial measures in our press release.

Let me begin by introducing our management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; our Group President, Nick Nash; and our Group Chief Financial Officer, Tony Hou. Forrest, Tony and myself will share strategy and business updates, operating highlights and financial performance for the fourth quarter of 2017. This will be followed by Q&A session in which we welcome any questions you have.

With that, let's begin with Forrest for our key strategic highlights.

Forrest Xiaodong Li

Thanks, Alan. Thank you everyone for joining today's call. I'm very pleased to share that all three of our businesses saw robust expansion in the fourth quarter of 2017 on both a quarter-on-quarter and year-on-year basis.

As you know, Garena is our most established business and is our largest source of revenue and profit. I'm happy to share that it continued to grow strongly, delivering quarterly adjusted revenue of $141.9 million, up 59% year-on-year. Quarterly adjusted EBITDA more than doubled year-on-year to $52.6 million, showing very strong growth year-on-year. The launch of Free Fire, a mobile battle royale game on 4 December 2017 on both the iOS App Store and the Google Play Store was an important milestone for us. We developed the Free Fire entirely in-house. I'm excited by the success it has had to-date, both in the region and beyond.

Free Fire was planned and designed for a mobile gamer right from the start. Our development team focused on features such short game lens, social elements and the less demanding hardware specs, which are more suitable for users in our region.

We were also able to launch the game in many markets quickly to capture a critical mass. The journey has been exciting and we're encouraged by the results. Free Fire has already achieved 6 million daily active users as we have only started monetizing the game in January, it is still too early to gauge Free Fire's revenue potential, but we're actively exploring to their channels of monetization. We will continue to step up our self-development capabilities to design games that meet the constantly evolving needs and the preferences of our gamers.

Meanwhile, we remain committed to building our partnerships with top-class developers, so that gamers in our region can enjoy a world-class game franchise. For example, we partnered with NetEase on the mobile RPG game, Onmyoji. We launched it in Thailand last year and Vietnam just a few weeks ago.

Let's move on to e-commerce. We take a long-term view on Shopee and the growth is our top priority for the business. I'm pleased to share that e-commerce GMV reached $1.6 billion in the fourth quarter of 2017, an increase of more than 200% year-over-year and another record quarter for Shopee. In line with our growth and the monetization roadmap, we are investing strategically to support big brands as they establish flagship stores on our Shopee Mall. We are already working with leading brands such as L'Oréal, Xiaomi, Unilever and [indiscernible] (00:05:52).

These partners work with us largely because we can meet their demanding requirements such as fulfillment support and other value-added services. Shopee now leases warehouse in a number of our markets to meet the needs of our sellers. We will continue to evaluate additional services to support sellers as we grow our seller base. I'm confident that we can expand monetization as we grow Shopee's market share. We're also planning to introduce new monetization tools as our relatively scaled growth, and the one market dynamics makes sense.

In summary, I'm very proud of the growth that we have achieved in 2017. We look forward to another strong year of growth. Our region is one of the world's fastest growing markets for digital entertainment, e-commerce, and the digital financial services. We're confident that we will continue to build our leadership by constantly innovating to better the day-to-day life of consumers and small businesses.

Before I hand the call over to Alan, I would like thank you for your [ph] thoughtful (00:07:02) suggestions over the past few months, particularly around how we present the business on an ongoing basis. Our Group CFO, Tony Hou, will be updating you on how we have refined our segmental financial disclosure to better facilitate your understanding of our businesses and measure our progress.

But first, over to Alan.

Alan Hellawell

Thank you, Forrest. I would like build on Forrest's remarks with more detailed commentary and business updates. Within digital entertainment, we continue to strengthen our market-leading role. Forrest has outlined it, adjusted revenue and adjusted EBITDA results. Quarterly active users, or QAUs, grew 74% year-on-year and 27% quarter-on-quarter to $87.8 million, largely driven by existing games such

such as Arena of Valor and the launch of Free Fire.

Meanwhile average revenue per user, or ARPU, came in at $1.60, compared to $1.80 for the fourth quarter of 2016, and $2 for the third quarter of 2017. The easing in ARPU was mainly due to rapid user growth around our newly launched games, which resulted in faster QAU growth compared to quarterly paying users or QPUs. We are pleased that QPUs increased to $7.2 million in the fourth quarter of 2017, from $6.5 million in the previous quarter. Looking ahead, we are excited about the pipeline of titles we have in store through the rest of 2018, and look forward to sharing details in due course.

With regard to e-commerce, the markets in our region continue to grow strongly. Frost & Sullivan for instance, just released its latest quarterly e-commerce report, estimating that 2017 GMV for Southeast Asia and Taiwan grew by 33% year-on-year to $31.8 billion. Shopee had an outstanding quarter with GMV reaching $1.6 billion, representing year-on-year growth of 206% and quarter-on-quarter growth of 48%.

Shopee's gross orders reached $98.3 million, which represents an impressive growth of 244% year-on-year and 49% quarter-on-quarter, largely driven by the rapidly expanding Indonesian market.

On a market by market basis, Indonesia experienced the strongest absolute growth in the fourth quarter. Even the more mature Taiwan market continues to display healthy growth rates in both GMV and gross orders. We also see our market share growing steadily in markets such as Thailand and Vietnam. Shopee's sharp growth trajectory is underpinned by a heavy focus on long tail product categories, such as fashion, and health & beauty, which serve the needs of our female customer base.

Our marketplace approach maps particularly nicely to the needs of those shoppers situated outside of capital city, where we believe the fastest GMV growth is occurring. We continue to devote resources to make Shopee the mobile platform of choice for both sellers and buyers. Fostering user engagement is critical to us. A recent YouGov ranking of brand recognition in Indonesia put Shopee among the top 10 well-known brands, the only e-commerce brand, along with other household names, such as Garuda Indonesia and Toyota.

In terms of our digital financial services, our GTV grew 311% year-on-year and 129% quarter-on-quarter to reach $1 billion in the fourth quarter of 2017, driven by closer integration with Shopee and expansion of use cases. We continue to focus our efforts on strengthening our infrastructure to support our existing platforms.

With that, I will pass on to Tony to talk more about the financials.

Tian Yu Hou

Thank you, Alan, and thanks to, everyone, for joining the call. First, let me highlight some positive changes in this quarter's release. On top of the segmental information, we have disclosed in the previous quarters, we have started to disclose both EBITDA and adjusted EBITDA by segment is further to help you better understand our profitability. For our digital entertainment business, we have revised our estimation for certain games' revenue recognition period by using average paying user lives instead of game licensing period. The revision applies to one of our top titles, Arena of Valor.

The impact of such changes was not significant. We believe that the revised estimations better reflect the economic assets of their respective games more accurately and result in higher quality financial reporting.

We have included the details quarterly and annual financial schedules together with the corresponding management analysis in today's press release. So rather than taking you through our disclosure line by line, I will focus my comments on some key financial metrics, so that we have more time for Q&A later. For Sea overall, our fourth quarter total adjusted revenue was our highest ever at $164.5 million, an increase of 73% year-on-year and 8% quarter-on-quarter. This was primarily driven by the continued growth of our digital entertainment business and the initial monetization efforts of our e-commerce business.

Digital entertainment adjusted revenue was $141.9 million, an increase of 59% year-on-year and 5% quarter-on-quarter, primarily due to the growth of our QAUs as we launch new games and expanded our existing games into new markets. Adjusted EBITDA was $52.6 million, an increase of 216% year-on-year and 17% quarter-on-quarter. Our initial efforts to [indiscernible] (00:13:17) Shopee platform are on track. E-commerce adjusted revenue was $9.3 million, up 62% quarter-on-quarter from the third quarter of 2017. We've also seen improvements in the efficiency of sales and marketing spend as a percentage of selling and marketing over GMV improved from 9.7% in the third quarter of 2017 to 8.5% in the fourth quarter of 2017.

The percentage for the full year also improved from 11% in 2016 to 8.3% in 2017. Adjusted EBITDA loss widened to $175.4 million as we continued our investment to fully capture the market opportunity in the region. We will stick to our strategy to grow the platform and strengthen our market leadership position, especially in our focused categories. We expect this investment trend to continue in 2018, as both our GMV and gross orders continue to grow.

Digital financial services revenue was $4.1 million, up 140% year-on-year from $1.7 million in the fourth quarter of 2016. The increase was primarily attributable to the addition of use cases to our AirPay platform and a further deepening of our market penetration. Adjusted EBITDA loss was $7.6 million in the fourth quarter of 2017, compared to a loss of $9.2 million in the same period of 2016. We had a non-operating loss of $62.3 million recognized in the fourth quarter of 2017. This was primarily due to a fair value loss of $52 million from the fair value accounting treatment for the convertible promissory notes and their interest expenses accrued on those same notes.

We also had an income tax expenses of $8.7 million in the fourth quarter of 2017, primarily due to the corporate income taxes and withholding tax expenses recognized for our digital entertainment business. As a combined result of all of the above, our adjusted net loss, which is net loss adjusted to exclude share-based compensation expenses, was $251.6 million in the fourth quarter of 2017 as compared to $62 million for the same period 2016.

I will conclude with our guidance for this year. We currently expect total adjusted revenue to be between $730 million to $770 million for the full year of 2018, representing year-on-year growth of 32% to 39%. For our e-commerce segment, we currently expect GMV to be between $7.5 billion to $8.0 billion for the full year of 2018, representing year-on-year growth of 82% to 95%.

Alan Hellawell

Thank you, Tony. We'll now open up the call for questions.

Q&A

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] And our first questioner today will be MC Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Hi. Good morning, Forrest, Nick and Alan. Congratulations on the good set of results. Couple of questions. Firstly, can you talk a bit about the PC versus mobile adjusted revenue mix? And secondly, in terms of pay ratio, it seems to have declined QoQ as it – I know you talked a bit about this over the first few minutes, but if we can also get a bit more color, perhaps by games, is it just Free Fire or is it also sort of due to AOV now you're monetizing in certain markets? Thank you.

<A - Forrest Xiaodong Li>: Thanks. Thanks for the question. And talking about the PC and the mobile, and we are pretty like excited about the growth opportunity of mobile. And so, as we have like just reported for Arena of Valor, we hit 10 million daily active users in the Q4 2017. At the same time, our self-developed game Free Fire like also reached 6 million daily active users in our region and beyond our region as well. So, we see this is a huge growth opportunity. I think we're going to continually try our best to capture such opportunities.

And for your question on the PC side, and currently, we have several like big titles, right, like League of Legend and the FIFA Online 3 and for like – looking at 2018, we do have a several high expected like PC game to be launched as well. I think I'm not going to just comment specific on any games in our future pipeline, but we remain very confident about the growth of both PC and mobile games in our region.

<A - Alan Hellawell>: I'm sorry, MC, you had a second question about conversion rate, is that correct?

<Q - Miang Chuen Koh>: Yes. Correct, Alan. Yeah.

<A - Alan Hellawell>: Do you mind indulging us in repeating it one more time?

<Q - Miang Chuen Koh>: Yes. So, in terms of the quarterly pay ratio, it appears to have declined [ph] but (00:19:21) QoQ. So, just wondering if I can get a bit more color on why that's the case, perhaps if you could attribute it to specific games. I mean, as far as you can disclose, is it mainly because Free Fire came on and that sort of make the active users base increase a lot, but not yet to pay users or is it also that AOV has not yet started monetizing in certain regions, and that's why the ratio has fallen?

<A - Forrest Xiaodong Li>: Okay. Yeah. I think actually like – yeah, as you just like mentioned, okay, so it is mainly due to the huge increase in terms of the user base of Free Fire and we launched a game just in December, but [indiscernible] (00:20:06) very well and but we only like start to monetize the game at – from the beginning of like this year, so starting in January. So, we also like – in terms of the monetization, we still just go over a moderate approach. So that's why you see a big surge in terms of the – our active user base. So, – but now it's really like reflecting in the – like a paying ratio. And but if you look at our -absolutely, our quarterly paying user number is increased a lot as well. So like from last quarter to Q3 from 6.5 million quarterly active user to 7.2 million quarterly active users in Q4. So, it's even just look at – that the pace, the absolute like paying a user base is – we think we still see a very robust growth. Yeah.

<Q - Miang Chuen Koh>: Okay. Great. I'll come back to the queue again. Thank you.

Operator

And our next questioner today will be Alicia Yap with Citigroup. Please go ahead.

<Q - Alicia Yap>: Hi. Thank you. Good morning, Forrest, Nick, Tony and Alan. Thanks for taking the questions and also congrats on the solid results. My first question is regarding your full year guidance. I listened Tony mentions about some changes on the revenue recognitions for some games in 4Q, and we notice maybe that the reported digital entertainment is actually slightly better. Would that actually the change has any effect into 2018 and how should we translate your guidance of 32% to 39% to this digital entertainment GAAP revenue? And then, is this the driver for digital entertainment, is that mainly driven by the gradual realm of the monetizations of Free Fire and also the AOV or is it also will be driven by some of the new games that in the pipeline you're going to be launch?

My second question is on the e-commerce is that your GMV guidance seems very robust. Can you share with us in terms of the growth rate that you expect for the reported revenues and also expectations on monetization for the major country, such as Taiwan, Indonesia and maybe Thailand? Where would you expect the GMV growth mainly come from? And then on monetization, where do you expect the main pick up of the growth come from? Would that be the Shopee Mall commission rate or the performance-based advertising in certain market? Thank you.

<A - Tian Yu Hou>: Thanks, Alicia. So, I will take the first question first. So, for the guidance, we're talking about adjusted revenue, which is more cash basis. So, the change in the GAAP revenue accounting wouldn't affect the cash guidance [ph] per se (00:23:14), and for the driver of the growth, especially on the digital entertainment side, yes, it's a combination of the existing titles and also the new titles that are on the road. So, we continuously focus on the user activeness and the user stickiness and while we provide better service to the users on our platform. So – yeah, so that's the answer to your first question.

And for the second question on the GMV guidance, well, it's a combination, so as for our major markets like Indonesia and Taiwan, of course, we will continue driving our strong growth in the coming year, and beyond that for the other markets like Thailand and Vietnam, we will also put our focus on that because we have seen a good opportunity windows for us to fully capture the market potential. So, Alan, you want to comment that?

<A - Alan Hellawell>: Yeah, maybe I'll add a little there. Alicia, you made reference to Shopee Mall, which is the branded part of our marketplace and we're indeed very excited about that. We in many markets now look to Shopee Mall for more than 10% of our GMV. And in Taiwan, where we've implemented a universal commission schedule, we had a 5% take rate there. So, to the extent that Shopee Mall significantly outstripped Shopee in terms of growth, all things being equal, we're going to see a nice bias or an improvement in the take rate there.

With regard to performance-based advertising, or we don't give that particularly a specific guidance there, we would just say we have implemented ad tools across almost all of our markets, the uptake has been very encouraging, and we do feel that that will become an important component of monetization in the same way some of our predecessors in the region have very, very successfully used ad tools to instill a little more order to these marketplaces. So, we're also very enthusiastic about that.

<Q - Alicia Yap>: Okay. Great. Thank you.

Operator

And our next questioner today will be Mike Olson with Piper Jaffray. Please go ahead.

<Q - Mike J. Olson>: Hey, good morning. Thanks for taking my question. So, I just have two. At this point, it sounds like Free Fire is relatively immaterial to Garena revenue as you kind of work to monetize that growing user base. But, I guess – please let me know if that's not correct, but what I was wondering is, is there a typical timeframe over which you find that you can successfully monetize a new title like should we begin to see Free Fire becoming more material in Q2 or would it be more in the second half of the year?

And then for Shopee, I guess, kind of just a follow-up from the last question. In the script, you mentioned some additional ways to monetize and drive higher overall take rate and you just talked about Shopee Mall and seller commissions and advertising. Is there more or are there more monetization tools beyond that that we're not thinking about or that haven't been discussed on the call? Thank you.

<A - Forrest Xiaodong Li>: Okay. Thank you for the question. Let me answer this. I think like for the first question specifically on Free Fire, so since we launched the game, it grew very, very well and we see the enthusiasm like on the game across actually from all over the world, across a lot of like our existing market and the new markets, the gamer are very enthusiastic about the game, and they are very active in the community. So, they have been giving us a lot of like suggestions in terms of the new features of the game and how the direction of the game should be. So, like to be very honest, like our [ph] internal (00:27:28) like development team, at this moment is – they are working day and night even like during the Chinese New Year.

So, they work pretty hard and to fulfill the expectation of the gamers from the product features, from the in continuity, enhanced graphic quality of the game, right. So, to be honest, at this moment, even just look at our – like our own focus is, we will rather to just continually make the game itself – like to make it a more like as a premium game and continue to make it more attractive to gamers. And we still see that the growth of the user base is very fast, and we are really excited about it, and we want to capture this opportunity and to try to build up the user base as big as possible.

So, at this moment, we start to explore like all the different type of the monetizations of the game, but in terms of like when we start to really focus on monetization, I would say it could be in the next quarter and it could be in six months. I don't have a very specific answer. It really depends on how the user base grows and how the response of the gamer community.

But in general, I'm very confident, I seldom see a game with very popular, with a huge user base – like user base that have no – have a very kind of like disappointing way to monetize the game and [indiscernible] (00:29:00) is not the case. I think like still for most of the games, the user base is critical. It's nice to have real loyal gamers to play the games, and there is always the way to figure out the monetizations later. So at that part, I'm pretty confident. I will keep update you in terms of our monetization progress of Free Fire moving forward.

And in terms of your second question on Shopee, and at this moment, like, still I think we took a pretty long-term view, and we don't – we have been [ph] not very (00:29:36) excited. Just to say okay, the immediate monetization like a – or like – in terms of it, like a very ish – like so, okay, so like six months or like the next six months like – what is the – what is our monetization, we are not focusing on that. And we see this tremendous growth opportunity of e-commerce in our region and that we want to capture that as much as possible the market share at this moment.

But we have also seen clear the monetization path, and I think from some pioneers of the industry and also see what the best practices from other regions right specifically the performance-based advertising, right and also the commissions. I think there is a one area we see there is a huge potential for us for the additional monetization is some value-added services. And as our platform grow very fast under the sellers on Shopee, they are growing very fast as well. So, recently I visit – just the – [ph] a salary in Indonesia (00:30:40). At the beginning of 2017, every day they only have like about 100 daily orders and now they have like a 1,500 daily orders.

So, that the growth to them is a tremendous. So, because of this growth, they also need a lot of value-added services such as they start to need hire people like to help them manage the – to processing of the orders, they need to have a setup start to have set up their small warehouse, [indiscernible] (00:31:07) just put everything in their house, right. And so all those areas, I think there is a tremendous opportunity to monetize to meet that the sellers demand as they also grow their scale. So, this is like a particular area, where we are also looking at and I will feel there is a huge opportunity there.

<Q - Mike J. Olson>: All right. Thank you.

Operator

And the next questioner will be Scott Devitt with Stifel. Please go ahead.

<Q - Scott William Devitt>: [indiscernible] (00:31:40) taking the question, I did have two. The first one is on Shopee and just in listening to JD's management team talk about their interest and efforts in the region as well given the sponsorship the companies share, I'm just interested in terms of how you think about the complementary nature of Shopee relative to JD and the ability to potentially work together in the region or is it just too early in the development of the markets to begin to think about something like that?

And then secondly, it'd be great if one of you wouldn't mind just adding a little bit more color on Nick's retirement and kind of that dynamics in terms of how responsibilities are going to be inherited upon his departure and maybe why not stay on the board when he leaves the company? Thank you.

<A - Alan Hellawell>: Sure, thanks. This is Alan. I'll take your e-commerce question or JD related question. We benefit from a very cordial relationship with Richard Leo and his team at JD. I would say to your question, I think that they're still in an exploratory phase. We know that they've made some investments in markets such as Indonesia, Thailand. They're doing some stuff in Vietnam. We communicate with them regularly; however, I think we're both exceptionally busy trying to determine how we deliver our value proposition to each of these markets, but we fully intend to continue our dialogue with them and we'll see where that goes.

With regard to your question about Nick and his retirement, I think if you don't mind we'll save that to right after FAQ wraps up and hopefully we'll gain some comments from both Forrest and Nick on that.

<Q - Scott William Devitt>: Great. Thank you.

Operator

And the next questioner today will be John Blackledge with Cowen. Please go ahead.

<Q - John Blackledge>: Great, thanks. Two questions. So, the June results were stronger than we expected driven by kind of bigger upside in gross orders versus what we had estimated. Just wondering if you can provide some insight into the drivers of the strong gross order growth? And in that regard, it looked like Taiwan's growth on a Q-over-Q basis was a bit slower than the other markets, just any call out there? And then just the last question, if you can just give some color on Shopee's logistics and delivery speed relative to competitors in some of the larger markets that will be helpful? Thank you.

<A - Alan Hellawell>: Sure. Yeah, I mean again in [indiscernible] (00:34:39), we were extremely pleased with the fourth quarter performance frankly across all of our markets. We, I would say, are still in kind of discovering the relevance of the marketplace model in a lot of our markets. And so, I believe that that value proposition has just been taken up much more readily than we would have anticipated. There are elements of what you might call a network effect. The more stores that we bring online and turn greater number of customers that they bring pre-existing from their social sites or a new fire level of growth. And to your question, our order intensity that constantly surprise us.

You mentioned Taiwan, I mean it is ultimately by so many different angles kind of our most matured market, but even having said that, I think the year-on-year growth and the quarter-on-quarter growth are significantly in excess of what we understand to be the underlying market growth rate. So we're actually very pleased with that. And forgive me, can you repeat your second question?

<Q - John Blackledge>: Yes. Sure. So just talk about Shopee's logistics and delivery speed relative to competitors in some of the bigger markets in Indonesia and Taiwan, et cetera, in relationships with the 3PLs. Thank you.

<A - Alan Hellawell>: So a couple items there. First of all just back to that key word network effect, by having a number of merchants which we measure in the millions and in an individual market such as Indonesia, a number that's already exceeded $1 million, we basically – statistically speaking are likely to have a merchant and some kind of approximate area to someone placing an order.

And so we've seen this in other markets around Asia, the market place player ending up not being particularly deficient in terms of average delivery time because of that principle. Our understanding, having looked at third party research is, we tend to deliver in a market like Indonesia within two days. And we believe that is the fastest pace of delivery in the market – in markets such as Taiwan which obviously probably have better infrastructure and are smaller geographically, it's even less than that.

But Chris Feng and his team at Shopee to his great credit from day one put huge emphasis on the technological aspects of rolling out an e-commerce platform and that really included from day one, an attempt to back end integrate with the leading 3PLs. This is something he's been able to achieve across all seven of our markets.

And so, I think I don't have any updated numbers in terms of delivery time or other kind of quantitative elements, but our understanding is by working with these guys on a daily basis, we're helping them help us in many ways, not just to improve the experience and delivery time, but in more for longer-term planning purposes, identifying hotspots of emerging demand and across one or several of Indonesia's 34 provinces and enabling them to grow their delivery center capacity, their last mile head count to anticipate and preempt that. So our general efforts are designed at consistently improving the logistics experience.

<Q - John Blackledge>: Thank you.

Operator

And our next questioner will be Andrew Orchard with Nomura. Please go ahead.

<Q - Andrew J. Orchard>: Hi. Good morning, guys. Couple of questions on Shopee as well. Firstly, on the sales and marketing spend for e-commerce. Can you walk us through the Q-on-Q decline in terms of sales and marketing spend at GMV? How did you manage to do – how did you manage to [indiscernible] (00:39:19) it back a little bit and what are you looking for in terms of sales and marketing in the next quarter and next year going forward? And also you talked about the leasing of warehouses for Shopee Mall, how do you expect this to evolve going forward? And in terms of future expenses, in terms of rental, where are you expecting this to hit towards eventually as a percent of revenue, percent of GMV and where would you book these costs? Thanks.

<A - Alan Hellawell>: Sure. This is Alan. I'll take your questions. So, you're referring to sales and marketing as a percentage of GMV having declined to 8.5% in the fourth quarter of last year versus 9.7% in the third quarter. I mean descending from [ph] 50,000 feet (00:40:11), we're clearly with every passing day that we grow magnitudes faster than many of our markets. We're moreover enjoying a level of operating leverage that others who may not be growing as fast don't have access to. That said, we are also singularly focused on investing as efficiently as possible in growing that GMV. And as we look into 2018, we are very focused similarly on continuously driving down S&M as a percentage of GMV.

You know that said, as one of your peers pointed out earlier in the call, we're targeting level of GMV growth which represents very strong growth, whereas as S&M as a percentage of GMV we're very hopeful we'll continue to go down. Obviously in absolute terms, it will grow relatively robustly. I'm not sure if I've answered your question, Andrew?

<Q - Andrew J. Orchard>: Yeah. I think that's good.

<A - Alan Hellawell>: With regard to your second question, just maybe a couple comments on why we're doing what we're doing or even before that the scale of what we're doing, it's actually very, very limited. And the genesis of some of these ancillary services owes to a lot of the larger brands that we begun to court and Forrest mentioned several of them in his prepared remarks.

These brands generally have very high standards and expectations in their partners and so, we may decide here to help co-locate some inventory for one vendor, we may there offer what you might call supply chain management services. The scale of these efforts is still from a P&L perspective de minimis. You know, it's early days and we believe that we've won the allegiance of a lot of these leading brands to our willingness to accommodate them. We don't have a sense that their demands will grow inordinately nor will the investments devoted to that [ph] balloon (00:42:41). But we'll keep you apprised. But right now it's really, it ends up bringing a lot of these brands over the try line.

And I would, with that comment, also emphasize that so many of these brands are looking for one stop shops and affiliating with e-commerce platforms in Southeast Asia. And we feel we are one of the very limited number of options that they can go to and we're really starting to see that advantage blossom with a growing list of multi-national leading consumer brands.

Operator

And our next question today will be MC Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Sure. Couple more questions from me. Firstly is the – in terms of the e-commerce revenue increase. It seems like mainly coming from Shopee Mall. Can we understand whether the Shopee Mall take rate is the same across all countries or not? And as you – the second question is as you mentioned before, Shopee Mall is about 10% of GMV or so. Can you give us a sense of what how big this – the contribution could be in a more mature state? Thank you.

<A - Alan Hellawell>: Yeah. So with regard to the Shopee Mall take rate, just to be very clear at this point in time, it's only being assessed in Taiwan. So that specific 5% take rate is exclusive to Taiwan. We have three categories of take rate MC, as you will recollect. We have a Shopee Mall, we've got cross-border and then we have the traditional Shopee C2C commission schedule. So the first two are now 5%. Cross-border for some period of time was 3%, and we've up that to 5% and we do charge that across a number of our markets.

The very nice thing just to pick up one of my responses earlier is that both Shopee Mall and cross-border GMV growth rates are significantly in excess of the underlying Shopee C2C growth rate. So again, just as a commission specific comment, we would expect the blended commission rate to continue to grow with time. And again, MC forgive me, your second question was?

<Q - Miang Chuen Koh>: Yeah. So we mentioned that Shopee Mall has about 10% GMV, just wondering like in the more mature state, would it be like 20%, 30% you think?

<A - Alan Hellawell>: I think we're generally a bit reluctant to provide that kind of guidance. I mean we look around the region. We see a lot of our peers within nearly 50-50 mix between the traditional C2C and the brand-oriented platforms. That is part of our framework as we think about things longer term. And I would also just once again say that the growth trajectory is such that we already have some markets which are probably closer to 15% of GMV coming from Shopee Mall. So I would think that the discussion does matter thinking about higher levels of mix going forward.

<Q - Miang Chuen Koh>: Sure. Thank you very much.

Operator

And the next questioner today will be Varun Ahuja with Credit Suisse. Please go ahead.

<Q - Varun Ahuja>: Yeah, hi. Good morning, everyone. Thanks for taking the questions. I've got three questions on e-commerce. Firstly, I just want to go back to the warehouse thing. I know you mentioned just initial very little investments that you're making. But given Taiwan, this is a more specific to Taiwan particularly because both PChome and [ph] Momo (00:46:44) does lot of warehouse hosting. And if you're looking to compete aggressively in that market, do you think this component is going to increase meaningfully for Taiwan or it's still pretty early days. Are you still watching it? And we'll given you – trying to grow Shopee Mall? Will you try to do warehouse in other markets besides Taiwan? That's number one.

Secondly, on the e-commerce, can you give some color on the kind of EBITDA losses that we may look at in 2018 given the aggressive approach on the GMV front. I know you mentioned that sales and marketing as an absolute amount will grow, but any figure on that, that you have in terms of EBITDA losses? Thirdly on gaming side, given the strong reply to the own game, how should we look at the own game going forward. Is there any particular genre that you're looking at to target in the next couple of years? Is there any mixed target in terms of revenue from own game versus leasing that will be helpful? Thank you.

<A - Forrest Xiaodong Li>: Okay. Thanks for the question. And for the first question about the fulfillment, about the warehouse, I think like this is in aligned with like what we see the value proposition of Shopee even from the day we started this platform. I think like at the beginning like two, three years ago when we started Shopee because we realized there was a huge opportunity to resolving the pin point of a lot of sellers on social platform. And I want to like to do the businesses through the mobile platforms. And so back then there was no such a great platform to fulfill the needs of the sellers, specifically focus on like social and mobile. So, that's how he got Shopee started.

I think as I've just mentioned – answered earlier question like when does the whole platform grows and our seller base is growing at a very fast rate as well. So, we see there is a tremendous like increasing need for sellers especially smaller sellers when they grow their business, they need a lot of support to do a business better. I think this is to help them to unlock the need, it's highly aligned with our interests because the other day if all the sellers on our platform grow very well and the whole Shopee platform will grow very, very well. So we continually communicate with the sellers, identify their needs, but at the same time like we'll see – so, we'll think about what is the priority, what is the most demanding requirement at this moment.

And then we will see like we think our capability like at a certain extent, we're going to help them and things like this is – warehousing is one of them and they do as I mentioned, a lot of sellers initially they start just from their house, they put everything in their house, but like a moving forward they do need a warehouse and also they need to increase the efficiency of their delivery rate.

So that's the angle when we look at this space, but at the same time we're very cautious in terms of the investment and in terms of the spending. So at this moment, it is still very, very small, it's much – like most of the – like almost all – I think all the warehouse like we have is by leasing, right, and so we are not going to put tremendous capital commitment on that part.

I think that I will leave Alan to answer your second question and I would jump into the third question first and regarding your like – our prospect of the – in terms of our game pipeline, definitely I think like game development, self-development capabilities is very, very critical for us. And so, we have that ambition to be like a world class, like a premium, like a game developer rather than just being a game operator. So that's the things, like this effort have been started like, back now four years ago. Like in 2013, we start to set up the studio we're seeing in Shanghai.

But today, we have like about 200 top-tier game designers in that studio and the Free Fire is just a good example. I think these take time to reach today's level, so we can develop the game, well-accepted by the – and the word like the gamer community. So it's very encouraging. I think like it is also proved like after a couple of years accumulation of knowledge and knowhow, and then we start to on the right track, and we now start to get the knowhow in terms of that the key factors that the key things of the game development. And we feel very encouraged and we're continually strengthening these capabilities.

Potentially, we may, continually like adding the top-tier game developers in our studio and that if like we feel good opportunity or like appears, we may like – we may set up like a new studios right to [indiscernible] (00:52:07) the talents right in different market. And also like we may, also possibly like just invest or acquire some like a proven game studios as well to continually strengthen of our self-development capability.

At the same time, I think like, we're also are very excited about, feel like working with the top-tier game developers from all over the world to make sure to bring their the best games, the heat games to gamers in our region. So in my view, I think this will be a very – I think this is kind of like a very balanced approach of like ultimately, I would say I feel very happy if that the split is about 50:50, like so probably half of the revenue from our self-developed games and half from the – like from the games, we partnered with the like other top-tier game developer in the world.

<A - Alan Hellawell>: And Varun, sorry going back to your second question, this is Alan. We unfortunately don't formally furnish EBITDA guidance. But let me share with you a few thoughts that may offer you at least a directional feel. First, an observation about the evolution of the markets. It's very clear in our mind and it becomes clear with every passing day that almost all of our markets are consolidating very quickly and more quickly than we would have anticipated even six months or nine months ago.

Secondly, as a matter of principle, when given the choice to ease our spend and maintain our share or invest more heavily to expand our share, we've chosen the latter strategy. Reason being, we believe that investment is going to help us achieve dominance in the categories that are so important to us, [ph] female (00:53:54) long-tail categories, that kind of dominance and the ability to be the go-to platform for these important and very profitable categories as we've talked about in the past, should bring us to higher monetization levels going forward. So, really just to conclude, at the end of the day, winning a merchant or a customer today in our mind is much better than having to spend more to win them in the future. So I hope that gets you closer.

<Q - Varun Ahuja>: Yeah. Thanks. Pretty clear. Thanks, Forrest. Thanks, Alan.

Operator

And this will conclude our question-and-answer session. I would like to turn the conference back over to Forrest Li for any further remarks.

Forrest Xiaodong Li

Thank you. And thank you for everybody participating in today's like earning call. And before we end the session, I would like to take this opportunity to extend my best wishes to Nick Nash, our Group President. As you may already know, like Nick is retiring from our company at the end of this year 2018. Nick has served as Sea's Group President since December 2014 and in the past three years, Nick played a very critical role in Sea's tremendous growth especially in our IPO in 2017. So, I would like to express my sincere appreciation for Nick's distinguished achievement as Group President.

Nicholas A. Nash

Thank you so much, Forrest. Serving as Sea's Group President has been one of the happiest experiences of my professional career. And I'm deeply honored to have had the opportunity to work alongside Forrest and our entire team during a period of extraordinary growth for the company. The end of 2018 is a natural moment for me to retire, both because of the milestones we have reached together as a team and also because of my personal aspirations for the next decades of my life.

These past few years have been marked by very special milestones. Our company has executed well, achieving strong leadership positions across each of our three segments in a part of the world with substantial growth potential. With our IPO completed, we're on a stronger financial footing for our next phase of growth. And most important, I have great confidence in our next generation of rising leaders who will step into my responsibilities with skill and dedication.

On the personal front, as many of you know, I came from the investing world and spent over a decade with General Atlantic supporting high growth companies around the world, including Sea. I've always had a lifelong passion for investing and supporting growth companies. After reflecting on what I've learned here at Sea, I want to share the unique experiences I've had to help a new generation of companies here in Asia on their growth journeys. That sharing of learnings from one generation of companies to the next has been a hallmark of what made Silicon Valley so successful. And I look forward to continuing that tradition here in Asia by starting a new private equity fund after I retire, dedicated to that mission.

Between now and then I will remain deeply dedicated to Sea's mission of strategic priorities. And post my retirement, I will always remain a close friend to Sea over the years to come. I have no doubt that Sea's finest years are ahead of it and I'm excited for the work we'll be doing in 2018 to make continued progress to our long-term goals.

Alan Hellawell

Fantastic. Thanks a lot, Nick. Well, this would conclude our conference call. As always, we remain available and committed to getting any questions that you, the investor, analysts have. Look forward to continuing to liaise with you throughout the quarter and look forward to our next earnings call. Thank you very much.

Operator

And the conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Sea Ltd
Company Ticker: 0860765D S
Date: 2017-11-21
Event Description: Q3 2017 Earnings Call

Market Cap: N.A.
Current PX: N.A.
YTD Change($): N.A.
YTD Change(%): N.A.

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: N.A.
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: N.A.

Q3 2017 Earnings Call

Company Participants

- Alan Hellawell
- Forrest Li
- Nicholas A. Nash
- Tian Yu Hou

Other Participants

- Miang Chuen Koh
- Alicia Yap
- John Blackledge
- Grace Chen
- Mike J. Olson
- Scott William Devitt
- Piyush Mubayi
- Andrew J. Orchard

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Sea Third Quarter 2017 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Alan Hellawell, Group Chief Strategy Officer. Please go ahead.

Alan Hellawell

Good morning and good evening, everyone, and welcome to Sea's 2017 third quarter earnings conference call. I'm Alan Hellawell, Sea Group's Chief Strategy Officer. Before we continue, I'd like to remind you that we might be making forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Also, this call includes discussion of certain non-GAAP financial measures, such as gross billings for our Digital Entertainment business, E-Commerce monetization for our E-Commerce business and group monetization for our overall business. We believe these measures can enhance our investor's understanding of the actual cash flows of our major businesses when used as a complement to our GAAP disclosures. For a discussion of the use of non-GAAP financial measures, please refer to the section on non-GAAP financial measures in our press release.

Let me introduce you to the management team on the call. We have our Chairman and Group Chief Executive Officer, Forrest Li; our Group President, Nick Nash; and our Group Chief Financial Officer, Tony Hou. Forrest, Nick, and Tony and I will share our strategy and business updates, operating highlights and financial performance through the third quarter of 2017.

After the prepared remarks, we will have a Q&A session. With that, let's begin with Forrest for our key strategic highlights.

Forrest Li

Thank you, Alan. Good morning and good evening, everyone. Thank you for joining the call. This is our first earnings announcement as a public company. Welcome to all of our shareholders who are on the call and a big thank you to everyone who worked on our listing on the New York Stock Exchange last month.

I look forward to working with you over many years to come. Today, I'm pleased to report that we beat our internal expectations in Q3. Sea delivered our fastest year-over-year growth in recent quarters. The turn of accelerating cash revenue growth has continued over the year. In cash terms, Sea's top line growth was up 73% year-over-year, up 21% quarter-on-quarter.

As most of you know, we use GAAP revenue plus changing Digital Entertainment deferred revenue and E-Commerce commission income as an approximate for cash revenues. Sea continues to invest for the future. I'm optimistic about the long-term potential of both business and the Greater Southeast Asia region.

Now, let me highlight some key achievements. Garena continues to build on our market leadership in online games. Digital Entertainment cash revenues were approximately $134.5 million in the third quarter, up 62% year-over-year and 18% quarter-on-quarter.

More than half of our Q3 gross billings came from mobile games. This is a new milestone. This will continue as smartphone use rise across the region. I'm proud that we co-developed our most important game, Arena of Valor. We did not just license it. Arena of Valor is based on Tencent's Honor of Kings. We have localized it using our local market knowledge. Arena of Valor is also a big eSports game in our region. Garena's new game launch plans are strong. I look forward to sharing more updates with you soon.

Our E-Commerce business, Shopee, also had an excellent quarter. GMV reached $1.06 billion, up 219% year-over-year, up 30% quarter-on-quarter. In first-half 2017, Shopee was the number one E-Commerce platform in Greater Southeast Asia by orders over twice the size of its nearest competitor. Shopee was also the number one E-Commerce platform in the region in terms of GMV close to 1.5 times the size of its nearest competitor.

Shopee's market leadership position has expanded. Shopee's annualized GMV in September was $4.7 billion based on September's monthly GMV of $389.2 million. We believe this is much larger than any of our competitors. Shopee is growing because more buyers are coming to our marketplace platform to shop. There is a strong network effect. The more sellers we have, the more buyers we attract and that attracts even more sellers. It is a virtuous cycle of growth. It means Shopee is now part of the everyday life of our consumers. At $4.7 billion of annualized GMV, Shopee is equivalent to 0.15% of the region's GDP.

We are making progress in monetizing our Shopee business. Shopee's cash revenue, represented by E-Commerce GAAP revenue plus commission income, almost doubled quarter-on-quarter. We will continue to make monetization a priority as well as GMV and order growth.

AirPay, Sea's Digital Financial Services segment, delivered good user and attraction volume growth. Total AirPay GTV grew 172% year-over-year to $448.2 million in Q3. That is $1.8 billion annualized. I'm very pleased to see extremely strong growth in the Shopee portion of AirPay GTV. This shows the value of linking AirPay to E-Commerce and online games, the two most important Internet use cases in our region.

Nick is now going to talk about the key driver of Sea's growth.

Nicholas A. Nash

Thank you, Forrest, and good morning and good evening to everyone. I want to reiterate first a warm welcome to all of you, all of our shareholders that are on this call, our colleagues and partners in the research community and members of the media as well.

Our October IPO was a very special milestone for our company and also for our region of Greater Southeast Asia. We're very grateful for your partnerships and support and we are working hard to make you proud.

As Forrest mentioned, in the third quarter of 2017, our total GAAP revenue plus the change in Digital Entertainment deferred revenue and E-Commerce commission income grew 73% year-over-year to $151.7 million. This was our highest year-over-year growth rate in recent quarters and speaks both to the acceleration in our Garena business for mobile as well as the growing revenue contributions from AirPay and Shopee.

Synergies across our three core platforms continue to deepen with early success in cross-selling Shopee to our Garena users as well as increased integration between Shopee and AirPay for payments. Overall, we are very proud of our business performance in the third quarter of 2017. Let me take you through the key drivers of our growth for each of our key platforms.

Garena Digital Entertainment GAAP revenue plus change in Digital Entertainment deferred revenue grew 62% year-over-year and 18% quarter-on-quarter in Q3. Disaggregating this, our gross billings for Garena represent the multiplication of quarterly active users, which we call QAUs, the percent of QAUs who are paying customers in the quarter or the pay user ratio and finally, the average revenue per paying user or ARPPU. And of course, the pay user ratio multiplied by ARPPU is our average revenue per user or ARPU.

Garena QAUs grew 54% year-over-year to 69.0 million in the third quarter. We are particularly proud of the fact that our ARPPU grew 22% year-over-year to $20.7, which is one of the highest year-over-year increases in that metric in recent quarters. And in parallel, our ARPU grew 10% year-over-year to $2.0. That growth in ARPU ensured that our gross billings grew even faster than our growth in QAUs.

Because of the operating leverage that stems from our platform approach, the ARPU increase has a powerful effect on our ultimate cash flows from the Garena segment. As Forrest mentioned, more than half of our gross billing for Garena came from mobile games in the third quarter. In addition, more than half of our quarterly active users and quarterly paying users for the third quarter came from mobile. And moreover, our ARPPU for mobile users on a gross billings basis was higher than for our PC users in the third quarter and that continues an unbroken trend of higher mobile ARPPU than PC ARPPU that goes back to early 2016.

Our user engagement was also very strong in the third quarter. One way to quantify that is to calculate our monthly active users in the last month of the quarter, which were 42.7 million. That number represents 61% year-over-year growth, even faster than our 54% year-over-year growth in quarterly active users, which indicates our rising engagement ratio.

Finally, let me spend a moment on our game launches and pipelines. As Forrest mentioned, it's quite strong. To give you a preview for our fourth quarter, we launched our mobile game, Arena of Valor, in Singapore, Malaysia and the Philippines in October. And in November, we've launched Onmyoji, a mobile RPG game, which we've licensed from NetEase and one of their most important games in North Asia.

Let me now shift to E-Commerce. We're very pleased with our progress in Shopee, which, as Forrest mentioned, achieved year-over-year GMV growth of 219% and quarter-on-quarter growth of 30%. Our gross orders grew by 204% year-over-year to 65.9 million. Disaggregated into its constituent drivers, our quarterly GMV for Shopee represents the multiplication of average monthly active buyers, the average number of transactions per monthly active buyer and the average order value in dollars per transaction all times three to get to the full quarterly result.

Let me take you through each of those drivers. Our average monthly active buyers grew 247% year-over-year from 1.7 million in Q3 2016 to 5.9 million in Q3 2017. We achieved 3.7 monthly orders per active buyer in Q3, slightly lower year-over-year and slightly higher quarter-on-quarter. And our average order value was $16.2, slightly higher year-over-year and slightly lower quarter-on-quarter.

Our trends in quarter-on-quarter average order value from the second quarter of this year to the third quarter of this year partly reflect individual market dynamics and partly reflect our evolving mix of GMV across our markets. Our market mix is a strong positive for our business and we believe a unique competitive differentiator for Shopee as a truly pan-Greater Southeast Asia platform.

Let me take you through what I mean by that. The relative share of our total GMV from our three middle-income markets, which are Indonesia, Thailand and Malaysia, grew by 3 percentage points. The relative share of our GMV from our rising affluent markets, Vietnam and the Philippines, also grew by 3 percentage points. And the relative share of our total GMV from our two higher-income markets, Singapore and Taiwan, reduced by 6 percentage points.

Now, those two markets grew quite well in absolute GMV terms, but on a relative basis, our middle income and rising affluent markets grew even faster. That mix shift of markets towards higher growth, middle and rising affluent markets lays a very strong foundation for our overall GMV growth going forward as those specific E-Commerce markets are the fastest growing in our region according to Frost & Sullivan. In fact, more than half of our GMV in Q3 came from those middle and rising affluent markets, especially Indonesia, which is our largest market by orders.

You can also see the strength mirrored in our disclosure on the mix of orders by individual market. For example, Vietnam has grown from 6% to 8% of orders in Q2 to 9% to 11% in Q3. Thailand has grown from 5% to 7% to 7% to 9% and the Philippines from 3% to 5% to 4% to 6%. Over that same period of time, Q2 to Q3, Taiwan has edged slightly downward from 36% to 38% of orders to 33% to 35%. Overall, these trends are very encouraging to us and they reflect the broad market opportunity across the entire Greater Southeast Asia region, which Shopee is capturing effectively.

In particular, we believe that we are now the largest E-Commerce platform by daily orders in two of our seven markets, Indonesia and Taiwan. We're close follower in Vietnam, Thailand and the Philippines on an orders-per-day basis.

Finally, I want to emphasize three crucial differentiators for Shopee versus other E-Commerce players in our market, many of whom are pursuing very different growth strategies. First, we continue to be smartphone app-centric. More than 93% of our orders in the third quarter were transacted through our mobile app, which we believe is a substantially higher ratio than most of the other firms in our region.

Second, our focus on the female E-Commerce consumer, which is reflected in our category mix continues to be a very strong differentiator. 29% of our GMV in the third quarter was from fashion; 16% from health and beauty; 11% from toys, kids and baby products; and 12% from home and living. Only 10% of our GMV was from computers, cellphones and cameras. We believe that we are the clear market leader across the region in these key female-centric categories, which have high customer stickiness, frequent repurchase rates and most important, much higher gross margins for our sellers than consumer electronics.

And third, we continue to believe we have best-in-class sales and marketing productivity in our region. Our sales and marketing expenses for Shopee for the third quarter of 2017 were $102.7 million. We spent more on sales and marketing in Q3 as a percentage of our GMV than we did in Q2, but by design and in line with our internal budget. On a year-over-year basis, our sales and marketing expenses fell from a bit less than 11% of GMV in the third quarter of 2016 to a bit less than 10% of GMV in the third quarter of 2017.

There are three main reasons why we have elected deliberately and in advance to spend more in Q3. First, some of our markets have transformed into a two-horse race faster than we had expected, which means that the end game is now closer in sight. Secondly, we have the growth momentum on our side. Through targeted investment, we are increasingly able, we believe, to tip the market in our favor and translate the investment directly into market share growth in the right categories. And lastly, having now achieved market share leadership by orders in Indonesia and Taiwan, we are now paying increasing attention to Vietnam, Thailand and the Philippines.

In E-Commerce business, market share of course over time should translate into monetization. I'll touch briefly on our monetization efforts for Shopee, which have performed exactly in line with our internal expectations for Q3. In the second quarter, we were only monetizing Shopee in Taiwan, Indonesia and Malaysia. We have now added three more markets for monetization, Thailand, Vietnam and Singapore.

If you think about our monetization as a grid with one axis being our seven markets and another axis being the four revenue tools we currently have, which are cross-border commissions, domestic commissions for branded goods, domestic commissions for smaller sellers that finally perform in click-based advertising, we are systematically filling out those 28 potential revenue opportunities on the grid.

We are now charging cross-border commissions in Taiwan, Thailand, Malaysia and Singapore. We're charging domestic commissions in Taiwan and hope to add one more market to that list in 2018. And we're generating revenue from advertising in Taiwan, Indonesia and Thailand and Singapore will follow fairly soon.

A key part of our monetization efforts is increasing the percentage of our GMV from branded products. We laid the foundation for this effort in late 2016 with the launch of Shopee official stores and have now deepened that effort with the introduction of Shopee Mall. Shopee Mall launched in Taiwan and Singapore in the third quarter and has already launched in Malaysia and Vietnam as of October.

As a part of that effort, we are also seeing increasing collaboration with major department stores in our region, particularly in Thailand. As we have spent some time with members of the equity research community and our investors on the road show, some of you asked for us to provide a bit more insight into our net GMV versus gross GMV ratio. Unlike other parts of the world, where returns are a large factor in that ratio, the single biggest reason in our business and our region more broadly for why net GMV is lower than gross GMV isn't returns per se, but rather the complexity of completing payments for orders.

Our return rates are actually quite low, often below 2%. Our key pain point is in payment and that's not just us, it's for the entire region, and working very hard on that by integrating AirPay into the Shopee experience step by step. We will not be disclosing our net GMV to gross GMV ratio on an ongoing basis for competitive reasons, but to provide you with some clarity for modeling purposes, we can share with you that our overall Shopee net to gross ratio in the third quarter was between 76% and 77% and for Shopee, excluding Singapore and Taiwan, between 72% and 73%. Taiwan, in part, because of its sophisticated payments infrastructure is around 80% to 82% and Singapore is even higher.

In general, we find that the net to gross ratio is lower for less affluent markets and we're proud of the fact that as we have increased the share of GMV from those less affluent markets, our net to gross ratio for Shopee overall held in a very tight band from 75% to 79% over the past six quarters.

In fact, in each of our individual major markets for Shopee, we've seen a intra-market increase in this ratio from the beginning of 2016 to today and that's particularly been the case in Indonesia, Taiwan and Vietnam.

Finally, let me shift to our AirPay Digital Financial Services segment. Digital Financial Services have third quarter GAAP revenue of $12.7 million, which represents 115% year-over-year growth versus the third quarter of 2016. Our total AirPay GTV grew 172% year-over-year and reached $448.2 million in the third quarter of 2017, annualized run rate of $1.8 billion.

We anticipate that as our user base and merchant network continue to expand, our revenue from our Digital Financial Services segment will continue to increase. In addition, we have recently attained PCI DSS Level 1 certification, which is a globally recognized information security standard in a payments industry that's also supported by Visa and MasterCard.

This certification allows us to store and process credit card information directly with our own servers instead of relying on a third-party provider. We've also launched a virtual debit card product in Vietnam, which allows AirPay users to shop online with a debit card number. We will continue to keep you apprised of developments and growth in our AirPay business in the quarters to come.

Finally, I'd like to reintroduce you to Alan Hellawell, who's a very important addition to our team. Many of you know him from his former life as the lead Asia Internet Equity Research Analyst for Deutsche Bank for almost a decade. Alan joined us as our Chief Strategy Officer in October and some of you may have had a chance to meet him in person during the IPO road show.

It's very important for me that we use these quarterly update calls as an opportunity not just to update you on numbers, but on the insights behind the metrics. Alan will be playing a key role at our investor engagement efforts to share as many years of [ph] Internet (22:09) knowledge and to contextualize our performance and strategy, [ph] leaving (22:14) that larger picture and the lessons learned from other markets.

With that, let me hand it over to Alan.

Alan Hellawell

Fantastic. Thank you, Nick. It's a great pleasure for me to join Sea after following the company for many years. In my previous role as an analyst, I have the privilege of bearing witness to the rise of the Chinese Internet economy over those many years, champion by name such as Tencent and Alibaba. It's my strong belief that Greater Southeast Asia is now poised to become the next great hub of Internet and E-Commerce growth.

And that the region will produce its own leading lights as indeed the world's other major Internet markets have. We, at Sea, seek a defining role in this growth, standing astride the areas that for instance Tencent and Alibaba have come to dominate [ph] to our north (22:57). There are, of course, differences in our approach versus those two specific companies, but no other company in this region is tapping into those proven business models as well as Sea is. That's why I joined the company and that's why I'm personally so optimistic about our growth potentials.

I'll be sharing my views on the evolving competitive landscape across our entire business from time to time on our future calls. For this first call, I thought it would be timely for me to focus my comments on the E-Commerce landscape. Let me start with my overall conclusion and then we can drill into details. My conclusion is simple, Shopee is winning.

In marketplace E-Commerce, as my former brethren in the research community would concur, category leadership turns into market share leadership and market share leadership turns into free cash flow generation. In a short period of time, Shopee has become the undisputed leader in the female-centric categories of fashion, health and beauty, toys, kids and baby products and home and living. We are not the leader in 3C and that's by design.

We have focused our efforts where the best margin opportunity is and where the best opportunity is for cross-selling our users exist. The fact that we are number one by daily orders across all categories, not just the ones we focus on, in Taiwan, Indonesia and now Vietnam magnifies an even more important fact. We're number one in our core female categories by an even wider multiple. Moreover, not only is Shopee winning, but our business model being an asset-like marketplace is much better suited to greater Southeast Asia than being a one key player with direct selling.

Shopee only makes only money when its merchant network makes money, plain and simple. That means, Shopee is tapping into and harnessing the entrepreneurial energy across our region. And that's clearly demonstrated by our over 1.9 million monthly active sellers who are using Shopee to improve their livelihood.

It also means we have the products people in our region want to buy. There is no way a direct selling model can generate the more than 100 million listing we had in the third quarter and with the degree of local nuance and the relevance that is so important in our long-tail categories. Everyone around the world buys essentially the same five or six brands of mobile phones, but everyone buys fundamentally different shirts and dresses that are locally relevant.

It's also particularly impressive to see how Shopee's model is yielding better fulfillment execution. For many years, the 1P players both in China and Greater Southeast Asia argued that a direct fulfillment model was better for customer satisfaction. Shopee's model proves otherwise. If I just use Indonesia as an example, by having hundreds of thousands of sellers across that market, the average distance between buyer and seller is significantly reduced.

I'd encourage you to read the recent CLSA report by Paul McKenzie that did a "mystery shopping" analysis of shipping times for the market's various E-Commerce platforms, both marketplace platforms like us and also 1P players.

In Paul's analysis, Shopee had the fastest shipping times of any competitor in the sample. Our average delivery times are exactly two days in his study and our second largest competitor in the market, also a marketplace model, clocked in at 3 days and 17 hours. Our second largest competitor on a regional basis, which is a hybrid model of 1P in marketplace, had an average of 4 days and 16 hours.

Finally, by being in all seven markets of Greater Southeast Asia, we can create a true cross-border E-Commerce network not just within our market, but also the rest of Asia. Cross-border is one of the fastest-growing slices of our GMV and we'll talk more about it in future calls.

To summarize, Shopee is winning. There were very strong network effects that support our growth and which create a deeper and deeper moat for competition the larger Shopee gets. I genuinely feel that there was a window of opportunity to create a Shopee-like platform that closed sometime in late 2015 or early 2016 in part, because Shopee was launched and raised the bar for any new entrants.

I sincerely believe it is now too late to recreate what Shopee has built, just as it was too late for someone to recreate what Alibaba had built in China over the last decade. It's telling to me that despite $2 billion of capital going into the second largest regional competitor behind Shopee over the past 24 months, that that particular competitor has gone from 6.6% market share by orders to 6.8% market share from 2016 to the first half of 2017. In comparison, spending a fraction of that amount of money, Shopee has grown from nothing in May [ph] 2015 (28:15) to now 15% of Greater Southeast Asian E-Commerce orders in the first half of 2017.

Shopee's investment in sales and marketing fell from less than 11% of GMV in the third quarter of 2016 to less than 10% of GMV in the third quarter of 2017. Over that same period of time, our GMV and gross orders more than doubled. That speaks volumes to me about how Shopee's model is fundamentally less about capital investment and more about network effects and true organic growth.

We are doing the things that money cannot buy and while capital certainly helps us grow, it's difficult for our competition to use capital to recreate what we have built. I look forward to spending time with each of you and would be happy to answer your follow-up questions in the Q&A.

With that, let me hand it over to Tony Hou, our Chief Financial Officer.

Tian Yu Hou

Thank you, Alan, and thanks, everyone, for joining our call. We had provided a detailed set of financial schedules for your review in the annex to this morning's press release that includes our unaudited third quarter and year-to-date income statements, cash flow statements and starting and ending balance sheet.

We also disclosed our GAAP revenue by reported segment for Digital Entertainment, E-Commerce, Digital Financial Services, plus the percentage of our segmental sales and marketing expenses of Digital Entertainment and E-Commerce businesses over the total sales and marketing expenses. In addition to these, we disclosed our deferred revenue balances for our Digital Entertainment, so that you can calculate our revenue plus change in deferred revenue, which is a good, good proxy for our gross billings.

Rather than take you through each number in our disclosure and to permit more time for Q&A at the end, let me focus on providing some additional color and context for your benefit. For Sea, overall, our third quarter GAAP revenue plus change in Digital Entertainment deferred revenue and E-Commerce commission income grew 73% year-over-year. In comparison, we grew 45% year-over-year from the first half of 2016 to the first half of 2017. This acceleration in growth is driven by the strong performance of our mobile games in our Digital Entertainment segment and the record growth of revenue for our AirPay and Shopee segments.

On a GAAP basis, our non-Digital Entertainment revenue was 15% of total revenue in the third quarter of 2017, up from 5% in the third quarter of last year. As Forrest and Nick mentioned, our third quarter Digital Entertainment GAAP revenue plus change in deferred revenue was $134.5 million, a 62% year-over-year increase and an 18% quarter-on-quarter increase.

As a technical accounting matter, our Digital Entertainment GAAP revenue was $79.8 million in the third quarter of 2017, a sequential decline from $91.5 million in the second quarter of 2017 and $86.2 million in the third quarter of 2016, but this is primarily driven by our transition to mobile games and the relatively longer recognition period for our new major mobile game, Arena of Valor.

Digital Entertainment gross profit declined in GAAP term for $39.7 million in the third quarter of 2016 to $24.2 million in the third quarter of 2017, but again this is driven primarily by the mismatch in the timing of revenue recognition and the cost recognition. Our revenue is deferred over a fairly long period over time in this segment, but other than our payment channel cost, the majority of our cost are expensed immediately in the current period.

You will notice a net gain from interest expense, net investment gains and foreign exchange of $25.8 million, but change was primarily attributable to an investment gain from the disposal of an equity investee in Vietnam, which is no longer a core for us, and a net gain on the re-measurement of our investment from other holdings, partially offset by interest expenses.

In the third quarter of 2017, $2.1 million of negative income tax reflected that deferred tax assets recognized our increasing deferred revenue from our Digital Entertainment business, partially offset by withholding tax expenses, also arising from our Digital Entertainment business. We did not recognize any deferred tax assets from Sea's new growth businesses like Shopee.

Finally, on our GAAP basis, we recognized a net loss of $132.8 million in the third quarter of 2017. Adjusted net loss, which is net loss adjusted to remove the share-based compensation expenses, was $127.1 million in the third quarter of 2017.

And finally, I will conclude with an update on our guidance for the rest of the year. In general, our guidance is very much in line with our analyst consensus. We currently expect total GAAP revenue plus change in Digital Entertainment deferred revenue and E-Commerce commission income to be $540 million to $550 million for the fiscal-year 2017, representing a year-over-year growth of 53% to 56% compared to the fiscal-year 2016.

For our E-Commerce segment, we currently expect GMV to be between $3.8 billion to $4.0 billion for the fiscal-year 2017, representing an year-over-year growth of 230% to 248% compared to the fiscal-year 2016.

Alan Hellawell

Thank you, Tony. We'll now open up the floor for questions. Austin?

Q&A

Operator

[Operator Instructions] And our first question comes from Miang Chuen Koh with Goldman Sachs. Please go ahead.

<Q - Miang Chuen Koh>: Thank you. Good morning to everyone and congrats on a good set of numbers. A few questions for me. So, maybe you can go through this one by one, first. For gaming, I noticed the ARPU obviously has done very well compared to first half. Though we did notice pay ratio has declined versus the first half in last year, can you provide some color there and perhaps your expectations ahead?

<A - Nicholas A. Nash>: Sure, MC, great to hear your voice and thanks for the question. You're absolutely right, ARPPU has done exceptionally well as has ARPU. And when we think about the growth of our games business from an ARPU perspective, there's really two ways to drive ARPU, one is to have the pay user ratio and ARPPU go up and the other is to have the ARPPU go up even more than an elasticity effect might be experienced on the pay user ratio. And there'll be quarters in which both go up and there'll be quarters in which we have to use the elasticity to our advantage. That's part of the answer.

The other part of the answer is our newest mobile game, Arena of Valor, has been experiencing a tremendous amount of growth in Indonesia in recent months by design. And by design as well, we've encouraged users to try the game out first before really deepening the push on monetization there as well. And finally, part of this reflects the ongoing shifts in our business from PC to mobile.

In general though, we're quite optimistic about not just pay user ratio, but the absolute number of monthly and quarterly paying users going forward. And I can tell you that already the initial signs for Q4 seem quite positive.

<Q - Miang Chuen Koh>: Okay. Got it. And on that point, can you provide maybe, whatever you could, some updates on AoV's traction in Indonesia and also the recent entry into [ph] AoV's (36:16) Singapore, Malaysia as well? And in aggregate, do you see those new markets as a – or rather how large do you think those new markets could contribute to your gaming revenues a year from now?

<A - Nicholas A. Nash>: Sure. Absolutely. Let me take it first from a high level, then drill into AoV specifically. We've showed in our prospectus a very nice piece of work from Niko Partners and Newzoo that laid out the total addressable market, market-by-market. For example, Indonesia was a $0.5 billion games market in 2016, but has the potential to grow to $2.1 billion over time.

Let me take it more market-by-market. Indonesia, in general, has the single greatest growth potential comparable to perhaps the Philippines across our entire region and mobile's going to be a big thrust of that. It's a little too early to tell exactly what our total monetization will be for AoV, but we'll keep this group updated on a quarterly basis.

Singapore and Malaysia are wonderful add-on markets for AoV, but just to go back to market sizing, Malaysia was a $0.3 billion market in 2016, Singapore is a $0.2 billion market. Both are growing but at substantially smaller rates than, say, Indonesia, Taiwan, Vietnam and others. So, in general, I would suggest that the growth opportunities in Singapore, Malaysia are probably a little smaller. [ph] However (37:31), Malaysia is growing at 20% compared to roughly 32% for Indonesia, Singapore, a bit smaller. So, I think you should think about Malaysia and Singapore as rounding out the portfolio and Indonesia as an opportunity for growth.

<Q - Miang Chuen Koh>: Got it. And maybe shifting to E-Commerce, I think in terms of the GAAP revenues, I just want to reconcile this number. I think on page 6, it says [ph] indeed that (37:54) it's $2.8 billion or so. And then, page 9 mentions $3.2 billion. So, I understand it's probably inter-segment eliminations here, but like looking at some confirmation there, yeah?

<A - Nicholas A. Nash>: Sorry. Can you just repeat the question, MC?

<Q - Miang Chuen Koh>: Sure. So, on the GAAP revenues for the E-Commerce segment, I think on page 6 of your financial statements, I think you have a number around $2.786 billion as the GAAP revenues. And on page 9, I think under E-Commerce, we have $3.181 billion [ph] FD (38:31) revenues. So, just want to reconcile the two numbers. I understand it's probably inter-segment eliminations, but [indiscernible] (38:38).

<A - Tian Yu Hou>: You're right.

<A - Nicholas A. Nash>: I'll ask Tony to jump in on that one.

<A - Tian Yu Hou>: Hey. Yeah. You're right, MC, it's due to the inter-segment eliminations.

<A - Alan Hellawell>: And, MC, awfully sorry. Maybe one last question then feel free to get back into the queue.

<Q - Miang Chuen Koh>: Sure. Understood. Last question here is, for the sales and marketing expenses [ph] in the Q (38:56), can you maybe provide a color, how much of that would be free shipping or subsidized shipping and what would that same percentage be for perhaps first half of this year and maybe third quarter last year? Just some rough numbers.

<A - Nicholas A. Nash>: Of course, MC, that's a great question. So, as we've always shared in the past, the vast, vast majority of Shopee's sales and marketing budget goes into loyalty-driven and success-driven sales and marketing for shipping. One sort of rule of thumb would be two-thirds or greater would fall to that category and our fixed costs for

Shopee are actually quite modest. It's one of the highlights of that business model. Most of our spending in Shopee is quite discretionary.

One thing we can share with you, by the way, is that as we continue to deepen with our customers in Shopee, we do tend to trail off their access to shipping promotion. One rule of thumb you might want to think about is it's pretty rare for a Shopee customer to get free shipping after they've placed their sixth order on the platform. To give you sort of a flavor for it, just an exception to that rule, but in general, we use the free shipping as a way to get people on to the program, on to the, what is now, a 3.7 purchase per active buyer per month program.

So, as the business grows, we'll certainly use that as an effective tool to drive reengagement, retention and ultimately a consistent behavior on the platform, but it is very much driven towards newer customers than older customers.

<Q - Miang Chuen Koh>: Great. Thank you for the answers. That's it for me.

<A - Nicholas A. Nash>: Okay, MC. Feel free to jump back in queue at this time.

Operator

Our next question comes from Alicia Yap with Citigroup. Please go ahead.

<Q - Alicia Yap>: Hi. Good morning and good evening. First, Nick, Alan and Tony, congratulations on the successful IPO and also solid first quarter of the public results. I've two questions. First is related to gaming. Just curious how is Onmyoji has been growing in the recent quarter? And then, could you update us on the pipeline for the upcoming games to be launched in the next couple quarters?

And then, second question is related to E-Commerce. Just wanted to know does the part of your redistributions that you showed on your slide, is that equally to the specific country? So, in other words, what are the main category for countries such as Indonesia and main category for Taiwan? And then, in order to help us to think about the future growth outlook and [indiscernible] (41:35) of the monetization in each country, how should we think about the overall GMV growth and also the take rate or the blended monetization rate for the E-Commerce business for next year? Thank you.

<A - Forrest Li>: Great. Thank you. I would love to take the Onmyoji question, where so far like we just -we launched a game, we started [ph] OPT (42:03) from this Monday. So, it's like two, three days ago, we officially opened the [indiscernible] (42:07) game in the evening on November 20. And so, we only have a very limited data up to this point of time, but like at this moment, we are very excited and we are confident about the future of this game.

Number one, even like just with the softer launch, we haven't really aggressive like start to marketing to the mass market of the game, which has the targeted very core base of the users. We accumulate – user base accumulated through the [ph] CBT and we can (42:41) tell like the enthusiasm from the gamer community on this game.

And [ph] on the first (42:49) day, in terms of how many new gamers come into the game, what is the active user is beyond our expectation. And respectively, while we're happy about, we see the second date retention rate of the [ph] things – of the first (43:03) date, the new user come in, that is extremely high, which means okay two things. Number one, gamers really love the game. So, they played one day and they cannot wait to come back at the second day.

And also that means like our – so far like the [ph] Walmart community to (43:21) – communication with the gamer community very efficient. So, we targeted the right core group of users for this game, which means we repeat the segment of the user base very well for this game.

Yeah, so that is all the data so we have for now. So, in a summary, we are very confident about the game and we just launched in Thailand. We get a lot of like best practices. We also look forward to launch the game in Vietnam soon. Yeah.

<A - Nicholas A. Nash>: Hi, Alicia. Thanks for joining the call. I know it must be incredibly late for you or early for you in Europe. So, thank you for being such a sport to dial in. It must be 2:00 in the morning for you. Thank you.

On your question of E-Commerce, couple quick reactions, we don't disclose sort of the other axes of that chart, which would sort of the country by country or market by market mix by category, but in general, it's quite consistent. One of the hallmarks of Shopee is that it has that very consistent female-centricity in very high margin categories across Greater Southeast Asia. As you see from our disclosure, we were 29% of GMV from fashion, 16% from health and beauty and so on and so forth, not dramatically different, market by market. So, you should use that as a general planning assumption.

In terms of our GMV growth, I think what we feel so proud of is that Shopee has really spectacularly grown faster than TAM. The Frost & Sullivan view on TAM growth for the overall GSEA region is about 29% growth from 2016 to 2021 and we have been growing just multiples of that over the last several years and we currently view this well going forward that we will continue to grow to very strong, strong multiple. What we'll probably do in our Q4 call is provide some forward-looking guidance for 2018 GMV growth, but that's far relative to our earlier guidance [ph] of TAMs (45:05) quite consistently where we were before.

<Q - Alicia Yap>: Thank you. All right. I'll look for that. Thank you.

<A - Nicholas A. Nash>: Thanks, Alicia.

Operator

The next question is from John Blackledge with Cowen's. Please go ahead.

<Q - John Blackledge>: Great. Thank you for the questions. Two questions on Shopee. The first is the GMV results were very strong and the monthly active buyer growth was higher than we expected. Just wondering if you can provide some more insight into the driver and drivers of the strong active buyer growth?

And then, on the logistics and fulfillment side for Shopee, could you just discuss your relationships with the third-party logistics companies across your markets and perhaps how these relationships could benefit Shopee as the volume of orders ramp perhaps significantly in the coming years? In other words, do those logistics companies have the capacity to scale as Shopee scales? Thank you.

<A - Nicholas A. Nash>: No problem. Thank you so much for the questions, John. Couple quick thoughts, let me start with monthly active buyers. In a single phrase, it's network effects. What's extraordinary about Shopee is that the word of mouth dynamic where both buyers are encouraging their friends to join through word of mouth, but as important, sellers are bringing in their "book of business." Particularly those that used to be social media sellers will bring all their Instagram followers, their Facebook followers, even their BlackBerry message followers onto Shopee and encourage them to buy for all the different tools that we provide between buyer and seller.

So, really we view this as a very strong validation of the structural element of Shopee as a very network effects oriented business as distinct from the traditional E-Commerce model of 1P, which is much more around procurement synergies and much more on fulfillment cost reduction. So, really at the core structural in terms of how well Shopee is growing.

In terms of logistics, it's the question we think about all the time and in some ways, we think of the logistics firms both as potential investment opportunities for us but also vendors in the ecosystem. Let me go country by country. In Indonesia for example, which is our largest country by orders, this historically been a relatively decent state-owned postal service plus four or five UPS or DHL equivalents in the country, most notably JNE. We have been told by JNE's management that we are their largest customer, Shopee as a system, probably one quarter of their overall volumes. And in general, we feel that Shopee will become the largest – one of the largest customers through its overall ecosystem of buyers and sellers for most of the large 3PLs in our region.

There are two things that we do to increase capacity, I think of it as hard capacity and soft capacity. On the hard capacity side, we are thinking very active about placing capital in the form of minority, non-consolidating stakes in several of the better-quality 3PLs in the region. We've already done this in Vietnam.

And if you look at our audit, you'll see a company called [ph] GHTK (47:58), which we invested at a very, very small valuation and then frankly, produced small amount of capital, but under our stewardship and under our ownership and also under our partnership as one of their biggest customer, that company has really flourished. And I'd like to do that in four or five other markets over the next five or six years.

The soft capacity side is actually as important, which is how do you measure that these companies have the right IT systems and the right track-trace, the right return capabilities to able to deliver great customer service? That's something we're doing already independent of having capital stakes in some of these companies. For example, in the case of JNE, because we're such an important customer, we actually put our own engineers on a seconded basis into their datacenter to integrate the two IT systems in a very nuanced, very fundamental kind of raw iron kind of way and you'll see us do more and more of that across the region as well.

But in a nutshell, important question for us, we don't think that there's going to be any real bandwidth constraint in terms of capacity in part, because finally, we're seeing a lot of third-party capital flood into this market. A lot of traditional private equity firms, mid-market investors, industrial investors are flooding capital into logistics. Nothing would make it happier and to see that capacity triple, quadruple over the next couple years and we think that'll happen quite predictably.

<Q - John Blackledge>: That's great. Thanks so much.

<A - Nicholas A. Nash>: You bet. Any more questions or will shift to the next question in queue?

Operator

Our next question comes from Grace Chen with Morgan Stanley.

<A - Nicholas A. Nash>: Hi, Grace.

<Q - Grace Chen>: Hi. Thank you. Hi, thank you for taking my questions and it's good to know that the second quarter have exited your internal expectations. The first question is about the gaming business. So, we see that the September quarter, the gaming business is actually doing quite well on the cash basis, can you share a bit more about the drivers behind it?

And also, as we've been discussing about the key drivers coming from the mobile games, as we are transitioning from the PC game and to mobile games, what are they key changes in the key metrics like users growth or ARPU in paying ratio in these key metrics between the PC game and mobile gaming business? That's my first question. Thank you.

<A - Nicholas A. Nash>: Hi, Grace. Sure, I'll jump in to that. Thank you so much for your kind words. And we're really pleased that the quarter has done better than we have expected and better than consensus as well. Let me first start with the drivers. It's very consistent with what we shared earlier. Ultimately, as a consumer-focused company, it's all about the number of consumers, so to have monthly active users and quarterly active users grow as quickly as they did is great for us. And we're particularly pleased to see ARPPUs rising as fast as they are.

I think when we announce Q4 earnings, we'll give an update on all the different metrics as well, but in general, we feel very optimistic about Q4 from where we stand right now. And in particular, when you think about mobile versus PC, interestingly and we love sort of looking back and maybe reflecting a little bit with some context on how things have transpired a little differently than perhaps we and even the market felt, mobile ARPPUs are terrific. It's almost a little bit of a misnomer that mobile has a lower ARPPUs than PC. And likewise, mobile pay ratios have been quite similar to our PC pay ratios in recent quarters.

So, we view mobile as nothing but additive to our business and it just gives us access, number one, to many, many, many users that may not have been able to afford a PC in their home; number two, it gives us access to literally everywhere you sit bandwidth versus many parts of our region had a very limited terrestrial broadband penetration; and then, number three, this is sort of a lesser appreciated fact, but very important, gives us access to more times of day, because the amounts of hours in the day you're sitting in front of a PC, hooked up to a broadband connection, may not be as a many minutes or snippets of minutes that you're on your go with a radio in your pocket and your cellphone. So, on all three accounts, mobile is really positive for the growth of our business.

<Q - Grace Chen>: Great. Thank you for your answer. And my second question is about the E-Commerce business. So, we can see that GMV growth has been very strong and we're rolling out the monetization plan country by country, [ph] but we also know (51:57) that dynamics in each country is actually quite different. So, can you share with us what's the similarity and differences as you roll out the monetization in different countries in this region? Thank you.

<A - Nicholas A. Nash>: Sure. Of course, Grace. And you'll notice very personally, as from someone from Taipei yourself, let me start with Taiwan, that's maybe exhibit A and then Indonesia is exhibit B and then, our three next markets are the big five, Thailand, Philippines, Vietnam has some similarities and differences between those two. But let me hold those both at maybe case studies. Taiwan is so fascinating for us. Taiwan in many ways is one of the most digitally connected markets in Asia. It's frankly where many of the world's laptops and mobile phone were manufactured for decades before they shifted to the Pearl River Delta.

And Taiwan has had a relatively stable industry structure for E-Commerce that dates back almost 15 years with three incumbents with relatively stable position. When Shopee was launched in June of 2015, it was very disruptive and innovative. We went straight to mobile app, which was very different with a very strong chat base capability. We were extremely supportive of social media sellers. And finally, we had a very unique approach to category mix, which was much more fashion and female-centric, the traditional players that were more electronic-centric. All four of those factors coming together had a very powerful impact on the market that I would argue have increased the overall pie size of E-Commerce in Taiwan. And what's interesting in some ways is compared to Indonesia, Taiwan arguably had more entrenched competition, because there were three players in the market with several good years of cash flows under their belt. One of them was even public.

So, in some ways, we're incredibly proud of Taiwan even more so than our accomplishments in Indonesia, because of the Normandy we had to storm, so to speak, over there and the fact that our monetization is already in full throttle in Taiwan with full mandatory commissions for every transaction, albeit lower than we think they'll get to is a great sign.

Now, let me show Indonesia as maybe exhibit B. Indonesia's case is a very different market. The income standards are probably one-fifth or one-fourth the level of per capita GDP as Taiwan. There really wasn't any dominant incumbent profitable publicly-traded E-Commerce business. And most importantly, E-commerce, as a percentage of retail, was far, far, far less than 3% or 4%. It was just getting started.

In Indonesia, the problem to be solved wasn't displacing a triumvirate or a troika of existing players, it was actually giving people access to E-Commerce for the first time in their lives. And interestingly enough, the same strategic elements worked, going straight to app, being very asset-light, having a wonderful social commerce element for rural sellers and town sellers to be able to sell to their friends, family and countryside colleagues and finally going after the right categories, particularly female-centric categories. The exact same playbook worked, albeit in a much more rural way.

So, you'll notice that we have many, many more employees in Indonesia than we do in Taiwan. That's because you have to get out there almost Unilever style on motorcycles and bicycles and cars to get out into the countryside. We are now at 1.9 million active sellers in Shopee and a huge fraction of those are in Indonesia. And if we were to show a heat map from space, you'd little red dots literally at every town and village across the country of any material scale.

So, the overall playbook was quite similar. The starting point for growth markets was rather different and we're very pleased to say that today we are the largest E-Commerce business in Taiwan by daily orders and we're the largest E-Commerce business in Indonesia by daily orders, which is very special.

Thailand, Vietnam, Philippines, in some ways, have a lot more in common with Indonesia. E-Commerce is so nascent there. The GDP per capita is a bit lower. And in many ways, the exact same playbook that we worked in Indonesia will work over there with one exception, which is in general those three markets have had less attention and less capital from international competitors. So, in some ways, the path to dominance there may be even simpler than we experienced in other markets.

Maybe we can shift to a few more questions. And then, Grace, if you have more, just jump back in queue.

Operator

Our next question comes from Mike Olson with Piper Jaffray. Please go ahead.

<A - Nicholas A. Nash>: Hi, Mike.

<Q - Mike J. Olson>: All right. Thanks. Hello. Good morning and congrats on the strong quarter. I have two questions if I could. So, for Shopee, following on that last question, maybe somewhat overlapping, you're up and running with both seller fees and advertising in quite a few markets now. So, for those looking for your strong GMV growth to translate into E-Commerce revenue, how would you describe the anticipated ramp in revenue realization rate over the next few quarters and years? In other words, how would you kind of expect to strike a balance between take rate or revenue realization and then seller and/or GMV growth? And then I have a follow-up. Thanks.

<A - Nicholas A. Nash>: You bet, Mike, absolutely. I think in general like most good things in life, we want to be patient. We've all learned the lessons of EachNet in China, where too rapid or too hasty of pushing to monetization without an exceptionally well-communicated strategy to the sellers and a really crisp articulation of the ROI to them from being on our platform can hurt you. And I won't belabor the point of EachNet, but there are many other examples as well. It's not lost on us that the most successful E-Commerce company in China today waited five or six years before really deepening into monetization.

We have one great advantage in our Shopee business, independent of the fact that we're part of the same family as Garena, which brings us tremendous cash flow, and that advantage is that our customer acquisition costs tend to be between $4 and $8 and our asset-light model means that we don't have the inventory carrying cost and the warehousing cost and a myriad of other expenses that 1P players have.

So, we really have the financial flexibility to be thoughtful and patient and we will always take $1 billion of final NPV over simply accelerating monetization or breakeven by a month or a week or a quarter here and there. So, we really want to be thoughtful and patient and do right by our shareholders and by the [ph] investors (58:01) community.

That said, market share does turn into monetization and you're seeing that happening in Taiwan, you're seeing a very vigorous and strong growth in our advertising revenues in Indonesia brick-by-brick. So, as the quarters and years go by, we'll certainly not be shy, but sharing with you where we are with the progresses, but we want to grow this orchard in a very patient nuanced way. There's no point trying to grow a Christmas tree in three months.

<Q - Mike J. Olson>: All right. That makes sense. And then, also on Shopee, how would you describe the risk or lack thereof for E-commerce competitors in the region potentially pivoting away from their larger focus on the 3Cs and into the categories that you're more focused on like fashion, health and beauty, et cetera? Thank you.

<A - Nicholas A. Nash>: Of course, Mike. You bet. In fact, in some ways, it's sort of a two-part question. Part of it is, how do they transition or can they transition from 3C into non-3C? And then simultaneously for those like one of our large competitors that are 1P direct-selling businesses, can they transition into more of a marketplace approach? And they're linked, because it's almost impossible to build a 1P non-3C business. It's almost a null set on a global basis.

At [ph] GA (59:09), we invested in tons of those businesses and very few of them ever got beyond about $1 billion of equity value. Most of them are quite smaller than that, because if you're trying to go after the truly long tail of non-electronics items, you need to have that incredible bench strength of millions and over time maybe even tens of millions of merchants creating that SKU listing to diversity.

So, again, both are important. Let me go one by one. Our customer base is disproportionately female and our seller base is disproportionately addressing that female market of health and beauty, fashion and the like. If someone is starting with a very male customer base and a very short-tail, largely electronics OEM supplier relationship base, in history, there are almost no good examples of transitioning from point A to point B.

Why? You simultaneously got to change both tires on the car, while you're driving it. You've got to acquire millions, if not tens of millions of women to be sticky customers and, at the same time, you have to acquire tens of millions of SKUs, typically generated by several million sellers. It's almost impossible to do both at the same time and overcome the brand inertia.

I love to joke with my American friends, how many people buy dresses at Best Buy? How many people buy lipstick at Circuit City before it went bankrupt? The point is that electronics retailers often build a very strong brand and clientele and credit to them around the male categories of buyers and the categories that they sell, but they have a very difficult time transitioning both factors simultaneously.

The second dynamic we talked about earlier is again going from 1P to 3P. And again, it's almost impossible to go into long tail without being 3P. The dilemma is that if you begin in 1P, you're directly competing with your own sellers. It's testament I think to that dynamic that our single largest competitor, the company for whom we're 2.2 times their size by daily orders, they have announced publicly that they have 100,000 sellers on their platform. After about six or seven years of business growth, we have 1.9 million active sellers and many more that are registered sellers. That literally 19 to 1 ratio I think is emblematic of the independence that we have relative to our sellers and the lack of conflicts of interest so that we don't compete with them directly.

<Q - Mike J. Olson>: Thank you, Nick.

<A - Nicholas A. Nash>: You bet.

Operator

Our next question comes from Scott Devitt with Stifel. Please go ahead.

<Q - Scott William Devitt>: Hi. Thanks. I have two questions both related to E-Commerce. First, I was wondering how you think about the linkage of the markets that Shopee serves and whether success in a single market improves the likelihood of success in other markets and what some of the border-crossing network effects may be that could drive that.

And then, secondly, just to try to hit the take rate question again in a different way, looking at take rates for mature E-Commerce marketplaces globally of Alibaba sitting around 4%, JD monetizes closer to the higher single-digits and then the western market players are more in the low-double digits. So, wondering long term, how you think Shopee fits in or market share leadership in this region kind of fits in with that very broad rate that does exist on a global basis. And if you're not willing to kind of speak with precision in terms of percentage take rate, some of the drivers that determine what that take rate may be once the market share leadership has been guaranteed. Thanks a lot.

<A - Nicholas A. Nash>: Very much so. Thank you so much, Scott. It's a very perceptive question. Let me start with just cross-border synergies and the benefit of it. There's really three key factors. Number one, by being in all seven markets and being quite substantial in at least five or six of the seven markets, it gives us a unique and unfair advantage in building a cross-border business and cross-border, in fact, is one of the fastest growing slices of our GMV and orders.

We'll provide more disclosure on that as the quarters unfold, but suffice it to say, it is a huge priority for us both between Greater Southeast Asia and the rest of Asia, which is important for overall economic integration, but between Greater Southeast Asia and its respective markets. So it's a really unique advantage that, frankly, only we and a handful of others have in this market.

The second element of being in multiple countries is the amortization of product expense across multiple markets. It's telling that if you're just a single market player, it's often hard to be best-in-class on product, but by having all seven markets united together, in terms of the raw framework of Shopee, the actual kernel of the engine, the chat technology, obviously deeply localized country-by-country as a framework for buyers and sellers, but their core technology is quite standard, that's very powerful.

And the last element is something that doesn't often get talked enough about, but credit to Forrest really always making this a priority, the talent. When you bring the smartest and young people and entrepreneurial dynamic people across this region together, you can do some very interesting things with career rotations and mobility. We find that some of the best E-Commerce talent in this region wants to try different markets out in their career and play a role in home office, play a role in the field. That's again an unfair advantage that we have versus many others.

On the second question on take rate, again, we need to be a little circumspect about how precise you want to get on this, but consistent with some of our earlier conversations, Scott, I think of it in two ways. For us, the real comparison is what does a fragmented emerging market E-Commerce marketplace look like with the category mix that we do? For example, if you think about Jingdong, which is around 8%, 7.5% to 7.8% take rates, great business, but interestingly actually their category mix on their marketplace is a bit more tilted towards 3C than ours.

I think if you were to look at a category-adjusted take rate for JD, it might be closer to the MercadoLibre take rate. Likewise, if you think about MercadoLibre, even they have perhaps somewhat different mix than we do, this could be even higher on a like-for-like basis. So, we look to those sorts of data points as very illustrative of where our take rates will get to over time and we feel quite confident that sort low double-digit is the ultimate end game state for us. In fact, there are illustration points like [ph] Zozo Shop (01:05:01) in Japan that have had even better than that in a remarkably similar model to Shopee, albeit more branded. So, those are really the reference points we have less the BABA 3% to 4% for a whole host of reasons and more the Jingdong and the MELI take rate zone on a category-adjusted basis.

Everyone, just a bit mindful of time, you've been so generous to share even just five minutes ahead of the hourly allotment, perhaps we can take one or two more questions and if those have – if anybody has 9:00 AM meetings to rush to, we certainly won't be insulted if you have to drop off, but I think Piyush has a question and then perhaps Andrew then we'll wrap up.

Operator

We do have our next question from Piyush Mubayi with Goldman Sachs. Please go ahead.

<Q - Piyush Mubayi>: Thank you for taking my question. I have some very simple questions. Could you give us a split of PC and mobile gaming growth rates if possible please? And second question is...

<A - Nicholas A. Nash>: Piyush, if you don't – go ahead.

<Q - Piyush Mubayi>: Split between PC – and just on the second question, I don't have more – any color around how 11/11 Singles' Day progressed for you and the competitive environment that you saw at that point of time? Thanks.

<A - Nicholas A. Nash>: Yeah. It went extremely well, Piyush. On Shopee division may put out a zone data shortly. So I won't steal their thunder on that, but exceeding our expectations and did exceptionally well. PC versus mobile growth rate, we don't disclose because [indiscernible] (01:06:17) manage the business as a unified segment. We've even got games, Piyush, like FIFA, which are both mobile and PC in our integrated experience with the consumer. What we have disclosed, to Forrest's earlier point, is that for the first time in our history, our gross billings for mobile exceeded that for PC, meaning greater than 50% mobile contribution in Q3.

And on a GAAP basis, you'll see that trickle in over the coming months and years to come, but mobile is already now greater than PC, which is a great milestone for us. And only about a quarter after I think Tencent itself reached that same special milestone.

Just mindful of time, maybe a quick question from you, Andrew, then we can jump off and let people get back to the day.

Operator

Our next question is from Andrew Orchard with Nomura. Please go ahead.

<Q - Andrew J. Orchard>: Hi, guys. Thanks for squeezing me in. Just another question, I think, on the monetization. I mean, Nick, you touched on the different buckets that you could look at in terms of monetization, right, like cross-border commissions versus domestic commissions at each of selling markets. Into the next year, what's more important, is it deepening where you're already making money in the buckets that already you've checked off or widening out where you could potentially – widening out what you could do where potentially you're not making money right now, but you could start to do that maybe next year?

And then, just very quickly, in terms of LoL, we've seen on some of the streaming websites, the LoL rankings slipping slightly versus some of the newer games like Playersunknown Battleground (sic) [PlayerUnknown's Battlegrounds]. Have you seen any sort of slippage in terms of your own metrics in LoL? Thanks.

<A - Nicholas A. Nash>: Sure, Andrew. We're going to be very efficient with time. So, in first in terms of Shopee monetization, I think the big four or what we described earlier, cross border commissions, domestic branded, domestic sort of more of C2C, and then of course click-based advertising. In terms of other sources of revenue, we've made some allusions in the past to sort of things we're doing to support our sellers in the logistic side, similar to sort of a Mercado Envíos in Latin America. But those are the big four that we're most focused on.

Ultimately, I want to be very clear in terms of our priorities. Our priority right now is just good old fashioned organic growth for the business, so we can grow out at platform.

In terms of your question on PUBG and others in a certainly an exciting new format and I think the deeper question we should all be asking ourselves and we're certainly asking ourselves is, how can we best optimize our user experience to reflect that game format. Because the Battle Royale genre is going to be an important one and you'll probably hear some announcements from us over the coming years, but how we want to embrace those kinds of games on an ongoing basis.

But in general, League of Legends continues to be a very strong game for us. We're proud to be the exclusive partner for Riot and we're proud to have Jin Oh, the former Head of International for Riot join our business. So, we don't disclose game by game breakouts, but again proud to be the partner for that game in this region.

Nicholas A. Nash

With that, I think we probably have to wrap up. Apologies for those who are running late for your next meeting, but wanted to make sure we squeeze everybody in and we very much look forward to having more interaction with you. Our doors are always open call and visit anytime. And we look forward to seeing you again in a few months time for Q4. Good night, everyone. Have a great day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2020-05-13
Event Description: Q1 2020 Earnings Call

Market Cap: 4104055.12511
Current PX: 429.6
YTD Change($): 54.0
YTD Change(%): 14.377

Bloomberg Estimates - EPS
Current Quarter: 2.713
Current Year: 11.858
Bloomberg Estimates - Sales
Current Quarter: 109527.125
Current Year: 465979

Q1 2020 Earnings Call

Company Participants

- Wendy Huang, Investor Relations
- Pony Ma, Co-Founder, Chairman and Chief Executive Officer
- Martin Lau, President and Executive Director
- James Mitchell, Chief Strategy Officer, Senior Executive Vice President
- John Lo, Chief Financial Officer, Senior Vice President

Other Participants

- Gregory Zhao, Analyst
- Piyush Mubayi, Analyst
- Han Joon Kim, Analyst
- Jerry Liu, Analyst
- John Choi, Analyst
- Alicia Yap, Analyst
- Alex Yao, Analyst
- Eddie Leung, Analyst
- Binnie Wong, Analyst
- William Packer, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Tencent Holdings Limited 2020 First Quarter Result Announcement Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. (Operator Instructions) Please be advised that today's conference is being recorded.

I will pass the call to Wendy Huang from Tencent IR team. Thank you. Please go ahead.

Wendy Huang, Investor Relations

Good evening. Welcome to our 2020 first quarter results conference call.

Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties, and may not be realized in the future for various reasons. Information about general market conditions is coming for a variety of sources outside of Tencent. This presentation also contains some unaudited non-IFRS financial measures that should be considered, in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS. Non-IFRS measures are intended to reflect our core earnings by excluding certain one-time and all non-cash items. For a detailed discussion of risk factors and non-IFRS measures, please refer to our disclosures on the IR section of our website.

Now let me introduce the management team on the call tonight. Our Chairman and CEO, Pony Ma, will kick off with a short overview; President, Martin Lau, and Chief Strategy Officer, James Mitchell will provide the business review.

Chief Financial Officer, John Lo, will conclude with financial review before we open the floor for questions.

I will now turn the call over to Pony.

Pony Ma, Co-Founder, Chairman and Chief Executive Officer

Thank you, Wendy. Good morning. Thank you for joining our call at this unusual time. As the world tackles COVID-19, our thoughts and hearts go out to all the people who are suffering from the pandemic. During this difficult period, we seek to provide online services that keep people connected, informed, productive, and entertained. So far, our businesses have proved resilient and cash flow generative, enabling us to increase our investment to fulfill our mission of Tech for Good. We are allocating time and resources, including over RMB2 billion of donations, to contribute to COVID-19 relief initiatives in China and globally.

And now, I will highlight the result we achieved in the first quarter of 2020. Total revenue was RMB108 billion, up 26% year-on-year and 2% quarter-on-quarter. Gross profit was RMB53 billion, up 33% year-on-year and 15% quarter-on-quarter. Our non-IFRS operating profit were RMB36 billion, up 25% year-on-year and 17% quarter on quarter. Non-IFRS net profit attributable to equity holders was RMB27 billion, up 29% year-on-year and 6% quarter-on-quarter.

Our platforms and products have never been more need and relevant as users stay-at-home. We believe this experience will also lead to acceleration of digitalization going forward. In social, users heavily relies on our social platforms to stay connected. Combined MAU of Weixin and WeChat increased 8% year-on-year to over 1.2 billion. In games, more players spend more time online, further strengthening our Number One position in China. Our games also will continue to grow internationally.

Immediate video views and subscriptions continue to expand as we release the top tier content. Music subscriptions increased, driven by effective content, payroll strategy. In FinTech, we operate the largest mobile payment platform in China by DAU, number of transactions [ph], increasing efficient and supporting small business. In cloud, we are number 3 [ph] public cloud services provider in China, steadily picking up market share amid intense competition. In utilities, we maintain our industry leadership in mobile security, mobile browser and Android app stores in China.

I will invite Martin and James to discuss business review.

Martin Lau, President and Executive Director

Thank you, Pony, and good evening and good morning to everybody. For the first quarter of 2020, our total revenue grew 26% year-on-year. VAS represented 58% of our total revenue, within which online games was 35% and social networks was 23%. FinTech and Business Services represented 25% of total revenue. And Online Advertising represented 16% of total revenue. For value-added services segment revenue was RMB62.4 billion in the first quarter, up 27% year-on-year and 19% quarter-on-quarter.

In social networks, revenue grew both year-on-year and quarter-on-quarter, mainly driven by item sales in smartphone games. Total VAS subscriptions increased 19% year-on-year to a RMB197 million, reflecting robust growth in video and music subscriptions as users spend more time online. Video subscriptions increased 26% year-on-year to RMB112 million due to popular self-commissioned drama and Chinese animated series, such as Sansheng Sanshi Pillow and The Land of Warriors Season 3. Our music services, an expanding paid music library contributed to subscriptions growth of 50% year-on-year to 43 million.

Online games revenue grew 31% year-on-year and 23% quarter on quarter, driven by more active users and higher paying ratio during the stay-at-home period. Consumption will normalize as users return to work. Total smartphone games revenue increased 64% year-on-year to RMB34.8 billion, driven by key titles including Honour of Kings, Peacekeeper Elite and PUBG Mobile, as well as consolidation of super sale. Sequentially, revenue grew 33% due to more playing time during the Chinese New Year and stay-at-home period. PC client games revenue decreased 15%

year-on-year to RMB11.8 billion, due to temporary closure of Internet cafes and soft DnF performance. Revenue increased quarter-on-quarter on favorable seasonality.

Turning to Social Networks. We are highly motivated by our roles and responsibilities in creating and helping people to stay in touch with their friends and families, and then connecting people to necessary services during this critical period. User engagement on Weixin and QQ increased, with daily messages and time spent on each service up double digits year-on-year. With strength in several functionalities on Weixin and QQ platforms to better serve specific use cases. For example, for the eLearning, teachers can now with customize QQ group toolbar with relevant Mini Programs such as online exams and home work collection tools to better manage online classes. Students can experience communal study time via virtual study rooms.

At healthcare services, we connected Weixin users with medical professionals in private or group chats, initiated via Tencent Health mini program or access point embedded in Weixin Pay. To support remote presentation, we extend the QQ's screen sharing function in video calls from PC to mobile devices.

On daily services, we increased the penetration in offline use cases contributing to Weixin Mini Programs exceeding 400 million DAU. We helped accelerate digital distribution or omni-channel consumption for offline services, especially grocery shopping and municipal services. We assisted local governments and businesses to disseminate e-vouchers expediting the recovery in offline consumption after the lockdown is over, especially for retailers and restaurants.

Let's move on to Online Games. During the stay-at-home period, users spend more time on our games for entertainment and social interactions, leveraging our best-in-class game content and large in-game social communities. We captured incremental entertainment demand. Our smart phone games DAU recorded strong growth year-on-year and quarter-on-quarter. Among our leading mobile titles in China, we upgrade Honour of Kings game engine last year, which allowed us to enhance audio and visual experiences of the game, enabling more attractive content such as the Five-Mountain themed skins we released during the Chinese New Year. We also introduced the location-based teamplay system which encouraged more interactions among players in the same city. Peacekeeper Elite collaborated with Rocket Girls 101, an idol girl group managed by Tencent, which emerged from a popular variety show. This drove user engagement to a new high, demonstrating the success of our cross-IP synergy.

Internationally, PUBG Mobile celebrated its second anniversary with multiple in-game events while we tailored our operations regionally to increase user reach and engagement. For League of Legends, we launched Teamfight Tactics mobile app, as well as new content contributing to higher user retention and time spent for this long standing franchise. For Brawl Stars, the high-cadence content updates kept user engaged and optimized player-matching mechanism further enhanced user experience.

We do have a substantial new game pipeline. In China, we will launch more titles across different genres by June. Internationally, licensed mobile RPG CODE:D Blood achieved initial success by downloads as well as growth in Japan like new PC tactical shooter, Valorant, enthusiastic responses from players during closed beta-testing, and was the most viewed title on Twitch in its first month. Looking forward, we expect in-game consumption activity to dip back toward more normal levels as players go back to work and time spent in games normalizes.

With that, I will now pass on to James.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Thank you, Martin. Turning to Online Advertising. Revenue was RMB17.7 billion in the first quarter. The above trend year-on-year growth rate of 32% reflected, a, increased consumer time spent on our apps during the stay-at-home period, which we expect to normalize in future quarters, and b, our platform's ability to deliver attractive returns on investment to advertisers. Sequentially, advertising revenue decreased due to seasonality.

By industry, games, Internet services and online education ad spend rose year-on-year, as these categories increased spending in reaction to more traffic and consumption for their services during the stay-at-home period. Fast moving consumer goods, auto and travel related ad spends declined.

Looking forward, we expect the overall China online advertising industry to experience industry wide headwinds, including first, consumers normalizing down that time spent online; second, online services advertisers adjusting their customer acquisition budgets as they reflect revised customer lifetime value assumptions; and third, multinational brands reducing their spending significantly as they face the pandemic in their home markets.

For Social and Others Ad, advertising revenue grew 47% year-on-year, driven by increased ad impressions, particularly on Moments. Our mobile ad network revenue also expanded sharply on more traffic and higher eCPMs, with video ads now representing over one-third of our app network ad impressions. We expect our social advertising revenue to revert to what its prior trend growth rate from the second quarter as ad impressions normalized somewhat and as some advertising categories review their customer acquisition budgets.

For Media Advertising, revenue was RMB3.1 billion in the first quarter, down 10% year-on-year, within which sponsorship ad revenue declined year-on-year as well as quarter-on-quarter due to budget cuts, delays in producing and airing certain variety shows, and suspension of NBA basketball games. In-feed advertising revenue grew year-on-year and quarter-on-quarter due to the popularity of several top tier drama series, and demand for reliable news and information during the pandemic. We expect media advertising revenue trends will be more challenging in the second quarter as multinationals reduce their brand budgets.

Looking at FinTech and Business Services, segment revenue was RMB26.5 billion, up 22% year-on-year and down 12% quarter-on-quarter. Within FinTech, revenue decreased sequentially as commercial payments, especially offline payment activities, and cash withdrawals reduced during the Chinese New Year and stay-at-home periods. FinTech margins were, however, stable sequentially due to the higher margin revenue streams such as wealth management and lending continued to grow, and as we managed our marketing and subsidy costs.

Looking forward, we have seen a healthy rebound in payments activities across offline and online in QR code, as well as point-of-sale transactions. For example, during the last week of April, our average daily commercial transactions value had recovered to late 2019 levels. Our wealth management business grew at a stable rate in the first quarter as aggregated customer assets increased year-on-year and quarter-on-quarter. And our WeiLiDai loan book remained healthy, reflecting the bank's prudent risk management policies.

Within Business Services, the pandemic delayed project deployments and new account acquisition, resulting in a sequential revenue decline. However, our Tencent Meeting software achieved breakout success and became the leading video conference app in China. We strengthened its security measures and introduce new functions to facilitate discussion and conference call management. In late March, we launched an international version Tencent Meeting called VooV Meeting. For WeChat Work, we enhanced industry solutions and deepened the integration with Weixin, helping us to sign more key accounts, especially in the retail, education and public sectors. Consequently, WeChat Work DAU has grown significantly during the period.

Looking forward, we expect Business Services to remain challenging in the short-term due to disrupted sales cycles, but we will continue increasing our investment, especially in enterprise software and cloud services, as we believe the experience of remote working will ultimately prompt offline industries in the public sector to accelerate the digitization.

And with that, I'll pass to John to speak the financials.

John Lo, Chief Financial Officer, Senior Vice President

Thank you, James. Hello everybody. For the first quarter of 2020, total revenue was RMB108.1 billion, up 26% year-on-year or 2% quarter-on-quarter. Gross profit was RMB52.8 billion, up 33% year-on-year or 15% quarter-on-quarter. Net other gains was RMB4 billion, down 64% year-on-year or up 11% quarter-on-quarter. This item mainly comprised of non-IFRS adjustment items including net gains on disposal of certain investee companies as well as net fair value gains on the investee companies. It was partially offset by RMB2.6 billion donations, primarily to combat the COVID-19 pandemic globally.

Operating profit was RMB37.3 billion, up 1% year-on-year or 30% quarter-on-quarter. Net finance costs were RMB1.7 billion, up 51% year-on-year or down 39% quarter-on-quarter. The year-on-year increase was mainly driven by greater interest expense resulting from higher amount of the indebtedness. The quarter-on-quarter decrease was due to recognition of ForEx gains for Q1 2020, while we recorded a ForEx loss a quarter ago.

Share of losses of associates and joint ventures was RMB281 million, down 90% year-on-year or 79% quarter on quarter, mainly due to changes in non-IFRS adjustment items of certain associates. On a non-IFRS basis, we recorded share of profit of RMB164 million for the first quarter of 2020 comparing to share of losses of RMB518 million a year ago. The change mainly reflected improved performance of certain investee companies.

Income tax expense were RMB5.9 billion, RMB2.1 billion and RMB4.8 billion for quarter one 2020, quarter four 2019, and quarter one 2019 respectively. Effective tax rate for the quarter was 16.7%. IFRS net profit attributable to equity holders was RMB28.9 billion, up 6% year on year or 34% quarter-on-quarter. Diluted EPS was RMB2.999, up 5% year-on-year and 33% quarter-on-quarter.

Now let me walk you through our non-IFRS financial numbers. For the first quarter, operating profit was RMB35.6 billion, up 25% year-on-year or 17% quarter-on-quarter. Net profit after NCI was RMB27.1 billion, up 29% year-on-year or 6% quarter-on-quarter. Diluted EPS was RMB2.817, up 29% year-on-year and 7% quarter-on-quarter.

Turning to segment gross margin. Gross margin for VAS was 59%, up 1.4 percentage points year-on-year and 8.9 percentage points quarter-on-quarter. The year-on-year growth was mainly due to improved margin for both PC and smartphone games, resulting from improved revenue mix towards high margin in-house games. The sequential increase was benefited from revenue mix shift towards higher margin in-house smartphone games, increase in margin of video subscription business as a result of higher subscription revenue and lower content cost due to the pandemic, and the absence of major e-Sport events, therefore lower content cost quarter-on-quarter.

Gross margin for Online Advertising was 49.2%, up 7.3 percentage points year-on-year or down 5.1 percentage points quarter-on-quarter. The year-on-year increase reflected lower content cost for video advertising and improve efficiency. Sequential decline mainly reflected revenue decrease due to negative seasonality. Gross margin for FinTech and Business Services was 27.9%, broadly stable year-on-year and quarter-on-quarter.

On operating expenses, selling and marketing expenses were RMB7 billion, up 66% year-on-year or 5% quarter-on-quarter. Marketing spending increased year-on-year, particularly in content platforms including Weixin's marketing campaigns during the Chinese New Year. As a percentage of revenue, selling and marketing expense increased from 5% in the first quarter of 2019% to 6.5% this quarter.

G&A expenses were RMB14.2 billion, up 25% year-on-year or down 12% quarter-on-quarter. The year-on-year increase mainly reflected greater R&D expenses and staff costs as we invested in tenants and technology to support business development. The Q-on-Q decrease reflected reduced outsourcing activities for R&D projects, and reduced traveling and entertainment expenses due to the pandemic. As a result -- as a percentage of revenue, G&A and R&D represented 13.1% and 7.4% respectively. As at quarter end, we had approximately 64,000 employees, up 18% year-on-year or 2% quarter-on-quarter.

Let's take a look at the margin ratios. For the first quarter of 2020, gross margin was 48.9%, up 2.3 percentage points year-on-year or 5.3 percentage points quarter-on-quarter. The year-on-year increase mainly reflected segment gross margin ratios improved their flow through to our branded gross margin, especially for VAS and Online Advertising segments. Sequentially, the margin increase was mainly due to revenue mix shift to VAS, which carry a higher margin. Non-IFRS operating margin was 32.9%, broadly stable year-on-year or up 4.2 percentage points quarter-on-quarter. Non-IFRS net margin was 25.9%, that should be stable both year-on-year and quarter-on-quarter.

Finally, I'll share with you some key financial metrics for the quarter. Total CapEx was RMB6.2 billion, an increase of 37% year-on-year or decrease of 64% quarter-on-quarter, within which operating CapEx grew 41% year-on-year to RMB5.5 billion, mainly due to more spending on servers to support operation of Tencent Cloud business, such as

Tencent Meeting; non-operating CapEx increased 7% year-on-year to RMB682 million.

At quarter end, free cash flow was RMB39.2 billion, up 133% year-on-year or 25% quarter-on-quarter. Starting from 2020, we adjusted our free cash flow parameters according to the latest market practice by subtracting payments for media content and lease liabilities, in addition to subtracting payments for capital expenditure from the operating cash flow. Comparative figures have been restated accordingly.

Net debt position was RMB5.7 billion, improved sequentially due to stronger operating cash flow, partially offset by payments for M&A initiatives. The fair value of our shareholdings in listed investee companies, excluding subsidiaries, was approximately RMB410 billion, that is about US$58 billion. Thank you.

Wendy Huang, Investor Relations

Thanks, John. We shall now open the floor for questions. Operator, we will take one main question and one follow-up question each time. Please invite your first question. Operator?

Questions And Answers

Operator

Thank you. Our first question comes from Gregory Zhao from Barclays. Please ask your question.

Gregory Zhao, Analyst

Hi, management. Thanks for taking my question and congratulation to the very strong quarter. I have -- so first, I have one big picture question is -- we know COVID-19 is gradually passing in China, so from your point of view, so what kind of structural changes COVID-19 brought to the industry and to Tencent, and also how shall we think about the changes to the user behaviors and your business strategies?

So also a quick one about your overseas gaming business in Q2. So we saw Activision Blizzard and some other gaming company give very strong guidance for Q2, and we know the corona is still ongoing in the overseas market in Q2. Shall we expect Tencent to deliver stronger overseas gaming performance in Q2? Thank you.

Martin Lau, President and Executive Director

Yeah, thanks for your question. I think in terms of structural changes, the biggest structural change is really for businesses and organizations to realize that there needs to be an online presence. When everything is actually shut down physically and offline, then it's actually very important for the businesses and organizations to be able to have online access to their consumers and then to the users via Internet. So I think that's a big realization. I think everybody feel that it's coming, but having experienced to COVID-19 lockdown means that, it's real and it's existential. So I think that will translate into many different front. For example, on retail, there will be more investment by -- at the retail shops and brands to establish direct linkage with the consumers. And I think Mini Programs is really one key infrastructure for them to be able to do that.

I think different government and municipal government and services would need to bring themselves online, and that would increase the overall investment in technology infrastructure and cloud investments on a longer-term basis. And in terms of specific segments, right, obviously there will be companies who needs to build up a remote working infrastructure and I think that would benefit tools, that enable remote working. And obviously, Tencent Meeting, has grown its user significantly during this pandemic period.

And in terms of verticals, I think online education is one area that would definitely benefit going forward, because I think a lot of students have been experienced with online education and the parents have also experienced that and that would drive the adoption of such a mode of education going forward. Online healthcare will be another area in which a lot of users would like to have access to more health-related information, and they're are getting used to having their disease diagnosed online both to AI or even connection with medical professionals. And the awareness of health would be much stronger going forward. And I think online healthcare would be one area that would grow significantly in the future.

So I think these are all the structural changes, right, you know that COVID-19 brings to the overall society, as well as the mindset of businesses. I think a lot of the consumers' mindset is already very much on mobile internet. But the businesses, there is some sort of inertia for them to make changes. But having experienced COVID-19, I think awareness for change would be much stronger and rest assured that there are a lot of investments that we have made in the past and we will be making even more for the future, which help us to take advantage and facilitate, and even lead these structural changes.

So on the gaming part, I'll ask James to answer.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Thank you for the question on the overseas game market, Gregory. So we believe that the game markets outside China, R&D's following a somewhat similar path to the market inside China. That's obviously a roughly two-month time lag. Given the later start of the stay-at-home periods in the rest of the world and the extent may not be as pronounced as in China. First of all, because in some regions, the lock-downs -- they stay-at-home periods less pronounced than in China.

And then secondly, because there may be some consumers who are concerned about unemployment risks, which may mitigate their in-games spending, but overall, there is an uplift in use of time spent on games. Games going [ph] to be more granular, the games that are seeing the biggest uplift are generally those that have longer session lines, because people now have more time to play the longer session like games. And also the games that are somewhat team based in nature, which I think reflects people realizing that, perhaps surprising, who would actually miss their work colleagues and they want to socialize with them, and one way of doing that is through games, through team-based games.

Looking forward, of course, we expect and hope that the situation will normalize in the rest of the world as it has done in China. But taking a more longer-term view, it's also worth observing that we are in the fortunate position of continuing to launch games globally during this period. You know Martin mentioned, Code: D-Blood in RPG that we launched in Japan. Riot has launched its Legends of Runeterra card game on mobile and PC in the last few days. And then as Martin also mentioned, Riot has launched Valorant which had an extremely positive reception from hardcore gamers on PC in the last month.

Gregory Zhao, Analyst

Thank you.

Operator

Your next question comes from Piyush Mubayi from Goldman Sachs. Please ask your question.

Piyush Mubayi, Analyst

Thank you for taking my question, and congratulations on your numbers. Hearing your commentary about how strong the quarter was and how you think the second quarter could see a reversal of that, could you just go through that fact about how much traffic is coming off and how quickly that slowing down to the extent possible in the months of April and May?

And just diving further into that question, if you look at advertising, how would advertising, for example, change or slowdown from the the pace that we've seen in the month of -- in the first quarter? And from -- if you go back and look at the ad load increase that came through, that wasn't a full quarter increase, if I'm not wrong about it, so surely the second quarter and hereafter, you should see substantial strength in the first quarter play through into Q2 and the rest of the year. Is there something we're missing here?

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Piyush, sorry, on the first question which business were you alluding to specifically?

Piyush Mubayi, Analyst

I'm alluding to the overall business, the trend that you've seen in the first quarter on both advertising and gaming, and your commentary that you're likely to see this reverse into Q2 because your guidance sounds a little bit more conservative?

Martin Lau, President and Executive Director

I think for whatever benefit that came through in the first quarter, because people stay at home more and thus have more time on the screen and spent more time on games and video and Internet services. We are seeing that normalizing basically, by and large, in April. It started to normalize in March, but pretty much normalized in April, and all normalized after May 1st holidays. So I think -- that's sort of -- the extent that you should think about.

And in terms of advertising. I think, James would probably will give you some color.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Yeah, I mean, this might be reiterating what we said in the prepared remarks in which case I apologize. We try to go a little bit deeper or little bit clear in case it wasn't clear. So the three factors that we think will act as headwinds for the industry as we look forward beyond the first quarter. The first is that in the first quarter, because of people staying at home, they spent more time online and more time results and more impressions, and particularly to the direct response to advertisers if there is more impressions then, all else equal, they will mechanically buy more and spend more money with the industry as a whole. And so, our assumption is -- going into the second quarter as people return to work and to school, the quantity of assailable impressions will normalize.

Then second factor is that, if you look at how the direct response advertisers operate, then they have a certain customer lifetime value assumption based on historic ARPUs, based on historic churn rates, and so forth, and they will bid up the eCPM or eCPC that they're willing to pay to a customer acquisition costs that is derived from that customer lifetime value assumption. And in the very short-term, if that's a sudden shock, which was the case with with the COVID-19, then they may not have time to fully update the customer lifetime value assumptions. But over the months as the situation stabilizes, then they may decide to review the customer lifetime value assumptions due to different assumptions about churn rate or different assumptions about retention rates or they may not, we don't know, but it's a risk.

What we do know is a third factor, which is the certain online advertising properties in China, such as online video. When historically close to half of the advertising revenue in that industry came from multinationals, and what we've seen in the last few weeks is that the half of the revenue that comes from local China-based companies has been fairly resilient. But half the revenue long-form video that comes from multinationals has experienced a substantial step down and a hypothesis as this reflects the fact that these multinationals have a global perspective, and to some extent, what they're seeing in the rest of the world affects how willing they are to spend money in every country, including in China.

So those are all headwinds that we think will affect the industry and what may affect us, and -- you should bear in mind. But I think that it's important not to get that in the parts, that's why it's been in this sort of discussion around whether our advertising revenue growth was constrained by lack of advertiser demand because of the ROIs, audience viewer tracking or limited supply. And I think what you can see from these results is, when there is a surge in supply, even if it's a surge in supply for reasons outside our control and beyond our expectations, then our revenue experiences a corresponding uplift, because fundamentally our appetite delivers high returns.

Piyush Mubayi, Analyst

Thank you.

Operator

Your next question comes from Han Joon Kim from Macquarie. Please ask your question.

Han Joon Kim, Analyst

Great. Thank you for the chance to ask a question. I think you've mentioned about the structural changes that have been happening for the industry. But I wanted to kind of follow-up on that. I wanted to see how you guys are thinking about your business plan as well. So I suspect you guys started the year with certain frame in mind that the world has changed. So to the extent of things like CapEx, those things about your business mix between consumer facing and enterprise facing, how do you think the content of your business changes? How does your investment plans and your financial kind of expectations change alongside that? Thank you.

Martin Lau, President and Executive Director

Well, I think, I would say we have anticipated the structural change, and I think you -- I have explained it, right. The structural change is something that everybody sort of anticipated. I think there is an inertia especially from the side of established businesses to say how much investment we're going to be making in order to make the change. And if I want to make the change, it requires money, it requires people, it requires a change in my organization, and overhaul on my supply chain. There is a lot that needs to be changed. So there is an initial inertia.

But then, I think you're going to this COVID-19 process, then everybody feels that they have to make the change, even though it's painful, it's costly, and it's going to be a bit challenging. So I think that's the structural change points. And as a result, I think we have not been experiencing any structural change in our framework on investment, because I think with the framework, the investment was already there. We were first to reorg our organization in the year of 2018 to establish our CSIG, cloud and industrial into that service group. So that basically set us up to embrace in China.

And it's actually because of that then we were able to have Tencent Meeting launched right in the midst of COVID-19 and be able to establish itself to be the, by and far, Number One standalone video conferencing tool in China, right. So I think from that perspective, there is no structural change in our investment framework, but I think we're excited that we will be putting more investments into both the consumer internet, as well as the industrial internet in order to drive and embrace the expedited change.

Operator

Your next question comes from Jerry Liu from UBS. Please ask your question.

Jerry Liu, Analyst

Hi. Thanks guys. Yeah, first just a follow-up on gaming. I appreciate the idea that as people return to work then they're spending less time in these games, but at the same time, we also heard comments about how we are excited about some upcoming games. So how do we reconcile those two things? Could some of these new games bring some upside to grossing this year or are some of these big games to kind where we'll take time to build that user base, so maybe we should have some patience with monetization?

And then the second, just a question on cloud. I appreciate also that with cloud, as people were at home, a lot of the projects were delayed, but as people go back to work now, and I'm also hearing comments about some challenges from management. So I'm just wondering if this is just as people need some time to put these big projects together or do we see maybe some of the enterprises being a little bit cautious with CapEx or just some of these bigger budgets? Thanks.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

I think on the game question then, you summarized the puts and takes very well and that's not a lot I would add to it. If you're looking for a synthesis of the two forces and where it nets out, then the reality is that we don't have a crystal ball and time will tell. But we wanted to be clear that on the one hand, we did have is an anticipated surge in -- on user time spent, and to some extent, in consumption within some of our existing games and we will need to digest and stabilize after that for a little while. But on the other hand, I think that we're very pleased just as we had that that Tencent Meeting launched just before the coronavirus broke out. So on the game side, we have some big interesting exciting games that have already been released or about to be released.

We think, to your point, those games may or may not take some time to feed through into monetization that it's already clear, that's the critical reception to those games and the reception of the most demanding players within the card game genre or other competitive first shooter genre has already been extremely positive which are leading indicators -- positive leading indicators for the future, no matter how quickly the monetization flows through.

Martin Lau, President and Executive Director

In terms of the cloud business, I think you have also pointed out at the right point, which is number one, as people return to work, then a lot of these projects which have been put into a halt would be restarted and it would actually take some time, right, for maybe the bidding process, maybe the negotiation of the contract, maybe sort of the implementation in order for it to enter into production and revenue-generating phase.

And two is, I think from the enterprises perspective, I think there is a little bit of -- I would see coming back to the drawing board and revisiting the business plan for -- some of the businesses which saw their business impacted during the COVID-19. But I think the good thing is, I think, the Chinese economic activities have returned -- rebounded quite nicely, right. So when that happens, then when these businesses start to see their business recover, then we feel that they would then be able to normalize their business plan. And at the same time, because they have gone through the COVID-19 shut down, their plans for the future in terms of digitization will probably be speeding up.

So I think there will be a period where everybody needs to restart, and there will be a period of hesitation, but then we hope and we believe that over time the future digitization wave will start to take off.

Operator

Your next question comes from John Choi from Daiwa Capital Markets. Please ask your question.

John Choi, Analyst

Good evening, gentlemen, and thanks for taking my question. My question is on the FinTech services. It seems like you guys have done a pretty good job in terms of -- on stabilizing the margins, but going forward, how should we think about the profitability given that, are we going to continue to be aggressive in their marketing or with the COVID-19 situation, how should we think about the cost control and how this will offset with the further diversified revenue stream?

And just a quick follow-up on the Mini Programs. Management did mention 400 million on daily active users. How has this really kind of reinforced our other parts of the ecosystem like payments for advertising during this period of time? Thank you.

Martin Lau, President and Executive Director

Yes, in terms of FinTech services, if you look at the changes to the lockdown -- during the lockdown, offline transaction volume pretty much nosedived. But it didn't really hurt our profitability. One is, the offline services were low margin, at the same time, there are a lot of marketing that's related to, getting the footprint out on the offline side. So when you have a lower transaction volume, we also didn't have as much marketing expenses, and that pretty much balance out each other.

I think when the business return to normal, right, then will have pretty much the payment volume returning to the same level as last year's December level. And at the same time, I would say, we will be starting to conduct more marketing activities, too, right. So that we will be watching out each other pretty much. So this pretty much reinforces our pretty consistent message, which is especially on the offline payment side, it's helping us to build payment as an overall infrastructure. So we are not -- we're not too much in a rush to create profit out of it, but instead, it's important for us to build market share and to build user behavior as well as coverage of the merchants.

In terms of the Mini Program, I would say, if you look the Mini Programs, it is a very basic infrastructure for our ecosystem, right. The Mini Programs actually help us to establish a relationship with a lot of service providers and it also helps the service providers to establish relationship with a lot of customers. And I think the ecosystem just gets stronger and stronger as we continue to build out the Mini Program infrastructure, and it was actually somewhat expedited during the COVID-19 pandemic as well. And we would see over time, I think it would actually help our payments, it would also help our advertising business.

But it's not going to be a immediate direct impact, but very clearly when businesses are running more of their services and getting more of their revenue and serving more of the customers on Mini Programs, then they will be more incentivized to run ads on our overall platform in order to drive more traffic into the Mini Programs. And I think over time, it also help us to build stronger relationship with these businesses so that we can get the cloud business better, and we also provide soft services to them, be it data analytics, be it helping them to acquire traffic and be it helping them to establish closer link with their customers.

Operator

Your next question comes from Alicia Yap from Citigroup. Please ask your question.

Alicia Yap, Analyst

Hi. Good evening, management. Thanks for taking my questions, and also congrats on the strong set of results. I have a follow-up on the advertising. I think with retailers leveraging the Mini Programs, should we actually see over time the increase in the demand for online app opportunity within the Mini Program official account to help mitigate some of the headwinds that we see from the multinational that you mentioned?

And also the iFit app you mentioned experiencing some recovering growth for the media ads. So is that implying media ads to also come out from the declining trend, especially with the easier year-over-year comp as we head into the second half? Quickly any last thought on the rationale and synergies on the recent investment in Afterpay and the (inaudible). Thank you.

Martin Lau, President and Executive Director

Well, the first part is -- I think related to the question before which is Mini Programs benefit for advertising, and I will take that question, which is I think it would definitely benefit advertising, but it will be more like over the longer term rather than shorter-term, because it's a little bit like an infrastructure that you would have the retailers if we're spending a lot of effort in terms of building their expertise on Mini Programs. And it's not just the Mini Program, but also finding ways to which they can drive traffic to the Mini Programs, right.

In the past, a lot of them rely on offline stores, and then having people to add to the official accounts and then basically leave it at that. But during the COVID-19 lockdown, it looks like a lot of direct sales effort by the shopkeepers by leveraging the social network was actually very effective. They also started to leverage a live broadcast as a way to acquire customers. So a lot of these new ways to which they can acquire traffic and attract users, be it new users or existing users have been developed and that they need to start building these capabilities. And once these are build, then they could dedicate a portion of the corporate resources to start bringing people into transaction to Mini Programs, which is something that they own themselves, which is very attractive for them when they think about the overall omni-channel mix.

And when that happens, then I think they would start thinking about, oh, we actually need to put in more advertising so that we can drive incremental traffic to Mini Programs. So I think it would take some time before we see the impact. But the structural migration towards Mini Program would definitely help our advertising going forward.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Alicia, on your question about media advertising then, I think you're asking about the second half of the year. We're already somewhat swimming against the tide by talking about current quarter conditions at a time when many companies not guiding at all. So I'll restrict myself to just talking about the second quarter, because the second half is still some way away.

But as far as the second quarter is concerned, for media advertising, then technically we still have a fairly difficult comparison period year-on-year. And more importantly, fundamentally, if you look at our video advertising revenue mix, while the in-feed is growing quickly and is an increasing proportion of the total, historically, the preponderance of our video advertising was the sponsorships and the 15 second spot ads. And as I mentioned in reply to an earlier question, a big double-digit chunk of that advertising comes from multinational brand advertisers who unfortunately are reviewing or reducing their spending globally. So therefore, you should expect the media advertising revenue should be under pressure in the second quarter of the year. Thanks.

Operator

Your next question comes from Alex Yao from JP Morgan. Please ask your question.

Alex Yao, Analyst

Thank you management for taking my question, and congrats on a strong quarter. First question is regarding your broader digital entertainment strategy, based on our observation, there seems to be a change in your broader digital entertainment strategy as evidenced by the recent management change in China Literature. Can you share with us your latest thoughts on Tencent broader digital entertainment strategy?

And then secondly, I believe you guys in the past have discussed strategy to increase the payment monetization. Do you still plan to do such monetization increase given the COVID-19 outbreak? Thank you.

Martin Lau, President and Executive Director

Well, in terms of the digital entertainment strategy, I think, where we have always been pretty consistent and we feel that -- digital entertainment is a very important part of our overall business, and we have a number of different platforms. And if you look at the broad strategy, right, we have always been focused on high quality, high fidelity, IP-oriented content. And if you look at the digital entertainment entered strategy, I think the key change over the past two years was actually sort of the endorsement of short and mini videos, and that's not really related to China Literature. But I think -- and the case of China Literature, it's really consistent with our overall strategy.

And what the management change there is really because of the fact that the funding team of China Literature have really started the entire literature platform business long, long time ago, right, and they have been acquired, and then they left, and then they started again, and then they acquired -- they reacquired the business that we sold. It has been a long time. So ultimately, they basically decided that they want to take a rest and that's why they passed on the bastion to people at Tencent. And that's why when we pick it up, right, there is a transition, a very smooth transition.

What we wanted to do is actually to continue to drive the core value of China Literature going forward. One is, to enhance the value of the writers work. We want to make sure that the value of the writers work are respected and they would receive the monetization, and part of it is actually fighting piracy, part of it is actually helping them to get more users, and also helping that had IPs to get monetization through monetizing the IPs and extending IPs into ancillary areas such as animes or videos or games.

And at the same time, we would want to explore free reading model, but that would be only under the writers content. And I think this model will be appealing to some writers, would not be appealing to some other writers, especially for the up and coming writers. I think the fee model supported by ads would be attractive model for them to get the initial audience, and get their writing SKUs up. But then we actually support. As you can see, right, a lot of the business that we run, the video and music and games, we always have free model to attract a lot of users, but then there will be a paid model, right.

So I think -- for China Literature, it is little bit the reverse. We only have the pay models. So if we have the free model ad supported plus the pay model, I think it would actually be creating even more value for the writers, and we feel we can also have a much tighter integration between China Literature and our traffic platforms, and our video platform, and our games business, and that will be overall positive for the core value proposition of China Literature and that would create a lot of value for both the writers as well as the consumers.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

I think on the second question about FinTech monetization, as you can see from this quarter's results, we have a number of different financial services within our ecosystem, including the core payments, including the wealth management business, including the lending business, including other emerging businesses, those various business lines have different margin profiles. And we're taking a long-term approach of progressively layering on incremental profit streams over time rather than feeding to need to do everything at once, which means when conditions are extremely benign, we're not going to grow at a hyper growth rate, but on the other hand, when conditions are challenging as they were in the first quarter, we can actually sustain what we view as easy growth rate, and also sustain what we view as attractive margins.

Wendy Huang, Investor Relations

Operator. In interest of time, we will take three more questions.

Operator

Your next question comes from Eddie Leung from Bank of America. Please ask your question.

Eddie Leung, Analyst

Hey, good evening guys. I have questions related somewhat to Mini Programs, but perhaps in a bigger scope about what you're seeing as a whole. We have been seeing development of leisures within Weixin kind of supportive to e-commerce transactions, right, live broadcasting, (inaudible) et cetera. So I'm just curious on your thought of the potential of Weixin becoming more prevalent in the e-commerce industry chain going forward? And how would that potentially affect the positioning of Weixin versus some of your e-commerce partners? Thank you.

Martin Lau, President and Executive Director

I think, the Mini Programs, as I said before, is infrastructural, too, and it actually helps all kinds of different services to connect themselves with consumers. And obviously, a big part of economic activity is actually in the form of retail and cellular products, right. So that's why Mini Programs does have an affinity for serving these retailers and people who have brands.

Now, therefore, if we look at e-commerce in the US, for example, right, you can see e-commerce platforms accounts for a certain percentage of total e-commerce, but then more than 50% of the e-commerce activities actually happen with the brands going directly to the consumers, and that's very, very low in China. And we felt that it's a combination of the fact that a lot of brands in China are nascent brands. So it takes time for them to build up their brand franchise.

But also there is a big part of it which is the lack of capabilities, right, had to move online. And to some extent, it's also harder in China to do that, because in the US, most of the sales -- a lot of the sales is actually through websites, which are probably more traditional and easier to manage. But if you are actually doing it on mobile phones, it is probably more difficult. Especially if you want to develop a mobile app which sells a particular brand, it's going to be very, very difficult to get the consumer recognition and even remembrance. And that's where Mini Programs come into play and we actually want to help a lot of the brands and retailers to establish an online presence which they own the control and they can actually get to directly connect to their users and they can also use to acquire new users online. So I think that's the reason why we are actually -- building up a lot of tools to facilitate that.

Now in terms of how we feel about a lot of the investee companies which are also engaged in e-commerce platforms. We think that what we do here by building a stronger e-commerce ecosystem within WeChat is actually going to be synergistic to them, right, because if there are more users who are more used to buying products and services on WeChat, then the spill over effect will be bigger and people would also be buying from the e-commerce platform. So if they're buying from a particular brand, they will be going to the Mini Programs. If they say I want to go take a look at the category, then they will be going to the platforms that are working with us. And if the consumer habit is actually coming to WeChat and look for products, that would be good for everyone.

Operator

Your next question comes -- all right. Your next question comes from Binnie Wong from HSBC. Please ask your question.

Binnie Wong, Analyst

Good evening management. I would like to seek your thoughts here on payment and the overall margin. As Tencent compete more in the higher margin revenue streams like wealth management and lending, where our close competitor has the first mover advantage and also committed to also grow this stream of revenue, what is our competitive edge here to gain share?

And presumably, as there's like savings in overseas marketing spend maybe this year, is it realistic to say the FinTech margins should improve this year overall? And if we think about on a group level, right, I think management highlighted near-term challenges in advertising and cloud, and then we'll keep on investment into cloud content and then might be mix shift to overseas games of lower margin? But yet there are some positive drivers in margins, say, expansion in the higher margin payment revenue streams along with -- like, probably robust games revenue. Do you see the margins -- the positive --

Wendy Huang, Investor Relations

Hi Binnie. Thanks for your question. We will address these questions first. Thank you.

Martin Lau, President and Executive Director

I think -- we don't think in terms of the blended margin. So that's a very difficult question to answer, because that's not the way we think about our business, right. Our business are always thinking from business-by-business, product-by-product, how do we expand the product itself and if the product actually sort of can generate incremental users and value, and then over time there will be monetization and then there will be a margin. And the company -- each business line as well as the company overall is actually aggregation of such drivers. So to some extent, we can't answer the question that you asked.

But I will try to answer your question in relation to FinTech, and you probably sort of can get a sense of how we think about it. So in terms of the FinTech, I think there are a number of different business components in there. The first one is actually the payment platform. And even within the payment platform, there is a component which is online, there is a component which is offline, and I talked about the offline part being relatively infrastructure type of business, right. It doesn't really sort of generate a lot of -- it's not run to generate profit per se, because we have very few margin there to start out with the monetization scheme.

And at the same time, we actually sort of put a lot of marketing and promotional costs, but that helps us to build the use cases and get a lot of users and that would help us to monetize the online traffic and it also sustains a very strong wallet presence, right, so that it help us to build our other FinTech businesses which you talk about which is wealth management and lending.

And within wealth management and lending, right, I think the way that we think about these businesses are not that we want to grab market share. We want to build the scale. This is not the way we think about it. The way we think about it is actually, we want to build the best-in-class in terms of product capability, in terms of consumer value, in terms of risk management. And for example, in wealth management, right, it's very easy to say, oh, I just want to build scale, and as a result, I want to sell as many wealth management products as possible.

And believe it or not, right, usually that wealth management products that sells the best is actually the most toxic. And if you go down that track, then we will not be fulfilling our promise to our users, right. So that's why I think the way we think about wealth management is like, how do we create a system in which we have a lot of user education, we have best product to our best knowledge, product selection processes. And we don't offer all the products, we only offer the products that we felt high quality, and then we provide a lot of risk explanation to the users. And as a result, hopefully over time, right, that users are not going to be all users in the world, but the users who are willing to learn, the users who want to understand the risk that they're buying, and eventually they can grow with the platform. These are the people that we want to serve. And ultimately it's a great wealth management platform.

Likewise, on lending, you can actually sort of always lend a lot of money outside, right, but then whether you can collect is a very big question mark. And you can also say, oh, we just want to charge more interest so that we can cover on the cost. This is not the way we think about it. We actually want to be exposed to high quality risk and the credit -- high quality credit, and as a result, we may not be expanding as much in scale, but we definitely sort of has got the best credit in the market.

And I think as we see in COVID-19, I know we -- it's actually stress testing our FinTech services. And I think we have passed the stress test, and that's how we think about these businesses. It's a long-winded answer to your question, but I hope that you get a taste on how we think about our businesses.

Operator

Your last question comes from William Packer from Exane BNP. Please ask your question.

William Packer, Analyst

Hi, there. Thanks so much for taking my question, and congrats on the strong results. Firstly, you talked about video games consumption normalizing as people return to work, but you also talked about structurally expanding the long-term audience. Is there any color or KPIs you could help us on gaming engagement post lockdown for a better feel of those long-term changes?

And then just a quick one on the advertising side. The color you've offered is helpful. Is there any underlying competitive shifts in the digital ad market share which we should be thinking about? Thank you.

James Mitchell, Chief Strategy Officer, Senior Executive Vice President

Well, why don't I start with both of them and someone else may supplement. But I think on the video game question, and specifically the comments about the structural opportunity for video games, then, there are various entertainment formats, including radio, television, magazines, and so forth. And then there's interactive entertainment, which is what we call video games.

We have an interactive entertainment group within Tencent. And the reason why I put interactive entertainment is because to some extent, what we think of is video games are actually sort of a super set rather than a subset of entertainment activities, and there's all sorts of entertainment activities that were traditionally passive and linear in nature, which we think can be enriched as they become interactive and immersive in nature. And so the earliest audience video games were effectively moving activities like Solitaire or chats online, but over time you see more team-based competitive social activities moving online.

And I think that during this period, you see more and more people engaging with interactive entertainment on a broader product, meaning that, for example, people who historically watched physical sports events are now watching Formula 1 or Basketball going or other sports played in any sports format often by the Formula 1 drivers or the Basketball professional players, alongside watching games like League of Legends that have become a powerful sports in their own right in the past couple of years. So that represents a structured expansion in the market.

Another example would be that historically, that's a gigantic live entertainment business around music concerts. And unfortunately, those are not occurring at the moment, but what is happening if you play Fortnite is fairly regular now.

Music concerts within Fortnite with Travis Scott, with Diplo, with a number of other stars recently, and those are attracting gigantically. And so to some extent, the time people are spending in the music concerts in Fortnite or the time they're spending watching racing car drivers playing a Formula 1 video game is not replacing the time they were previously spending playing World of Warcraft. It's sort of supplementing that and expanding the breadth of the interactive entertainment into new -- newer broader entertainment categories. So that's an example of structural expansion in a qualitative sense.

And then in a quantitative sense, we have seen that for some of our games, particularly for the more team-based competitive games. The audience now is structurally larger than it was going into this situations. So the time spent per user is normalizing downward, because people are getting busier in China, in particular, but the number of people who have found these attractive forms of entertainment is broader than it was in the past. So that's on the video game question.

With regards to the advertising question and the competitive landscape, I think our view is that, we've always been highly competitive within the China online advertising industry by virtue of our traffic, by virtue of the premium nature of some of our content. What's changed in the last year or so is really that we have enhanced our technology.

And I think one of the best proof points for that is the very rapid growth, more than doubling in revenue year-on-year in our ad network business, because as you know, the ad network business is other people's inventory. It's not directly tied to whether Weixin has a white collar user base or whether we are running three or four hours per day in Weixin, it's tied to how competitive on a real time basis, our ads [ph] serving, our ads targeting is versus the other companies providing networks in the market. And so the fact that our ad network business was actually the biggest contributor to our ad revenue growth in recent months. I think it speaks to the fact that -- speaks to the reality that our ad tech capabilities are now more competitive than they're ever been.

Wendy Huang, Investor Relations

Thanks, James. We are now closing the call. If you wish to check out press release and other financial information, please visit the IR section of our company website at www.tencent.com. A replay of this webcast will be available soon. Thank you and see you next quarter.

Operator

Ladies and gentlemen, this does conclude today's conference call. Thank you for participating. You may now disconnect your lines.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2020-03-18
Event Description: Y 2019 Earnings Call

Market Cap: 3190680.68846
Current PX: 334
YTD Change($): -41.6
YTD Change(%): -11.076

Bloomberg Estimates - EPS
Current Quarter: 2.842
Current Year: 12.115
Bloomberg Estimates - Sales
Current Quarter: 103842.5
Current Year: 466243.537

Y 2019 Earnings Call

Company Participants

- Jane Yip, Investor Relations
- MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer
- LAU Chi Ping (Martin Lau), Executive Director and President
- James Mitchell, Chief Strategy Officer and Senior Executive Vice President
- John Lo, Chief Financial Officer, Senior Vice President
- Unidentified Speaker

Other Participants

- Binnie Wong, Analyst
- Eddie Leung, Analyst
- John Choi, Analyst
- Alicia Yap, Analyst
- Thomas Chong, Analyst
- Gregory Zhao, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by and welcome to Tencent 2019 Fourth Quarter and Annual Results Announcement Conference Call. At this time, all participants are in a listen-only mode. After the speakers presentation, there will be a question and answer session. (Operator Instructions) Please be advised that today's conference is being recorded.

I'd now like to hand the conference over to your speaker host today Ms. Jane Yip. Thank you. Please go ahead ma'am.

Jane Yip, Investor Relations

Thank you. Good evening. Welcome to our 2019 fourth quarter and annual results conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-IFRS financial measures that should be considered in addition to, but not as a substitute for measures of the Company's financial performance prepared in accordance with IFRS. Non-IFRS measures formerly referred as non-GAAP measures are intend to reflect our core earnings by excluding certain one-time or non-cash items. For a detailed discussion of risk factors and non-IFRS measures, please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight, our Chairman and CEO, Pony Ma will kick off with a short overview; President, Martin Lau will discuss our strategy review; Chief Strategy Officer, James Mitchell, will speak about the business review; and Chief Financial Officer, John Lo will conclude with financial review before we open the floor for questions.

I will now turn the call over to Pony.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Thank you, Jane. Good evening, everyone. Thank you for joining us. During 2019, we reinforced our leadership in consumer Internet and extend our purpose in industrial Internet while sustaining healthy operating and financial metrics. Let me update you on our key achievement in our four strategic areas. In social, Weixin ecosystem became increasingly vibrant and better connect to users with services. Annual transaction volume your Mini Programs have crossed RMB800 billion as it related to QQ we branded their products with enhanced chat features and (inaudible) as well as expanded entertainment used cases via Mini Programs, increasing QQ's popularity among young generation.

In online games we extend our China leadership while expanding internationally via popular games, including PUBG Mobile, (inaudible) and Call of Duty Mobile. Our international revenue rose to 23% of online game revenue in the fourth quarter of 2019. In content and advertising, video subscriptions exceed 100 million milestone in the year. We innovated our business model and increased operating efficiencies of our long form video business. Significantly reducing its 2019 operating loss to below RMB3 billion, much lower than industry peers. Despite macro headwinds we achieved robust advertising revenue growth, progressively realizing the long-term potential in Moments and expanding our mobile ad network.

In FinTech and Business Services, average daily commercial payment transactions exceed 1 billion in the fourth quarter as we deepen the penetration among offline merchants. We consistently expand our market share in cloud with revenue crossing RMB17 billion in 2019, number of paying customers surpassed 1 million.

Now let me go through the headline financial numbers and John will provide a more detailed discussion in the financial section. Total revenue was RMB106 billion, up 25% year-on-year and 9% quarter-on-quarter. Quarterly revenue for the first time exceed RMB100 billion both including and excluding Supercell contribution. Gross profit was RMB46 billion, up 31% year-on-year and 9% quarter-on-quarter. Our non-IFRS operating profit was RMB30 billion, up 35% year-on-year and 6% quarter-on-quarter. Non-IFRS net profit attributable to equity holders was RMB25.5 billion, up 29% year-on-year and 4% quarter-on-quarter.

Moving to platform update, in social combined MAU of Weixin and WeChat increased 6% year-on-year to 1.165 billion. Smart devices MAU of QQ declined 7.5% year-on-year to 647 million, but we proactively cleaned up spending and bought accounts. In games we solidified our number one position in China with Peacekeeper Elite popularity and extend our international success with the launch of Call of Duty Mobile and Teamfight Tactics during the year.

In media music subscription growth accelerated benefiting from the pay for streaming model. In FinTech we operate the largest mobile payment platform in China by DAU and transaction volumes. In cloud, we continue to outgrow peers with increasing scale and higher operating efficiency. In utilities we maintain our industry leadership in mobile security of our browser and Android apps for in China.

I'll invite Martin to discuss strategy review.

LAU Chi Ping (Martin Lau), Executive Director and President

Thank you Pony and good evening and good morning everybody. As we headed into the year of 2020, I believe all of us are facing the massive challenges of the coronavirus pandemic, which is profoundly impacting China as well as globally. I would like to say our hearts go out to the people and the families that are affected and we hope their conditions will improve and their difficulties will go away soon.

Now at Tencent we rose up to the challenge and we tried to provide relief and help to people in need in a number of different ways. We established an emergency fund of RMB1.5 billion to procure and donate medical supplies and equipment to offer relief support and sponsor pandemic-related programs development as well as to spun some medical research to try to solve this problem.

At individual level, our employees volunteered to help deliver donated resources on the ground to the troubled area of Hubei, thousands of our employees also worked around the clock to develop a number of pandemic related online products to serve over a billion users in China. To help efficiently combat the outbreak, our technologies and smart solutions play a crucial role to digitalize public services rapidly generating over a thousand related Mini Programs in municipal services, healthcare and education. Leveraging our high DAU platforms, authorities can deliver pandemic-related news and timely information promoting public awareness and educate improvement measures. A reliable and smooth live broadcast system enabled schools to move courses online and helped students resume their studies. For enterprises, we upgraded our remote working and collaboration solutions to help mitigate interruptions to their business. We also helped retailers to leverage Mini Programs to move online in order to recover sales. Successful retailers have seen their sales through Mini Programs increasing by ten fold and some even more. For Internet users, our free online courses and rich digital content enriched their leisure time at home. Our communications and social platforms connect users with their friends and family, including when they are under quarantine. We believe these efforts fully embody our mission, which is value for users tech for good.

Now the outbreak also presented short-term impact to some of our businesses, which I would like to summarize for all of you. For mobile payment, offline commercial transactions and revenue declined significantly as many restaurants and store did not open after Chinese New Year. The volume rebound quickly after work resumed. During this time we reduced marketing expenses and therefore net-net, we expect limited negative impact of mobile payment on our profitability.

For online advertising, despite some advertisers reduced spending during this period, our performance-based advertising is sustaining robust year-on-year growth rate, driven by our high ROI as well as our healthy and diversified advertiser mix. For cloud services, there is a short-term negative impact on revenue due to delayed implementation of projects. However, we believe the coronavirus outbreak capitalized the expansion in industry demand and addressable market for long-term as enterprises embraced digital upgrades.

For smart industries, increased adoption by consumers and enterprises led to growth in users and traffic to our WeChat work, Tencent Meeting, Tencent Health and Tencent education services. So Mini Programs as an easy to deploy digitization tool, it is used by many merchants and institutions to move their services online rapidly. Therefore DAU, daily visit, and number of Mini Programs surged especially in fresh food and grocery delivery services, municipal services, remote working, online healthcare services and online education.

For digital entertainment, it is not only an alternative to out-of-home activities, but also help to reduce people's anxiety during such a difficult time. Users are increasing their time spent on a whole range of digital content services, including our online games, video and reading services. We believe challenges are transitory, but user behavior and enterprise mindset change are structural. We are well-positioned to accelerate the digitization of industries for the future.

So that concludes the discussion focused on the COVID outbreak. Now let's move on to some strategic areas that we are pioneering the industry evolution and also facilitating the digital upgrade. In the area of Smart healthcare leveraging our AI and cloud technologies, we are committed to bringing convenient and professional healthcare services to users and institutions. During the outbreak our Tencent Health, Tencent Medipedia and Health Code services help prevent the spread of coronavirus and also acquired large number of users.

First on Tencent Health, it is our all-in-one entry point for online medical services. Over 300 million Weixin users use it as an important access to real-time data and information as well as conduct online consultation. During the outbreak, we launched AI-powered tools to enable users to self-diagnose via chatbots. These services and tools were also built into our smart solution facilitating 40 medical institutions to deliver prompt and timely services to help contain the spread of coronavirus.

Second, Tencent Medipedia provides reliable and professional medical information resource, covering knowledge graph of over 10,000 diseases. We developed pandemic related content and distributed via our multiple high traffic platforms such as Weixin and Tencent News attracting over 600 million page views. We also launched a free online consultation to enable access to over 10,000 doctors from our ecosystem partners such as WeDoctor and Doctorwork.

Third Health Code becomes the most used ePass for verifying health and travel history during the outbreak, leveraging our extensive reach of Weixin and easy to use Mini Programs. Health Code rapidly covered 900 million users across more than 300 cities and counties with 8 billion total visits since early February.

Now, moving onto remote working, which has gained strong momentum recently as more users and organizations are using remote working as their main type of working. Tencent Meeting, which is our dedicated business video conference app has recorded over 10 million DAU within 2 months since launch in last December and has become the largest standalone app for cloud conferencing in China.

In particular we saw strong demand from business, government and education sectors and helped employees work from home and student resume their studies. Our product delivered secure stable and high-definition video experience leveraging our advance security cloud and AI technologies. Users can join meeting via multiple channels across platforms and devices such as mobile app, Weixin, Mini Programs, PC, and phone calls.

Our team responded swiftly to customer feedback and upgraded the product frequently releasing 14 versions in the recent 40 days. With infrastructure and sales team support from Tencent Cloud, we're able to enhance Tencent Meeting's performance and efficiency. For WeChat Work, it has become a leading hub for team work in China with millions of enterprises adopting it to resume working and usage surged tenfold recently. Our unique proposition lies in integration with Weixin, which facilitates business, customers management and sales conversion via Weixin Moments, Mini Programs and Weixin Pay in addition to providing a collaboration tool for the employees internally. This helps us attract clients and increased engagement.

Meanwhile, as we expanded our client base, we encountered differentiated needs from some industries. For example, government and financial institutions prefer private cloud deployment because of the security, therefore WeChat Work now can be deployed flexibly on both public and private cloud to cater to different customer needs. Our customers can also select and configure specialized solutions among our rich office tool offerings provided by over 20,000 SaaS providers allowing tailor-made system to better serve business operations.

Now moving to consumer Internet, our mini video app WeiShi achieved rapid growth and presented strong momentum leveraging our social platforms. Using WeiShi users can create and share 30 second videos to Weixin Moments. They can also use Weixin and QQ plug-ins to discover talk of the town videos in a timely basis. These initiatives contributed to the quarter-on-quarter growth of more than 80% in daily active users and over 70% in daily upload for the fourth quarter for WeiShi. To engage users we made WeiShi attractive and fun by introducing certain innovative and interactive features. For instance we launched WeiShi challenge, a 30 second challenge for interesting act led by celebrities and imitated by users. Tens of millions of users participated and uploaded video to compete with both KOLs and friends during the past half year.

We also creatively added Red Envelope feature in WeiShi, which can be shared to Weixin and QQ. During the spring festival of 2020, users exchanged 1.6 billion WeiShi video Red Envelopes. We also constantly enhanced technologies for content creation, curation, and recommendation. We provide AI-powered cameras for WeiShi users to lower difficulties in creating content. Our advanced video recognition system accurately tag and classify the content to be readied for recommendation to users. And while deep learning users interest graph, the smart recommendation engine is able to facilitate content discovery for them.

In terms of content we leverage our rich in-house IPs to expedite unique content creation by KOLs and MCNs. For example, we allow KOLs and MCNs to repurpose our high quality content from Tencent Video and Tencent Sports to produce clips and highlights for mini video. We encouraged star players of Honour of Kings and other Tencent Games to share their weekly moments on Weishi. In addition Weishi and Tencent Animation & Comics also produced popular mini drama series, Tong Ling Fei, which was converted into unique mini videos for Weishi by MCNs and KOLs and has attracted large number of video views.

Moving onto our online games business especially on online mobile games, we have made significant breakthroughs in self-developed games for international markets. For example PUBG Mobile has become the most popular international mobile game in terms of DAU and MAU. Call of Duty Mobile was the largest new launch by downloads and was crowned as the best mobile game of the year in 2019 by TGA, The Game Awards. Moreover, Supercell's Brawl Stars was one of the best performing original IP mobile titles in 2019.

If you look at the global chart, we've developed 5 of the top 10 most popular international mobile games. The proven success globally demonstrate our accumulated capabilities built up over many years. First, our know-how in mobile game development, our in-house studio group Timi and Lightspeed & Quantum representing the highest level of mobile game development capability have delivered authentic PC and console game quality on mobile.

Second, advanced technological know-how, leveraging our strategic partnership with Epic Games, we have deep technical experience in the industry-leading game engine and our heavy investment in AI and cloud technology over the years ensure a good in-game experience as well as reliable and high-speed access to our games. Thirdly, our long-term business cooperation with partners over the years have paved the way for our smooth and in-depth communication along the topics of IP development, gameplay design, international user insight, global population as well as operational experiences exchange.

Last but not least, expertise in operating large-scale social networks and games, we're experienced in curating social experiences players to promote their enjoyment and engagement. We also organized top global eSports tournaments to further popularize our games. Going forward we've strengthened our technology service and platform to position ourselves to capture the opportunities from an expanding addressable game market and long-term digital upgrades in various industries.

So with that, I'll pass to James to talk about our business review.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Thank you, Martin, good evening or good morning everyone. For the fourth quarter of 2019, our total revenue grew 25% year-on-year. VAS represents 50% of our revenue within which online games were 29% and social networks 21%. FinTech and Business Services represented 28% of total revenue and online advertising 19%. The value-added services segment revenue was RMB52.3 billion in the quarter, up 20% year-on-year and up 3% quarter-on-quarter.

In social networks, our total VAS subscriptions were 180 million at the end of 2019, up 12% year-on-year. Growth in video and music subscriptions was driven by self-commissioned Chinese animated series, our paid music content library and bundled subscription offerings. Total video subscriptions were 106 million, up 19% year-on-year. Our social network revenue increased 13% year-on-year to RMB22 billion among which live broadcast services and music subscriptions revenue grew strongly year-on-year. Social network revenue was flat quarter-on-quarter as the seasonal decline of in-game item sales offset digital content revenue growth.

Turning to online games, revenue grew 25% year-on-year and grew 6% quarter-on-quarter to RMB30.3 billion. Non-China markets contributed 23% of our game revenue benefiting from key titles such as PUBG Mobile and Call of Duty Mobile as well as the consolidation of Supercell. The smartphone games total revenue rose 37% year-on-year to RMB26 billion driven by titles such as Honour of Kings and Peacekeeper Elite as well as rapid growth from international markets. Sequentially, smartphone games revenue increased 7% as consolidation of Supercell offset soft seasonality in China. The PC client games revenue decreased 7% year-on-year and fell 10% quarter-on-quarter to RMB10.4 billion, paying users in D&F declined, while global revenue from League of Legends increased.

Diving into social networks, within our Weixin ecosystem, we focused on facilitating service and commerce connections. After the outbreak of COVID-19, we added a dedicated health care section within Weixin Pay's public service entry point, which has been used by more than 300 million people, where beta testing live broadcast and Mini Programs and launch tools, which enable merchants to increase sales conversion and encouraged social sharing of their shows in Mini Programs.

For QQ we enabled AI-based recommendation for stickers and elevated the entertainments experience within QQ Mini Programs. As a result QQ user engagement increased and daily messages sent per QQ user grew at a mid-teens percentage year-on-year in the quarter. We optimized features for QQ School-plus-Home groups, which has served over 120 million users since the COVID-19 outbreak began. Schools can attend or students can attend live broadcast curriculum courses and online tutoring programs from leading educational content providers. We offer online classroom management tools for teachers to handle school routines such as homework assignment.

For online games, in China, we enhanced the vitality of our keys smartphone game franchises with high quality content updates, such as the inclusion of the Auto Chess mode in Honour of Kings, and new gameplay systems for Peacekeeper Elite. For PC client games a record number of viewers watched League of Legends World Championship in Paris. Tie-in marketing activities and item sales increased League of Legends paying users and revenue quarter-on-quarter. However, Dungeon & Fighter paying users decreased in the fourth quarter due to content challenges. And Martin has already called out some highlights from our international game business.

Moving to online advertising, our total advertising revenue was RMB20.3 billion a quarter, up 19% year-on-year and up 10% quarter-on-quarter. Our social and others advertising revenue was RMB16.3 billion up 37% year-on-year and up 11% quarter-on-quarter underpinned by healthy demand from verticals including e-commerce education and games. We believe our Weixin Moments advertising provides highly attractive ROIs and we added a fourth ad unit per user day in Weixin Moments during the e-commerce promotional periods in the fourth quarter, which generated positive advertiser sell-through and consumer engagement. We've permanently implemented the fourth ad load from mid-February.

For our Mobile Ad Network, we signed up high traffic media partners such as entertainment and social media services and added more rewarded video ad inventories. Our Mobile Ad Network revenue more than doubled year-on-year in the quarter and was the largest contributor to our sequential advertising revenue growth, which we believe testifies to our increasing ad tech capabilities even on non-Tencent sites.

Our media advertising revenue for the fourth quarter was RMB4 billion down 24% year-on-year and up 8% quarter-on-quarter. While we generated relatively low advertising revenue around NBA basketball games in the fourth quarter, our video and news advertising revenue each increased quarter-on-quarter.

Looking at FinTech and Business Services revenue was RMB29.9 billion in the fourth quarter, up 39% year-on-year and up 12% quarter-on-quarter. FinTech services revenue grew robustly year-on-year and quarter-on-quarter as our platforms and services are increasingly adopted by consumers, merchants, and both management partners. As Pony mentioned, commercial payments activity recorded a new high with over 1 billion average commercial transactions per day, exceeding the major global card networks, and average value per transaction also increased.

For wealth management, our active customer base more than doubled year-on-year as we expanded into the mass market and our aggregated customer assets increased over 50% year-on-year. And for lending, WeiLiDai originated loan balances increased. Within Business Services, our cloud services revenue sustained rapid growth driven by increased volumes of key contracts and clients. Gross margins improved as we continue to optimize supply chains and expand our business scale. We exceeded a million paying cloud customers as we expand sales teams to different regions and industries and deepened our partnerships with systems integrators. And we enhanced our enterprise software as a service offerings via our first-party products, notably Tencent Meeting and WeChat Work as well as partnerships with third-party software providers.

And I'll now pass to John to discuss the financial metrics.

John Lo, Chief Financial Officer, Senior Vice President

Thank you, James. Hello, everyone. For the fourth quarter of 2019 total revenue was RMB105.8 billion up 25% year-on-year or 9% quarter-on-quarter. Excluding the impact from consolidating the Supercell consortium growth, I'll refer it as Supercell afterwards for simplicity, total revenue would have been 21% year-on-year or 6%

quarter-on-quarter. Gross profit was RMB46.1 billion up 31% year-on-year or 9% quarter-on-quarter. Net other gains were RMB3.6 billion compared to a net loss other losses of RMB2.1 billion in the fourth quarter of 2018 and up 289% quarter-on-quarter.

The year-on-year change was mainly due to non-IFRS items including one-off expenses relating to share issuance to Timi strategic partnering in quarter four last year. And net favorable gains from certain investee companies. Sequentially, the increase was mainly due to the increase in fair value gains of certain investees, which were also non-IFRS adjusted. Operating profit was RMB28.6 billion up 65% year-on-year or 11% quarter-on-quarter. Net finance costs were RMB2.8 billion up 102% year-on-year or 58% quarter-on-quarter. The year-on-year increase was mainly due to greater interest expense results from higher amount of indebtedness, share of losses of associates. And joint ventures for the fourth quarter of 2019 was RMB1.3 billion compared to share of profit in the fourth quarter of 2018 in the third quarter on a non-IFRS basis. Share of profit decreased from RMB1.9 billion a year ago and RMB2.1 billion a quarter ago to RMB1.3 billion this quarter. Partly due to the consolidation of Supercell, which was (inaudible).

Income tax (Technical Difficulty)

Operator

Ladies and gentlemen, your speaker is currently experiencing some technical difficulties with the line. Please standby while we address the situation. Your lines will be placed on music hold until the conference resumes.

Ladies and gentlemen, thank you all for staying on the line, we will now resume the call.

John Lo, Chief Financial Officer, Senior Vice President

Hi, let me walk you through our non-IFRS financial numbers. For the fourth quarter operating profit was RMB30.3 billion up 35% year-on-year or 6% quarter-on-quarter. Net profit after NCI was RMB25.5 billion, up 29% year-on-year or 4% quarter-on-quarter. For the full year 2019 operating profit was RMB114.6 billion up 24%. Operating margin was 30.4% up 0.8 percentage point. Net profit after NCI was RMB94.4 billion up 22%.

Turning to segment gross margin, gross margin for VAS was 50.1%, down 3.3 percentage points year-on-year or 1.7 percentage points quarter-on-quarter. The year-on-year decrease was primarily impacted by continued revenue mix shift from higher margin PC client games to lower margin smartphone games. The Q-on-Q decrease was mainly due to increased cost from major eSports tournament in the quarter. Gross margin for online advertising was 54.3%, up 17.7 percentage points year-on-year or 5 percentage points quarter-on-quarter, 5.5% in first quarter. Fourth quarter year-on-year and quarter-on-quarter increases primarily reflected lower content cost for video advertising as well as revenue mix shift from media advertising to higher margin social and others advertising.

Gross margin for FinTech and Business Services was 28.1%, up 3.6 percentage points year-on-year, or 0.4 percentage points quarter-on-quarter. The year-on-year increase was mainly driven by revenue mix shift from social payments to higher margin commercial payments. Benefiting from increased loyalty users were more willing to retain funds in our ecosystems and increasingly utilizing more FinTech services such as wealth management and micro loan services on our platform. This led to improved margin year-on-year.

On operating expenses, selling and marketing expenses were RMB6.7 billion up 17% both year-on-year and quarter-on-quarter. The year-on-year increase mainly reflected greatest marketing spending on Fintech and cloud services, smartphone games and digital content services. As a percentage of revenues selling, marketing expense decreased from 6.7% in the fourth quarter of 2018 to 6.3% in the quarter, mainly due to the reduction of advertising and promotion expenses as a result of internal initiative to reduce less effective marketing campaigns.

Sequentially, increase in selling and marketing expenses mainly reflect a seasonally higher marketing spending on smartphone games and digital content services as well as expenses attributable to Supercell commencing this quarter.

G&A expense were RMB16 billion up 41% year-on-year or 18% quarter-on-quarter, mainly due to increases in R&D expenses, staff costs as well as expenses attributable to Supercell commencing this quarter. Within G&A, R&D expenses were RMB8.9 billion up 49% year-on-year or 12% quarter-on-quarter. G&A and R&D represented 15.1% and 8.4% of revenues respectively. As at quarter end, we had approximately 53,000 employees, up 16% year-on-year or 3% quarter-on-quarter. For the whole year 2019 selling and marketing expenses were RMB21.4 billion down 12% and represented 5.7% of revenues. R&D expenses were RMB30.4 billion up 32% and represented 8.1% of revenue.

Total G&A expenses excluding R&D expenses was RMB23 billion up 24% and represented 6.1% of revenue. Let's take a look at the margin ratios. For the fourth quarter 2019 gross margin was 43.6% up 2.2 percentage points year-on-year or broadly stable quarter-on-quarter. Non-IFRS operating margin was 28.7%, up 2.3 percentage points year-on-year or down 0.7 percentage points quarter-on-quarter.

Non-IFRS net margin was 25.2%, up 1.4 percentage points year-on-year or down 0.6 percentage point quarter-on-quarter. For the full years 2019, gross margin was 44.4% down 1.1 percentage point. Non-IFRS operating margin was 30.4% up 0.8 percentage point. Non-IFRS net margin was 25.9%, up 0.2 percentage point. For 2019 on IFRS basis, basic EPS was RMB9.856 and diluted EPS was RMB9.643. Non-IFRS basic EPS was RMB9.966 and diluted EPS was RMB9.729. Subject to the approval of shareholders at the Annual General Meeting to be held on 13th of May 2020, we are proposing an annual dividend of HKD1.2 per share payable to shareholders on 29th of May 2020. This represents an increase of 20% from last year.

Finally I will now share with you our several key financial metrics for the quarter. Total CapEx was RMB16.9 billion, an increase of 270% year-on-year and 154% quarter-on-quarter. Within which operating CapEx almost doubled to RMB7.1 billion mainly due to advanced procurement on servers for business growth in 2020. Non-operating CapEx increased significantly to RMB9.8 billion mainly reflected the land use right acquired for new project.

For 2019, total CapEx was RMB32.4 billion up 35%, within which operating CapEx was up 6% year-on-year. As at quarter-end, free cash flow was RMB37.9 billion up 27% year-on-year or stable quarter-on-quarter. For 2019 free cash flow was RMB120.3 billion up 37%. Net debt position was RMB15.6 billion, the sequential increase primarily reflect the payments for M&A initiatives and media contents and consolidation of Supercell's indebtedness, partly offset by strong free cash flow generation. The fair value of our share holdings in listed investee companies excluding subsidiaries was approximately $60.2 billion at year end compared to roughly $50 billion last quarter and roughly $34.7 billion last year.

Thank you. We shall now open the floor for questions.

Jane Yip, Investor Relations

Thank you. And we are sorry for the technical -- the system technical problem that we just encountered. We shall now open the floor for questions. And operator, we will take one main question and one follow-up question each time. Please invite the first question.

Questions And Answers

Operator

Thank you. (Operator Instructions) Our first question comes from the line of Binnie Wong from HSBC. Please go ahead.

Binnie Wong, Analyst

Hi, good evening management. My question is on the advertising, we see the revenue from social network actually further re-accelerate to 37% since 2Q. With this re-acceleration and also considering the competition, do you see that, what is the competitive edges in Tencent's ad network versus peers? And what are the drivers to propel us into 2020?

And then with that, can I also ask a question about the short form video. Given that, I think in the press release you mentioned that we are in the early stage of a multi-year investment and you said that experience from overcoming a later start of a long form video give you the confidence. What are the applicable experience you learned and the challenges you see. Thank you.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Binnie, thank you for the questions. So I think your first question was around our social advertising revenue growth and what do we see as our competitive advantages. People looking at Tencent from the outside are often of the view that our key competitive advantage is, we have a large amount of traffic for our application and that's certainly true. But if you look at the biggest contributor to the quarter-on-quarter revenue growth, it was actually our ad network business, which is ads on other people's applications. And so, I think that speaks to the fact that we are increasingly competitive from a technology perspective because of the investment we've made across the platform.

We're obviously very competitive from a targeting perspective because of the data we aggregate on users. We're also competitive in terms of conversion, specifically conversion from the impression to the transaction. I think that there is many different services in China that can convert traffic impression into click or even an app download, but because we integrate the advertising platform and the payment platform together, we're actually quite capable of converting the impression into a transaction.

And so, that's why if you look at the advertiser categories that are doing particularly well for us, it includes our businesses like, activities like e-commerce, education and games. And all of which really when they're buying ads, they're less focused on the impression or even on the app install, they're most focused on the actual end revenue generation. And we think that over the long term, more and more advertisers will feel the same way and that will play more and more to our benefit.

So anyway that's some of the reasons why our ad network business is doing particularly well. More broadly, our social advertising business benefits from all of the factors above, plus the fact that we have roughly 1 billion daily active users across our properties, which is uniquely broad in China, plus the fact that we have content information on our users because we serve them in a video, music, news feed, literature and so forth, games as well as serving them for communication, social and commerce.

So, all-in-all what we think that our social and other advertising is a very strong portfolio of properties and very strong technology platform where we've seen particularly good growth and continuing to see very good growth from segments such as e-commerce, games and education. And we believe that we will strongly outperform the market.

LAU Chi Ping (Martin Lau), Executive Director and President

In terms of WeiShi and short video, I would say, if you look at Tencent's history, there have been a few products that we came from behind and then we actually became the absolute industry leader. And I would say games is in such a category and our news and our payment platform and most recently, the long form video. And I think in each one of these instances, we have, first of all, have to build up the capability that's specific to that product vertical. And after that we can actually start leveraging our unique Tencent resources and capabilities.

So in this short video right now, what are our unique Tencent advantages, I would say in the prepared remarks, we have point to some of them including our product innovation on the product side, integration with our social network that can bring traffic as well as sharing experiences for our users as well as our long-standing investment in various kinds of content, be it games and long video and literature or the IP related content.

I think these are all important Tencent advantages that we can bring to bear in the future. And well, so far we have been doing that, but then in the future, we can actually do it even more. But what are the key important vertical expertise that we need to build, I would say it's mainly the recommended engine for -- the recommendation engine for these kind of short and mini videos, as well as a system that would actually bring in a very large number of content providers, which is somewhat different from the long-form video right in which you have a small number of very professional providers of content.

Now I think this is something that we have to build over time, I think we have achieved some success and at the same time if you look at the recent success of what James talk about which is our ad tech and that is actually a tech which is very similar to the recommendation engine of mini videos. And if you look at the large number of content providers that we need to manage, that's actually somewhat similar to the official accounts as well as mini programs that we are curating.

So I think we have pockets of expertise in each one of these areas. It's just an important time for us to bring it into the Weishi product and integrate it in such a way that, we can actually build up the vertical expertise within that product. And at the same time start leveraging our unique resources in a more prominent way. So that's why we believe this is a battle that we would definitely continue to play in and we're actually quite confident that over time, we will make significant headway into the industry.

Operator

All right. Thank you.

Jane Yip, Investor Relations

The next question please.

Operator

Your next question comes from the line of Eddie Leung from Bank of America. Please go ahead.

Eddie Leung, Analyst

Good evening. Thank you for taking my questions. I wish everyone well. I have a question...

Unidentified Speaker

(inaudible).

Eddie Leung, Analyst

Sorry. Yes, I have a question on -- have a question on our consumers Internet...

Unidentified Speaker

...who is asking question or what. So is it a problem with the person asking the question or it's our line? Can we see (inaudible). I know, but there must be a line that's with a lot of interference, right, so which one it is? If it's us then we should drop and then dial in again. If it's somebody else then we should ask another person to ask the question.

Eddie Leung, Analyst

Hello? Yes, thank you for taking my question. I wish everyone well. Have a question on your consumer Internet strategy, so Tencent is developing more used cases about services. So that's pretty obvious, not just about entertainment. So obviously that's a competitive advantage, but on the other hand, it seems like some leading video traffic platforms are entering more and more digital entertainment services, we have seen news about games, literature, news, live broadcast et cetera. So just wonder how would that affect your strategy and perhaps the industries, our cost structure in running digital entertainment. Thanks.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Yeah, I will take that question. And I think every now and then you would see this kind of news. And if you track the evolution of the China Internet industry history, this is something that repeats every few years. And each one of the sector that you talk about, there have been many, many players in a market, take the example of games, for example, right. There have been many different players and it's far from being a winners take home market.

And so, I think it's actually completely fine for different players to want to go into these different verticals. But I think the important thing is actually what do we do, right. I think what we try to do is actually to be the best in class player in each one of these verticals. So I would take games as an example right. So games, it has always been a market with many, many different players and Tencent actually came from the very behind and step by step now became the leader in the market in China and now expanding our presence all around the world. And I would say there are a number of things that we have to do right.

We have done right in the past and we will continue to do and invest in those areas in the future. And this include one, I would say just, we have a very strong franchise over some of the most important genres, if you look at mobile as an example, if you look at tactical tournament as an example, these are game genres in which we have an absolute leadership position here and they have essentially become both genre defining as well as smart social networks for such type of gamers right.

So I think that has a very strong franchise and we will continue to be the innovator in those genres. Secondly, I would say in the game industry, it's about development capability and development capabilities rests both within creativity as well as technical know-how. And I think you have gone pretty deep into describing what are the technical know-how that we have and over the years by being successful in different genres, I think we have demonstrated our creativity. And I think those are the things that we have to continue to do well and do better on.

And thirdly, I would say is, the relationship that we have with game IP and game companies around the world. And a lot of the leading game companies are our partners or our investee companies. And these are built over a very, very long term, and as a result we can actually work with the other game companies and bring exciting new games in different formats to the market. And I think I would say, we also have a very strong presence in social network, and that has a strong synergy with our game business because games are by nature, especially online games, mobile online games are by nature social networks, right. You want to play with your friends or you want to play with your game mate right. So by having a social network that actually can connect with all your friends, as well as new friends from the games, it actually give us a very specific advantage.

And I would say, finally, we actually have a very strong ancillary ecosystem around games. So if you look at eSports, if you look at streaming platforms, all these places where people discover games and engage with KOLs and games as well as with their friends. So I would say, these are all the advantages that we have and we have invested for a long time in this vertical to be the leader and we'll continue to do better. If we have newcomers into market, it will actually incentivize us to do even better.

Operator

Thank you. Our next question comes from the line of John Choi from Daiwa. Please go ahead.

John Choi, Analyst

Thank you management for taking my question. My first question is actually on your recent remote working initiatives. It seems like we're getting very strong momentum as you mentioned, how does the management see the long-term (Technical Difficulty) revenue and what current receptiveness from the users when it comes to subscription or billing. And a follow up on the online video content cost for 2020. How does management see this and how will this impact the profitability? Thank you.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

What was the product you're referring to when you say, it's doing well?

John Choi, Analyst

The remote working products by Tencent Meeting and retail work.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Okay. Well, I will take that question. So I think we have actually talked quite a bit about this category of products. And I would say one, the fact that we have actually invested in this category is that, we feel that there is a trend with increasing digitization of various businesses and institutions. We feel that this is definitely the future trend, but I think because of the coronavirus pandemic, it actually expedited that or necessitate that conversion. So, during the time when nobody goes to work on location as well as schools are not open then clearly, there is only online solutions that is available for people.

I think when the market actually reopens then a lot of the use cases will ship back to offline, but then I think this consumer habit education have already taken place and people would shift a part or retain a part of their usage habit online. So -- and they also would discover the efficiency, right. If you don't have to travel two hours to attend one hour of class meeting maybe right, that's a better and more efficient way of doing.

So I think this does capitalize our longstanding vision on the trend within the short period of time. Now with respect to the products that we talk about right. So we have been building WeChat Work for a while. And I would say, WeChat Work is a product, which works with established organization. So if you have a company or if you have an organization, if you have a school, then you can adopt that solution. And then it can actually help you to do internal collaboration. And you can actually start stacking in other kind of star solutions onto and help that organization to be more online.

Now what we discover as an additional important and pretty unique feature of our WeChat Work in addition to just being an internal collaboration tool is that, with integration to Weixin, it actually allows a lot of the Company, it's not only to engage in internal communication, but also it can become a good CRM tool for them to engage with the consumers over WeChat. So I think that is an additional advantage of WeChat Work.

Now, with respect to Tencent Meeting, it's a completely different proposition. It's actually a very easy to use application that anybody can form a group and start video conferencing. So it actually covers used cases in which it like people within different organizations can actually convene a meeting very conveniently. So as a result, you can see during the coronavirus that adoption of Tencent Meeting is actually very high, especially in terms of sign up new users.

I think for a product like Wechat Work and also a product like Ding Ding right, you can cater to the internal needs of enterprises and for the enterprises you have already signed up, you actually suddenly can have more activity within those sign up accounts. But then for Tencent Meeting, it actually allows people to download the app and immediately be able to connect to each other. So we felt they cover different use cases. And both of them are going to be our flagships for enterprise collaboration development for the future.

At this point of time, I think we're very focused on market coverage and we are not worried about monetization yet. We felt that if it gets a lot of users in the same line of logic that we have been using as Tencent, in many, many of our products that we invest initially to get the users, and eventually the monetization would come.

LAU Chi Ping (Martin Lau), Executive Director and President

On the Tencent video content costs question, so 2019 was obviously a challenging year for all long-form video services, including our own. But we actually feel that we have made a substantial efficiency gains. If you look at the full year results, out of all of the long-form video platforms we're the leader by revenue, but we also lost far less than our peers, our full-year operating loss was under RMB3 billion. And that speaks partly to the fact that we have been quite disciplined about content spending.

Now, looking forward, we think this remains a growth market, therefore we'll continue to invest aggressively and invest more each year in long-form video contents. And one of the reasons we're comfortable doing that is that, we are uniquely vertically integrated. A substantial chunk, not only of our own drama series, but also of our competitors drama series derives from other companies within the Tencent Group. And it could be intellectual properties based on novels from China literature, it could be drama series that are produced by new classic media.

In the fourth quarter of 2019, I think the most popular drama series, both on our own platform and on our competing platform was actually both, it was China Literature IP and New Classics Media drama series. So given we are currently the most efficient in the industry and given we're the most vertically integrated and given we think that the value of content will appreciate over time, we'll continue to invest hopefully intelligently in growing our long-form video content portfolio.

Perhaps, we can take the next question.

Operator

Thank you. Next question comes from the line of Alicia Yap from Citigroup. Please go ahead.

Alicia Yap, Analyst

Hi, good evening management. Thanks for taking my questions and congratulation on finishing a solid 2019. A couple of questions. Number one is, on the FinTech business, you mentioned, it will be negatively impacted by the outbreak. While we believe the offline transactions is impacted, but we also see the increase in online transaction like the smart retail and also the online grocery purchase, that should help to offset the decline in the offline transaction. So I think on directionally, how serious is the sequential decline after FinTech transaction? If you could help us frame the magnitude of the impact in the first quarter that will be helpful.

And then second question is related to the strong demand on the Tencent Meeting and also the Wechat Work. I understand it's a limited opportunity short term in terms of monetization, but then any big picture outlook that you could help us to think about in terms of the future opportunity, how that would translate enterprises think about the IT demand, IT upgrade and how that will help your cloud and business services growth opportunity in the future years to come? And just quickly on cost component, any spike of these bandwidth that we'll be concerned about...

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

I think Alicia, we'll cap it at two questions.

Alicia Yap, Analyst

Okay.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Yes. So Alicia, why don't I answer the first question on the FinTech impact. So I think the heart of your question was that, a substantial chunk of payment transaction is online and therefore that should mitigate the negative impact from lower offline transaction. So I want to be clear about this. We generate over a billion payment transactions per day, that's a gigantic number, it's more than Visa and Mastercard put together. Within that billion plus, there is a number of online transactions, e-commerce transactions, movie ticketing transactions, traveler transactions and so forth.

But it's far from a majority. When you're handling a billion transactions a day, almost by definition the majority are offline transactions. And so, what we saw in February and the early part of March is that, there was a very substantial negative impact on offline transactions, both from a supply perspective, meaning that the merchants, particularly the smaller merchants who accept QR code payment were not actually at work and therefore not accepting payment. And then in addition from the demand side, consumers were generally staying at home, and so not out and about making payments.

As we moved into March, we have seen that, first of all, the POS merchants recovered relatively quickly as consumers began to work and began to go out and about again. And then more recently, we've seen the QR code transaction volume also picking up as the small and medium sized merchants return to work.

So we are seeing a recovery, but I want to emphasize that the negative impact in the period after Chinese New Year, was quite substantial. Now when I talk about the negative impact, I'm really talking about the negative impact on revenue. From a profit perspective, a, as Martin mentioned, we optimized our marketing and other expenses during the downtime. So the lost revenue was not necessarily flowing through into lost profits. And then B, within our FinTech portfolio, one chunk of the profits flows from the payment business, but another chunk flows from the asset management and lending businesses. And the asset management business, in particular the wealth management has continued to grow at quite a healthy pace. And that's naturally a relatively profit generative business. So more of an impact on revenue than on profits.

LAU Chi Ping (Martin Lau), Executive Director and President

So on the Business Solutions, I will answer the three questions, one is, in terms of monetization, there is actually -- there are little monetization at that time with Tencent Meeting and WeChat Work. Now in terms of the future, I think -- I actually dedicated a whole page as well as I talked pretty much at length on what we feel holds in the future. And we felt basically Tencent Meeting is a great way for people to have across organization business type of video collaboration and video conference versus WeChat for work holds the future for helping internal collaboration for enterprises as well as for consumer-facing enterprises to do CRM.

So there is actually a very bright future for both applications. And I think we're just at the beginning of this big wave of digital transformation for enterprises and institutions. And finally, because there is no revenue at this point of time, we do carry a cost in terms of human capital investment as well as the bandwidth and especially the bandwidth for Tencent Meeting is actually quite a bit, because the usage traffic is actually quite a lot.

But on the other hand, we do have a very strong CDN capability built over the years to optimize the cost associated with this kind of traffic. And to some extent relative to what we're spending on content, this is a small amount of money on a relative basis. So that's why we will take it and I think it's a worthy investment for the future.

Alicia Yap, Analyst

Thank you.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

Next question please.

Operator

Thank you. Our next question comes from the line of Thomas Chong from Jefferies. Please go ahead.

Thomas Chong, Analyst

Hi, good evening. Thanks management for taking my questions and congratulations on a solid set of result. My question is about the FinTech business, given the coronavirus, can management comment about our strategy in terms of the take rate improvement. Would we actually slow down the take rate improvement to help the merchants to patent [ph] through these challenging period?

And also on the wealth management side. James, just mentioned that it's going healthily. Can we understand about the different wealth management products like, insurance, micro lending, money products, how we should think about the product innovations for this year. And a very quick follow-up is on the overseas gaming strategy. Given the fact that, we have over 20% of the gaming revenue from overseas, what's the long-term goal that we are looking into. And our strategies in ramping up the overseas contribution, would be great. Thank you.

Jane Yip, Investor Relations

Okay, we will address your question first. Thank you.

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

So in terms of the FinTech business, I think during the coronavirus, we see a lot of the offline businesses that we serve have seen their business basically shuttered due to the lockdown. So I think what we are trying to do our best at is actually to help alleviate their difficulties. And some of it is basically helping them to try to get some businesses online. I think in some cases -- some merchants have been able to elaborate Mini Programs as well as other means right, even forming a group for example to sell their products online.

And some of them actually achieved quite encouraging results. And at the same time, I think over time, we try to build tools so that the merchants can actually manage their operations more efficiently and at the same time try to get more users to do online and offline transaction. So those are going to be the focus for us. We have never wanted to run our FinTech payment business based on heavy monetization model, that has never been our vision. What we want to do is actually make it convenient. And at the same time, we try to be able to add value to the people, the merchants we serve and over time, we're able to get some monetization out of the additional value that we provide.

So that's our strategy. Now in terms of wealth management, as you talk about the -- in terms of our FinTech solutions, there is wealth management, there is our loan and consumer loan, micro loan business. And then over time we are going to build some more presence in insurance. I think each one of these services, we have always tried to bring some innovations as well as additional value proposition for our users.

I think a big part of it is centered around just reducing the entire customer acquisition cost and engagement cost in the industry, and along the way, right, pass some of the savings back to the consumers. Another broad stroke strategy is in terms of leveraging technologies and our data analytics to get better in terms of risk management. So when the risk is actually reduced then again there are some savings that we can actually create and that can be shared with the users as well as with our partners.

So I think a lot of the innovations would be around these principles. And we actually find a lot of opportunities to have innovation, we can't go through one by one, but I think in broad stroke, these are the areas that we find we can add most value on.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

For our international gaming strategy, I think Martin spoke about that in some detail in his six slides. I'd refer you back to that side, I do just want to emphasize that ultimately it is product-driven business and the best products come from the best studios. And we believe that within the Tencent family now, there's a number of really extremely successful studios. Just to pick one at random, if you look at Riot Games, their pipeline including games like Valorant, including games like Runeterra, including games like Wild Rush has been one of the best pipelines of any game studio in the world. And our existing product, League of Legends as you know the biggest and best PC game in the world.

But it's not just Riot, it's Timi, which has global success with Call of Duty Mobile, it's Quantum that has global success with PUBG Mobile, it's Supercell that has had the recent global success with Brawl Stars and other products coming out this year. So there's a number of elements to the strategy, but people sometimes forget the importance we place on the core studio expertise and the 4 studios I guess mentioned best in class studios globally.

Next question please.

Jane Yip, Investor Relations

And sorry, due to the time constraint, may we have the last question please?

Operator

Thank you. Last question comes from the line of Gregory Zhao from Barclays. Please go ahead.

Gregory Zhao, Analyst

All right. Good evening, management. Thanks for taking my question. So just a quick follow-up on the COVID-19. So we think some of your investment company also see some impacts during the epidemic situation. So I just want to understand, so what kind of support you can provide to these companies, for example, traffic or technology support (Technical Difficulty) the dynamics of our entertainment related services such as live streaming, music, literature and long or short video services. And how shall we think about COVID-19's impact and how will that reshape our users long-term behavior? Thank you

MA Huateng (Pony Ma), Co-Founder, Chairman and Chief Executive Officer

So the second question on the long-term impact of, potential long-term impact of COVID-19 on the digital entertainment industry, clearly people who are under quarantine situation or people who can't go to school or work are spending more time at home, and that's unfortunate, but it's a necessary reality. And when they're at home, there's a number of activities they can partake and a limited number of activities they can partake in. And some of those you mentioned including music, watching films, watching short video content, playing games, therefore see increased usage.

Now as and when the COVID-19 situation normalizes then, one would expect people to venture out of home and participate more in out-of-home activities once again. But I think that said, even with the SARS crisis, which was on a much lesser scale, there was clearly a structural change in consumer behavior where in pre-SARS compared to post-SARS people spent more time on digital entertainment. And that may again be the case here, but I want to emphasize that from our perspective that's probably the less structural change, the greater structural change will be enterprises recognizing the importance of in a remote working and recognize the importance of being able to stay in contact with their consumers even if their storefronts offline or closed.

That's why it's so important for us that we invest the money and invest time in really making enterprise facing apps be that they can be and we gave the example of the Tencent Meeting video conferencing service that's enjoyed spectacular growth. And that's partly because it's in the right place at the right time and serving a real need, but that's also partly because I think we've rushed up 14 updates in 40 days, which is incredibly fast update pace for any app. And difficult to get through the app stores actually.

So anyway, we think that there will be some temporary changes in consumer behavior -- revert to normal relatively quickly. But there will also be some structural changes to consumer and especially enterprise behavior that will be longer-lasting.

LAU Chi Ping (Martin Lau), Executive Director and President

Okay. On your first question, it took me a little bit to think about it because frankly, I have to say we actually work with our investee companies and providing the support throughout their life cycle. And there are all kinds of different technologies and management expertise as well as traffic and product co-operations that we actually do with them during normal times. So our support for them has always been sort of ongoing.

But in relation to the pandemic, I actually felt we have not provided any specific support to our investee companies. And the reason I think about it is, basically, I think all of our investee companies are actually best in class companies in their own right. And instead of asking for help, I think they're offering help. So, all of us during this difficult time is actually not think about what incrementally we can do better for ourselves, but more thinking about how we can do to help the general society.

So I have to say, I can think about all our investee companies basically spending their effort in trying to in their own industries provide support to their business partners or their users or government entities that need help in a way that the people who need help are not our investee companies is actually the general public. And I think I'm proud to say a lot of our investee companies have rise to see that challenge and dedicate their resources and helped them and play an important role in fighting against the coronavirus.

Jane Yip, Investor Relations

Thank you. We are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our Company website at www.tencent.com. The replay of this webcast will also be available to you. Once again we apologize for the disruptions caused by the system technical problems for tonight. And we hope everybody stay healthy, look forward to connecting with you again next quarter.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2019-11-13
Event Description: Q3 2019 Earnings Call

Market Cap: 3127411.66282
Current PX: 327.4
YTD Change($): 13.4
YTD Change(%): 4.268

Bloomberg Estimates - EPS
Current Quarter: 2.709
Current Year: 10.008
Bloomberg Estimates - Sales
Current Quarter: 105041.467
Current Year: 380202.226

Q3 2019 Earnings Call

Company Participants

- Martin Lau, Executive Director
- Jane Yip, Assistant General Manager, Investor Relations & Global
- Pony Ma, Chairman of the Board and Chief Executive Officer
- James Mitchell, Chief Strategy Officer
- John Lo, Chief Financial Officer
- Unidentified Speaker

Other Participants

- Alicia Yap, Analyst
- Eddie Leung, Analyst
- Han Joon Kim, Analyst
- John Choi, Analyst
- Grace Chen, Analyst
- Gregory Zhao, Analyst
- Binnie Wong, Analyst
- James Lee, Analyst
- Alex Yao, Analyst
- Piyush Mubayi, Analyst

Presentation

Martin Lau, Executive Director

Thank you for standing by, and welcome to the Tencent Holdings Limited 2019 Third Quarter Result Announcement Conference Call. At this time all participants are in listen-only mode. There will be a presentation followed by the question-and-answer session. (Operator Instructions) I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip, Assistant General Manager, Investor Relations & Global

Thank you. Good evening. Welcome to our 2019 third quarter conference call. I'm Jane Yip from the IR team of Tencent.

Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future, for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited, non-IFRS financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance, prepared in accordance with IFRS. Non-IFRS measures formerly referred as non-GAAP measures are intend to reflect our core earnings by excluding certain one-time and non-cash items. For a detailed discussion of risk factors and non-IFRS measures, please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight. Our Chairman and CEO, Pony Ma will kick-off with a short overview. President, Martin Lau will discuss the strategy review. Chief Strategy Officer, James Mitchell will speak about the business review and Chief Financial Officer, John Lo will conclude with financial review, before we open the floor for questions.

I would now turn the call over to, Pony.

Pony Ma, Chairman of the Board and Chief Executive Officer

Okay. Thank you Jane. Good evening, everyone. Thank you for joining us. During the third quarter, we experienced sustained healthy growth rate in our operating and financial metrics. Notably, our FinTech and Business Services and advertising segment revenues, each increased at double-digit percentage rates from the second quarter; thanks to rising user activities and improved advertising technology.

This growth demonstrates the strength of our new business, and our diversified business metrics -- mix. Our non-IFRS operating and net profit grew at a faster year-on-year rates versus the prior quarter. Looking forward, we will continue investing in our products, technology and services as we seek to provide value to our users and to do good for society.

I will now share a few highlight numbers, from the third quarter. Total revenue was RMB97.2 billion up 21% year-on-year and 9% quarter-on-quarter. Gross profit was RMB42.5 billion, up 20% year-on-year and 9% quarter-on-quarter. Our non-IFRS operating profit was RMB28.5 billion, up 27% year-on-year and 5% quarter-on-quarter. Non-IFRS net profit attributable to each equity holders was RMB24.4 billion up 24% year-on-year and 4% quarter-on-quarter.

Moving to platform update, in social, combined MAU of Weixin and WeChat increased 6% year-on-year to 1.15 billion. Smart device MAU of QQ declined 6% year-on-year to 653 million as we proactively clean up spending in Spot accounts. In games, we solidified our number one position in China with Peacekeeper Elite popularity, and extend our international success with Call of Duty: Mobile and Teamfight Tactics. In FinTech, we operate the largest mobile payment platform in China by DAU and payment volumes with increasing user engagement.

In media, daily video views within Tencent video app, increased both year-on-year and quarter-on-quarter despite a challenging content approval environment. Live streaming services and music subscriptions also grew strongly. In cloud, we continued to outgrow peers and have achieved significant scale in our business. In utilities, our App Store and Mobile Browser App remained category leader in China.

I will ask Martin to discuss strategic review.

Martin Lau, Executive Director

Thank you Pony, and good evening and good morning to everybody. This quarter marked the first anniversary of our strategic organization upgrade, which strengthens our franchise in consumer Internet and extends our footprint to industrial Internet.

While we believe that the upgrade will generate its desired results over the next few years, we're pleased to share some initial achievements, both quantitatively and qualitatively. From a quantitative perspective, our non-IFRS earnings growth has accelerated from 19% in the second quarter to 24% in the third quarter. This growth is driven by first, FinTech services and second, social ads and third, international games, which are all relatively new business areas and each one of them have large growth potential in our view. Over the past year, as a result, we have improved the quality, diversity and headroom of our growth profile in these tangible business areas, while at the same time, pursuing emerging growth in enterprise businesses and short content industry.

From a qualitative perspective, first, we have consolidated our enterprise-facing activities into the Cloud and Smart Industries business group, to assist various industries in reaping the benefits of digitization.

Second, we established the platforms and content business group to execute a more focused content strategy, leveraging our strengths in high DAU platforms and premium content. Third, we've proliferated our Mini Programs ecosystem, enabling service providers to efficiently connect with their customers. Fourth, we have made encouraging progress towards globalizing our business, particularly for online games where we created, published and operated some of the most popular mobile games outside of China. Fifth, we have streamlined our operations to be more agile. For example, we merged our ad sales teams and simplified our inventory formats. We set up a technology committee to drive the use of the common software code base, and we are more efficiently prioritizing our sales and marketing activities. In the same spirit of continuing innovation, we upgraded our corporate mission and vision to Value for Users, Tech for Good.

Now diving into the progress, we've made in serving enterprises with CSIG. We have rapidly expanded our client base and locked in key contracts, driving fast growth in our cloud revenue and more importantly achieving substantial scale. We have integrated our proprietary technologies in areas such as, securities offering, streaming, AI and Big Data analytics, into smart industry solutions. For example, our security software facilitates anti-fraud, identity authentication and data protection and it's increasingly adopted by Internet, financial and municipal services customers.

Operationally, we have optimized our supply chain for hardware, such as, service and networking equipment, enabling us to offer more cost-competitive products and services. And we have also unified our enterprise sales teams to increase customer acquisition efficiency. During the year, we've built several industry-leading cases and made great progress in different sectors. For example, our Digital Guangdong projects is regarded as the benchmark for digitizing municipal services in China, and we're leveraging that success by implementing WeCity solution in other cities, such as, Changsha and Chongqing. Our Travel YunNan on mobile project pioneered digitizing tourism, facilitating tourist access to scenic spots, transportation and public facilities, while supporting businesses and administrators to increase touch points and overall efficiency.

Our Smart Retail solutions provide digital tools to help retailers deepen consumer insight and streamline processes -- initiatives to facilitate merchant on-boarding process and are penetrating more sub sectors.

Moving on to our content business and the progress in PUBG, we're increasing the interaction between our content apps, traffic apps and social platforms, so as to understand our users better, identify users' trends earlier and provide the right content to a broader audience in a more timely manner. In premium content, where we're reinforcing our content creation capabilities in areas, such as drama series, live shows, anime and literature. We're also benefiting from synergies, between different content formats.

For example, we're developing popular online literature, IPs into drama and anime series and success examples, such as, The Untamed and The King's Avatar emerged. We're using variety shows to identify new artists, who then contribute content and talent to our music platform.RISE, a band selected from participants in the Tencent Video variety show, sold almost 1.5 million copies of its first digital album on the debut of its release on Tencent Music platforms. In the area of short-form content, we've built strong presence in news feeds, via QQ KanDian, QQ Browser, Kuaibao and Weixin Top Stories and are now increasing our advertising revenue from these services.

We believe the news feeds' competitive landscape, has largely stabilized, with our products holding a significant market share. In short and mini video, which emerged more recently, we already have over 10 billion video views per day, and we're building out our content creation and distribution system, focused on our Weixin application. We believe the short and mini video market will eventually settle down around several successful apps, similar to the case in the news feed market.

In terms of Mini Programs, the Mini Programs in our view present a vibrant ecosystem that facilitates service and transaction delivery, offline and online integration and benefits of performance ads and payments business. We are the global pioneer for Mini Programs and a clear China market leader with Mini Programs having over 300 million DAU and the number of mid-to-long-tail Mini Programs grew 60% year-on-year in the third quarter.

To further our ability to serve vertical industries through smart solutions, we're now pilot testing vertical Mini programs via three new takeaways in our Weixin Pay main interface. First, health care. Our health care gateway integrated services such as medical content from Tencent Medipedia for information, direct connections to hospitals for registration and consultations and electronic social security card for efficient payment. Second, mobility. Our mobility gateway allows users to check bus schedules, plane routes ahead, pay for public transportation and pay for traffic fines and parking if they're car owners. Thirdly, smart retail. Our smart retail gateway is a decentralized marketplace for retailers. Users can browse recommended products from nearby franchise stores, brands and also communicate with sales representatives.

In terms of globalization, we have made good progress to increase our global presence and we believe, we're making particularly a breakthrough in our games business. As a first step, if you remember, we have invested in and partnered with many of the best game companies in the world with business cooperation or equity investment in 8 out of the 10 game companies worldwide. More recently, we've proven that we can self-develop games that achieve global success. For example, PUBG Mobile has become the top game in terms of DAU globally, excluding China according to [ph] FME.

In the most recent quarter, the Call of Duty Mobile, which we co-developed with Activision Blizzard gained over four million 5-star reviews on Google Play and a 4.9% rating on iOS, following its October launch, which has become one of the most successful mobile game launch in the past couple of years. International markets now contribute a teens percentage of our games revenue. Looking forward, we'll focus on strengthening our capabilities in serving international markets by firstly, incubating our own IPs that are suitable for global audiences and broadening our partnership with international IP owners. Secondly, pioneering new types of gameplay that can resonate the worldwide and thirdly, localizing our game publishing and operational capabilities for multiple regional markets.

We believe we have a tailwind on our back because a) gamers, globally are increasingly active on smartphones and b) gamers globally are increasingly excited about multiplayer action games, both of which are areas of strength for Tencent. Now finally, I want to close this section by talking about something that's very important for us long term. This week on the 21st anniversary of Tencent, we upgraded our corporate culture and announced our new corporate mission and vision, which is Value for Users, Tech for Good. Throughout our history, users and responsibilities have always been at the heart of everything we do.

Whenever we faced challenges and crossroads, we abide by the user-oriented approach as our guiding principle. The 99 Giving Day Program, the implementation of our parental guidance platform and our use of AI technology in healthcare are few examples illustrating our conviction and commitment to the cause of tech for good.

In order to fulfill our commitments, we continue to prioritize the needs of our users and to incorporate social responsibilities into our products and services. We support various industries to upgrade digitally, and we will strive to promote the sustainable development of society. We'd like to have all of you, our investors and friends, to keep giving us suggestions to help us achieve this mission.

With that, I'll pass to James to talk about our business review.

James Mitchell, Chief Strategy Officer

For the third quarter of 2019, our total revenue grew 21% year-on-year. VAS remained our largest revenue segment, representing 52% of revenue, within which online games were 29% and social networks 23%. FinTech and Business Services represented 28% of our revenue and online advertising was 19%. For Value-Added Services, segment revenue was RMB50.6 billion in the quarter, up 15% year-on-year and up 5% quarter-on-quarter. Social networks revenue is RMB22 billion, up 21% year-on-year and up 6% quarter-on-quarter. Year-on-year growth benefited particularly from live streaming and in-game item sales, while quarter-on-quarter growth benefited from the same factors as well as more streaming music subscriptions.

Our total VAS subscription counts increased 11% year-on-year to 171 million, due to the growth of online video and music streaming services. Video subscriptions reached to 100 million up 22% year-on-year, while music subscriptions reached 35 million up 42% year-on-year. Our online games revenue grew 11% year-on-year and 5% quarter-on-quarter to RMB28.6 billion. Total smartphone game revenue increased 25% year-on-year to RMB24.3 billion due to key game performance in China and increasing contributions from international markets.

New role-playing and strategy games contributed to the quarter-on-quarter growth along with Peacekeeper Elite although there was a substantial gap between Peacekeeper Elite's cash receipts versus its reported revenues due to that game's long revenue amortization cycle. PC client game revenue decreased 7% year-on-year and 2% quarter-on-quarter to RMB11.5 billion due to fewer paying users production in reduction in DnF.

Moving to social networks, in Weixin, we introduced initiatives to advance our partner's development skills and help them participate in our Mini programs ecosystem. Mini Programs ecosystem. For systems integrators our Growth Program provides training and development tools to help them better assist Mini Program owners. The Mini program owners seeking to enhance the performance of their Mini programs, we launched Industry Assistance, a dashboard providing analytical insights such as comparing their customer acquisition and monetization capabilities against industry benchmarks.

In Q2, we added functionalities that enrich users' social and entertainment experience. We released a feature providing icebreaking topics in 5-minute chat rooms to inspire conversations. We enabled users to dedicate songs to their friends, and we allowed users to listen to synchronized music streams together. During the quarter, our game business accelerated its year-on-year revenue growth and more importantly, improved its underlying vitality and longevity. We're increasingly developing games that can become global hits such as PUBG Mobile and Call of Duty: Mobile establishing leadership in the most competitive genres globally such as first-person action games, and operating high DAU games that can themselves become platforms for new modes, such as, League of Legends with Teamfight Tactics.

As a result, we and our majority-owned subsidiary upgraded six of the top 10 smartphone games by monthly active users globally, during the third quarter. For smartphone games in China, Peacekeeper Elite released the summer content update which enhanced user engagement. We introduced a map edit of Honor of Kings that encourages user-generated content and users are increasingly buying seasoned passes in Honor of Kings. The smartphone games internationally, PUBG MOBILE doubled its monthly active user base year-on-year and released successful royal passes in, July and September.

Call of Duty mobile exceeded 100 million downloads in the month after its launch, making this game the highest impact mobile game launches in recent history. So, PC Games in China, DnF revenues decreased sharply year-on-year as its 11th anniversary expansion pack in June underperformed last year's 10th anniversary expansion pack in June underperformed last years 10th anniversary expansion pack and we're focused on enhancing DnF's user engagement. Our PC games internationally, League of Legends, Teamfight Tactics, mode has established global leadership in the emerging auto chess genre, with over 30 million monthly users and it's starting to contribute to revenue by the League of Legends. Last week, China's government announced a regulatory policy limiting gameplay time for children and teen-aged players. We have already implemented a healthy Gameplay System in our games with similar or stricter limits that is now being announced and consequently, we expect very limited additional impact from this regulation on our game business.

Moving to online advertising, we grew our advertising revenue by 13% year-on-year and 12% quarter-on-quarter to RMB18.4 billion in the third quarter. We saw strong advertising demand from the games, education and eCommerce verticals offsetting weakness from the automobile sector. We believe our advertising business enjoys a long runway for profitable growth ahead, as we make use of our rich data sets to target the right advertisements to our uniquely large user base, across our broad range of social media and affiliate properties. Our media advertising revenue was RMB3.7 billion, down 28% year-on-year and down 17% quarter-on-quarter. Our mobile video DAU was stable year-on-year, but the uncertain video content schedule materially reduced our video sponsorship advertising revenue.

However, we believe the worst of this trend now appears to be behind us. Our social and other advertising revenue increased 32% year-on-year, and 23% quarter-on-quarter to RMB14.7 billion. Key drivers of the accelerated growth rate included, first more inventory and more impressions in Weixin Moments, which remains the premium wide-reach online advertising venue in China, providing advertisers with multiple times more DAU than they can access, through competing properties.

Second, streamlined ad formats and new video ad formats in our ad network, resulting in our ad network revenue growing twice as fast year-on-year, as our overall social and others advertising revenue. We believe the success of our ad network, which competes head-to-head with our biggest peers for advertiser budgets in real-time speaks to our increasingly competitive ad tech product, following our 930 Ad Tech unification. And third, increase DAU and new interstitial and pre-roll video ads within, our Mini programs, which we view as, key properties of future advertising revenue growth, given the increase in the high volume of consumer transactions taking place within Mini programs.

Looking at FinTech and Business Services, segment revenue was RMB26.8 billion up 36% year-on-year and up 17% quarter-on-quarter. Within FinTech services, our payment ecosystem posted more user activity and money flow, deepening consumer and merchant engagement. Our commercial payment revenues grew robustly year-on-year and quarter-on-quarter benefiting from increased daily active consumers and per consumer transactions as Weixin Pay becomes more widely available, especially among high transaction value merchants.

Our wealth management platform more than doubled its active customer base year-on-year, contributing to rapid growth in aggregated assets under management. Users are increasingly retaining cash in their Weixin balance and LiCaiTong accounts. This trend hurts our revenue in the short-term by reducing our withdrawal fees, but helps our margins since we don't incur funding costs on transactions funded from Weixin Pay and LiCaiTong balances, and speaks to deepening consumer confidence in our payment services.

Our FinTech business generated a double-digit operating profit margin in the third quarter benefiting from increased commercial payment volumes as well as fees associated with lending and asset management activities. We believe our FinTech business also enjoys a long-run rate for profitable growth, given the value our mobile payment service contributes to the economy, and to the society, together with the convenience and innovation of our lending and asset management services.

Within Business Services, our cloud services revenue grew 80% year-on-year to RMB4.7 billion as we expanded our customer base in the education, financial, municipal services and retail sectors, as well as increasing revenue from existing customers. We're enhancing the operating efficiency of our cloud services, as we expand our business scale and optimize our supply chain. For example, we're shifting from OEM to ODM procurement, which enables us to provide more tailored services and pass lower costs on to our customers.

And with, that I'll pass to John to discuss the financial review.

John Lo, Chief Financial Officer

Thanks James. Hello everyone. For the third quarter of 2019, total revenue was RMB97.2 billion, up 21% year-on-year or 9% quarter-on-quarter. Gross profit was RMB42.5 billion, up 20% year-on-year or 9% quarter-on-quarter. Net other gains was RMB932 million, down 89% year-on-year or 77% quarter-on-quarter. The year-on-year decrease was primarily due to non-IFRS items, including net gain from May 20, paying upon its IPO in the same quarter last year, partially offset by quicker impairment provision against investments.

Sequentially, the decrease was mainly due to the decrease in net fair value gains of certain (inaudible) which are also known IFRS adjustment. Operating profit was RMB25.8 billion, down 7% year-on-year or 6% quarter-on-quarter. Net finance costs were RMB1.7 billion, up 17% year-on-year or down 12% quarter-on-quarter. The year-on-year increase was primarily due to greater interest expense, resulting from the increase in indebtedness, partially offset by the recognition of foreign exchange gains. Share of profit of associates and joint ventures was down 90% quarter-on-quarter to approximately RMB234 million, mainly reflecting certain associated booking non-cash fair value changes of the investment portfolios. On a non-IFRS basis, share of profit of associates and joint venture decreased by 14% quarter-on-quarter.

Income tax expense was RMB3.3 billion, up 3% year-on-year or 4% quarter-on-quarter, mainly reflecting higher taxable income. The effective tax rate for the quarter was 13.7%. Net profit attributable to equity holders was RMB20.4 billion and diluted EPS was RMB2.127 million, both down 13% year-on-year and 16% quarter-on-quarter. The year-on-year decrease was mainly due to higher base last year as a result of recognition of fair value gains for Meituan Dianping IPO. The Q-on-Q decrease was mainly due to decrease in fair value gains from investment as mentioned earlier. On a non-IFRS basis, net profit attributable to equity holders was RMB24.4 billion and diluted EPS was RMB2.548, both up 24% year-on-year and 4% quarter-on-quarter.

Let me walk you through non-IFRS financial numbers. Operating profit was RMB28.5 billion, up 27% year-on-year or 5% quarter-on-quarter. Operating margin was 29.4% up 1.4 percentage points year-on-year, or down 1.3 percentage points quarter-on-quarter. Net profit attributable to equity holders was RMB24.4 billion, up 24% year-on-year and 4% quarter-on-quarter. Turning to segment gross margin. Gross margin for Value-Added Services was 51.8%, down 4.7 percentage points year-on-year or 0.8 percentage points quarter-on-quarter. The year-on-year decrease was primarily due to revenue mix shift from higher-margin products such as PC games, the digital content services, including music, video streaming, subscriptions and live streaming services as well as higher content costs for smartphone games. Sequentially margin was broadly stable.

Gross margin for Online Advertising was 48.8%, up 12.1 percentage points year-on-year or 0.2 percentage point quarter-on-quarter. The year-on-year increase primarily reflected revenue mix shift from media advertising to social and other advertising which has a higher margin. Sequentially, margin was broadly stable. Gross margin for FinTech and Business Services was 27.7%, up 2.6 percentage points year-on-year and 3.7 percentage points quarter-on-quarter. The year-on-year increase reflected growth in merchant payment transaction volume and increased service, fee income of various payment-related services and lending business. In addition, the increase in margin also a result of revenue contribution from cloud services and improved cost efficiency from economies of scale. The Q-on-Q increase reflected higher merchant payment, transaction volume as well as contributions from higher margin.

On operating expenses, selling and marketing expenses were RMB5.7 billion, down 13% year-on-year or up 21% quarter-on-quarter. The year-on-year decrease reflected our prudent cost management initiatives. Sequentially, selling and marketing expenses increased due to seasonally higher marketing spending on digital content, FinTech Services and smartphone games. Selling and marketing expense represented 5.9% of the quarterly revenue. G&A expenses were RMB13.5 billion, up 24% year-on-year and 8% quarter-on-quarter, primarily driven by increase in R&D expenses and staff force. Within G&A, R&D expenses were RMB7.9 billion, up 27% year-on-year and 11% quarter-on-quarter.

As a percentage of quarterly revenue, G&A was 13.9% and R&D was 3.1%. At quarter end, we had approximately 60,000 employees, up 16% year-on-year or 8% quarter-on-quarter. Let's take a look at the margin ratios. Gross margin was 43.7% down 0.3 percentage point year-on-year and 0.4 percentage point quarter-on-quarter. Non-IFRS operating margin was 29.4% up 1.4 percentage point year-on-year or down 1.3 percentage points quarter-on-quarter. Non-IFRS debt margin was 25.8%, up 0.5 percentage point year-on-year or down 1.4 percentage point quarter-on-quarter. Before I close my remarks, I will share several key financial metrics for the third quarter.

Total CapEx was RMB6.6 billion, up 11% year-on-year and 52% quarter-on-quarter, of which operating CapEx increased 12% year-on-year to RMB5.8 billion. The increase mainly reflected more spending on servers to support expansion of our cloud business. Non-operating CapEx increased 3% year-on-year to RMB804 million. Free cash flow was RMB37.7 million, up 36% year-on-year or 82% quarter-on-quarter. This was the result of net cash flow generated from operating activities of RMB44.2 billion, offset by payments for capital expenditure of RMB6.5 billion.

Net debt position was RMB7.2 billion, which has improved 75% compared to last year. The sequential decrease mainly reflects a strong free cash flow generation, partially offset by payments from M&A initiatives and media content. The fair value of our shareholdings and listed investing companies, excluding subsidiaries was approximately $49.9 billion compared to $47.9 billion last quarter. During the period from August 28 to October 11, 2019, we repurchased 3.5 million shares with an aggregate cost of approximately $148 million.

Thank you. We shall now open the floor for questions.

Jane Yip, Assistant General Manager, Investor Relations & Global

Operator, we will take one main question and a follow-up question each time please. Shall we invite question now.

Questions And Answers

Operator

The first question comes from the line of Alicia Yap from Citigroup. Please ask your question.

Alicia Yap, Analyst

Hi. Good evening, management. Thanks for taking my questions. I have a question related to games developments and game publishing opportunity. With the success of Call of Duty mobile, it seems that Tencent has further stepped up the development capability to win more well-known console IP to help Global Studio to transform their games into mobile gameplay.

In selecting the titles or partners, what are the criterias that you will be looking, when you decide to license for IP? And on domestic publishing, since there has, been some noises about a new competitor, maybe eyeing on games distribution and publishing, will this affect Tencent publishing market share in the coming future? Thank you.

Unidentified Speaker

Yes. In terms of game development and game publishing, I think, the fact that our game development capability is now well-recognized in the global market by consumers with the success of PUBG Mobile, and more recently the Call of Duty Mobile, I think it's a very big breakthrough for us and we're very pleased to see that.

Now, I think we have established ourselves as the pre-eminent mobile game developer for not only China, but also global market and when you add that to the fact that over the past many years, we have actually already established a very strong relationship through strong partnership as well, as equity investment relationship with many top game companies in the world. I think when you add those together right, it's actually opening up a significant opportunity for us. And of course when we choose the titles I think consumers' and gamers need are the most important criteria that we look at right? If the game title has got a very large follow-ship and consumers and gamers are expecting to see an exciting title and we can develop that and deliver that for the users, I think, that's the most important criteria, and I think that our philosophy also resonates with a lot of our partners.

When we develop these games, it's not only games that open up commercial (inaudible), but also it retains the original creativity for the game developers and our partners which is very important too. In terms of domestic publishing, I think, we feel very good about our position and the fact that we have strong operational as well as development capability, as well as very strong relationships around the world with the IP and game owners and at the same time the fact that we have a very strong leverage over our social platforms, I think give us a pre-eminent position in the industry which I think it's very difficult to shake up.

Jane Yip, Assistant General Manager, Investor Relations & Global

Next question please.

Operator

Thank you. The next question comes from the line of Eddie Leung from Bank of America. Please ask your question.

Eddie Leung, Analyst

Hi, guys. Good evening. Thank you for taking my questions. Starting with our short and Mini video strategy, you mentioned it about strong growth of video views within some of your large user platforms, while you also run several independent short and mini video apps.

So, just wondering is there any priority, when you think about allocation of our resources, for example marketing resources to grow the content consumption of video? And related to that, if we have the traffic spread across different channels and platforms, would that affect the budget allocation from some of the advertisers? Thank you.

Unidentified Speaker

Yeah, I think the way we look at the short and mini video landscape is very similar to the way we look at new speed with one additional tweak. If you look at short and mini video, I think the overall portfolio that we have created is one, in our social platform, we continue to curate a social short and mini video, which is not counted in the 10 billion video views, right? But that is really a video -- short video and mini video that are sent among the different users. We think that's actually a part of social network, and that we have a very, very strong lead in. That's number one.

Number two, in terms of the media side of the mini videos and short videos i.e. when people watch the video for content purpose, then it's actually very similar in our view to the newsfeed market, in which you have people who just want to watch it for a light experience within the traffic platforms and we offer that within our social platform, within our browser and within even our newsfeed.

But at the same time, when you look at a very dedicated short and mini video experience, then the flagship product that we have is actually Weixin. And a lot of marketing dollars and content dollars will be dedicated to that application. And in terms of advertising, I think as long as the video format is actually quite similar, then the ad format will be very similar, and as a result, the pool of ad dollars that are in the pool for competitive pricing would be actually sort of quite similar too, so it should not be a problem.

Eddie Leung, Analyst

Got that Martin. Thank you.

Jane Yip, Assistant General Manager, Investor Relations & Global

The next question please.

Operator

Thank you. The next question comes from the line of Han Joon Kim from Macquarie. Please ask your question.

Han Joon Kim, Analyst

Great, thank you for the chance to ask a question. I wanted to get management's perspective on how you look at blended consolidated margin trajectory between all the puts and takes. I feel like we've started to see some slowdown in the second derivative of that. So some perspective from your end would be great. Thank you.

James Mitchell, Chief Strategy Officer

Hi Han Joon, thank you for the question. I'm not sure that I completely understood the slowdown you were alluding to. I think in general though, one broad observation to make is if you look at our gross profit growth year-on-year, this quarter, then the very large majority was driven by first of all FinTech and Business Services segment and secondly our advertising segment. And in fact, and each of those grew their gross profit dollars roughly 50% year-on-year, which we thinks speak to the fact that our business is actually diversifying and incubating new growth drivers quite quickly. And obviously, there has been times in the early days of those new growth drivers when they generated low or negative margins. But, you can see now, if you look at both our advertising and our FinTech and Business Services that the gross profits are growing very substantially and that's translating into improved operating profitability as well for both those segments. Did you have a second question?

Han Joon Kim, Analyst

No, no, that was it, thank you for addressing the question.

Jane Yip, Assistant General Manager, Investor Relations & Global

Thank you. And the next question please.

Operator

Thank you. The next question comes from the line of John Choi from Daiwa. Please ask your question.

John Choi, Analyst

Good evening. And thank you for taking my question. I have a kind of a follow-up question from -- after Alicia. On your recent success on PUBG Mobile and Call of Duty Mobile, it seems like Tencent has been really positioned as a global powerhouse in game development, particularly in mobile.

But if we think on a longer perspective, where does the management think that Tencent has to further invest or strengthen its capability? Is there like -- is the -- is there any area or such as infrastructure is in place or any new areas that Tencent has to really consider to become more of a true global player? And second, just quickly on the media ads. I know third quarter was very challenging, any color to the fourth quarter and 2020 will be very helpful. Thank you.

James Mitchell, Chief Strategy Officer

Thank you for the questions, John. So media advertising while we generally don't give detailed forward-looking guidance. We do believe that the worst is behind us now and our media advertising trends would improve. In terms of the question about where we need to enhance our capabilities, to further strengthen our game globalization strategy, then there's a few areas, where we believe we have more work to do and room to further improve.

One is, incubating nurturing and developing our own intellectual properties, that's something that, I think we've achieved quite successfully within the China market, and we would like to extend that -- IP management capability globally. A second area of focus is, extending into more genres of games. So, to-date, we've been most successful in the biggest and most competitive genre which is first-person action games. And the fact that we can be successful in the biggest most competitive genre, it gives us some confidence that we -- if we put our minds there, we ought to be successful in some other genres. But clearly, that requires more, further effort.

And then thirdly, on the game operations, when we began our globalization, we largely operated the games from China. Subsequently, we've discussed that there's enormous value to actually having, an international game operation platform.

But, if you look at the success of some of our peers, such as, for example, Garena with Free Fire then, often beyond the global platform, there's also increasingly value in having a regional live operations and regional publishing capabilities, particularly in some of the emerging markets around the world -- historically monetized very poorly for mobile games, but are now starting to monetize more substantially. So, those are a few of the areas where we believe there's further room for us to improve, as we globalize our game business.

Jane Yip, Assistant General Manager, Investor Relations & Global

And the next question please.

Operator

The next question comes from the line of Grace Chen from Morgan Stanley. Please ask the question.

Grace Chen, Analyst

Thank you. Thank you for taking my question. My question is about the gross margin. We can see Tencent is making really good progress to extend game business overseas. I'm wondering, how the rising revenue mix from overseas gaming business will affect the VAS margin trend going forward? Is there any difference in terms of margin profile? A follow-up question is for 5G. It would great if the management can share your view about the opportunities from the take of 5G in China in your business -- like which segments in your business will benefit more from 5G and how? Thank you.

Martin Lau, Executive Director

I think in terms of you know the overseas games you know, it will carry normally a lower margin due to the fact that some of the games that's been upgraded by other partners. And so, the result will be a little bit lower than that of those in China.

Unidentified Speaker

Well, on the other hand, -- it depends on the different models too right, if the some -- in some cases right we co-develop the game, and the game is actually operated by our partner. Then we bought the development revenue, which is higher margin in itself right, you know, either it drives higher revenue growth, but then the margin will be lower or the revenue growth is not as much, but it's high margin. So, it depends on the model. Now, in terms of 5G, I think obviously we are at a early stage of the development 5G right, and we feel that when speed increases, it's going to be -- enabling for the bandwidth consuming services, so video I think will definitely be quite an interesting opportunity. And at the same time, I think, it would allow a lot of new applications that can be delivered over the network instantaneously. So, one area that we have been looking into is cloud gaming. And if you look at the current version of the cloud gaming, the most successful cloud gaming is actually how Mini games within WeChat. And by and large, it's actually relatively narrow band type of game, very simple.

But, in the future, if very large amount of data can be transmitted within a very short period of time, then the game experience, all of these -- cloud gaming models could be very, very interesting and different. And in addition, I would also say that if you look at Mini programs, right, Mini program is essentially an application that trades flexibility for bandwidth right. So, when you have almost unlimited bandwidth at flash speed, then Mini programs will become very, very exciting. There will be a lot of other opportunities that will be opened up by Mini programs. So, these are the kind of things which I think it will be very tangible for us.

Jane Yip, Assistant General Manager, Investor Relations & Global

Thank you. And the next question please.

Operator

The next question comes from the line of Gregory Zhao from Barclays. Please ask the question.

Gregory Zhao, Analyst

Hi, management. Thanks for taking my question. So my question is about your FinTech business. So, just want to understand a bit more about the overall -- the industry, the TPV, the growth trend and your market share gain? So, given your dominant market position, shall we expect some initiatives to expand the payment take rate in the next couple of years. And also, if you can share some commercial payment TPV and the revenue growth trend will be very helpful. And a quick follow-up on the Mini program. So, in the press release you mentioned the Mini program -- the MAU exceeding 300 million and expanding to some vertical areas like healthcare and the smart retail. So, just wanted to understand a bit more about the monetization progress, especially in healthcare and the smart retail, and what's the contribution to your social advertising revenue. Thank you.

Unidentified Speaker

In terms of FinTech right now, I would say number one it is -- the [ph] QTV is actually growing quite rapidly because of both the number of merchants adopting the solution and the increase in payment habits created by the users, and also the increase in average ticket size.

And secondly, I think if you look at the overall industry, right, there has been an improving economics, and that's mainly driven by one, there are actually less subsidies offered by our peer, and as a result it actually improved the overall industry dynamics. And two, we actually cross-sell our FinTech solutions -- FinTech Services such as loan products and money market and wealth management products.

I think, in terms of the overall payment itself, it's still infrastructure type of business. There are monetization and in margin related to commercial payments. And I think the mobile payment solutions companies including ourselves are still adopting an approach that we're not making a lot of profit from the payment itself, but trying to expand the use case and expand the market share of mobile payment vis-a-vis other forms of payment. Now, in terms of Mini programs, I would say at this point of time, number one, right, what we disclosed is actually a DAUs. So, there's a huge difference between DAU and MAU. So, I think that's number one in our view. Number two is, there's a big difference between whether the Mini programs are used for mid-tail and long-tail type of Mini programs or they're actually just changing our functionality into a Mini program, and as a result, that's called a Mini program.

So, we focus much more on the mid to long-tail ecosystem, and, I think that's actually growing very vibrantly and that's definitely by far industry-leading in China. And in terms of Mini program's monetization, I think we actually said, Mini programs actually helps to increase the ecosystem of transactions within WeChat ecosystem. And as a result, it helps on performance ads and it helps on our payment business. Now, it's a little bit hard to quantify this, because the fact is our advertisers would advertise on our performance ad, and sometimes they get exposure on their services, sometimes they actually try to bring the transaction onto their Mini programs. So, it's hard to quantify that.

But, I think Mini programs, is definitely a very important part of the value chain when we try to monetize through advertising when there's traffic, and then when the brands and the content -- the merchant is actually trying to advertise, right, Mini programs actually help them to execute the transactions faster and so is our reach at payment right? So, the two added together actually helps transactions flow. And as a result, it helps more and more advertisers to advertise. So, when people look at WeChat, performance at solution, they look at, oh, there's a lot of traffic, they also look at the ease of transaction which is facilitated in the Mini programs. So, I think it's actually helping the entire social ads business.

Jane Yip, Assistant General Manager, Investor Relations & Global

And the next question please.

Operator

Thank you. The next question comes from the line of Binnie Wong from HSBC. Please ask the question.

Binnie Wong, Analyst

Hey good evening management. A quick follow-up on the Mini program, given the high-frequency DAU that we saw, and considering that many of our key strategic investments like (inaudible) those guys are also spending quite aggressively on user acquisition. What is our strategy to incentivize more of these transactions, also got shifted to Mini program and also maybe within the richer ecosystem? And then, second question is that, on the media advertising I think management made a comment that the worst is likely behind us. I just want to understand that, is that more coming from the news feed or is it from the video properties, we have and also how do we see the advertising inflection point? Are we there already, and then, how should we see the outlook? Thank you.

James Mitchell, Chief Strategy Officer

Binnie, thank you for the two questions. On the first question, we may need you to ask that again a different way as we didn't really catch the meaning behind it unfortunately. On the second question about advertising, the macro environment will be whatever it will be and we don't aspire control that. But what we can control is our competitive position. And we believe that since the 930 Reorganization and the combination of our ad sales and ad tech into combined advertising and marketing services group, that we have sharply improved our competitive position and I think, that's in a manifest already in the acceleration you're seeing in our social and other advertising revenue, it's particularly apparent in for example the ad network business, where we're competing head-to-head with the other big online advertising companies in China, where we have experienced very strong growth, as we undertake measures like standardizing and unifying the different ad formats, which makes it a much larger -- more liquid pool in which the media buying trading and desks find it easier and more efficient to transact and was the case before.

So, we believe that we've become slightly more competitive, in the social and other advertising as a result, and we're also seeking to extend that competitiveness to the media advertising business, which we believe is well underway. And once again when you're looking at a business like advertising, because of the intricacies of net versus gross, it's important to really focus on the gross profit growth as well as the revenue growth -- and our advertising gross profit grew at what we think is a very rapid rate year-on-year, reflecting the benefits of the technology changes we're putting in place. Now, if you could just ask the first question again?

Binnie Wong, Analyst

Okay. Sorry. My first question is that on the Mini program side, given that it's a high frequent DAU app -- you see the frequency there. So, how are you thinking that, because we have a lot of investments. And then, say like (inaudible) these guys also spending a lot in user acquisition right? And then also in your call conference also hear that some of the merchants say Uniqlo, I think, they're talking about the improving conversion that -- on Mini program, is actually better than the other app.

So, these improving conversion rate in e-commerce is that something that we can actually see that as a major driver to get more and more of the Mini program adoption -- the rising adoption? And what are the other things that we will -- management is expecting to see to drive the adoption in Mini program from here because I think the DAU is high, and then I guess the next step is that -- what's the next step in terms of going into monetization through this? Thank you.

Unidentified Speaker

I think you touched point a lot of different points, and so I would try to say number one Mini Programs is actually adopted by a lot of different merchants and it's driven by the fact that it is a high frequency usage scenario and at the same time, it facilities offline and online interactions. A lot of offline players now they can actually establish an online presence through Mini Programs. And it also benefits from the fact that there's a better ecosystem around Mini Programs including the performance ads ecosystem including the payment.

And as Mini Programs' providers actually get better in terms of their programming capability and operational capability, it actually helps Mini Programs to be more conversional, right, as you have identified in some of the offline merchants right -- the conversion rates have been improving continuously because they are leveraging our tools to make their Mini Programs better and better in serving customers. So, all these are drivers right, which would benefit the Mini program owners and as a result benefit our ecosystem. And I think -- what comes with -- will be quite natural right there will be more traffic being created by the Mini Programs and the Mini Program owners will be spending more time into curating their Mini Programs. So, that would actually create a virtuous cycle, and when that happens it will benefit our performance ads business, it will benefit our payments business. And it will create actually a stronger transactional culture within our social platform and that will actually benefit the entire Mini Program ecosystem further. So, I hope that answers your question.

Binnie Wong, Analyst

Yeah, thank you, very helpful, thank you.

Jane Yip, Assistant General Manager, Investor Relations & Global

Thank you. And due to the time constraint, we will take the last three questions. Shall, we have the next question please?

Operator

Thank you. The next question comes from the line of James Lee from Mizuho Securities. Please ask your question.

James Lee, Analyst

Hey, thanks for taking my questions. My question regarding advertising. It seems like when we talk to advertising agencies in general, it seems like -- social advertising in general is gravitating towards influencer and KOL advertising and it's moving pretty quick to top-tier influencer. I was wondering -- and I think for eCommerce as well -- I was thinking how are you guys are responding to that specifically? And also secondly, on the NBA content, just curious what the status on that? Is that still suspended indefinitely? Thanks.

Unidentified Speaker

Well, to be honest right, what you guys identified is probably the talk of the time, but frankly, what we have seen is that by and large the ad dollars are still in the programmatic side right, people who are actually advertise with standardized content -- or standardized ad format or standardized ad format through AI and through data crunching and targeting trying to find the right audience and eventually resulting in action and click as well as eventually transaction. I think that's still, by and large, the way to which performance ads work. Now, there is a pretty visible trend toward a (inaudible). But I think in terms of total ad dollars, it's still relatively small.

In terms of NBA, I would say, we have built a very strong relationship with NBA over the years, and we actually have a lot of users who are very positive on NBA content. I think what has happened in the market should not really be prohibiting the engagement between the users who like the NBA content and NBA as a franchise. So what we are trying to do is actually to work through this difficult period and to maintain the positive engagement of sports between the users and the sports franchise. And over time, I hope the problem resolves itself.

James Lee, Analyst

Thank you and the next question please.

Unidentified Speaker

Please go ahead.

James Lee, Analyst

James, do you have another question?

Oh, yeah, I was going to ask revenue contribution from Supercell in 4Q, thanks.

James Mitchell, Chief Strategy Officer

We'll report the fourth quarter when we report the fourth quarter results. But I think that Supercell has filed financials historically in Finland. So, I guess you can use those as a basis for modeling purposes.

James Lee, Analyst

Okay, thanks.

Thank you. And the next question please.

Operator

The next question comes from the line of Alex Yao from JPMorgan. Please ask the question.

Alex Yao, Analyst

Hi. Thank you, management for taking the question. First question is regarding the international mobile gaming opportunity. How do you think about the size of the TAM addressable market for international gaming relative to the domestic gaming market? And secondly, I'd like to follow-up on the FinTech and the business segment gross margin trends. It seems to me that the gross margin has improved pretty meaningfully quarter-over-quarter and also year-over-year in this quarter. Can you elaborate the driver behind the margin improvement and help us understand, to what extent can we extrapolate the margin improvement trend into the future quarters? Thank you.

James Mitchell, Chief Strategy Officer

So the question on the international versus domestic game, I mean, quantitatively, the game software market is about $100 billion of which China is about 30% and other countries are about 70%. So, from that very top-down perspective, then the time -- is a bit more than twice as big outside China as it is inside China. That's roughly true as well for the mobile game market, which is I think where we have most competitive advantage at this point in time.

But obviously, there's total addressable market and there's actually addressable market -- and the actually addressable market depends on some of the initiatives I talked about earlier in terms of us extending our footprint from action games to what other popular genres of mobile games, in terms of us further regionalizing our publishing in that operation skills, and also in terms of our ability to nurture and cultivate intellectual property.

On the second question around the FBS gross margin, there's a number of factors that contribute to the gross margin. One is the extent to which we aggregate financial services around the core payment platform.

And as you're aware, on the asset management side, we've been growing quickly the number of users of our asset management services more than double year-on-year on the lending side, our loan product has enjoyed rapid growth, it's extremely convenient and popular with users due partly to its convenience. In the most recent quarter, we've also begun to see some contributions from insurance. So, that's on the FinTech. On the payments itself, then there's a margin tailwind, first of all from the increasing propensity of consumers to fund with in KanDian or Weixin Pay accounts and that impacts the cost side of the equation. And then secondly, on the revenue side of the equation to the extent that the commercial payment volume outgrows the remittance volume, then the commercial payment volume generates a much discount rate for us. And then thirdly, on the business services component of FBS, the original infrastructure as a service tends to be lower margin. But as we deliver solutions, such as the smart retail solution, then we're aggregating in software-as-a-service, on top of the infrastructure-as-a-service and the software-as-a-service generates higher margins.

So those are some of the structural tailwinds. Now in addition, in any given financial period there can be tailwinds or headwinds based on factors such as competitive intensity, particularly the subsidies around merchant adoption, and as Martin mentioned, now that many merchants do accept mobile payments already, some of that merchant acquisition subsidy activity has decelerated which has contributed to the improvement in margins that we've seen.

James Lee, Analyst

Thank you and the next question please?

Operator

Thank you. The last question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask your question.

Piyush Mubayi, Analyst

Thank you for taking my question. This is quick. I just wanted to understand the weakness in the media advertising revenue line for the quarter, which seems to be pretty sharp. And if there's any color you can give us or provide how quickly this could bounce back? Thank you.

James Mitchell, Chief Strategy Officer

Well we've already provided color, but we believe it is bouncing back, and by our standards, that's much more forward-looking commentary than we would normally give. So unfortunately, we're not going to provide further sort of details as to exact timing and obviously to some extent, it's a function of macro environmental factors as well.

But, in terms of the sharp pace of decline in the third quarter, then one of the key factors is really the uncertainty as to when we would be able to -- certain key drama series. Now in the end, we did add many of the drama series that we hoped to add during the quarter, but because there was uncertainty as to the timing I mentioned was more difficult to sell sponsorships than it would normally be. And for those big budget drama series, these sponsorships historically contribute a very substantial double-digit percentage of total revenue.

And so, even if we add the drama series, even if the drama series achieved the exact number of audience that we were hoping it would achieve; if we lose that sponsorship opportunity because the timing of the airing of the drama series is volatile, then that has a meaningful negative impact on our media advertising revenue. But again, I want to emphasize that there are many drivers in our business and media advertising revenue are important as it is. It's now less than a third of our advertising revenue which in turn is smaller than our FinTech and Business Services revenue, so it's important to keep in mind.

We have a broad portfolio, and when we have a broad portfolio it's almost inevitable that any point in time there will be activities that are underperforming, and there'll be other activities that are overperforming. But, I think we're pleased that this quarter our FinTech Business Services -- our social advertising and our mobile games globally really was key drivers for the future are all performing very well.

Piyush Mubayi, Analyst

Thank you James.

Jane Yip, Assistant General Manager, Investor Relations & Global

Thank you, and we're closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. A replay of this webcast will also be available soon. Thank you, and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating, Tencent Holdings Limited 2019 Third Quarter Results Announcement Conference Call. You may all disconnect.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2019-08-14
Event Description: Q2 2019 Earnings Call

Market Cap: 3248757.33692
Current PX: 340
YTD Change($): 26
YTD Change(%): 0.0

Bloomberg Estimates - EPS
Current Quarter: 2.596
Current Year: 9.84
Bloomberg Estimates - Sales
Current Quarter: 103640.75
Current Year: 391951.981

Q2 2019 Earnings Call

Company Participants

- Jane Yip, Assistant General Manager of Investor Relations and Global Communications
- Huateng Ma, Chairman
- Martin Lau, President
- James Mitchell, Chief Strategy Officer and Senior Executive Vice President
- John Lo, Chief Financial Officer and Senior Vice President

Other Participants

- Alex Yao, Analyst
- Alicia Yap, Analyst
- Eddie Leung, Analyst
- Grace Chen, Analyst
- John Choi, Analyst
- Binnie Wong, Analyst
- Gregory Zhao, Analyst
- Jerry Liu, Analyst
- Piyush Mubayi, Analyst
- Thomas Chong, Analyst

Presentation

Operator

Thank you for standing by, and welcome to the Tencent Holdings Limited 2019 Second Quarter and Interim Results Conference Call. At this time, all participants are in listen-only mode. There will be a presentation followed by a question-and-answer session. (Operator Instructions) I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Thank you, and good evening. Welcome to our 2019 second quarter and interim results conference call. I'm Jane Yip from the IR team of Tencent.

Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the Company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight, our Chairman and CEO, Pony Ma will kick off with a short overview; President, Martin Lau will discuss strategic review; Chief Strategy Officer, James Mitchell will speak to the business review; and our Chief Financial Officer, John Lo will conclude with financial review before we open the floor for questions.

I will now turn the call over to Pony.

Huateng Ma, Chairman

Thank you, Jane. Good evening. Thank you for joining us. During the second quarter of 2019, we sustained solid year-on-year growth in users, revenues and profit. In games, we released successful new titles in several genres and popularized [ph] innovative game experience, while promoting balanced gameplay for young players. In payment, we've widened merchant adoption and grew average transaction and total payment value rapidly. In content, we deepened our exclusive relationship with NBA, the most-watched professional sports league in China and reinforces our position as a leading digital entertainment platform. Our diversified business portfolio has broadened our revenue streams and strengthened our business in the current challenging business environment. We will continue to invest to enhance our platforms, services and technologies to better support our users and enterprise customers.

I will now share a few highlight numbers. Total revenue was RMB88.8 billion, up 21% year-on-year and 4% quarter-on-quarter. Gross profit was RMB39.1 billion, up 14% year-on-year or down 2% quarter-on-quarter. Non-GAAP operating profit was RMB27.3 billion, up 23% year-on-year or down 4% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB23.5 billion, up 19% year-on-year or 12% quarter-on-quarter.

Moving to platform update. In Social, combined MAU of Weixin and WeChat increased 7% year-on-year to 1.133 billion, benefiting from the wide adoption of Mini Programs and Weixin Pay. Smart devices MAU of QQ was largely stable at 707 million. In games, our new game, Peacekeeper Elite has become one of the faster performing games in China. Users' activities increased in our flagship titles, driven by new content and season passes. Internationally, PUBG MOBILE grew our global user base. In media, daily video views within Tencent Video apps increased year-on-year due to our popular anime series and video clips from hit dramas.

We are enhancing short and mini video distribution across Mobile QQ Browser, QQ KanDian, and Weixin top stories [ph]. In payment, we operate the largest mobile payment platform in China with a robust growth in users, merchants and transaction volumes. In cloud, we are the number two public cloud service provider in China steadily picking up market share amidst intense competition. In utilities, QQ Browser is a key platform for distributing our content feeds. We applied our industry in leading security capabilities to enhance the offerings of our smart industry solutions for the financial, healthcare and retail sectors.

I will now invite Martin to discuss the strategic review.

Martin Lau, President

Thank you, Pony, and good morning, good evening to everybody. Today I'll talk about our leadership in creating and providing high-quality content, which is a key strategic asset and capability in our overall content business and it has fueled the growth of our long video platform. We also provide differentiated content for our short video and mini video platforms going forward.

Many observers questioned the role of high-quality content given the recent boom in user-generated content such as mini videos. We believe high-quality content as enduring an persistent appeal providing users with education, lifelong bonding experiences, immersion and stimulation in a way that is difficult for short-form user-generated content to match. While short and mini videos have captured significant time spent, we believe it was mostly additive to Internet time spent as opposed to taking time away from high-quality content.

The length of user time spent on high-quality content such as professional sports, eSports and popular drama series continues to show healthy growth trends. Moreover, there are emerging synergies between long and short-form content and we can capture the growing opportunities of both. For example, we are re-purposing our high-quality content to produce video clips and highlights for mini videos contributing to rapid growth in short video consumption within our Tencent Video application, as well as in our new feeds.

Our leading games are also sources of many popular short and mini videos. We believe we have unrivaled capabilities in terms of producing, curating, and operating high-quality content. First, we source high-quality content both internally and externally. On the one hand, we possess market-leading in-house IP incubation platforms, such as China Literature Group, Tencent Games, Tencent Video and Tencent Comics. On the other hand, we partner with global best-in-class content providers, such as the NBA, Sony, Universal, Warner and the BBC to name a few to bring their content to target audiences in China. Second, we have accumulated insights and expertise in content management. Our operations team manage, curate and deliver content to target audiences in suitable formats coupled with the right storytelling and packaging, while our technology groups ensure smooth content delivery. Third, we use our content platforms such as Tencent Games and Tencent Video, as well as our communication and social platforms, Weixin and QQ to bring content to the widest possible user base with amplifications through social interactions. In turn, the users become enthusiastic fans of the content, creating resonance and loyalty to the IP.

In the next two pages I'll discuss two case studies to illustrate how we create, curate and enhance high-quality content using our platforms. The first one is on novels. With our subsidiary, China Literature, we have become the market leader in terms of incubating online novels and converting them into hit entertainment formats in China. For example, The King's Avatar is a popular China Literature novel about an eSports player. We have created drama series and anime series based on The King's Avatar IP with each ranked number one of its kind by video views during their broadcast periods. We are also about to release a movie and we develop and publish mobile games based on this IP.

The Master of Diabolism is another novel from a joint venture under China Literature and it's especially popular among female readers. We've produced two series of its anime and cumulated, generated over 2.2 billion video views on our platform. We also released the drama series based on The Master of Diabolism, which ranked the top costume drama by video views in the heavily contested month of July of this year.

Our second case study illustrates our ability to partner with the best content internationally and sharply upsize its China audience base. Since we signed our first exclusive contract with the NBA in 2015, we have helped the NBA to approximately triple its full season audience to 490 million viewers and its average per game live-streaming audience to 3.7 million viewers. This growth both boosted the NBA's brand power in China and substantially increased its monetization capability. On the other hand, it has also contributed to Tencent Sports becoming the top online destination for sports fans. Based on the success of the first contract, we recently announced that we have successfully extended our partnership with NBA for five more years. Looking forward, we intend to deliver NBA content across high-DAU platforms in live-streaming, video-on-demand, short and mini video formats with even better innovative packaging. We intend to enrich NBA VIP and membership benefits including club merchandise and online streaming privileges, and at the same time, we intend to cooperate further with NBA in developing NBA branded mobile games and eSports events.

So with that, I'll pass to James to talk about the business review.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Thank you, Martin. For the second quarter of 2019, our total revenue grew 21% year-on-year. VAS remained our largest revenue segment, representing 54% of our revenue; within which online games were 31% and social networks, 23%. Online advertising was 18% of our revenue, and FinTech and Business Services represented 26%. Looking at value-added services, segment revenue was RMB48.1 billion in the second quarter, up 14% year-on-year and down 2% quarter-on-quarter.

Social networks' revenue was RMB20.8 billion, up 23% year-on-year and up 2% quarter-on-quarter. Virtual item sales in live-streaming services and games contributed notably to the year-on-year and quarter-on-quarter growth rates. Our VAS subscription counts increased 10% year-on-year to 169 million due to the growth of online video and music subscription services, within which video subscriptions were 97 million, up 30% year-on-year and up 9% quarter-on-quarter due to factors including joint membership promotions with our partners such as JD.com and Meituan-Dianping, as well as the popularity of our Chinese anime series.

For online games, total smartphone games revenue increased 26% year-on-year to RMB22.2 billion, benefiting from the popularity of key titles and new releases. Sequentially, smartphone game revenue grew 5% as we launched more games following the renewal of the banhao approval process offsetting weak seasonality.

PC client game revenue decreased 9% year-on-year, although cash receipts increased year-on-year. PC client game revenue decreased 15% quarter-on-quarter due to adverse seasonality. Focusing on our social networks, Weixin and QQ continued to enhance their chat experiences in content consumption boosting user engagements and time spent. For Weixin, we're successfully building out a uniquely vibrant Mini Programs ecosystem. By providing development tools, access to consumers and monetization opportunities, Mini Programs helped developers and service providers efficiently expand their businesses online. The number of mid and long term Mini Programs more than doubled year-on-year. Mini Programs are also becoming more diversified in nature. For example, content Mini Programs allow users to conveniently create, upload and share videos, music and news within Weixin. More than a dozen content Mini Programs have attained over 1 million DAUs.

Benefiting from the popularity of Mini Programs, Weixin broadened it's use cases and grew its user time spent. In our latest upgrade for Mobile QQ, we introduced QQ Mini Programs, within which entertainments and game categories are particularly popular among the QQ users. We enriched the QQ Chat experience by enhanced functionalities for video and voice messages and added an extended screen photo format boosting daily messages per user quarter-on-quarter. And we helped users expand their social graph to an upgraded algorithm to recommend connections based on common interests and shared contacts.

For smartphone games, existing titles and recent releases drove resumed revenue growth. We launched 10 games this quarter, up from one game in the first quarter, including an augmented reality game, Catchya and role-playing games such as Fairy Tail and Raziel. Honour of Kings increased its revenue year-on-year benefiting from its season pass initiative. Other games that notably contributed to quarterly revenue, included earlier releases such as Naruto Mobile and Red Alert Online, as well as more recent titles such as Perfect World Mobile. Peacekeeper Elite has now exceeded 50 million daily active users and it's in early stage monetization particularly via season passes. However, its revenue contribution this quarter was very small due to our revenue deferral policy.

In July, we released three games in different genres, KartRider Rush is a racing car game, Game of Thrones: Winter is Coming is a strategy game and Dragon Raja is a role-playing game. The fact that all three games have achieved top 10 positions in the iOS grossing chart in China is a positive sign for our industry pointing to player demand for a range of experiences, which appear to complement rather than cannibalize each other.

Internationally, PUBG MOBILE attained over 50 million daily active users, while new games Speed Drifter and Chess Rush achieved initial popularity. For PC client games, League of Legends's new play mode, Teamfight Tactics has become the clear global leader in the auto-chess category since releasing internationally in June and in China in July benefiting its daily active users in time spent. League of Legends China cash receipts increased year-on-year due to popular eSports-themed skins. For Dungeon & Fighter, we're currently prioritizing enhancing the user experience. I'm putting less emphasis on player spending initiatives for the next few months.

Moving to our online advertising business. Segment revenue increased 16% year-on-year to RMB16.4 billion amidst challenging macroeconomic conditions and increased short video ad inventory supply. We expect these negative factors may continue impacting the industry through the rest of this year. Sequentially, our advertising revenue increased 23% benefiting from seasonally high demand from categories such as eCommerce and online education.

Our media advertising revenue was RMB4.4 billion, down 7% year-on-year or up 26% quarter-on-quarter. The year-on-year decrease was mainly due to the absence of the FIFA World Cup this year and the unexpected delay of certain top-tier drama series. Operationally, our mobile video DAU was stable year-on-year as consumers continue to value the differentiated storytelling and immersive experiences that long-form video can provide versus short-form video. In April, we released Season 2 of Produce 101, a highly popular variety show, which achieved record ad billings for Tencent Video program.

Our social and others advertising revenue was RMB12 billion, up 28% year-on-year and up 21% quarter-on-quarter. Growth benefited from more ad inventory and impressions, notably, the third ad load in Weixin Moments and the ad inventory in our QQ KanDian news feed.

Looking at FinTech and Business Services, segment revenue was RMB22.9 billion, up 37% year-on-year and up 5% quarter-on-quarter. Excluding the negative impact of reduced interest income on custodian cash balances, segment revenue was up 57% year-on-year and up 7% quarter-on-quarter.

Within FinTech services, commercial payment grew rapidly in terms of users, merchants, transaction volumes and revenue driving the year-to-year segment revenue growth. Our commercial payment volume grew over 10% quarter-on-quarter. LiCaiTong grew its AUM over 30% in the past six months to over RMB800 billion as of June indicating a trend that our users are increasingly keeping money within our payment system. This trend lowers the frictional cost for users to use Weixin Pay and also has the effect of reducing our withdrawal fees and thus our revenue as well as our bank charge expenses. The overall impact should enhance the vitality of our FinTech business in the long run. We continue to focus on FinTech risk management to sustain long-term platform growth.

Within Business Services, expanding our industry-facing sales teams and enhancing our product offerings enabled us to sign up more key accounts and large contracts, which contributed to rapid cloud services revenue growth year-on-year. Through close partnerships with independent software vendors and resellers, we've also increased our cloud services penetration amongst small and medium businesses.

And with that, I'll pass to John to discuss the financial review.

John Lo, Chief Financial Officer and Senior Vice President

Thank you, James. Hello, everyone. For the second quarter of 2019, total revenue was RMB88.8 billion, up 21% year-on-year or 4% quarter-on-quarter. Gross profit was RMB39.1 billion, up 14% year-on-year or down 2% quarter-on-quarter. Net other gains was RMB4 billion, down 64% sequentially. Lower net gains from investees and high impairment provision against certain adjustments, which are both non-GAAP adjustments were the reasons for sequential decrease. Operating profit was RMB27.5 billion, up 26% year-on-year or down 25% quarter-on-quarter. Net finance costs were at RMB2 billion, up 72% year-on-year and 77% quarter-on-quarter. The increase was primarily driven by greater interest expense as a result of recent bond issuance and ForEx loss.

Share profit of associates and joint venture was approximately RMB2.4 billion compared to share of losses of RMB3 billion last quarter. On a non-GAAP basis, share profit of associates and JV was RMB2.4 billion compared to share of losses of RMB518 million last quarter, due to improved performance of certain investees. Income tax expense was RMB3.2 billion, down 10% year-on-year and 33% quarter-on-quarter, mainly due to recognition of tax benefit. The effective tax rate for the quarter was 11.6%. GAAP net profit attributable to shareholders was RMB24.1 billion and GAAP diluted EPS was RMB2.52, both metrics up 35% year-on-year or down 11% quarter-on-quarter. On a non-GAAP basis, net profit was RMB23.5 billion and diluted EPS was RMB2.46, both went up 19% year-on-year and 12% quarter-on-quarter.

Let me walk you through our non-GAAP financial numbers. Operating profit was RMB27.3 billion, up 23% year-on-year or down 4% quarter-on-quarter. Operating margin was 30.7%, up 0.5 percentage point year-on-year or down 2.6 percentage points quarter-on-quarter. Net margin was 27.2%, down 0.6 percentage point year-on-year or up 1.8 percentage points quarter-on-quarter.

Turning to segment gross margin. Gross margin for VAS was 52.6%, down 6.4 percentage points year-on-year and 5 percentage points quarter-on-quarter. The year-on-year decrease reflected revenue mix shift to low-margin products, sequentially, margin contraction was a result of higher video content cost and revenue mix shift to lower margin products, such as black box cars [ph] and licensed games. Gross margin for online advertising was 48.6%, up 11.2 percentage points year-on-year and 6.7 percentage points quarter-on-quarter. The year-on-year increase primarily reflected rapid growth of social apps. Sequentially, seasonal uptick of China advertising market contributed to margin expansion. Gross margins for FinTech and Business Services was 24%, down 2 percentage points year-on-year and 4.5 percentage points quarter-on-quarter. The absence of interest income from the custodian accounts per PBOC guidelines since mid-January was the main reason behind the year-on-year decrease. The rapid growth of commercial payment business accounts for the sequential decline. On operating expenses, selling and marketing expenses were at RMB4.7 billion, down 26% year-on-year or up 11% quarter-on-quarter.

The year-on-year decrease reflected our prudent cost management initiatives. Sequentially, selling and marketing expenses increased due to marketing activities for new game releases following the resumption of banhao approval process. Selling and marketing expense represented 5.3% of quarterly revenue. G&A expenses were RMB12.6 billion, up 28% year-on-year and 11% quarter-on-quarter, primarily driven by increase in R&D expenses and staff costs. Within G&A, R&D expenses were RMB7.1 billion, up 24% year-on-year and 10% quarter-on-quarter. As a percentage of quarterly revenue, G&A was 14.2% and R&D was 8%. At quarter-end, we had approximately 56,300 employees, up 15% year-on-year and 3% quarter-on-quarter.

Let's take a look at the margin ratios. Gross margin was 44.1%, down 2% -- 2.7 percentage points year-on-year and 2.5 percentage points quarter-on-quarter. Our blended gross margin contracted due to pull-through from reduced VAS gross margin and mix shift to lower margin revenues. Non-GAAP operating margin was 30.7% broadly stable year-on-year and down 2.6 percentage points quarter-on-quarter. Non-GAAP net margin was 27.2%, broadly stable year-on-year and up 1.8 percentage points quarter-on-quarter.

Before I close my remarks, I will share some key financial metrics for the second quarter. Total capex was RMB4.4 billion, down 38% year-on-year and 3% quarter-on-quarter, of which operating capex dropped 43% year-on-year to RMB3.8 billion, because last year we purchased large quantity of service to support our cloud business expansion. Non-operating capex increased year-on-year to RMB602 million. Free cash flow was RMB20.7 billion, up 27% year-on-year or down 14% quarter-on-quarter. Net debt position was RMB15.8 billion, which has improved 55% compared to last year. In the second quarter, our total cash grew 6% quarter-on-quarter following payments for annual dividends and M&A activities, while total debt grew 9% quarter-on-quarter due to our recent bond issuance. As a result, our net debt position increased 64% from the previous quarter. The fair value of our shareholdings in listed investee companies excluding subsidiaries was approximately RMB329 [ph] billion or roughly US$48 billion compared to RMB310.7 billion or roughly US$46 billion last quarter.

Thank you. We shall open the floor for questions.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Operator, shall we have the first question, please.

Questions And Answers

Operator

Thank you. We have the first question comes from the line of Alex Yao from JPMorgan. Please ask your question. Please note you are allowed to ask one question each time.

Alex Yao, Analyst

Thank you management for taking my question. Very quick one on the advertising outlook in the coming quarters. Can you talk about the macro-environment, as well as the oversupply situation. I think James you mentioned that you expect this oversupply situation will persist into second half this year, what are your strategies to address such a market condition and how do you think about the 2020 outlook? Do you think the current oversupply situation will be better? Would there be a new incremental advertising release over the next four quarters or so? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Thank you for the question, Alex. So, our assumption is that the macro-environment will remain difficult for the rest of the year and that the situation of heavy supply of advertising inventory will continue for the rest of the year and potentially into next year. And that obviously flows through to some extent into our advertising revenue particularly on the media side and particularly with industries such as automobiles, real estate, financial services. In terms of what we can do then, some of these challenges around the macro-economic situation around the industry-wide inventory supply not within our direct control. What we can control the factors such as the rate of our own inventory growth, our ability to provide new tools to advertisers, our capabilities in terms of targeting ads to the right users. And those factors also have an impact on our growth rate. And so we seek to use those factors to sustain what we view as a healthy although not super rapid rate of advertising in the current challenging environment. Thank you.

Operator

Thank you. The next question comes from the line of Alicia Yap from Citigroup. Please ask your question.

Alicia Yap, Analyst

Hi, good evening, management. Thanks for taking my questions. My question is regarding the online games. How should we reconcile this discrepancy between our expectation versus the reported games revenue and the deferred revenues growth this quarter? You noted in the press release that the Peacekeeper Elite, the game has seasoned initial success right in monetization, but with limited reported revenues in the second quarter due to the deferred impact, but yet your sequential growth in the deferred revenue really didn't show very strong number. So, we understand it could be related to different movement or contribution from different games and the timing, but could you walk us through how we should be looking at the provided number to judge or estimate the trend for the third quarter and the second half gaming revenue growth?

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Thank you, Alicia. So in terms of the game revenue trends in the second quarter, as you're probably aware, the second quarter is seasonally a much slower quarter than the first quarter. And if you took at our history than historically, our game reported revenue and the deferred revenue associated with games have often declined quarter-on-quarter from the first quarter. If you look at some of our listed comparables, their deferred revenue associated with games declined to double-digit rate quarter-on-quarter.

So I think that on our side, the fact that this year's second quarter both our reported revenue and our deferred revenue increased quarter-on-quarter for the smartphone games is actually quite positive and encouraging. And zooming in on Peacekeeper Elite, and -- the game has launched strongly. It is generating healthy revenue now from its season passes. However, the very large majority of our Peacekeeper Elite's cash flow generation in the second quarter was deferred to subsequent quarters. So, only a minority -- a small minority was captured in our reported revenue line and Peacekeeper Elite was not even among our top 10 games in terms of reported revenue in the second quarter. On the other hand, we saw a pretty healthy quarter-on-quarter trends from a number of our mobile games, including PUBG MOBILE internationally, including our new game Catchya, including Perfect World Mobile. So, I think overall, we were quite happy with the recovery in smartphone game revenue. Now obviously, it takes some time for -- what we see to flow through fully into reported financials because of revenue cycle, but the fact that deferred revenue was up quarter-on-quarter and more seasonally a slow quarter for deferred revenue, I think gives us some comfort on our side. Thank you.

Operator

Thank you. The next question comes from the line of Eddie Leung from Bank of America. Please ask your question.

Eddie Leung, Analyst

Good evening. Thank you for taking my questions. Could you tell a little bit about your strategy in high-quality content especially, how you defined on DAU an independent user platform versus investing in certain upstream content providers, given your past experience in investing in game studios for our information? And then just a follow-up question on games, James, could you also give us your thought on the potential new entrants from the short video industry? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Yes. In terms of the high-quality content, I would say our platform strategy is actually to be an all-inclusive platform. We try to include as much content as possible, so that you can see with respect to our video platform and as well as China Literature. But at the same time, what we find is that -- and that applies to our music platform as well, but what we find in becoming a strong all-inclusive content platform there is actually a lot of synergies, if we can work with the content providers more closely.

And as a result, when you look at our games platform, for example, we have been very early on investing in game studios, so that we try to establish a very deep partnership as well as close partnership relationship with the content providers, because we felt that once we have that relationship, a lot of times what we can do is we can curate the content better, we can take a long-term perspective and invest in the content better, and we can understand the content more and we can help the content developers to understand our platform more. So that as a whole, we can actually help the content to be more popular within our user base and at the same time, for our user base, we can contribute more traffic to the content developers. So it's a win-win relationship that we can build once we have a deeper relationship as opposed to just a mercantile relationship. So, in almost every single content platform, we have tried to find different ways to establish a stronger relationship with the content providers. And that is one of the reason why we have very strong capability in creating, in curating, as well as in popularizing the high-quality content.

Now, I would say within the games segment, right, when you look at potential new entrants from mini video player, I think overall, we felt there is already a lot of competitors in the gaming sector. And throughout the history, the game industry actually thrive on having a lot of different competition. And to some extent, I would say, we welcome new entrants to some extent, because when people bring in new ideas, this is exactly how we can actually expand the gaming industry, the gaming industry is actually driven by innovation.

Now, we do believe that in order to be a very strong player in games, you actually require a lot of domain expertise, which took us many, many, many years to build. And at the same time, I would also want to say that for our existing games and especially, the very large games right, there's extremely strong network effect in the games especially, when it's coupled with our social network and that's a unique advantage that we have. So I think overall, we are not too concerned about having more and more players to be playing in the gaming market. And I also want to point out that when you are already a player that's making a lot of revenue from apps, the incentive to move into gaming is actually not extremely obvious because to some extent, you're already making a lot of revenue from the gaming industry as a whole. So, that's sort of what my reaction is.

Operator

Thank you. The next question comes from the line of Grace Chen from Morgan Stanley. Please ask your question.

Grace Chen, Analyst

Thank you. Thank you for taking my call. My question is about the cloud business. The -- I noticed that in the press release said that, Tencent deepened partnership penetration in the small and medium business through close partnerships with independent software vendors. So I'm wondering whether the management can elaborate more about the partnerships with software vendors? Are there -- are these mainly international or domestic software partners and in which type of software solutions? Also is Tencent interested in developing in-house software solutions and what type of software solutions that, that could be? Thank you very much.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

In terms of our cloud business, as you know, number one, I want to say our cloud business have actually sort of registered very strong growth in the quarter and we believe we have been consistently picking up market share in the past few quarters. Now with respect to the mix of the cloud business, right, we have been traditionally quite strong in terms of getting businesses from Internet players. And more recently, we have also made pretty strong inroads into some of the enterprise sectors, including financial verticals, including government verticals.

And the last piece of the puzzle is really building more exposure to the small and medium enterprises, which I think over the past couple of quarters, we have made good progress. And that progress is mainly made with respect to what you have described, which is building relationships through the ISVs, and through the ISVs, who have a lot of connection to the different SMEs, right, where you can actually sell our cloud solutions to them.

And these ISVs, they maybe experts in a particular industry, so, for example, they may be experts in a restaurant industry, some of them maybe experts in the financial or retail industry, and when we build relationships with them, we can actually through them cover a lot of smaller players and companies and customers within those sectors. There are also some companies, who are bigger in size and in some of these companies we have actually invested in them in order to establish a stronger relationship. So take the example of Donghua Software or Beiming, there are number of ISVs, larger ones that we have invested in them, so that we can actually go through them in order for us to cover the small and medium enterprises. I also want to point out that another initiative that we've done with respect to the small and medium enterprises is increasing our toolkit for Mini Programs. When we can provide a set of tools for companies to connect their Mini Programs to our cloud services, then we have a much higher probability of picking them up as our cloud solutions.

Now, one more point to add is that in addition to all these initiatives, we have also been developing SaaS solutions both on our own, as well as working with SaaS providers in China, so that we have exposure to SaaS software solutions such as CRM, such as document processing, as well as enterprise messaging. So, we believe our SaaS initiative is also another way through which we can cover small and medium enterprises in the cloud market.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Thank you. And the next question, please.

Operator

The next question comes from the line of John Choi from Daiwa Capital Markets (sic). Please ask your question.

John Choi, Analyst

Thank you for taking my question. I have a question on your marketing expense. This quarter we've seen a pretty -- came down quite a bit on year-over-year and I think on the press release you said you guys have reduced on less effective marketing campaigns. Can you guys elaborate a bit more on these initiatives and how should we think about the spending trend for marketing and also -- sales and marketing -- and also for other OpEx items towards the end of the year? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Yes, I think since the last quarter -- last quarter last year, we had very strong control on selling and marketing expenses. In particular, we will look at -- while they are spending, we will look at whether they have been spent effectively and efficiently, and if it doesn't meet our threshold, then we will cut the entire campaign completely. As opposed to in the past, we tend to assign a budget and we just sort of let them finish all the marketing activities before doing a thorough assessment on the ROIs. And I think there are other ways in which we can measure the effectiveness by comparing similar activities between different business groups and between different departments to ensure that we get the best -- have control of this -- those marketing activities. Also, I think we do have -- we do give out budget on a piecemeal basis as opposed to in the past in which we give out all the budget all at the same time and we do reviews [ph] on a monthly basis to ensure that you know the marketing objectives have been matched before assigning the following month's budget for that. That's why you have been seeing a sharp decline in the selling and marketing expenses in the past two to three quarters on year-on-year basis. Going forward, of course, this initiative will continue, but at the same time, as you understand, those marketing activities can dial [ph] up and down according to needs and the amount and according to how our competitors spend in particular in some areas just like payment. Like a year ago, we have been spending quite a lot in the payment side, but once we get to certain momentum and when compared with spending versus our peers, we tend to spend less and more wisely.

Huateng Ma, Chairman

So I think to summarize, one is very strong cost control initiative at the company. Second, I would say there is some -- because of the macro-environment we can get better deals in terms of advertising and promotions. Thirdly, with respect to certain verticals such as payment, when the revenue of the market get hit, right, when interest income were actually taken away, the marketing spend of the different players actually get rationalized a bit. So it's a balancing act. But going forward, I think we believe a lot of the fat has been cut already and then when we are ready to promote for new games, right, then the marketing expenses will probably go up. But I think overall, because of the cost control and the overall market environment, I think it's much healthier marketing environment now than before.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Thank you. And the next question, please.

Operator

The next question comes from the line of Binnie Wong from HSBC. Please ask your question.

Binnie Wong, Analyst

Thank you management for taking the questions. My question is on the video side. So on the short-form video, thank you for highlighting the differentiation of your short video against your peers in your opening remark, and if you think about how to yield the maximum synergies, right, from your unique advantages in your content creation platform, I guess what it boils down to is, how effective and how targeted we can push the right format to your target audience. So I guess the question is, how much data user insight is the short video team or your technology team can be shared to do them all right -- to do the -- better targeting than our peers? And then the second question is on the long-form video side, how should we think about to mitigate the negative impact on the media as of unexpected drama delay especially when we are approaching the National Day and there might be more regulatory, I mean, in terms of the tightening on the content side, and then how are we thinking about any operational measures such as any product change in terms of the type of drama to drive revenue growth on the media front? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Well, I think we do have a lot of data about our users. So over time, we have been building a lot of technologies in order for us to leverage these data, right, for feeding the right short and mini video to our users. I think so far the result has been encouraging especially, after the establishment of our PCG because we consolidated our tech resources to create the tech platform that can support our long video, our short video and our mini video. I think more progress have been made on the short video front, because if you look at the short video growth within our overall platform has actually grown very strongly across our QQ KanDian, our QQ Browser, as well ours -- as well as Tencent Video. So, that actually has made very significant progress.

Now with respect to mini videos, I think it would take some time before we really start to promote our Weixu [ph]. On Weixu, we actually viewed it as a very strategic product for us. We will be building up the technology, the content curation capability, as well as the ability for us to target the mini video to the different users through a recommended feed over the long run. And as and when our engagement and retention have reached our target, we will actually start promoting it in a very big way.

John Lo, Chief Financial Officer and Senior Vice President

In term -- Binnie, in terms of your question about long-form video and how we mitigate the impact of the unexpected delays to key drama series, then I think at a high level, we don't necessarily seek to mitigate fluctuations in individual business lines by doing things in adjacent business lines. You saw last year that when our game revenue, which was a much bigger proportion of our total revenue than video was under pressure, we didn't seek to accelerate monetization elsewhere. We believe we have a relatively diversified broad revenue mix. And one of the strengths of the position we're in is that we can afford to take some hits in the nature of the business and rely on the breadth and depth of our capabilities to move us forward. So, that's a high-level answer. Now getting a little bit more granular in terms of what the video team are doing in this environment, clearly, from a content perspective given the difficulty putting drama series and especially, historical costume drama series on air, we have been doubling down our focus on some other content categories. So we've talked a great deal about Chinese anime, where we believe we're the clear market leader now in terms of both production and distribution and where we can leverage the competitive advantage that accrues to us from our relationship with China Literature as the upstream inspiration for many of these animated TV series. We've been an aggressive investor in documentaries, and then our Produce 101 variety show, we think is the highest rating and highest grossing variety show in the market. So that's on the content side.

On the revenue side, the traditional 30-second spot advertising revenue is under pressure because of macro factors and because of the delays to the drama series. That said, we continue to grow our subscription revenue at a reasonably fast rate. And in the past 12 months, we've more than doubled or approximately tripled the advertising revenue on the news feed inside our Tencent Video app, which is less directly tied to individual hit content and more broadly related to the daily active user base of the app, which remains healthy despite some of the challenges we are facing.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Thank you. And the next question, please.

Operator

Next question comes from the line of Gregory Zhao from Barclays. Please ask your question.

Gregory Zhao, Analyst

Hi, management, thanks for taking my question. As I think starting from September, JD reported TeamBuy [ph] business towards Weixin level one entry and we also know Pinduoduo actually leveraged your social network and launched a very unique TeamBuy business model in the past two years. So just want to check your expectation on JD's new launch on the TeamBuy? And also want to understand your strategies to balance your resources to our investment company? And also very quick follow-up on the content cost. I think you mentioned you increased your -- the cost in shorter video side. So specifically, I want to understand in which area will you spend the money, do you directly pay for some MCNs [ph] or some video studios to produce some shorter video contents? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

In terms of JD, we did renew the contract and they are going to launch a new user experience. We continue to believe that there is a lot of potential with respect to both building an e-commerce ecosystem within Weixin and the level one entry point for users, because I think as our experience shows, there are a lot of users who actually go into that entry point. And if the entry point is going to be able to provide a great user experience and at the same time provide great products to the users and have a high retention rate for the individual users, as well as create some additional leverage over our social network, right, there could be a lot of potential in the level one entry point.

So we do believe there is potential and we hope the new product design would actually sort of unleash some of these potential. I think interestingly you have brought up Pinduoduo, which for a long time, right, they did not have a level one entry point and they have been able to leverage the social network to bring great benefits to their own business, right, which to some extent validates the point that I made, which is there is a lot of potential within Weixin to build a strong ecosystem around e-commerce.

And if you see now, we have provided a level two entry point for Pinduoduo. And I think these two user experiences are actually quite different and we do intend to provide help to both companies in order to generate the right user experience, as well as the right user excitement according to their differentiated product experience and category management experience. Now on content, maybe John, do you want to answer that question?

John Lo, Chief Financial Officer and Senior Vice President

All right. I think in terms of short video content, a lot of those contents are self-generated and there are not a lot of content costs in [ph] which we pay to MCNs or whatever right now.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Okay. Thank you. So due to the time constraint, may we have the last three questions, please.

Operator

The next question comes from the line of Jerry Liu from UBS. Please ask your question.

Jerry Liu, Analyst

Hey, thank you very much. My question is on FinTech. We've seen pretty good revenue growth and margin improvement in this business, but this quarter we also flagged the fact that users are not withdrawing the cash actually slowed the revenue growth and margin -- margins a bit. Just wanted to get an outlook for the next few quarters maybe next couple of years as we develop more financial products marketplace as we do new services and products in this area, how do we see the revenue growth in margins trending? Thanks.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

Well, number one, as you have pointed out, the trend, the short-term trend is actually the users actually keeping more money within our ecosystem. And as a result, the short-term impact is that it affects the revenue because the users are withdrawing less cash and since we've already paid for the cost, the banking cost of such cash, when they withdraw less, the margin also get impacted negatively.

But net-net, it's actually a very good trend from our perspective, because it helps the users to be transferring money and paying for services at zero cost when they keep the money within our system, right. So the frictional cost has been reduced. So it's actually structurally a great and a very healthy trend for the overall payment system, which then brings to the next question, which is over the long run, we do believe FinTech business has got a lot of potential, right. This is something which is I would say similar to our social and performance ad right. We viewed it as a multi-year -- multi-year growth opportunity. And there is already a very large user base. There is already a very large transaction volume and a lot of merchants actually rely on the payment platform to actually conduct their businesses.

So by and large, right, we have a lot of traffic and platform franchise to actually monetize. But at the same time, what we want to do is actually monetize through value-added way, not through just keep increasing the charges, because we felt that it's still a very competitive environment. So, in terms of going forward, FinTech services particularly, our micro loans could be quite important. But under the current environment, right, while there is still a lot of potential in terms of expanding our loan portfolio, we do want to make sure that it's expanded in a measured way, so that our risk management is actually done in the proper way especially, under the current macro-environment, right, we try to be airing even on the more conservative side to make sure that we are not exposing ourselves to too much risk. And at the same time, since, clearly, there is a lot of headroom for us to grow, right, we want to spread over a multi-year period rather than try to draw it all in a short period of time. So, that's how we look at our overall FinTech services.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

The next question, please.

Operator

The next question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask your question.

Piyush Mubayi, Analyst

Martin, can I just ask another question on FinTech, you talked about the broader direction, you talked about a few specifics, but could you also talk through what's going on with the payment -- the competitive landscape at this point? Any new strategies that you're deploying and confirm whether there has been a change of guard from your side? And if I might ask about two quarters ago you talked about commercial being more than 50%, I think that was in fourth quarter, where are we on that number? And lastly, the gross margins were down about 400 basis points on a sequential basis, is that a new number we should go with or can we see that potentially bounce back to where we were a quarter ago? Thank you.

Martin Lau, President

I think in terms of the overall competitive landscape, I think our positioning is still very strong, especially, in terms of the frequency payment. I think we are the highest DAU, as well as MAU payment platform in China and I think the number of transactions that we have is also highest. And in terms of the overall transaction volume of our commercial transactions, it has been growing at a faster rate than the overall transactions too. So, I think the overall positioning is actually quite strong. In terms of -- what was your second question with respect to numbers, we missed that, sorry? The payment margin, I think it is a function of many different numbers. So, I think as the payment business is still in a flux of changes particularly with the taking away of the interest and this new change in which we were able to retain more of the cash within the overall system, which is having impact on both the revenue and the cost and the velocity of payment. I think at this point, it's hard to make a number at this point of time. I think it will probably take a couple of quarters for us to take a more stabilized view of the business then we can probably give you a better number.

And the final question, please.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

And the final question, please.

Operator

This is the last question comes from the line of Thomas Chong from Jefferies. Please ask your question.

Thomas Chong, Analyst

Hi, thanks, management for taking my questions. I have a question regarding our M&A strategies. Given you have talked a lot about content, should we expect our M&A strategies to focus more on music or short-form video going forward or games because that's [ph] -- can management give us some direction on how we use our cash? Thank you.

James Mitchell, Chief Strategy Officer and Senior Executive Vice President

So, thank you for the question, Thomas. In general, if you look at the total amount of capital we're deploying in investments then the rate of investment has slowed quite notably from the first half of 2018 to the second half of '18 and the first half of '19, and that's partly because the amount of capital we're deploying into investments has decelerated after an unusually rapid pace in the first half of '18 when we were investing in smart retail and game broadcast sites. And that's partly also because the rate of divestments has picked up pretty sharply, so in recent months -- in some months, our rate of divestments has matched our rate of investments.

In terms of where we are focusing than historically for the past 10 years or so, we've been quite active investing in upstream content and that includes game studios, that includes TV production businesses, literature, music and that continues. But the greater change is that we have become more active in some of the sort of frontier opportunities particularly enterprise software, also financial technology, education technology to some extent, health-related technology opportunities.

So overall, we continue to invest at a more measured pace than at the beginning of last year. And as the Internet transforms more aspects of everyday life, then we feel that Tencent has a role to play in helping that transformation and sometimes we can play that role entirely by ourselves and sometimes we want to play that role in tandem with partners. And with some of those partners, it makes sense for us to form an equity relationship to deepen institutionalized relationship.

Operator

There are no more questions on the queue. Ms. Yip, please begin your closing remarks.

Jane Yip, Assistant General Manager of Investor Relations and Global Communications

Thank you, and we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. A replay of this webcast will also be available soon, and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating Tencent Holdings Limited 2019 second quarter and interim results conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2019-05-15
Event Description: Q1 2019 Earnings Call

Market Cap: 3.07TRI
Current PX: 322.00
YTD Change($): +8.00
YTD Change(%): +2.548

Bloomberg Estimates - EPS
Current Quarter: 2.354
Current Year: 9.752
Bloomberg Estimates - Sales
Current Quarter: 93951.421
Current Year: 396633.453

Q1 2019 Earnings Call

Company Participants

- Jane Yip, 'IR'
- Pony Ma, 'Chief Executive Officer'
- Martin Lau, 'President'
- James Mitchell, 'Chief Strategy Officer Senior Executive Vice President'
- John Lo, 'Chief Financial Officer Senior Vice President'
- MA Huateng, 'Co-Founder Chairman of the Board and Chief Executive Officer'
- Unidentified Speaker, ''

Other Participants

- Natalie Wu
- Grace Chen
- Wendy Huang
- John Choi
- Alicia Yap
- Gregory Zhao
- Karen Chan
- Binnie Wong
- Eddie Leung
- Han Joon Kim

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Tencent Holdings Limited 2019 First Quarter Results Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. (Operator Instructions) I must advise you that this conference is being recorded today.

I will now hand the conference over to with your host today, Ms.Jane Yip. Thank you, please go ahead.

Jane Yip, 'IR'

Thank you. Good evening.

Welcome to our 2019 first quarter results conference call. I'm Jane Yip from the IR team of Tencent. Before we start a presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS For detailed discussion of risk factors and non-GAAP measures please refer to our disclosure documents are the IR Section of our website. Let me introduce the management team on the call tonight. Our Chairman and CEO, Pony Ma will kick off with a short overview. President Martin Lau will discuss strategic review, Chief Strategy Officer, James Mitchell, will speak to the business review.

And Chief Financial Officer, John Lo will conclude with financial review before we open the floor for questions. I will now turn the call over to Pony.

Pony Ma, 'Chief Executive Officer'

Thank you, Jane. Good evening, everyone.

Thank you for joining us. Our key platforms continue robust growth in users, traffic and activities, nourishing our environment ecosystem, and reinforcing our expansion from consumer internet to industrial internet. In the first quarter of 2019, we generated moderate growth in areas such as online games and our new segment, FinTech and Business Services, contributed too significantly to overall revenue growth year-on-year. We have also managed our cost-effectively amidst the challenging macro and business environment.

Also results for the quarter, total revenue was RMB 85.5 billion, up 16% year-on-year and broadly stable quarter-on-quarter. Gross profit it was RMB 39.8 billion up 7% year-on-year and 13% quarter-on-quarter. Non-GAAP operating profit was RMB 28.5 billion, up 13% year-on-year and 27% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 20.9 billion up 14% year-on-year and 6% quarter-on-quarter.

Now, let me give you a quick update on our key platforms. In social combined MAU of Weixin and WeChat increased 7% year-on-year to over 1.1 billion. Smart devices MAU of QQ increased slightly year-on-year to over 700 million, within which young users became more engaged and grew double-digit year-on-year. Qzone smart devices' MAU was 572 million, up 4% year-on-year.

In online games, we expanded total user base for our overall portfolio. Daily active user benefit from content updates and in-game marketing activities is sold in key PC and mobile titles, such as Honour of Kings, LoL and DnF As well as our new game Perfect World Mobile. In media, Tencent video average daily active users increased slightly year-on-year, while daily video views increased drastically benefiting from short videos and popular anime series. Short and mini-video daily views grew strongly, boosting our media feeds business in mobile QQ Browser, QQ KanDian and Tencent News.

In payment, our merchant networks further expand and enable strong growth in commercial payment business. We operate the largest mobile payment platform in China, measured by active users and the number of transactions. In utilities, our mobile security products continued to strengthen market leadership in its strategically important segment. I will invite Martin to discuss strategic review.

Martin Lau, 'President'

Thank you Pony, and good evening and good morning. Over the years, we have been incubating new businesses organically within the company. Some new businesses have reached significant scale. Starting this quarter, we have a new revenue stream segment called FinTech and Business Services to mark a new milestone for the evolution of our business.

This revenue segment reflects; number one, the emerging demand for digital payments, financial services and enterprise solutions as China's economy grows rapidly; number two, the synergies between these services with our existing online businesses. Number three, the robust scale and operational expertise in these areas accumulated through substantial organic investments for years. And overall, this segment demonstrates our drive to expand our company capabilities as well as to broaden our revenue base. Now, let's take a closer look at FinTech services which constitute the majority of revenues within the segment.

We have two revenue streams in this sub segment. Number one, payments, where merchants pay us transaction fees and consumers pay us cash withdrawal fees, and credit card repayment charges. Number two, other FinTech services such as wealth management, micro-loan and insurance products, where financial institution partners pay us fees and commissions for distributing their products to our user base. As for the business dynamics, social payment fees cover significant costs that we pay to banks, when consumers move money from their bank accounts into our payment system.

On the other hand, commercial payment generates a reasonable gross margin, but bears marketing costs which made it dial up or dial down depending on the competitive dynamics in the market. Micro-loans and wealth management products are generally higher in margin. Overall, we operate our FinTech businesses in a highly regulated environment. Under Business Services, we have two revenue streams, one, cloud where enterprise customers pay for PaaS and SaaS products, as well as our tailored technology solutions.

Secondly, smart industry offerings, where our partners pay service fees for industry specific solutions to assist enterprises in their industry embarking on digital transformation. In terms of business dynamics, cloud business where IaaS and PaaS products make the majority of our offerings, have low margins and is capital intensive. SaaS and technology solutions, which are currently sub-scale in China is expected to generate healthy margins over the longer run. Smart industry solutions are at initial stage but carry attractive business potentials in the future.

Now moving on to discussing milestones and outlooks for the two different sub segments. For FinTech services, we launched Tenpay in 2005, built to the technology rails for our payment service on PC and later expanded into mobile. In 2013, Weixin expedited mobile transition with the launch of Weixin Pay. User adoption quickly expanded especially during the Chinese New Year in 2014, when we used to red envelope gifting function to unleash the power of social payment.

And later to shape consumer habit of using Weixin Pay in commercial transactions. We increased our user stickiness by creating more and more use cases over the years. In 2016, we kicked off our merchant adoption campaign to deepen offline penetration. We signed up flagship partners in key verticals such as retail and restaurants.

In addition, we proliferated our coverage of long-tail merchants through channel partners, as well as leveraging our investee's merchant network. For mom-and-pop store merchants were provided to innovative and easy-to-deploy turnkey solutions such as QR codes and Mini Programs, to enable online and off line convergence. These initiatives allowed us to provide point-of-sales solutions to tens of millions of merchants nationwide. Executing these initiatives, enables payment-related revenue we generated today, as well as supports the efficient distribution of financial services, such as Personal Wealth, products, and micro-loan products online.

With a strong focus on risk management, we have grown our FinTech Business at measured pace. FinTech business also allowed us to build enterprise relationships and industry expertise that are complementary to our emerging Business Services Sub segments. Now for our Business services, our cloud infrastructure was already at substantial scale for meeting our internal cloud requirement, before we begin serving external customers. Built upon our established strength, the internet sector such as games and video, we expanded our external cloud business integrating our technological capabilities in areas such as security, AI, big data analytics, and LBS Through cloud-based solutions, our customers can apply advanced technologies to their businesses, facilitating their digital upgrade.

We differentiate ourselves in this business, not only with advanced technology but also by providing customers with options to connect to our VAS and active user base on Weixin, QQ, Official Accounts, Mini Programs, Payments and WeChat Work etc. We work with our channel partners and ISVs to develop tailored offerings including over 200 IaaS, PaaS and SaaS products and more than 90 industry specific solutions. Through data centers across 25 geographic regions worldwide, we're able to better serve our customers. In return, our scalable services allow us to pass along the benefits to customers through attractive rates or deals maximizing value for their IT budget.

Benefiting from the above initiatives and our full suite of business services, we make breakthroughs in smart industries, such as finance, retail, municipal services, tourism and health care. As example, what built showcases around tourism services in Yunnan province, and municipal services via Digital Guangdong initiative. To conclude the strategic review session, our decade-long investment in FinTech and Business Services prove that our strategy of allocating capital to a range of organic investments can expand our capabilities, broaden our revenue base, as well as generate sustainable profitable growth for the future. Now with that, I will pass to James to talk about business review.

James Mitchell, 'Chief Strategy Officer Senior Executive Vice President'

Thank you Martin. The first quarter of 2019 our revenue grew 16 % year-on-year. VAS remained our largest revenue segment representing 57% of our revenue, within which online games was 33%, and social networks 24%. Online advertising represented 16% of our revenue and our new FinTech and Business Services segment contributed 25%, leaving the other segments at 2% total revenue.

Diving into Value-Added Services, segment revenue was CNY 49 billion in the first quarter, up 4% year-on-year and up 12% quarter-on-quarter. Social network revenue was up 13% year-on-year and up 5% quarter-on-quarter. Virtual gifts and live streaming services and video subscriptions contributed to the year-on-year and quarter-on-quarter growth rates and increased in-game item sales also contributed to the sequential revenue growth. Our total VAS subscription count increased 13% year-on-year to 165 million, due to the growth of online video and music services.

Our video subscription counts for 89 million, up 43% year-on-year, but stable quarter-on-quarter as the rescheduling of several top-tier drama series impacted our rate of new subscriber additions. For online games, our total cash receipts were up 10% year-on-year, while our reported revenue dipped 1% year-on-year. The difference between the cash and reported revenue trends is a result of our deferral policy for virtual items sold within games. PC client games revenue in CNY 13.8 billion, down 2% year-on-year.

And total smartphone games revenue was CNY 21.2 billion also down 2% year-on-year. We released one new mobile game in the quarter, compared to eight games in the first quarter of 2018. Sequentially, reported game revenue grew 18% quarter-on-quarter, due to favorable seasonality plus content updates and key titles. PC client games revenue was up 24% quarter-on-quarter and smartphone game revenue increased 11%.

Moving on to our social networks initiatives. First, social video. Users are increasingly using Weixin and Mobile QQ's in-app camera functions to record samples of their daily lives which they share to friends and in their timelines. Each day, hundreds of millions of videos are uploaded with active users of this function posting an average of four social videos per day.

Second, content video. Our original long-form IPs are developing their own fan bases and activities within our social networks. For example, we recently released Season 2 of Produce 101 for which we provided short and mini-video highlight clips that our users share and vote on, amplifying the usage content engagement. That Mini programs were enabling users to share interesting or practical information products and services for Mini programs, via Weixin Groups.

For example, millions of users participated in community group by activities enabling merchants serving localities to effectively access their potential customers. We released our latest version of Mobile QQ in April, with features for young users such as recommending new friends based on similar interests. And we enabled Mini programs and mini-games within QQ For smartphone games, our user base continues to grow in key genres. Honour of Kings released a substantial content update in January, which increased its active users and monetization.

We introduced additional seasonal skins for limited time sales. For example, the seasonal White Tiger skin was among the game's top-five grossing products to date. Our new 3D massively multiplayer online role-playing game, Perfect World Mobile, generated an enthusiastic response from players increasing our DAU within the role-playing game --. The game has achieved healthy cash receipts, but because we launched it late in the first quarter and because of our deferral policy, the game only contributed marginally to first quarter reported revenue.

Outside China, PUBG MOBILE exhibited strong usage trends exceeding a 100 million monthly active users in February. We introduced the new Royale Pass in PUBG MOBILE in March, to celebrate its first anniversary contributing to higher monetization. Looking forward, we're pursuing multiple initiatives to revitalize growth. First, we're resuming a more normal pace of new game launches in coming quarters.

For example, we launched Peacekeeper Elite to our tactical tournament user base last week. Second, we're introducing Season Passes in several key games in China to stimulate user engagement and retention with opportunities to incrementally increase monetization pay rates to. And third, following the success of PUBG MOBILE in international markets, we'll seek to identify other China developed games suitable for international publishing over the medium term. In PC client games, core users' activity levels and monetization improved quarter-over-quarter, benefiting from favorable seasonality and content updates.

For League of Legends, user engagement grew as we released several skin items which proved very popular driving cash receipts to rebound both year-on-year and quarter-on-quarter. In Dungeon Fighter, we raised the game level cap to 95 in the January content update, enhancing user engagement, and Chinese New Year promotional packages contributed to sequential growth for DnF's paying users and ARPU Shifting to online advertising, segment revenue of CNY 13.4 billion, increased 25% year-on-year, which we view as a reasonable growth rate given an expanded revenue base in challenging macro-environment. Revenue declined 21% sequentially hurt by the seasonality and by rescheduling of top-tier drama series out of the quarter. Media advertising revenue was CNY 3.5 billion, up 5% year-on-year and down 33% quarter-on-quarter.

In-feed ads grew substantially year-on-year and quarter-on-quarter. However, we did not add certain top-tiered drama series that we can intended to broadcast during the first quarter, reducing our video pre-load ad inventory and negatively impacting our overall media advertising revenue. Social and other advertising revenue was CNY 9.9 billion, up 34% year-on-year and down 16% quarter-on-quarter. Higher ad fills rates and increased ad loads across our inventories in Weixin Moments Mini Programs and QQ KanDian contributed to the year-on-year revenue product.

Bidding intensity generally reduced in the first quarter versus e-commerce high season of the fourth quarter pushing down our average cost per clicks quarter-on-quarter. We continue to grow our advertising business at a measured pace reflecting our commitment to optimizing long-term advertiser returns rather than maximizing short-term revenue growth. Looking at our new revenue segments, Fin Tech and business services, for the first quarter segment revenue was CNY 21.8 billion, up 44% year-on-year, to the robust growth in commercial payment, other FinTech services such as -- WeiLiDai and cloud services. Sequentially, segment revenue as stable as healthy growth and commercial payments and cloud services offset the absence of interest income from custodian cash account since January the 14per of People's Bank of China guidelines.

Within FinTech services, commercial payment volume increased sharply year-on-year, driven by more transactions per user. Per user transactions in turn benefited from the number of monthly active merchants accepting our payment service more than doubling year-on-year. Within business services, Tencent cloud sustained a rapid year-on-year revenue growth rate. Our enhanced and broader laaS and PaaS offerings contributed to growth in new customers, and in spending priorities in existing customer.

And with that, I'll pass to John to discuss the financial review.

John Lo, 'Chief Financial Officer Senior Vice President'

Hello everyone. For the first quarter of 2019, total revenue was CNY 85.5 billion, up 16% year-on-year or 1% quarter-on-quarter. Gross profit was CNY 39.8 billion, up 7% year-on-year or 13% quarter-on-quarter.

We have net other gains of CNY 11.1 billion, in contrast to net other losses of CNY 2.1 billion last quarter. To change mainly due to increases in net fair value gains and deemed disposal gain relating to our investee companies, which are both non-GAAP adjustments. During the quarter, we donated CNY 700 million to Tencent Charity Fund. Operating profit was CNY 36.7 billion, up 20% year-on-year, or 113% quarter-on-quarter.

Share of loss of associates and joint ventures was approximately CNY 3 billion compared to share profits of CNY 16 million last quarter. On a non-GAAP basis, share of losses of associates and joint ventures was CNY 518 million compared to share profits of CNY 1.9 billion last quarter. Income tax expense was CNY 400 million down 16%

year-on-year as a result of lower withholding tax as well as entitlements of preferential tax treatments and benefits. The sequential increase was due to recognition of preferential tax benefit for key software enterprise in last quarter.

We stepped to a lower base in the fourth quarter. The effective tax rate for the quarter was 14.7%. GAAP net profit attributable to shareholders was CNY 27.2 billion up 17% year-on-year or 91% quarter-on-quarter. GAAP diluted EPS was CNY 2.844 up 17% year-on-year and 91% quarter-on-quarter.

Let me walk you through the non-GAAP financial numbers. Operating profit was CNY 28.5 billion, up 13% year-on-year or 27% quarter-on-quarter. Operating margin was 33.3% down 1.1 percentage points year-on-year or up 6.9% points quarter-on-quarter. Net profit attributable to shareholders was CNY 20.9 billion, up 14% year-on-year, on 6% quarter-on-quarter.

Non-GAAP diluted EPS was CNY 2.187, up 14% year-on-year or 6% quarter-on-quarter. Net margin was 25.4%, down 0.6 percentage point year-on-year or up 1.6 percentage points quarter-on-quarter. Turning to cross-sell segment gross margin. Gross margin for Value-Added Services was 57.6% down 5.7 percentage point year-on-year or a 4.2 percentage points quarter-on-quarter.

The year-on-year decrease primarily reflected a revenue mix shift to lower margin digital content services and the higher content costs as we renew and sign up more authorized music content during the year. Sequentially, revenue growth from our in-house games and lower our video content cost due to rescheduling of top-tier genres contributed to margin improvement. Gross margin for online advertising was 41.9%, up 10.7 percentage points year-on-year, or 5.3% percentage points quarter-on-quarter. The year-on-year and quarter-and-quarter changes primarily reflected relatively lower video content costs as discussed earlier.

As well as revenue mix shift to higher margin social and other advertising. Gross margin for FinTech and business services was 28.5% up 2.4% points year-on-year and 4% points quarter-on-quarter. Margin improved due to a, growth of high-margin services such as commercial payments, and b, with reduced subsidies to mom-and-pop store merchants and small merchants in certain verticals. Despite the loss of interest income as a result custodian money, mentioned earlier.

As we move revenues relating FinTech and business services to the new segment, other segment will now comprise the financial results of investment in production of and distribution of films and television programs for third parties, copyright licensing, merchandise sales and various other activities. These initiatives generally carry a rather low and choppy margin but it's small , the new base will have an insignificant impact on our branded gross margin. On operating expenses, selling and marketing expenses were CNY 4.2 billion, down to 24% year-on-year, or 26% quarter-on-quarter. To reduce expenses year-on-year was due to fewer games released and our cost management initiatives.

Selling and marketing represented a 5% of quarterly revenue compared to 6.7% last quarter. G&A expenses were CNY 11.3 billion, up 20% year-on-year or broadly stable quarter-on-quarter. The year-on-year increase reflected higher R&D expenses and staff course and the G&A R&D expenses were CNY 6.5 billion, up 30% year-on-year, or 9% quarter-on-quarter. As we increased investments in people, platforms and technologies to support business expansion.

As the percentage of revenue G&A was 13.3% and R&D was 67.6%, compared to G&A at 13.4% and R&D at 7% last quarter. At quarter-end, we had approximately 54,600 permanent employees, up 18%, 16.6% year-on-year, and broadly stable quarter-on-quarter. Let's go through margin ratios, gross margin was 46.6% down 3.8 percentage point year-on-year, or up 5.2 percentage points quarter-on-quarter. The year-on-year decrease reflected fast margin contraction and revenue mix shift to FinTech and business services, which carry lower margin.

Sequentially, segment gross margin ratios improved and through your branded gross margin. Non-GAAP operating margin was 33.3% down 1.1 percentage point year-on-year, or up 6.9 percentage points quarter-on-quarter. Non-GAAP margin was 25.4% down 0.6 percentage points year-on-year or up 1.6 percentage points quarter-on-quarter. Before I close my remarks, I will share several key financial metrics for the first quarter.

So CapEx was CNY 4.5 billion down 29% year-on-year or 1% quarter-on-quarter. Of which operating CapEx was broadly stable at CNY 3.9 billion and non-operating CapEx dropped 74% year-on-year to CNY 636 million. Free cash flow was CNY 23.9 billion, up 72% year-on-year or down 20% quarter-on-quarter. In line with historical trend, lower operating cash flow due to payments of year-end bonuses reduce free cash flow sequentially benefiting from healthy operating cash flow and controlled investment activities.

We further reduce our net debt position by 21% quarter-on-quarter to RMB9.6 billion. The fair value of our shareholdings listed investee companies excluding subsidiaries was approximately CNY 310.7 billion or USD 46.1 billion compared to CNY 238 billion or USD 34.7 billion at the end of 2018. Thank you. We shall now open the floor for questions.

Jane Yip, 'IR'

Operator, let's take one question from each a person. We invite the first question now. (Question And Answer)

Operator

Yes. Our first question comes from Natalie Wu from CICC Please ask the question.

Natalie Wu

Hi, thanks for taking my question. I have a question regarding the advertising business. Just wondering apart from the macro and seasonality issue you mentioned above. Did you see any competition issue coming from other parties? And how should we see this sector growth in the rest of this year given that you just lifted your ads inventory in several key products like moments, like KanDian? Should we expect some reacceleration later this year for advertising business revenue? Thank you.

MA Huateng, 'Co-Founder Chairman of the Board and Chief Executive Officer'

Thank you for the question Natalie. In terms of the factors affecting advertising as well as the macro environment. We also pointed to the impact of several top-tier, drama series that we expect to broadcast in the first quarter and were not broadcast in the first quarter which had a negative impact on our media advertising revenue since those drama series can carry substantial advertising loads you also asked about the competitive landscape and clearly it is a competitive market. We think, we have a very differentiated proposition but within our overall advertising revenue mix.

There are some products which have more direct competition and some products have less direct competition. And then in terms of the growth rate looking forward, there's a number of puts and takes the macro-environment will be whatever it will be. We are adding advertising inventories over time at a steady pace. But as we mentioned in the introductory remarks our focus is really on optimizing the long-term returns for our advertisers as well as sustaining a very healthy user experience rather than on in maximizing the short-term advertising revenue results.

Natalie Wu

Thank you.

Operator

Our next question comes from the line of Grace Chen from Morgan Stanley. Please ask a question.

Grace Chen

Thank you for taking my question.

My question is about -- and also thank you for the additional disclosure of the Fin Tech and Business Service breakdown. My question is about the margin for the segment. We're seeing sequential margin improvement even though there's negative impacts on the absence income generated from custodian cash balances with enhanced monetization of FinTech, should we expect margin will continue to increase in the following quarters. Thank you.

Pony Ma, 'Chief Executive Officer'

In terms of the FinTech and business services margin, we can see that there's quite a lot of improvement during the period despite the fact that, we have ended our custodian money to POBC and it will be a lot of interest. Due to a few reasons. Number one, in terms of the face-to-face receipt payment platforms we have been beforehand we have been giving out, subsidies for exemptions on cash withdrawal fees to those pump mom-and-pops merchants. But now, we have adjusted the program a little bit by offering loyalty programs, points rather than, free withdrawal quotas.

As a result the margins improved by quite a bit. Number two, is in terms of some sort of verticals which we have given out exemptions, on rates or concession rates, take rates. We have resumed, the normal take rate for those verticals such as small restaurants, and things like that. And also I think, in terms of the Licaitong beforehand, we have a -- grow up.

This -- alternative but now it has padded up little bit and the interest generated from this account. All in all, there will be -- there has been improving gross margin in this period. Having said that, the margin you're looking at is just the gross margin and not necessarily mean that that's operating margin. From time to time, we'll look at the competitive landscape, and we will dial up or down -- promotion costs and as subsidies when appropriate.

Jane Yip, 'IR'

Thank you. And the next question please.

Operator

Thank you. Our next question comes from the line of Wendy Huang from Macquarie.

Please ask a question.

Wendy Huang

Thank you, management. I just want to get more color on the new trends for growth as well as the long-term outlook. So, since you really built the structure last year which particular industry for example, you have mentioned the health care and cloud, retail cloud etcetera.

Which particular industry has made clear progress since then? And also, can you provide more disclosure on the cloud revenues in the loan growth as well as the possibility? Thank you.

Pony Ma, 'Chief Executive Officer'

Yes in terms of the cloud business. I think, new it's actually progressing quite nicely. And as we have talked about it in our prepared remarks.

Number one, we have made a breakthroughs in a number of different segments in particular I would say, it's around smart retail. And the financial sector as well as municipal services. So, I think, that those are clear examples in smart retail, we were able to really combine the strengths of our cloud infrastructure and our ecosystem, which include our advertising and our Mini Programs, our payment as well as our Official Accounts. And we also added in our technology in particular the analytics and AI and we are providing very strong solution to retailers.

For example, retailers can actually easily digitize their customers when they customers go to their physical stores by scanning a QR code, they can pay for the services and then access them Mini Programs and become a digital member. And as a result it that we've built strong relationship with these retailers and subsequently helped them to digitize your operations, and help them to move their operations. And to cloud and help them to engage in efficiency improvement through data analytics. We also called out examples such as our project with the Yunnan province in which we help them to embark on the digitization of their tourism industry, and also in digital Guangdong in which we helped the municipal services to be digitized and the cloud-based so that they can be serving the citizens of Guangdong in a big way.

So these are clear examples. Now in terms of the actual number, we don't have separate disclosure on sub-segment. But I would say the growth trends have been pretty consistent. Now in different quarters sometimes there are lumpy revenue here and there.

So that the year-on-year growth rate may go up and down a little bit but I think the growth trend has been consistent for our cloud business. In terms of margin, it is still losing money on operating basis. So that's what we can tell for now. Thanks.

Jane Yip, 'IR'

Thank you and the next question. Please.

Operator

Our next question comes from line of John Choi from Daiwa. Please ask your question.

John Choi

Yes. Hi, I'm sorry for that. Thanks for taking my question. I was wondering if I -- could we get some update about the recent launch of your new game Peacekeeper Elite.

How is that trending. And what of monetization that management is expecting and if we've also noticed that Tencent has launched all quite a bit of season passes in China and how is that progressing as well and just a housekeeping question on the content cost on video content in your release it says it's relatively controlled this quarter, should we be expecting that this is going to be a new trend or on this is more of a quarterly issue? Thank you.

John Lo, 'Chief Financial Officer Senior Vice President'

In terms of Peacekeeper Elite for a new game is actually a very successful launch. And part of the reason is because we have provided a pretty individualized to incentive package for users, which have been playing Exciting Battleground.

So I think that's quite successful and we have been able to monetize the game and there was initial spending that people who came into the game and then spent and over time it becomes sort of more normalized. Now I would say at the current time. We are much more focused on making sure that we retain customers. Number one, we want to attract the gamers and number two, want to retain the gamers and then over time we would work more on the monetization side.

So, at this point of time it is still much more focused on the user experience. Retention I would say, as we observe in the past week has been pretty good. But on the financials, I also have -- we'll have to note that because we have a deferral policy so even the one we are generating gross revenue for the revenue to actually come into our P&L, it would take some time. Now -- okay in terms of the Battle Pass, James will actually talk about it.

James Mitchell, 'Chief Strategy Officer Senior Executive Vice President'

Yeah. So as you may know the season passes have proven a very impactful for certain games such as Fortnite in the rest of the world in the past year and now we are starting to launch the season pass concept in China for a number of key games such as Honour of Kings and QQ Speed. And in terms of the impact of season pass, first engagement what we generally see is that the players who buy the season pass engage with the game more because there are more activities for them to complete in order to unlock the rewards that they have sort of paid for through the season pass. Secondly, paying ratio typically introduction season passes boosts paying ratio because there are some users who didn't want to pay purely for the in-game items but are willing to pay for the season pass and the associated activities.

And then third if we look at cannibalization impact, than when we introduced season pass in these games, what we study in -- what's the impact on spending prior to the season pass and post the season pass, and whether the season pass is bringing revenue forward, that we would otherwise generate it later anyway and depending on the game what we see is that the cannibalization impact is either relatively smaller or its zero. So net-net, the season passes can be quite accretive to revenue, if they're targeted correctly and have the right content and activities inside them. So that's on the season pass. And then your question around the video content cost.

As a number of forces at work, one, force is that I believe the biggest participants in the online video, streaming video industry have generally become more cost-conscious in the last six to nine months. Second is that a number of us including in Tencent have shifted some of our spend from licensed content to self-developed content where we're in more control of our destiny. But then the third which is very important for the current period is that because there's some contents that the industry intended to put on air in the first quarter and couldn't put on air -- therefore, while the cash costs of already been born the -- reported expenses have not yet been expensed and will be expensed as and when that content is ultimately put on that. So some part of the reduction in video content cost that you're seeing is due to that timing impact rather than due to a real change in underlying fundamentals

Jane Yip, 'IR'

Thank you and the next question please.

Operator

Sure. Our next question comes from Alicia Yap from Citigroup. Please ask a question.

Alicia Yap

Hi.

Thank you. Good evening management, thanks for taking my questions. Internet research I have a questions related to these industrial internet initiatives. What could be the biggest hurdle that prevent you from executing the initiative smoothly? Will that be the corporate budget constraint.

Now that we have more intense trade war and potential weaker Chinese economy or would that be the talent and the readiness of the corporate whether the enterprise are able to get enough software or IT talent to help them upgrade the process. And then with monetization besides all these payment, cloud service and also the Mini program apps that we can charge, will there be incremental solutions revenues that Tencent expects to capture down a roll. And it just one housekeeping question for our Peace Elite the deferred revenue schedule would that be a 3 months, 6 months, 9 months or 12 months? Thank you.

MA Huateng, 'Co-Founder Chairman of the Board and Chief Executive Officer'

Yeah.

That's actually pretty good question, and I think the key challenge to Industrial internet is actually the creation of the solutions that can actually help the companies in different industries to embark on this digital transformation. I think your -- if you look at the willingness, right? You're more and more companies realize that at the end of the day or their consumers are actually on the internet they are connected to the mobile internet, so they need to be there they also recognize that there's a lot of technology solutions out there , which eventually can actually help them to improve their operations and make them more efficient in their operations, and help them to serve their customers on the overall mobile internet to better. Now, the problem is really how to make that transformation and it feels like if we create a big team of people and help a company we can actually sort of new create very compelling solutions, so in the case of for example when we dedicate a team of people to help the Yunnan Province and the Guangdong Province then it actually helps them to really upgrade their technology infrastructure and help them to really provide the solutions to serve the citizens. But and then -- in other companies in when we dedicate resources to do it and there's a lot that we can do.

But the problem is actually not that scalable right? Every single company will need a team of tens or even hundreds of IT people to create custom made solution. So what we have been trying to do is really to provide these kind of development capabilities as well as solutions to scale and that would involve us creating showcases and trying to generalize these showcases into more applicable solutions throughout the entire industry. That would also involve us working with a lot of third parties such as ISVs and system integrators and help them to embark on create this capability so that they can actually create digital transformation solutions for the different industries and businesses. So, if you look at China is actually market which has less penetration of technology solutions, SaaS solutions.

So that's sort of a manifestation of this problem. And I think it would take some time before we create these solutions and create these awareness and capabilities in the ecosystem. But we felt that if that's done right? If we look at a longer-term when these solutions and resources available companies can really benefit from these digital transformation. The value propositions that obviously there.

So we felt that over the long run these challenges will be overcome.

Unidentified Speaker, ''

In relation to the PC game deferral period for the major PC games. It normally ranges from six to nine months. Where's for games just like League of Legends in might be up to close to 1.5 years.

Jane Yip, 'IR'

Thank you and the next question please.

Operator

Sure. Our next question comes from Gregory Zhao from Barclays. Please ask a question.

Gregory Zhao

Hi management, thanks for taking my questions. So my question for us about your FinTech business. So assuming your cloud business is do is break even or maybe some little, I mean lossmaking with can we see the gross margin of your FinTech businesses is that could be currently it's above 30%. And also can you help us understand the margin profile of each of the FinTech segment like payments, like your wealth management and the financial businesses.

So, what there current to take-rate annualized take-rate and of the margin profile, and also if look at the payment business on long run, although we know the Take-rate is much lower than your US peers but given business scale, so how shall we think about the margin profile of your payment business? Thank you.

Pony Ma, 'Chief Executive Officer'

Well, as we have disclosed right now the FinTech business is actually much bigger than the business services right? So I think that would be the way if you try to sort of allocate the margin which we don't disclose right now, that is one factor that you need to consider. Now in terms of the FinTech businesses, you can see we disclosed that there are a number of different revenue streams. There is a revenue stream which is social payment in the sense that we charge users when they withdraw fees, withdraw money into the bank account will also charge the users when they use our payment platform to pay for credit card charges, which is essentially a withdrawal as well.

But that's actually really an offset against a very high banking charge that we pay to banks when consumers transfer money from their bank into our payment system. So that's firstly right? Secondly is actually the commercial payment, which we said, generates modest margin and as John talked about that but the margin that we generate on that is actually somewhat dependent on competitive pressure. Sometimes we actually have to subsidize the charges that we charge on merchants. If we want to expand our footprint.

And finally, it's the financial FinTech services charge that we charge on different products when we distribute these wealth management products or micro-loans or Insurance products or its user base. And on that and we charge a net fee so the margin is actually quite good. So I think that's sort of the margin profile of this business. Now in terms of the take-rate that we have vis-a-vis global peers, I think you are absolutely right in the observation that's actually much lower than global peers.

But at the same time right even if you look at credit card charges in China is actually much lower than credit card charges around the world as well. I think it's really because of the fact that the Chinese economy was actually built the payment infrastructure was actually built at the later time and as a result, it's somewhat reflective of a lower cost. If you think about the credit card charges then you will determine that it was actually a long time ago in which you pay a much higher IT cost, you may pay much higher communication costs. But today the efficiency of the entire system is actually higher.

So to some extent, I felt that need the Chinese credit card charge is actually good benchmark of what the cost it is today. And what we are trying to provide is actually a competitive solution that allowed extension of payment solution and penetration of the solution into a wider penetration into the China. So that's why it's somewhat even lower than the credit card charge which I think is actually quite reasonable.

Gregory Zhao

Thank you very much.

Jane Yip, 'IR'

And the next question please.

Operator

Thank you. Our next question comes Karen Chan from Jefferies. Please ask a question.

Karen Chan

Thank you for taking my questions. So, just a follow-up question on your new mobile game Peacekeeper Elite. How does the margin of that compare to other self-developed titles? And also, is it fair to say that the payment competitive landscape in China is sort of easing off? Where that we can potentially scale back in merchant or use a subsidiary? Thank you very much.

MA Huateng, 'Co-Founder Chairman of the Board and Chief Executive Officer'

I think that the margin on Peacekeeper Elite has many factors flowing into it and let's see how the game monetization behaves and then we'll have a clearer view on the margin.

John Lo, 'Chief Financial Officer Senior Vice President'

In terms of the payment side, I think they -- in the first quarter it has moderated a bit right? But I think if you look at the historical trend is -- it's actually quite fluctuating from quarter-to-quarter I know it really depends on that the promotion activities of the different players in the market. So, I would not say this is a trend that the subsidy is actually moving towards a lower end. I think it's historical phenomena in the first quarter.

Jane Yip, 'IR'

Thank you.

And we will take the last three questions from the floor.

Operator

Our next question comes from the line of Tammy Wong from HSBC Please ask your question.

Binnie Wong

Hi. Thank you, management for taking my question.

There's Binnie here. My question is basically on the online advertising and overall in terms of on a macro level. We see the trade war tension has been heating of and this also macro uncertainties. How does that change our growth outlook and especially coming to advertising, which is relatively more sensitive to macro here.

The reason we ask that we observed some of your competitors have been seen some challenges. And then, I guess on to your industry level, it seems that competition remain intense as there's always concern about an oversupply of advertising inventory. How does that impact our pricing and also the timing of potentially launching our third ad load in moments? Thank you.

MA Huateng, 'Co-Founder Chairman of the Board and Chief Executive Officer'

Thank you for the question, Benny.

So in terms of the macro impact on advertising business than that there clearly is some flow-through from both the weak economy and also the volatile stock market to advertising activity. And that's particularly evidenced in sectors such as automobile, real estate and then internet services. Both the big established but not yet profitable O2O companies and also some of the internet start-ups who have curtailed debt spending. On the other hand there are some other sectors such as consumer products, games, education, which are relatively robust but in aggregate it is a mixed picture because of the macro impact from a competitive perspective.

We feel that our advertising pricing is generally quite competitive already, that's not true all across the board. But in general we think that we have in a very keen pricing and where we don't then we'll optimized by improving our technology, driving up the click through rates and delivering a better return to advertisers. So, we really add inventory based on when we believe that our platforms and technologies in force are ready to ingest more inventory and to serve the right appropriate advertising is the incremental inventory rather than based on the macro environment. So the inventory deployment plan is more function of our internal development rather than the external macro situation.

Binnie Wong

Okay. Thank you so much.

Jane Yip, 'IR'

Thank you. And the next question please.

Operator

The next question comes from the line of Eddie Leung from Bank of America. Please ask a question.

Eddie Leung

Good evening. Just a follow-up question on industrial internet.

How should we think about investment for these business initiatives in the sense that how much are we thinking about tangible investments in the form of capital expenditures, sales and marketing, and how much is more like covered by diverting the internal resources to focus on certain project. And if it's more about the tangible part. Could you give us some color whether which would be seeing for example the CapEx or headcount growing more significantly in this year. Thank you.

John Lo, 'Chief Financial Officer Senior Vice President'

Sorry it is true that, we have to make investments in pretty much the areas that you talked about. Firstly, it is the capital expenditure and we have to invest in servers particularly ahead of the demand so that we can actually serve our customers and that will be in the form of fixed investment and in addition we need to add our headcount and that would be in the form of both sales and marketing as well as the delivery of the services, right? We need to add tech people so that we can build the products and solutions for our customers and as I alluded to in the earlier answer to on industrial internet, one of the key challenges is actually making sure that there are solutions available for the companies who are eagerly hoping to upgrade themselves digitally. And as a result we actually have to dedicate to a pretty large team of development people just to provide the showcases. And at the same time I would say that would -- to some extent divert some resources.

But the resources are actually quite different people right now. If you think about product managers who and then engineers and developers who are actually developing solutions that conserve hundreds of millions of people in our internet platform versus creating more enterprise like solution to customers. It's actually somewhat different and we also leverage quite a bit of our internal technology team, right now, when somebody in our overall internet platform create less a machine learning algorithm. We can actually some provide it as a solution to our enterprise customers.

And so to some extent, there are some synergies, that we can actually leverage. And I would say from an operating perspective, this business is still in investment mode. So in addition to the capital expenditure, we also generated some operating losses, so that's another area of investment. And finally, I would say around industrial internet, we are also seeing investment opportunities right now, so they are companies which are developing interesting solutions, their partners who can actually help us to build our business faster.

And there are ecosystem partners in which they can actually develop a specific solution for an industry. That has strategic synergies with us and these are companies which will invest in. So I think investments actually come into play in these areas.

Eddie Leung

Understood.

Thank you.

Jane Yip, 'IR'

Thank you. And we'll have the last question.

Operator

Our last question comes from the line of Han Joon Kim from Deutsche Bank.

Please ask your question.

Han Joon Kim

Great. Thank you for the chance to ask a question. We disclose that our PUBG global MAU is around 100 million, so just wanted to get a perspective on how you guys are thinking about the globalization of your business kind of revenue generation, is it contributing to your mobile game revenues now? And how do you think about scaling this? Thank you.

James Mitchell, 'Chief Strategy Officer Senior Executive Vice President'

So, if you look at our game revenue than non-China contributes a high single-digit percentage of global game revenue looking forward as we mentioned in the prepared remarks. We believe that there's a convergence underway between the China game market and the rest of the world or Western game markets that's convergence in terms of the platforms on which people are playing games meaning PC console mobile. Its convergence in terms of the game business model meaning that the shift to the free to play games and it's also a convergence in terms of the genres of games that people like, meaning the for example first person shooter games which historically were less popular in China have now become more popular in China. So, given those convergence trends we are in more closely reviewing future games to assess whether they're suitable for global publishing as opposed to just net China publishing.

And importantly, we've built up a degree of global publishing infrastructure for PUBG MOBILE And we now have people in different geographies who are accustomed to doing up in game operations, communicating with the app store's, communicating with users, enhancing the localizing content for the different geography needs. And so over the medium to long-term then we hope to derive more value out of that infrastructure by publishing in a more appropriate games through that infrastructure globally.

Jane Yip, 'IR'

Thank you operator, and we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website at www.tencent.com.

The replay of this webcast will also be available soon. Thank you. And see you next quarter.

Operator

Thank you.

Ladies and gentlemen, that does conclude our call for today. Thank you for participating. You may all disconnect.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2019-03-21
Event Description: Q4 2018 Earnings Call

Market Cap: 3.35TRI
Current PX: 351.40
YTD Change($): +37.40
YTD Change(%): +11.911

Bloomberg Estimates - EPS
Current Quarter: 2.173
Current Year: 9.592
Bloomberg Estimates - Sales
Current Quarter: 88306.231
Current Year: 400547.019

Q4 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Thomas Chong
- Wendy Huang
- Han-Joon Kim
- Alicia Yap
- John Choi
- Eddie Leung
- Grace Chen
- Richard Kramer
- Yue Natalie Wu
- Gregory Zhao

MANAGEMENT DISCUSSION SECTION

Jane Yip

Non-GAAP Financial Measures

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS

For a detailed discussion of Risk Factors and non-GAAP measures, please refer to our disclosures documents on the IR section of our website

Huateng Ma

Business Highlights

Opening Remarks

- 2018 marked the 20th anniversary of the founding of Tencent
- Throughout our history, we embrace changes to stay at the forefront of the industry
- Recently we launched a strategic organizational upgrade to extend our strength into Consumer Internet and to embrace the opportunities of the Industrial Internet

- We will share key milestones with you in the future

Market Leadership

- During the year, we strengthened our market leadership in key areas and built deeper connection with our users, advertisers, merchants and enterprise partners
- In social, Weixin becomes the way of life in China aided by Weixin Pay and Mini Programs penetrating more use cases
- The sharing of mini-videos within chat also drove rapid growth in user activities

Mobile QQ

- Mobile QQ continue to focus on young user engagement via social video sharing and newsfeed benefiting from increased user traffic and advertiser demand, social and others advertising revenue rose 55% year-on-year
- In online games we are the world's largest game platform by user's revenues with technical capabilities to operate multiple blockbusters simultaneously
- By MAU, League of Legends continue to be the biggest PC game and PUBG MOBILE becomes the most popular smartphone game globally

China

- In China, we sustained market leadership and also implement the Healthy Gameplay System in our most popular mobile titles to encourage balanced game time for young users
- In media and content, we grew digital content subscriptions 50% year-on-year to over 100mm
- Thanks to our popular self-commissioned transactions

New Platforms & Content GROUP

- Newsfeed, short-video and mini-video views increased rapidly across our media platforms, QQ Browser and WeiShi
- We grouped our content businesses to form a new Platforms & Content Group we call PCG, enabling us to focus resources on systematics content creation and management, as well as algorithm enhancement

Ecosystem

- In ecosystem, our payment service expand users and merchant adoption, enabling us to grow commercial transactions [ph] activity (00:05:24) and upsell FinTech production
- We stepped up investment in Tencent Cloud integrating AI and big data into the offering to drive organic growth of our own Cloud business and assist the digital transformation of wireless industries
- Our customized solutions for smart industries are equipped with tools leveraging our social and technical capabilities

Revenue Growth

- Now let me go through the headline number and John will provide more detailed discussion in the financial section
- For Q4 2018, total revenue was RMB 84.9B, up 28% year-on-year and 5% quarter-on-quarter
- Total games revenue which include platform revenue share book and social networks was 36% of total revenues compared to 45% for Q4 2017

Non-GAAP Operating Profit

- Non-GAAP operating profit was RMB 22.4B, up 2% year-on-year or down 1% quarter-on-quarter
- Non-GAAP net profit attributable to shareholders was RMB 19.7B, up 13% year-on-year and stable sequentially
- For the full year of 2018, total revenue was RMB 312.7B, up 32% year-on-year
- Non-GAAP operating profit was RMB 92.5B, up 13% year-on-year
- Non-GAAP net profit attributable to shareholders was RMB 77.5B, up 19% year-on-year

MAU

- For our key platforms, in social, combined MAU of Weixin and WeChat increased 11% year-on-year to 1.1B driven by use of communication needs as well as adoption of Mini Programs and Weixin Pay
- Total MAU for QQ was over 807mm
- Smart devices MAU increased 2% year-on-year to 700mm
- For Qzone smart devices MAU was 532mm, down 4% year-on-year
- In online games, we expand total user base benefiting from the popularity of tactical tournament games and action games on mobile
- In PC, we released several niche genre games and received encouraging feedback from players

Media

- In media, Tencent Video expanded market share in China in terms of mobile DAUs and paying subscriptions
- We also used short and mini-video to push the time spent in our media feeds business across Tencent News, QQ KanDian, QQ Browser and other news properties
- In payment, we further broadened use cases and grew total commercial payment volume rapidly despite intense market competition
  - We are now operating the largest mobile payment platform in China, measured by active users and the number of transactions
- In utilities, QQ Browser and our Android App Store Yingyongbao maintained market-leading positions
- Our online security team expands their research to cover a range of new use cases, such as automobile security

Chi Ping Lau

Q4 Highlights

Opening Remarks

- In this section, I will discuss some of our strategic initiatives that have, firstly, contributed to the growth of our social platforms as well as our core businesses in payment, advertising and cloud, and secondly, have formed our key proposition to help our enterprise partners to embark on their digital transformation

Mini Programs

- Now starting with this page on Mini Programs, the platform has become very popular among users
- It benefits from a number of key drivers, firstly, for users, given the ubiquity of Weixin Mini Programs enables to further enhance user [indiscernible] (00:10:02) easy access to a broad range of daily life services
- Total active users of Mini Programs grew more than 250% year-on-year and daily visits per user also increased 54% year-on-year in Q4

Long-Tail Mini Program

- For service providers, they can connect with consumers via Mini Programs and drive transactions, leveraging mobile payment, social sharing, data analytics and targeted advertising
- Our Mini Programs are distinguished partly by the benefits they bring to long-tail service providers
- Daily visits to long-tail Mini Program increased from 13% as of the end of 2017 to 43% as of the end of 2018

China

- For developers, our Mini Programs are designed to facilitate cross-platform development and instantaneous deployment, a unique advantage that increase development efficiency
- On top of that, we also provide cloud-based development kits to make the development process even easier
- As an emerging platform, we are helping to develop the talent pool in the developers
- On that front, we partner with more than 100 universities to include Mini Programs in their curriculum and students now make up 24% of Mini Programs developers in China

Weixin Pay

- Now turning to the next page is Weixin Pay
- That platform has grown from strength-to-strength
- By the end of 2018, tens of millions of mom and pop stores can now accept mobile payment via our easy-to-deploy QR code solutions, which does not require expensive point-of-sales equipment
- In total, the number of merchants actively transacting via Weixin Pay increased 80% year-on-year in Q4 2018

Meituan-Dianping

- We also made significant progress in the food and retail categories, with a well-executed strategy that leveraged Mini Programs, Scan-to-Pay, customized management tools and partnership within investing companies such as Meituan-Dianping
- Merchants using Weixin Pay typically see fast customer adoption

- Average daily commercial transactions on Weixin Pay more than doubled year-on-year in 2018, as did the accompanying merchant tick rate revenue to Tencent
- On a daily basis, there are over 1B transactions on Weixin Pay, the majority being commercial transactions
- We believe Weixin Pay is the clear mobile payment leader in China in terms of daily users and the number of total as well as commercial transactions

Wealth Management Platform

- Built upon our extensive user reach and deep user engagement, we're able to upsell FinTech products to consumers at low acquisition cost
- Our wealth management platform, LiCaiTong accumulated over RMB 600B of customer assets as of year-end
  - We also helped WeBank distribute micro-loan products WeiLiDai to individual consumers, which loan balance has been growing very rapidly
- We also launched a new product called WeiYeDai to serve small and micro businesses alongside with WeBank

Advertising Business

- Now, moving on to our advertising business
- In our recent strategic organizational upgrade, we have merged our ad sales teams to enable them to sell both brand advertising as well as performance advertising
- Key advertising accounts now benefit from coordinated sales coverage and the ability to buy efficiently across all our ad inventories
- SME advertisers benefit from the ability to bid and place ads in a more timely and efficient fashion

Advertising Data Analysis Platform

- We've also centralized our advertising data analysis platform, greatly enhancing our ad targeting capabilities
- And now, we can optimize traffic value by dynamically allocating our partner, our own inventories to the most suitable pricing models including CPC, CPM and optimized CPA.
- We continue to support our partners in achieving sales growth with our rich-content partnership, smart retail solution, as well as technology support

Broad Portfolio

- We have a broad portfolio of inventories, attracting a healthy mix of advertisers across industries and budget ranges
- We continue to focus on enhancing ROI to deliver value to advertisers, and this is particularly important amid headwinds in the current macroeconomic environment
- Ad loads on our properties are generally lower than most peers in the market and we'll continue to manage it conservatively to produce sustainable growth over the long-term

Cloud Business

- For our cloud business, we made good progress in 2018
- For the full year, cloud revenues more than doubled to RMB 9.1B
- In Q4, cloud-paying customers also more than doubled year-on-year
- Tencent Cloud has become a clear market leader catering to online games and video customers, leveraging our infrastructure and operational expertise

Internet Services

- In internet services, by leveraging our strategic partnership in key verticals, we have quickly expanded the customer base in categories, including e-commerce, social media and community, handset manufactures and smart transportation
- In the financial, we are the partner of choice for top banks and that provides, showcases small and medium-sized financial institutions

Retail

- In retail, we assist retailers to execute a digital transformation
- We help them strengthen customer engagement via CRM and data analytics, enhance their marketing ROI using customer targeting and anti-fraud technologies, and also help them to upgrade their internal operations via smart solutions, integrating AI, LBS and big data technologies
  - We will continue to invest aggressively to enhance our cloud capabilities and offerings

Core Platform

- Finally, talking about our ecosystem, which continued to expand during the year, partly driven by our strategic investments
- Making strategic investment bring benefits to our core business
- By leveraging best-of-breeds category leaders to tap into new opportunities, allow us to focus our own attention and resources on our core platforms
- Also, through upstream investments, we have enriched our IP portfolio in games and our digital content

Partnership with investee

- In addition to that partnership with investee companies also enable us to capture emerging opportunities and help us to expand our offerings to meet evolving user needs usually in different verticals, where our investee companies have unique and domain expertise
- It also helped to accelerate the adoption of our enterprise-facing services such as payment, advertising and cloud
- As a strategic investor, we’re committed to creating value for investee companies by offering access to a large user base, as well as supporting the business growth by providing them with infrastructure, technology and capital

Strategic Investments

- During the past decade, we have built a handpicked portfolio covering games, digital content, O2O services, FinTech and emerging tech areas to over 700 investee companies
- More than 100 investee companies were valued over $1B each and over 60 are publicly-listed already
- Going forward, we'll continue to make strategic investments to strengthen our ecosystem and in the process, bring benefits to our users, our partner companies, as well as ourselves

James Gordon Mitchell

Q4 Highlights

Revenue

- For Q4 2018, our total revenue grew 28% year-on-year
- As a percentage of revenues, VAS represents 51%, online advertising was 20% and the other segments accounted for 29%

VAS Business

- Starting with our VAS business
- Segment revenue was RMB 43.7B in Q4, up 9% year-on-year, though down 1% sequentially
- Social network revenue was up 25% year-on-year and up 7% quarter-on-quarter, with growth flowing from live streaming services and video subscriptions
- Our total VAS subscriptions increased by 19% year-on-year to 160mm, as our video and music subscriber bases grew rapidly due to soft-commissioned video content and our music content library
- Online game revenue in the quarter was down 1% year-on-year and down 6% quarter-on-quarter

QQ and Weixin

- In our social networks, video interaction and consumption contributed substantially to activity growth in both QQ and Weixin
- For Mobile QQ, AI-enhanced filming capabilities helped young users create imaginative and fun content to share with friends, boosting short and mini video uploads by over 50% year-on-year

QQ KanDian

- In QQ KanDian, we added new video categories and enhanced recommendation algorithms, introducing users to more relevant and interesting content and so significantly increasing daily video views
- We also added bullet chatting within videos as a tool for viewers to interact
- The Weixin and new function allows users to film and share instant videos that are available for 24 hours, and Weixin is providing background music matching the context of these user-created videos

Enterprise App

- Our enterprise app, WeChat Work is gaining popularity, especially among large enterprises
- WeChat Work can assist productivity in several ways
  - First, through integration with Weixin and Mini Programs, WeChat Work helps enterprises deepen their customer engagement and strengthen their post-sales interactions
  - Second, WeChat Work supports customer database management, allowing enterprise to more carefully analyze their data
  - And third, WeChat Work facilitates office administration by plug-ins for capabilities such as expense claim approvals

smartphone Games

- For smartphone games, total revenue for the quarter was RMB 19B, up 12% year-on-year, due to new Action and RPG titles, but down 2% quarter-on-quarter, as we generally prioritize user engagements and other measures over monetization initiatives in a seasonally slow period
- We released nine new games in the quarter
- As many of you know, monetization approval for new games resumed in December
- So far, seven new smartphone games for which we have publishing rights have received such approvals
  - These include titles in the role-playing, strategy, casual and functional genres

Backlog

- Given the backlog, game releases both for ourselves and the industry as a whole likely to initially be slower than in previous years
- At our own initiative, we launched a pilot project to introduce our Healthy Gameplay System, promoting balanced gameplay for under 18-year-olds
- Starting with Honour of Kings, the system is now implemented in 39 of our smartphone games, covering a large majority of young players
- As a result, play time for minors reduced significantly, whilst adult players' activity and consumption were not materially impacted

China

- Within China, our Action games such as QQ Speed Mobile and Cross Fire Mobile grew users by seasonal initiative and introduction of season passes
- We released several role-playing games based on popular IPs, including Battle Through the Heavens, our mobile MOBA game, Honour of Kings held its flagship eSports event in December, attracting over 75mm unique viewers, an industry record for smartphone games
- And we released an expansion pack for Honour of Kings in late January which has been well received
- In international markets, App Annie has ranked PUBG MOBILE the most popular game globally by MAU for iOS and Android since last November

PUBG MOBILE

- Google Play named PUBG MOBILE as Best Game of 2018, citing its competitive and immersive game experience
- Following the release of its Royale Pass in January, we believe PUBG MOBILE became the highest grossing game developed and published by a Chinese company in international markets
- Several of our investees' mobile games also attained notable success
- Supercell's new mobile game Brawl Stars was the most downloaded game in 50 markets
  - Epic's Fortnite ranked number one in the U.S. iOS Grossing Chart in Q4
- And Free Fire, Garena's first self-developed game, was the fourth most downloaded game globally in 2018

PC Client Games

- Our investees' success benefits us financially but also operationally in terms of shared insights into industry trends and user behavior, enabling us and our partners to influence this development of a health game industry globally
- For PC client games, revenue for the quarter was RMB 11.2B, down 13% year-on-year due to users shifting to mobile and down 10% sequentially due to season of unfavorability
- The League of Legends user engagement trends have improved globally due to new game content and improved specifically in China with the additional benefit of a China team winning the World Championships in November, when 99mm viewers watched the live broadcast of the League of Legends finals in South Korea

NBA2K Online 2 Game

- Our recently released NBA2K Online 2 game has significantly expanded NBA2K franchise user base with a more powerful game engines, superior graphics and better balanced gameplay
- And we launched two new PC games, Iris Fall and Bladed Fury to better serve niche audiences

Online Advertising

- Moving to online advertising
- Fourth quarter revenue was RMB 17B, up 38% year-on-year and up 5% quarter-on-quarter
- Media advertising revenue was RMB 5.2B, up 26% year-on-year and up 2% quarter-on-quarter
- Within media, video advertising increased year-on-year, helped by our variety in documentary shows, but rescheduling several highly-anticipated drama series out of Q4 2018 and into later into 2019 led to a sequential revenue decline

Media Revenue

- Our news advertising revenue, on the other hand, increased year-on-year as we added inventory following the revamp of our news feed ad system, and increased quarter-on-quarter benefiting from sports events and news feed

- Media revenue generated from feed ads grew over 10 times year-on-year, benefiting from traffic growth with the completion of our system revamp and rising fill rates

Social and Other Advertising Revenue

- Our social and other advertising revenue was RMB 11.8B, up 44% year-on-year and up 6% quarter-on-quarter
- Advertiser demand and increased ad inventory especially in Weixin Moments, Mini Programs, and QQ KanDian, drove the year-on-year revenue growth
- Impressions growth in Mini Programs and positive e-commerce seasonality boosted revenues quarter-on-quarter, albeit to a lesser extent than in Q4 2017 because the growth of Mini Programs' advertising revenue in Q3 2018 created an usually high base for quarterly comparison
- During the quarter, we showed a second ad unit in Weixin Moments to approximately 50% of Moments DAUs
- Click-through rates remained high for both the first and second ad units

Tencent Video Business

- Focusing on our Tencent Video business, we continued to lead the China online video market in terms of DAU, time spent, and revenue
- Driven by premium content, we had 89mm video subscriptions at quarter-end, up 58% year-on-year
- Revenue from subscriptions increased 65% year-on-year
- User engagement trends were healthy as video views per DAU increased over 40% year-on-year and contributed to advertising revenue growth of 21% year-on-year
- Our operating losses remained lower than those of industry peers

Video VIP Loyalty Program

- We released sequels to several popular IPs, including Season 3 of our adventure drama, Candle in the Tomb, and Season 2 of our animated series, The Land of Warriors
- In December, we upgraded our video VIP loyalty program, enabling subscribers to access tiered benefits, including e-commerce and Traveler privileges

China

- We're the leading destination for viewing sports online in China with the richest portfolio of major sports rights
- For example, we've helped expand the NBA's audience in the country, leveraging our user base, communities, content curation, and video streaming capabilities
- Average unique visitors per live stream to NBA game in China have almost tripled over the past three years

Payments and FinTech Services

- Moving on to our payments and FinTech services, revenues sustained rapid growth, powered by three engines:
    - First, merchants paying us transaction fees for use of our payment services

  - Second, users, particularly heavy users, paying us cash withdrawal fees and credit card repayment charges
  - And third, financial institutions, including our affiliate WeBank, paying us service fees for making available wealth managements and microloan products

Cash

- On the regulatory front, we completed the full transition of our payment routes to central clearing settlement systems
- And we moved all custodian cash to PBoC accounts in January this year
- On the product front, Weixin Pay saw continued growth in users and per-user transaction volume
  - We added new consumer features such as virtual cards for dependents, and we enhanced our account management tools for enterprises

LiCaiTong Wealth Management Platform

- Our LiCaiTong wealth management platform has accumulated 100mm users who have subscribed to money market funds paid by their bank cards
- In parallel our new LingQianTong service allows users to invest excess cash balance in their Weixin Pay accounts directly into money-market funds

Shek Hon Lo

Financial Highlights

Gross Profit

- For quarter four 2018, our total revenue was RMB 84.9B, up 28% Y-on-Y and 5% Q-on-Q
- Gross profit was RMB 35.2mm, up 12% y-over-y or down 1% quarter-on-quarter
- Net other losses were RMB 2.1B, which mainly consist of one-off expenses relating to ordinary share issuance to strategic partners of TME and the impairment provisions for certain investees

Non-GAAP Basis

- Share of profits of associates and joint ventures were RMB 16mm, compared to share of loss of RMB 120mm for Q4 2017
- On a non-GAAP basis, share of profit of associated and joint venture was RMB 1.9B vs
- RMB 495mm for quarter four 2017

Income Tax Expense and Tax Rate

- Income tax expense was approximately RMB 1.9B, down 39% year-on-year or 41% Q-on-Q
- The year-on-year decrease was mainly due to preferential tax benefit entitlements

  - This sequential decrease mainly reflected the reversals relating to the entitlements of preferential tax benefits partially offset by higher withholding tax

- The effective tax rate for Q4 was 12%

GAAP Profit

- GAAP net profit attributable to shareholders was RMB 14.2B, down 32% Y-on-Y and 39% Q-on-Q
- The Y-on-Y increase in GAAP profit was greatly affected by noncash expenses relating to capital raising as mentioned above coupled with substantial deemed disposal gains relation to the capital activities of certain investee companies such as the IPOs of Yixin, Sea and Sogou in quarter four 2017

Operating Profit and Shareholders

- Let me walk you through the non-GAAP numbers
- For Q4, operating profit was RMB 22.4B, up 2% Y-on-Y or down 1% Q-on-Q
- Operating margin was 26.4%, down 6.5 percentage points Y-on-Y or 1.6 percentage points Q-on-Q
- Net profit to shareholders was RMB 19.7B, up 13% Y-on-Y or broadly stable Q-on-Q.
- Net margin was 23.8%, down 3.9 percentage points Y-on-Y or 1.5 percentage points Q-on-Q

Gross Margin

- Turning to gross margin
- Gross margin for value-added services was 53.4%, down 5.9 percentage points Y-on-Y or 3.1 percentage points Q-on-Q.
- The Y-on-Y decrease was mainly due to higher content costs for video and music services and lower revenue contribution of higher margin PC client games
- The quarter-on-quarter decrease was mainly due to lower proportion of revenues from our PC games, lower revenue contribution from self-developed smartphone games, and increased content cost for our live broadcast and music services
- Gross margin for online advertising was 36.6%, broadly stable Y-on-Y and Q-on-Q.
- Gross margin for others was 23.1%, again broadly stable Y-on-Y and Q-on-Q.

Operating Expenses

- On operating expenses, selling and marketing expenses was RMB 5.7B, down 5% Y-on-Y or 13% Q-on-Q.
- The year-on-year and quarter-on-quarter decrease were mainly driven by the reduction of advertising and promotion expenses due to cost control initiatives
- Total G&A expenses was RMB 11.4B, up 29% Y-on-Y or 4% Q-on-Q

G&A

- On the G&A, R&D expenses were RMB 6B, up 24% year-on-year or down 5% Q-on-Q.

- The year-on-year increase of total G&A mainly reflected greater R&D and staff cost
- The quarter-on-quarter increase was mainly reflecting [ph] quicker (00:31:20) spending on staff fringe benefits and conference fees
- At quarter-end, our employee count increased to approximately 54,300, year-on-year increase of 21% reflecting expansion of our business scope

Margin Ratio

- Let's go through margin ratios for quarter four
- Gross margin was 41.4%, down 6 percentage points Y-on-Y or 2.6 percentage points Q-on-Q.
- Gross margin contraction and revenue mix shift to other segments, which carry a lower margin are the main reasons

Non-GAAP Operating Margin

- Non-GAAP operating margin was 26.4%, [ph] that's (32:00) 6.5 percentage points year-on-year or 1.6 percentage points Q-on-Q.
- Non-GAAP net margin was 23.8%, down 3.9 percentage points Y-on-Y and 1.5 percentage points Q-on-Q

EPS

- For 2018, on GAAP basis, basic EPS was RMB 8.336 and diluted was RMB 8.228
- Non-GAAP basis, basic EPS was RMB 8.203 and diluted EPS was RMB 8.097
- Subject to shareholders' approval at our AGM to be held on 15 of May 2019, we are proposing an annual dividend of HKD 1.00 per share, payable on 31 of May 2019

CapEx

- Before I close my remarks, I'll share a few key financial metrics
- For fourth quarter, total CapEx was RMB 4.6B, down 8% year-on-year or 24% Q-on-Q
- Operating CapEx was RMB 3.7B, down 29% Q-on-Q, non-operating CapEx was RMB 893mm

FCF

- As at quarter-end, FCF was RMB 28.6B, up 18% Y-on-Y or 9% Q-on-Q
- For 2018, FCF was RMB 83.4B, down 11% year-on-year
- Our net-debt position improved by 58% to RMB 12.2B quarter-on-quarter

Operating Cash Flow

- Healthy operating cash flow plus the disposal of our shares in certain investee companies and capital raising from TME more than offset M&A cash outflows in Q4

- The fair value of our shareholdings in the listed investee companies excluding subsidiaries was approximately RMB 238B or roughly $34.7B at year-end
- I would like to let you know that following our strategic upgrade from the Consumer Internet to the Industrial Internet, we will add a new revenue segment to better reflect our evolving business mix in the next quarter

QUESTION AND ANSWER SECTION

<Q - Thomas Chong>: I have a question related to advertising. Can management comment about the macro headwinds to our advertising, including social and others, as well as media? And how should we think about the growth trends in Moments as well as Mini Programs? Should we expect to increase the ad loads in Moments in coming quarters? Thank you.

<A - James Gordon Mitchell>: Thomas, thank you for your question. In terms of macro headwinds, it does appear that the uncertainty late last year may have resulted in slower advertising spending, particularly in some high-ticket price categories such as automobiles, reflecting a deceleration in sales of automobiles. So I suppose that’s not desirable, but it’s fairly natural. As far as Tencent was concerned, we believe we continue to grow substantially faster than the market in Q4. And in turn, we think that reflects the quality of the inventory that we bring, the targeting technology we provide around the inventory and the attractive prices that we charge.

Looking forward then, you can see from our latest quarterly results that we still have ample room to increase ad load over time at a measured pace in some of our key inventories such as Weixin Moments where we’re currently running 1 to 2 ad units per day vs. global peers running around 10 ad units per day. And we’re also starting to bring online news feed inventory where we’ve been focused on really increasing traffic first and now that we’re in a position where the traffic is growing nicely, you can see it in Q4, the revenue began to pick up as well on the news feed side. So that’s how we see the advertising environment.

<Q - Thomas Chong>: Thank you. May I have a quick follow up regarding the online video advertising? Given the fact that we see some delay in terms of the launch of some of the drama programs, how should we think about the trend in Q1 and 2019? Thank you.

<A - James Gordon Mitchell>: Well, as you observed, there are some delays across the industry to launch in certain categories of content in online video, for example, costume drama series. And costume drama series are relatively important in terms of their ability both to drive advertising and also subscription revenue. So, obviously, the subscription revenue reacts with a longer time lag to changes in the content, but the advertising revenue reacts relatively immediately. So, yes, there may be some pressure for the overall online video industry’s advertising revenue in coming months as the industry waits to bring onstream some of the content.

<Q - Wendy Huang>: First, can you give us an update on the games in the pipeline with approval considering that you launched as new titles in Q4, but additionally, you get seven titles with approval? And also, can you clarify whether the seven titles you mentioned you get approval that actually includes the license to the titles, which is actually given up by other companies? And also, a very quick follow-up on the advertising questions Thomas asked earlier. So how should we think about advertising margin trend going forward? It seems, actually, it stabilized a little bit this quarter. And also related to that, what would be the content cost in 2019? Thank you.

<A - James Gordon Mitchell>: So, in terms of the new games, just to clarify, seven new smartphone games have been approved since the banhao was resumed, the issuance of banhao resumed. But we’ve also had one PC game approved. So, in total, eight games approved since resumption of banhao, and that includes licensed games. We have several dozen more games in the approval pipeline awaiting approval. As we commented in the opening remarks, the fact that there is this backlog for approval will likely have some impact on the industry growth and our growth within the industry in the next few months. But we’re pleased that the situation is clearer now and that the backlog is being worked through at a fairly rapid pace.

In terms of the margins for advertising segment, as you know, historically, those depend to a great extent on the mix of different products. And so, for example, when we grow the advertising within Weixin Moments, that's a relatively high-margin stream. As we grow the advertising around video entertainment content, that's a relatively low-margin stream. And then inventory where we share advertising with partners such as Official Accounts, we're somewhere in the middle. In the near term, the flipside of not being able to show some of the video content one might otherwise show is that the video content costs may not be as heavy as they would otherwise be for the industry and for us within the industry.

<**Q - Han-Joon Kim**>: I have a question on the margins. And if I'm reading this correctly, it seems like WeChat Pay gross margins improved sequentially, and we talked to a few factors that drove it. But as we think about 2019, could you walk us through some of the puts and takes and how much operating leverage we can kind of see here in terms of gross margins?

<**A - Chi Ping Lau**>: Well, I think for WeChat Pay, the gross margin, number one, I think it's going to be driven by a number of different factors, which actually are quite dynamic because we actually take in the revenue from the merchants as well as from consumers. But at the same time, we actually have to pay a very big chunk of that to the banks as bank charges. And at the same time, nowadays we actually sort of have lost the interest to income from the reserve cash, but we are now trying to compensate partly for that through cross-selling of our FinTech products. So it will be a pretty dynamic situation in the course of the year of 2019.

A big swing factor would be the bank charges, and [indiscernible] (00:42:40) is actually competitive dynamics and also our ability to cross-sell more financial products. And at the same time, what you see is the gross margin, but below the gross margin there's actually a marketing cost, which is actually also very high because despite the fact that we have positive gross margin on the growth side, we are actually engaged in a lot of marketing activities, including consumer subsidies, including some merchant rebates in order for us to continue to build market share and also make our payment mechanism – make our payment platform more popular with merchants. So that actually is another cost, which is quite dynamic as well.

So I think, all-in-all, what I want to say it's a dynamic situation. We run our payment platform more as an infrastructure business for now. And over time, I think if we can achieve more success in cross-selling the financial products, then it may generate more revenue and more margin. But again, it's a long-term vision for our business. For the near-term, I think we're very focused on making sure that we can continue to make WeChat payment even more popular among the users and merchants.

<**Q - Han-Joon Kim**>: Got it. Understood. And if I just have a quick follow-up question. I noticed a pretty sharp spike in content costs, and the cost breakdown. So I just want to understand the nature of that, and that happens to be more one-off in nature or something that's going to be recurring. Thank you.

<**A - Shek Hon Lo**>: Sorry, Han. Can you just repeat about question for the content cost?

<**Q - Han-Joon Kim**>: Yeah, the cost breakdown actually shows a fairly sharp increase in the content cost in Q4 relative to prior trends. So I just wanted to see if there was any particular one-offs included in there or if this is something that's going to be recurring.

<**A - Shek Hon Lo**>: I think it's something to be recurring, due to the fact that there are a lot of things that are increased – and the content cost, such as interactive live video; if we had more revenue, then there would be more sharing. And also, there has been more content cost in respect of music being paid for, so we have more content costs. And on top of that, online games, mix and things like that would affect the content cost we need to share with the developers.

<**Q - Alicia Yap**>: I have a questions on the online games. Given Perfect World just launched and the initial ranking was very strong. From the past record, usually the MMO tends to spike in the first couple months and then drop out very quickly after that. Do you think Perfect World will be the similar case? Or do you think it will be different this time? And could you share with us the reasons that boost the strong games performance? Is that because of the game quality, or is it because of the Tencent successful promotional effort?

And the follow-up questions I have is related to advertising. So just wondering because of the Mini Programs advertising, if I remember correctly was actually introduced late Q2, so it actually benefited Q3. And just wonder how we reconcile Q4 that we didn't get much of that benefit. Is it really because of the macro or is that we were too optimistic about the ramp of ad opportunity within the Mini Programs? Thank you.

<A - James Gordon Mitchell>: Hi, Alicia. So, first of all, on the Perfect World game, it has been commendably successful and we obviously hope it remains so. I think in terms of the factors that contributed to its success, the game quality is obviously one; the long history of the intellectual property is another. Our ability to target the game to the right audience is a third, and then I think our publishing skills in general are a fourth.

You made a comment that MMO RPG games sometimes have a big bang and then diminish quickly. I think if you actually look at our game portfolio, then you'll see that we have many MMO RPG games that have been successful and revenue generative and profitable for many years. And that would include a TLBB or TMNT board game or new or a number of games. And yeah, and while it's true that compared to a game like Honour of Kings that starts monetization at a low level as it's building audience and then it gradually matures into higher and high monetization over time, role-playing games you often see a burst of activity and spending in the first month and then it consolidates down to a lower level. A, that's something that's true across the industry; and B, the lower level to which the revenue consolidates down to can still be a very attractive level in absolute terms. So that's the role-playing game side.

On the advertising side then, we've said in the past and we'll say again, you shouldn't read too much into changes in the rate of growth year-on-year from one quarter to the next. If you look back at the last five quarters, I think every quarter, we've either accelerated or decelerated, and then accelerated and decelerated, and it's important not to overreact to those.

As you observed, we did begin to put advertising to Mini Programs from the middle of the year, and that resulted in a very strong advertising result for us in Q3. And the Mini Programs ad revenue continued to increase at a double-digit rate from Q3 to Q4, but relative to our previous years, I think that, A, we didn't have as much benefit on the video side because of the deferral of certain key content out of Q4 into the following year; and then B, there may have been some macro impact in terms of the very high-ticket price advertising as well.

<Q - John Choi>: I have a question on Cloud. I think this quarter you guys also have done a pretty good job, I think RMB 9B for the full year, I think fourth quarter roughly about RMB 3B. Could management give us more color, apart from games and video? I know that Internet services, financial, retail, having also stated, I think, Martin kind of emphasized these verticals, but could you kind of give us more color on – the contribution of these verticals in terms of paying customers or revenue? That will be great. And highlight what will be the growth drivers going forward? And if I may have a follow-up, quickly on advertising, given that short-form video continues to be a pretty big success right now, are you seeing any behavior changes from our advertisers that has impacting our advertising business? Thank you.

<A - Chi Ping Lau>: Well, in terms of cloud, I would say, we have actually provided quite a bit of color around the cloud business, right, and it's a combination of – we had more paying customers and as we continued to serve the existing customers, right, they will actually increase the spending with us over time. So, I think these are the drivers. And at the same time, we have been increasing our product portfolio, from just the infrastructure to also pass.

For example, we have been launching our online security cloud service which has been a pretty distinctive to manage for us, because we have been engaged in the online security industry for a long time and that when we package these technologies and capability into a product, into a pass for our users, right, they adopt it. So, I think it's a combination of more paying customers, higher spend with existing customers and also enriching portfolio of products.

In terms of the growth for 2019, I think we continuously work on the areas in terms of signing more customers, in terms of serving the existing customers better so that we can increase their spend. Some of these customers have multiple cloud providers including also their own IDC operation, so over time you want to prove that we have cost competitiveness as well as our service level and the product portfolio so that we can move more of their data center usage into our cloud.

And at the same time, we'll continue to improve our product offering so that we can get into more revenue sources as well as high-margin areas. And finally, we want to build up our relationship with partners, both in terms of distribution as well as in terms of SaaS partners, right, so that we can actually distribute a larger portfolio of SaaS services which are in nature of higher margin to our customers.

<A - James Gordon Mitchell>: On the question around short-form video, it's certainly true to observe that services like [indiscernible] (00:53:13) have grown their traffic very quickly in the last course of 2018 and grown their advertising revenue fairly quickly as well. I would observe that there is some advertiser overlap, but it's not complete advertiser overlap, relative to Weixin Moments, for example, which attracts more brand-conscious advertisers, the short video sites tend to attract more clearly performance-oriented advertisers. Also, if you look at the identities of the top two or three biggest advertisers on those platforms, they would be generally companies that don't advertise on Tencent inventory for competitive reasons anyway.

And I think the bigger picture is that the China advertising market would always have multiple companies growing share. There's never been a point in time and there probably will never be a point in time when we're the only company growing shares. So what's important to us is not who are the other companies growing share at any point in time, but are we actually outgrowing the market.

And I think that if you look the data reported across the industry, there are some successful companies growing advertising revenue in the mid-20% year-on-year and there are others whose advertising revenue is growing in teens, or flat, or even down year-on-year. We grew our advertising revenue at over 30% year-on-year, 38% year-on-year in a season – in a macro-economically difficult quarter.

So, we feel that we're clearly outperforming the market and we look forward to attempting continue to do so given that the tailwinds we enjoy in terms of substantial traffic, substantial traffic growth, information about our users, and ability to target the right ads to them and the technologies that we're increasingly bringing to bear around advertising.

<Q - Eddie Leung>: I have a question on Industrial Internet strategy. Enterprise services seemed to have long education and sales processes. So just curious on how you guys internally prioritize the resource allocation among various, let's say, industry verticals and use cases? I suppose at this early stage, it might be a bit difficult to use concrete ROI analysis? Or am I wrong?

And then, just a follow-up question, again, on Industrial Internet strategy. For the upcoming quarter, you mentioned that there will be a separate segment. So should we assume most of that revenues at the moment are both under the others segment? Thank you.

<A - Chi Ping Lau>: In terms of Industrial Internet, I think, Eddie, you're right in saying that the sales cycle is typically long, and it varies across different industries, right? So, I think what we do is actually taking a longer-term approach, which means that as we identify the industries that has potential, then we will put our resources to target those industries and knowing that it may take some time in order to break into the industry, and – but this is not something that you can actually avoid.

You can never allocate resources, then you'll never break into the vertical. So, that's why what we try to do is, we dedicate the resources. We actually create also the product, right, in order for us to demonstrate our technology as well as capability. And over time, once we can win certain showcase deals within the industry, right, and we can actually start to make a much better sales within the company, so – within the sector.

So, take an example, we know that in the financial sector, there's actually a big need for cloud services, right, but then the requirement for security, the requirement for services is actually very high, right. So, in breaking into the financial sector, what we do is, one, we have a showcase around WeBank, which is very clear from ground up, build up through our Tencent Cloud. And the other one is actually breaking into some of the very key banks, such as Consortium Bank, Associate Bank of China. And so, once we have been able to break into these very large accounts, right, we're then allotted the other financial institutions that would take that as a point of comfort and then they would come into using our services. So, I think that's how we do it.

What was the second question?

<A>: [indiscernible] (00:58:30)

<A - Chi Ping Lau>: Yeah, I think that's true. Your understanding is true. The new segment will be carving out from others to provide more information around that.

<Q - Grace Chen>: I just have a quick question about the gaming business, in particular cloud gaming. It would be great if the management can share with us your view about the market potential of cloud gaming in China and how Tencent positions itself to capitalize on cloud gaming. Thank you.

<A - James Gordon Mitchell>: Well, we think that, over the medium term, the potential for cloud gaming is quite interesting, because it will allow people to play more sophisticated graphically-immersive games on low-end devices, whether those be low-end PCs or TV screens or low-end smartphones. And I think that that's true globally. It may be, to some extent, disproportionately true in China given China has an unusual combination of actually very good bandwidth, but relatively low-end PC and smartphone mix compared to some developed markets.

In terms of whether this is an appropriate opportunity for Tencent – and I think it's actually a very appropriate opportunity for Tencent for a few reasons. One is that we are a fairly capable gaming company and this is a natural evolution of games. The second is that we're a company that has increasingly substantial cloud resources. And one of the critical success factors providing cloud stream games, particularly cloud stream interactive games that actually having servers in relatively close physical proximity to the users, because if you're trying to enable people to play a competitive cloud stream game from a central server on the other side of the world or the other side of the country, then no matter how good the bandwidth is, the physical latency means that for fast-paced games involving bullets, it's actually impossible to provide an experience equivalent to what you would get from a client-processed game.

So, we have that distributed server infrastructure across China. We have the game expertise. It's something that we're naturally very excited about, both from an evolution of games perspective, but also from a deepening of our cloud services perspective. And so, it's something that we're looking into closely. But it's also something that, I think, will take a few years to fully materialize. In the initial stage, it may be more about supporting single-player games, where the latency is less of an issue and then gradually upgrade to multi-player games, which is obviously the bigger revenue opportunity over the course of a number of years.

<Q - Richard Kramer>: A couple of things. First of all, you mentioned in the release about more accurate targeting of advertising and having merged your platforms to allow for multiple charging modes. Can you comment a bit more specifically about how much of the Weixin data will be available to advertisers for targeting purposes, maybe beyond products like WeChat Moments, and how close the integrated Weixin will be with the rest of the content ads?

And maybe my second question, if I'm looking across your portfolio of services, whether it's music, video, gaming content and others, what sort of prospects do you see for bundling those services into a sort of all-encompassing content bundle, where when someone is taking multiple services, they might be less prone to the churn that you very commonly see in China content services? Thanks.

<A - Huateng Ma>: Yeah. In terms of targeting, look it's very important to note that we don't provide any data to outside parties. Within the targeting, basically, it's a process in which the advertiser would specify what they're looking for, and then we will, within our own ruse figure out to who are the people to target for them within our own network. So there's absolutely no sharing or providing of data outside of our own service, not to advertisers, not to the other traffic partners. So I think that's very important to know, but because we have our mining algorithm that runs within our own firewall, right, so then we can actually provide the kind of advertising targeting and keep on iterating to make it better. So that's how we do it.

And at the same time, as we have pointed out quite a few times right, we do not subscribe to the notion that you need to have a sharing of data among all our different platforms, because I think as a company we actually put our user privacy at the forefront of our concern. So that's why we felt, if you look at the ability for us to target a lot of the benefit would actually come from the fact that we keep on improving our own technology. And when we pool together our technical expertise, it's actually focused on improving our targeting and data analytics technology, so that we can make every single platform better in terms of targeting the new users, but it's not going to be a blindly sharing of the different data across different platforms even internally.

<A - James Gordon Mitchell>: On the portfolio bundling question, it's an interesting topic and it's certainly something that we think about. You linked it to churn reduction, and actually, I'd say that on the churn reduction side, the industry – Tencent within the industry are making good progress anyway and that's partly because we have more regular better content now, so instead of someone subscribing to watch a single Hollywood movie and then churning once they've watched that movie, increasingly it's built around drama series, TV series, so they're more recurring episodic in nature and people tend not to stay for longer. Also, as increasingly providing the subscription of billing through our mobile payment solution and that tends to result in more convenience of payment, therefore higher stickiness, therefore lower churn.

So when we look at the portfolio bundling opportunity, we're looking at it less from a churn reduction perspective and more from a sort of value-enhancement perspective, both to Tencent as the recipient of the consumer's payments but also to the consumer in terms of whether they're actually getting appropriate value and making full use of the content that's available. And I think that's something that is the jury is still out globally. Amazon Prime is doing great bundling in video and music, but then Netflix and Spotify are also doing great providing video and music individually. In a China context, we have 160mm subscriptions now, the majority of them are digital content subscriptions. On the one hand that's a gigantic number, it's bigger than the entire pay television industry in the United States in terms of subscriptions, but on the other hand it's a small number, because it's still only a teens percentage of the population.

So for the immediate future, while we're doing some interesting experiments around bundling, the primary focus is on making each individual product, be it our video subscription service, our music subscription service, our digital services be as strong as they can be and as fully satisfy their user bases as possible within their vertical domain rather than trying to provide a full horizontal solution at a higher price.

<Q - Yue Natalie Wu>: I have two questions. First one is related with your mobile game. Just wondering for the stronger performance of HoK during Chinese New Year, how much is related towards the seasonality and how much is related with the Battle Pass? Should we expect the part of the – I mean a part of the [indiscernible] (01:07:55) to continue throughout this year if it was to some extent related with the Battle Pass system? And my second question is related with the e-commerce endeavor within WeChat ecosystem. For example, the function of shopping within WeChat based on friends recommendation, which is called [ph] Howchin (01:08:20), that has just been launched. What kind of the strategic resources you are planning to promote this function and how big can that kind of the function grow? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of Honour of Kings, I think we're actually quite happy to see the fact that this game has been actually able to not only sustain its user base, it has actually been able to attract a lot of users [indiscernible] (01:08:58) to come back to the game during the Chinese New Year period. And that's actually mostly due to the fact that we have done a very large upgrade, which improve the entire graphics to a new level. And at the same time, we have improved the matching mechanism. We have improved the tech behind it. So I think it's actually a testimony to the fact that when you have a PVP game that has been popular that hasn't reached such a large user base, whenever you provide a good upgrade, then a lot of people actually come back to play the game.

So I think the most important thing in the pretty good uptick is actually because of this. And then there's the seasonality. And then the Battle Pass, I think, is really a new trial, I don't think that's provided a lot of benefit yet, but over time hopefully the Battle Pass can become another addition to our continued revenue generation. In terms of the e-commerce, I think we are doing a lot of different trials within our platform. I think at this point in time, it's too early to tell. But if at the time when we see more insights, then we can provide an update to our investors.

<Q - Gregory Zhao>: [indiscernible] (01:10:37). Thanks for taking my question. So my question is about sales and marketing expense. So the press release management value decreased from advertising and the promotion expenses and reduced some less effective marketing campaign. So just want to have a better understanding that in which business category and what kind of marketing campaigns you call your advertising budgets. And one quick follow up on the content cost. So your industry peers, like IG who mentioned on their conference call, they expect the overall online advertising – sorry online video content market to be more rational in 2019 so given the control of the celebrity's income by the government. So just wanted to check what the implication to Tencent Video services, especially on cost and the margin? Thank you.

<A - Shek Hon Lo>: All right. In terms of selling and marketing expenses, I must say that we have done a stringent sort of cost control on a number of matters. Number one, as you know, since we understand that there's latency in the publishing rights approval, so some of the games set for the pre-launch promotion, we have cut down. And number two is we have revealed a lot of different products and some of which are still under research and fine-tuning. And we have decided not to spend too much money at that point in time, but instead, we'll look at the ROIs for some of the campaigns. While we're doing it, if we find out that it's not – if it is not as good as expected, we would cut it immediately.

And there are a lot of different campaigns, including the offline as well as the online because selling and marketing cost is something that we can dial up or down easily, according to how much we would like to spend that. So it is pretty easy for us to control. Say for instance, as Martin has mentioned earlier in some circumstances, if we want to invest further, we can spend more money on the payment platform side whereas if we feel like that it's in good shape, we can lessen it to some sort of extent.

<A - James Gordon Mitchell>: In terms of your question about content costs, then it is correct to observe that the content cost we would pay top-tier drama series, for example, are a little bit lower than they have been in the past. Now of course, there's some caveats attached to that. One is the other format costs continue to increase. The second is that, while the costs we would be paying and capitalizing today are stabilizing or dipping, they wouldn't flow through to a P&L benefit for a year or more given the relatively lengthy production cycle for these top-tier drama series.

And I'd also refer back to the comment I made earlier that to the extent that the companies in the industry aren't showing some of the high quality content that's earlier commissioned or paid for, then they aren't expensing it either, which is good for costs, but they also aren't generating the advertising revenue they would have otherwise generated, which is not so good for revenues. So as usual with the online video industry, there's a lot of moving parts and sometimes they cancel each other out a little bit.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2019-03-21
Event Description: Q4 2018 Earnings Call

Market Cap: 3.35TRI
Current PX: 351.40
YTD Change($): +37.40
YTD Change(%): +11.911

Bloomberg Estimates - EPS
Current Quarter: 2.173
Current Year: 9.592
Bloomberg Estimates - Sales
Current Quarter: 88306.231
Current Year: 400547.019

Q4 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Thomas Chong
- Wendy Huang
- Han-Joon Kim
- Alicia Yap
- John Choi
- Eddie Leung
- Grace Chen
- Richard Kramer
- Yue Natalie Wu
- Gregory Zhao

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2018 Fourth Quarter and Annual Results Presentation. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I'd now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Thank you. Good evening. Welcome to our 2018 fourth quarter and annual results conference call. I'm Jane Yip from the IR team of Tencent.

Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of Risk Factors and non-GAAP measures, please refer to our disclosures documents on the IR section of our website.

Let me introduce the management team on the call tonight. Our Chairman and CEO, Pony Ma will kick off with a short overview; President, Martin Lau will discuss strategic highlights; Chief Strategy Officer, James Mitchell will speak to business overview and Chief Financial Officer John Lo will go through the financials followed by a Q&A session.

I will now turn the call over to Pony.

Huateng Ma

Okay, thank you, Jane. Good evening, everyone. Thank you for joining us. 2018 marked the 20th anniversary of the founding of Tencent. Throughout our history, we embrace changes to stay at the forefront of the industry. Recently we launched a strategic organizational upgrade to extend our strength into Consumer Internet and to embrace the opportunities of the Industrial Internet. We will share key milestones with you in the future.

During the year, we strengthened our market leadership in key areas and built deeper connection with our users, advertisers, merchants and enterprise partners. In social, Weixin becomes the way of life in China aided by Weixin Pay and Mini Programs penetrating more use cases. The sharing of mini-videos within chat also drove rapid growth in user activities.

Mobile QQ continue to focus on young user engagement via social video sharing and newsfeed benefiting from increased user traffic and advertiser demand, social and others advertising revenue rose 55% year-on-year. In online games we are the world's largest game platform by user's revenues with technical capabilities to operate multiple blockbusters simultaneously. By MAU, League of Legends continue to be the biggest PC game and PUBG MOBILE becomes the most popular smartphone game globally.

In China, we sustained market leadership and also implement the Healthy Gameplay System in our most popular mobile titles to encourage balanced game time for young users. In media and content, we grew digital content subscriptions 50% year-on-year to over 100 million. Thanks to our popular self-commissioned transactions.

Newsfeed, short-video and mini-video views increased rapidly across our media platforms, QQ Browser and WeiShi. We grouped our content businesses to form a new Platforms & Content Group we call PCG, enabling us to focus resources on systematics content creation and management, as well as algorithm enhancement.

In ecosystem, our payment service expand users and merchant adoption, enabling us to grow commercial transactions [ph] activity (00:05:24) and upsell FinTech production. We stepped up investment in Tencent Cloud integrating AI and big data into the offering to drive organic growth of our own Cloud business and assist the digital transformation of wireless industries. Our customized solutions for smart industries are equipped with tools leveraging our social and technical capabilities.

Now let me go through the headline number and John will provide more detailed discussion in the financial section. For the fourth quarter of 2018, total revenue was RMB 84.9 billion, up 28% year-on-year and 5% quarter-on-quarter. Total games revenue which include platform revenue share book and social networks was 36% of total revenues compared to 45% for the fourth quarter of 2017.

Non-GAAP operating profit was RMB 22.4 billion, up 2% year-on-year or down 1% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 19.7 billion, up 13% year-on-year and stable sequentially. For the full year of 2018, total revenue was RMB 312.7 billion, up 32% year-on-year. Non-GAAP operating profit was RMB 92.5 billion, up 13% year-on-year. Non-GAAP net profit attributable to shareholders was RMB 77.5 billion, up 19% year-on-year.

For our key platforms, in social, combined MAU of Weixin and WeChat increased 11% year-on-year to 1.1 billion driven by use of communication needs as well as adoption of Mini Programs and Weixin Pay. Total MAU for QQ was over 807 million. Smart devices MAU increased 2% year-on-year to 700 million. For Qzone smart devices MAU was 532 million, down 4% year-on-year. In online games, we expand total user base benefiting from the popularity of tactical tournament games and action games on mobile. In PC, we released several niche genre games and received encouraging feedback from players.

In media, Tencent Video expanded market share in China in terms of mobile DAUs and paying subscriptions. We also used short and mini-video to push the time spent in our media feeds business across Tencent News, QQ KanDian, QQ Browser and other news properties. In payment, we further broadened use cases and grew total commercial payment volume rapidly despite intense market competition. We are now operating the largest mobile payment platform in China, measured by active users and the number of transactions. In utilities, QQ Browser and our Android App Store Yingyongbao maintained market-leading positions. Our online security team expands their research to cover a range of new use cases, such as automobile security.

With that, I will pass to Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony and good evening – good morning to everybody. In this section, I will discuss some of our strategic initiatives that have, firstly, contributed to the growth of our social platforms as well as our core businesses in payment, advertising and cloud, and secondly, have formed our key proposition to help our enterprise partners to embark on their digital transformation.

Now starting with this page on Mini Programs, the platform has become very popular among users. It benefits from a number of key drivers, firstly, for users, given the ubiquity of Weixin Mini Programs enables to further enhance user [indiscernible] (00:10:02) easy access to a broad range of daily life services. Total active users of Mini Programs grew more than 250% year-on-year and daily visits per user also increased 54% year-on-year in the fourth quarter.

For service providers, they can connect with consumers via Mini Programs and drive transactions, leveraging mobile payment, social sharing, data analytics and targeted advertising. Our Mini Programs are distinguished partly by the benefits they bring to long-tail service providers. Daily visits to long-tail Mini Program increased from 13% as of the end of 2017 to 43% as of the end of 2018.

For developers, our Mini Programs are designed to facilitate cross-platform development and instantaneous deployment, a unique advantage that increase development efficiency. On top of that, we also provide cloud-based development kits to make the development process even easier. As an emerging platform, we are helping to develop the talent pool in the developers. On that front, we partner with more than 100 universities to include Mini Programs in their curriculum and students now make up 24% of Mini Programs developers in China.

Now turning to the next page is Weixin Pay. That platform has grown from strength-to-strength. By the end of 2018, tens of millions of mom and pop stores can now accept mobile payment via our easy-to-deploy QR code solutions, which does not require expensive point-of-sales equipment. In total, the number of merchants actively transacting via Weixin Pay increased 80% year-on-year in the fourth quarter of 2018.

We also made significant progress in the food and retail categories, with a well-executed strategy that leveraged Mini Programs, Scan-to-Pay, customized management tools and partnership within investing companies such as Meituan-Dianping. Merchants using Weixin Pay typically see fast customer adoption. Average daily commercial transactions on Weixin Pay more than doubled year-on-year in 2018, as did the accompanying merchant tick rate revenue to Tencent. On a daily basis, there are over 1 billion transactions on Weixin Pay, the majority being commercial transactions. We believe Weixin Pay is the clear mobile payment leader in China in terms of daily users and the number of total as well as commercial transactions.

Built upon our extensive user reach and deep user engagement, we're able to upsell FinTech products to consumers at low acquisition cost. Our wealth management platform, LiCaiTong accumulated over RMB 600 billion of customer assets as of year-end. We also helped WeBank distribute micro-loan products WeiLiDai to individual consumers, which loan balance has been growing very rapidly. We also launched a new product called WeiYeDai to serve small and micro businesses alongside with WeBank.

Now, moving on to our advertising business. In our recent strategic organizational upgrade, we have merged our ad sales teams to enable them to sell both brand advertising as well as performance advertising. Key advertising accounts now benefit from coordinated sales coverage and the ability to buy efficiently across all our ad inventories. SME advertisers benefit from the ability to bid and place ads in a more timely and efficient fashion.

We've also centralized our advertising data analysis platform, greatly enhancing our ad targeting capabilities. And now, we can optimize traffic value by dynamically allocating our partner, our own inventories to the most suitable pricing models including CPC, CPM and optimized CPA. We continue to support our partners in achieving sales growth with our rich-content partnership, smart retail solution, as well as technology support.

We have a broad portfolio of inventories, attracting a healthy mix of advertisers across industries and budget ranges. We continue to focus on enhancing ROI to deliver value to advertisers, and this is particularly important amid headwinds in the current macroeconomic environment. Ad loads on our properties are generally lower than most peers in the market and we'll continue to manage it conservatively to produce sustainable growth over the long-term.

For our cloud business, we made good progress in 2018. For the full year, cloud revenues more than doubled to RMB 9.1 billion. In the fourth quarter, cloud-paying customers also more than doubled year-on-year. Tencent Cloud has become a clear market leader catering to online games and video customers, leveraging our infrastructure and operational expertise.

In internet services, by leveraging our strategic partnership in key verticals, we have quickly expanded the customer base in categories, including e-commerce, social media and community, handset manufactures and smart transportation. In the financial, we are the partner of choice for top banks and that provides, showcases small and medium-sized financial institutions.

In retail, we assist retailers to execute a digital transformation. We help them strengthen customer engagement via CRM and data analytics, enhance their marketing ROI using customer targeting and anti-fraud technologies, and also help them to upgrade their internal operations via smart solutions, integrating AI, LBS and big data technologies. We will continue to invest aggressively to enhance our cloud capabilities and offerings.

Finally, talking about our ecosystem, which continued to expand during the year, partly driven by our strategic investments. Making strategic investment bring benefits to our core business. By leveraging best-of-breeds category leaders to tap into new opportunities, allow us to focus our own attention and resources on our core platforms. Also, through upstream investments, we have enriched our IP portfolio in games and our digital content.

In addition to that partnership with investee companies also enable us to capture emerging opportunities and help us to expand our offerings to meet evolving user needs usually in different verticals, where our investee companies have unique and domain expertise. It also helped to accelerate the adoption of our enterprise-facing services such as payment, advertising and cloud. As a strategic investor, we're committed to creating value for investee companies by offering access to a large user base, as well as supporting the business growth by providing them with infrastructure, technology and capital.

During the past decade, we have built a handpicked portfolio covering games, digital content, O2O services, FinTech and emerging tech areas to over 700 investee companies. More than 100 investee companies were valued over $1 billion each and over 60 are publicly-listed already.

Going forward, we'll continue to make strategic investments to strengthen our ecosystem and in the process, bring benefits to our users, our partner companies, as well as ourselves.

Now with that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Thank you, Martin. Good evening or afternoon or morning, everyone. For the fourth quarter of 2018, our total revenue grew 28% year-on-year. As a percentage of revenues, VAS represents 51%, online advertising was 20% and the other segments accounted for 29%.

Starting with our VAS business. Segment revenue was RMB 43.7 billion in the fourth quarter, up 9% year-on-year, though down 1% sequentially. Social network revenue was up 25% year-on-year and up 7% quarter-on-quarter, with growth flowing from live streaming services and video subscriptions. Our total VAS subscriptions increased by 19% year-on-year to 160 million, as our video and music subscriber bases grew rapidly due to soft-commissioned video content and our music content library. Online game revenue in the quarter was down 1% year-on-year and down 6% quarter-on-quarter.

In our social networks, video interaction and consumption contributed substantially to activity growth in both QQ and Weixin. For Mobile QQ, AI-enhanced filming capabilities helped young users create imaginative and fun content to share with friends, boosting short and mini video uploads by over 50% year-on-year.

In QQ KanDian, we added new video categories and enhanced recommendation algorithms, introducing users to more relevant and interesting content and so significantly increasing daily video views. We also added bullet chatting within videos as a tool for viewers to interact. The Weixin and new function allows users to film and share instant videos that are available for 24 hours, and Weixin is providing background music matching the context of these user-created videos.

Our enterprise app, WeChat Work is gaining popularity, especially among large enterprises. WeChat Work can assist productivity in several ways. First, through integration with Weixin and Mini Programs, WeChat Work helps enterprises deepen their customer engagement and strengthen their post-sales interactions. Second, WeChat Work supports customer database management, allowing enterprise to more carefully analyze their data. And third, WeChat Work facilitates office administration by plug-ins for capabilities such as expense claim approvals.

For smartphone games, total revenue for the quarter was RMB 19 billion, up 12% year-on-year, due to new Action and RPG titles, but down 2% quarter-on-quarter, as we generally prioritize user engagements and other measures over monetization initiatives in a seasonally slow period. We released nine new games in the quarter. As many of you know, monetization approval for new games resumed in December. So far, seven new smartphone games for which we have publishing rights have received such approvals. These include titles in the role-playing, strategy, casual and functional genres.

Given the backlog, game releases both for ourselves and the industry as a whole likely to initially be slower than in previous years. At our own initiative, we launched a pilot project to introduce our Healthy Gameplay System, promoting balanced gameplay for under 18-year-olds. Starting with Honour of Kings, the system is now implemented in 39 of our smartphone games, covering a large majority of young players. As a result, play time for minors reduced significantly, whilst adult players' activity and consumption were not materially impacted.

Within China, our Action games such as QQ Speed Mobile and Cross Fire Mobile grew users by seasonal initiative and introduction of season passes. We released several role-playing games based on popular IPs, including Battle Through the Heavens, our mobile MOBA game, Honour of Kings held its flagship eSports event in December, attracting over 75 million unique viewers, an industry record for smartphone games. And we released an expansion pack for Honour of Kings in late January which has been well received. In international markets, App Annie has ranked PUBG MOBILE the most popular game globally by MAU for iOS and Android since last November.

Google Play named PUBG MOBILE as Best Game of 2018, citing its competitive and immersive game experience. Following the release of its Royale Pass in January, we believe PUBG MOBILE became the highest grossing game developed and published by a Chinese company in international markets.

Several of our investees' mobile games also attained notable success. Supercell's new mobile game Brawl Stars was the most downloaded game in 50 markets. Epic's Fortnite ranked number one in the U.S. iOS Grossing Chart in the fourth quarter. And Free Fire, Garena's first self-developed game, was the fourth most downloaded game globally in 2018.

Our investees' success benefits us financially but also operationally in terms of shared insights into industry trends and user behavior, enabling us and our partners to influence this development of a health game industry globally.

For PC client games, revenue for the quarter was RMB 11.2 billion, down 13% year-on-year due to users shifting to mobile and down 10% sequentially due to season of unfavorability. The League of Legends user engagement trends have improved globally due to new game content and improved specifically in China with the additional benefit of a China team winning the World Championships in November, when 99 million viewers watched the live broadcast of the League of Legends finals in South Korea.

Our recently released NBA2K Online 2 game has significantly expanded NBA2K franchise user base with a more powerful game engines, superior graphics and better balanced gameplay. And we launched two new PC games, Iris Fall and Bladed Fury to better serve niche audiences.

Moving to online advertising. Fourth quarter revenue was RMB 17 billion, up 38% year-on-year and up 5% quarter-on-quarter. Media advertising revenue was RMB 5.2 billion, up 26% year-on-year and up 2% quarter-on-quarter. Within media, video advertising increased year-on-year, helped by our variety in documentary shows, but rescheduling several highly-anticipated drama series out of the fourth quarter of 2018 and into later into 2019 led to a sequential revenue decline.

Our news advertising revenue, on the other hand, increased year-on-year as we added inventory following the revamp of our news feed ad system, and increased quarter-on-quarter benefiting from sports events and news feed. Media revenue generated from feed ads grew over 10 times year-on-year, benefiting from traffic growth with the completion of our system revamp and rising fill rates.

Our social and other advertising revenue was RMB 11.8 billion, up 44% year-on-year and up 6% quarter-on-quarter. Advertiser demand and increased ad inventory especially in Weixin Moments, Mini Programs, and QQ KanDian, drove the year-on-year revenue growth. Impressions growth in Mini Programs and positive e-commerce seasonality boosted revenues quarter-on-quarter, albeit to a lesser extent than in 4Q 2017 because the growth of Mini Programs' advertising revenue in 3Q 2018 created an usually high base for quarterly comparison. During the quarter, we showed a second ad unit in Weixin Moments to approximately 50% of Moments DAUs. Click-through rates remained high for both the first and second ad units.

Focusing on our Tencent Video business, we continued to lead the China online video market in terms of DAU, time spent, and revenue. Driven by premium content, we had 89 million video subscriptions at quarter-end, up 58% year-on-year. Revenue from subscriptions increased 65% year-on-year. User engagement trends were healthy as video views per DAU increased over 40% year-on-year and contributed to advertising revenue growth of 21% year-on-year. Our operating losses remained lower than those of industry peers.

We released sequels to several popular IPs, including Season 3 of our adventure drama, Candle in the Tomb, and Season 2 of our animated series, The Land of Warriors. In December, we upgraded our video VIP loyalty program, enabling subscribers to access tiered benefits, including e-commerce and Traveler privileges.

We're the leading destination for viewing sports online in China with the richest portfolio of major sports rights. For example, we've helped expand the NBA's audience in the country, leveraging our user base, communities, content curation, and video streaming capabilities. Average unique visitors per live stream to NBA game in China have almost tripled over the past three years.

Moving on to our payments and FinTech services, revenues sustained rapid growth, powered by three engines: first, merchants paying us transaction fees for use of our payment services; second, users, particularly heavy users, paying us cash withdrawal fees and credit card repayment charges; and third, financial institutions, including our affiliate WeBank, paying us service fees for making available wealth managements and microloan products. On the regulatory front, we completed the full transition of our payment routes to central clearing settlement systems. And we moved all custodian cash to PBoC accounts in January this year.

On the product front, Weixin Pay saw continued growth in users and per-user transaction volume. We added new consumer features such as virtual cards for dependents, and we enhanced our account management tools for enterprises.

Our LiCaiTong wealth management platform has accumulated 100 million users who have subscribed to money market funds paid by their bank cards. In parallel our new LingQianTong service allows users to invest excess cash balance in their Weixin Pay accounts directly into money-market funds.

And with that, I'll pass it to John to talk to the financials.

Shek Hon Lo

Hello, everyone. For quarter four 2018, our total revenue was RMB 84.9 billion, up 28% Y-on-Y and 5% Q-on-Q. Gross profit was RMB 35.2 million, up 12% year-over-year or down 1% quarter-on-quarter. Net other losses were RMB 2.1 billion, which mainly consist of one-off expenses relating to ordinary share issuance to strategic partners of TME and the impairment provisions for certain investees.

Share of profits of associates and joint ventures were RMB 16 million, compared to share of loss of RMB 120 million for the fourth quarter of 2017. On a non-GAAP basis, share of profit of associated and joint venture was RMB 1.9 billion versus RMB 495 million for quarter four 2017.

Income tax expense was approximately RMB 1.9 billion, down 39% year-on-year or 41% Q-on-Q. The year-on-year decrease was mainly due to preferential tax benefit entitlements. This sequential decrease mainly reflected the reversals relating to the entitlements of preferential tax benefits partially offset by higher withholding tax. The effective tax rate for the fourth quarter was 12%.

GAAP net profit attributable to shareholders was RMB 14.2 billion, down 32% Y-on-Y and 39% Q-on-Q. The Y-on-Y increase in GAAP profit was greatly affected by noncash expenses relating to capital raising as mentioned above coupled with substantial deemed disposal gains relation to the capital activities of certain investee companies such as the IPOs of Yixin, Sea and Sogou in quarter four 2017.

Let me walk you through the non-GAAP numbers. For the fourth quarter, operating profit was RMB 22.4 billion, up 2% Y-on-Y or down 1% Q-on-Q. Operating margin was 26.4%, down 6.5 percentage points Y-on-Y or 1.6 percentage points Q-on-Q. Net profit to shareholders was RMB 19.7 billion, up 13% Y-on-Y or broadly stable Q-on-Q. Net margin was 23.8%, down 3.9 percentage points Y-on-Y or 1.5 percentage points Q-on-Q.

Turning to gross margin. Gross margin for value-added services was 53.4%, down 5.9 percentage points Y-on-Y or 3.1 percentage points Q-on-Q. The Y-on-Y decrease was mainly due to higher content costs for video and music services and lower revenue contribution of higher margin PC client games. The quarter-on-quarter decrease was mainly due to lower proportion of revenues from our PC games, lower revenue contribution from self-developed smartphone games, and increased content cost for our live broadcast and music services. Gross margin for online advertising was 36.6%, broadly stable Y-on-Y and Q-on-Q. Gross margin for others was 23.1%, again broadly stable Y-on-Y and Q-on-Q.

On operating expenses, selling and marketing expenses was RMB 5.7 billion, down 5% Y-on-Y or 13% Q-on-Q. The year-on-year and quarter-on-quarter decrease were mainly driven by the reduction of advertising and promotion expenses due to cost control initiatives. Total G&A expenses was RMB 11.4 billion, up 29% Y-on-Y or 4% Q-on-Q.

On the G&A, R&D expenses were RMB 6 billion, up 24% year-on-year or down 5% Q-on-Q. The year-on-year increase of total G&A mainly reflected greater R&D and staff cost. The quarter-on-quarter increase was mainly reflecting [ph] quicker (00:31:20) spending on staff fringe benefits and conference fees. At quarter-end, our employee count increased to approximately 54,300, year-on-year increase of 21% reflecting expansion of our business scope.

Let's go through margin ratios for quarter four. Gross margin was 41.4%, down 6 percentage points Y-on-Y or 2.6 percentage points Q-on-Q. Gross margin contraction and revenue mix shift to other segments, which carry a lower margin are the main reasons.

Non-GAAP operating margin was 26.4%, [ph] that's (32:00) 6.5 percentage points year-on-year or 1.6 percentage points Q-on-Q. Non-GAAP net margin was 23.8%, down 3.9 percentage points Y-on-Y and 1.5 percentage points Q-on-Q.

For 2018, on GAAP basis, basic EPS was RMB 8.336 and diluted was RMB 8.228. Non-GAAP basis, basic EPS was RMB 8.203 and diluted EPS was RMB 8.097. Subject to shareholders' approval at our AGM to be held on 15 of May 2019, we are proposing an annual dividend of HKD 1.00 per share, payable on 31 of May 2019.

Before I close my remarks, I'll share a few key financial metrics. For fourth quarter, total CapEx was RMB 4.6 billion, down 8% year-on-year or 24% Q-on-Q. Operating CapEx was RMB 3.7 billion, down 29% Q-on-Q, non-operating CapEx was RMB 893 million.

As at quarter-end, free cash flow was RMB 28.6 billion, up 18% Y-on-Y or 9% Q-on-Q. For 2018, free cash flow was RMB 83.4 billion, down 11% year-on-year. Our net-debt position improved by 58% to RMB 12.2 billion quarter-on-quarter.

Healthy operating cash flow plus the disposal of our shares in certain investee companies and capital raising from TME more than offset M&A cash outflows in the fourth quarter. The fair value of our shareholdings in the listed investee companies excluding subsidiaries was approximately RMB 238 billion or roughly $34.7 billion at year-end.

I would like to let you know that following our strategic upgrade from the Consumer Internet to the Industrial Internet, we will add a new revenue segment to better reflect our evolving business mix in the next quarter. Thank you.

Jane Yip

Thank you, John. We shall now open the floor for questions. Operator, we will take one main question and one follow-up question each time. Shall we invite the first question, please?

Q&A

Operator

Certainly. The first questions comes from the line of Thomas Chong from Credit Suisse. Please go ahead.

<Q - Thomas Chong>: Good evening. Thanks, management, for taking my questions. I have a question related to advertising. Can management comment about the macro headwinds to our advertising, including social and others, as well as media? And how should we think about the growth trends in Moments as well as Mini Programs? Should we expect to increase the ad loads in Moments in coming quarters? Thank you.

<A - James Gordon Mitchell>: Thomas, thank you for your question. In terms of macro headwinds, it does appear that the uncertainty late last year may have resulted in slower advertising spending, particularly in some high-ticket price categories such as automobiles, reflecting a deceleration in sales of automobiles. So I suppose that's not desirable, but it's fairly natural. As far as Tencent was concerned, we believe we continue to grow substantially faster than the market in the fourth quarter. And in turn, we think that reflects the quality of the inventory that we bring, the targeting technology we provide around the inventory and the attractive prices that we charge.

Looking forward then, you can see from our latest quarterly results that we still have ample room to increase ad load over time at a measured pace in some of our key inventories such as Weixin Moments where we're currently running 1 to 2 ad units per day versus global peers running around 10 ad units per day. And we're also starting to bring online news feed inventory where we've been focused on really increasing traffic first and now that we're in a position where the traffic is growing nicely, you can see it in the fourth quarter, the revenue began to pick up as well on the news feed side. So that's how we see the advertising environment.

<Q - Thomas Chong>: Thank you. May I have a quick follow up regarding the online video advertising? Given the fact that we see some delay in terms of the launch of some of the drama programs, how should we think about the trend in Q1 and 2019? Thank you.

<A - James Gordon Mitchell>: Well, as you observed, there are some delays across the industry to launch in certain categories of content in online video, for example, costume drama series. And costume drama series are relatively important in terms of their ability both to drive advertising and also subscription revenue. So, obviously, the subscription revenue reacts with a longer time lag to changes in the content, but the advertising revenue reacts relatively immediately. So, yes, there may be some pressure for the overall online video industry's advertising revenue in coming months as the industry waits to bring onstream some of the content.

<Q - Thomas Chong>: Thank you.

<A - Jane Yip>: Thank you. And the next question, please?

Operator

Certainly. The next question is from the line of Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you. First, can you give us an update on the games in the pipeline with approval considering that you launched as new titles in Q4, but additionally, you get seven titles with approval? And also, can you clarify whether the seven titles you mentioned you get approval that actually includes the license to the titles, which is actually given up by other companies? And also, a very quick follow-up on the advertising questions Thomas asked earlier. So how should we think about advertising margin trend going forward? It seems, actually, it stabilized a little bit this quarter. And also related to that, what would be the content cost in 2019? Thank you.

<A - James Gordon Mitchell>: So, in terms of the new games, just to clarify, seven new smartphone games have been approved since the banhao was resumed, the issuance of banhao resumed. But we've also had one PC game approved. So, in total, eight games approved since resumption of banhao, and that includes licensed games. We have several dozen more games in the approval pipeline awaiting approval. As we commented in the opening remarks, the fact that there is this backlog for approval will likely have some impact on the industry growth and our growth within the industry in the next few months. But we're pleased that the situation is clearer now and that the backlog is being worked through at a fairly rapid pace.

In terms of the margins for advertising segment, as you know, historically, those depend to a great extent on the mix of different products. And so, for example, when we grow the advertising within Weixin Moments, that's a relatively high-margin stream. As we grow the advertising around video entertainment content, that's a relatively low-margin stream. And then inventory where we share advertising with partners such as Official Accounts, we're somewhere in the middle. In the near term, the flipside of not being able to show some of the video content one might otherwise show is that the video content costs may not be as heavy as they would otherwise be for the industry and for us within the industry.

Operator

Thank you. The next question comes from the line of Han-Joon Kim from Deutsche Bank. Please ask your question.

<Q - Han-Joon Kim>: Great. Thank you for the chance to ask the question. I have a question on the margins. And if I'm reading this correctly, it seems like WeChat Pay gross margins improved sequentially, and we talked to a few factors that drove it. But as we think about 2019, could you walk us through some of the puts and takes and how much operating leverage we can kind of see here in terms of gross margins?

<A - Chi Ping Lau>: Well, I think for WeChat Pay, the gross margin, number one, I think it's going to be driven by a number of different factors, which actually are quite dynamic because we actually take in the revenue from the merchants as well as from consumers. But at the same time, we actually have to pay a very big chunk of that to the banks as bank charges. And at the same time, nowadays we actually sort of have lost the interest to income from the reserve cash, but we are now trying to compensate partly for that through cross-selling of our FinTech products. So it will be a pretty dynamic situation in the course of the year of 2019.

A big swing factor would be the bank charges, and [indiscernible] (00:42:40) is actually competitive dynamics and also our ability to cross-sell more financial products. And at the same time, what you see is the gross margin, but below the gross margin there's actually a marketing cost, which is actually also very high because despite the fact that we have positive gross margin on the growth side, we are actually engaged in a lot of marketing activities, including consumer subsidies, including some merchant rebates in order for us to continue to build market share and also make our payment mechanism – make our payment platform more popular with merchants. So that actually is another cost, which is quite dynamic as well.

So I think, all-in-all, what I want to say it's a dynamic situation. We run our payment platform more as an infrastructure business for now. And over time, I think if we can achieve more success in cross-selling the financial products, then it may generate more revenue and more margin. But again, it's a long-term vision for our business. For the near-term, I think we're very focused on making sure that we can continue to make WeChat payment even more popular among the users and merchants.

<Q - Han-Joon Kim>: Got it. Understood. And if I just have a quick follow-up question. I noticed a pretty sharp spike in content costs, and the cost breakdown. So I just want to understand the nature of that, and that happens to be more one-off in nature or something that's going to be recurring. Thank you.

<A - Shek Hon Lo>: Sorry, Han. Can you just repeat about question for the content cost?

<Q - Han-Joon Kim>: Yeah, the cost breakdown actually shows a fairly sharp increase in the content cost in the fourth quarter relative to prior trends. So I just wanted to see if there was any particular one-offs included in there or if this is something that's going to be recurring.

<A - Shek Hon Lo>: I think it's something to be recurring, due to the fact that there are a lot of things that are increased – and the content cost, such as interactive live video; if we had more revenue, then there would be more sharing. And also, there has been more content cost in respect of music being paid for, so we have more content costs. And on top of that, online games, mix and things like that would affect the content cost we need to share with the developers.

<Q - Han-Joon Kim>: Thank you.

<A - Jane Yip>: Thank you. And your next question, please?

<A - Shek Hon Lo>: Sorry.

<A - Jane Yip>: So please go ahead.

Operator

Next question comes from the line of Alicia Yap from Citigroup. Please ask your question.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my question. I have a questions on the online games. Given Perfect World just launched and the initial ranking was very strong. From the past record, usually the MMO tends to spike in the first couple months and then drop out very quickly after that. Do you think Perfect World will be the similar case? Or do you think it will be different this time? And could you share with us the reasons that boost the strong games performance? Is that because of the game quality, or is it because of the Tencent successful promotional effort?

And the follow-up questions I have is related to advertising. So just wondering because of the Mini Programs advertising, if I remember correctly was actually introduced late 2Q, so it actually benefited the 3Q. And just wonder how we reconcile 4Q that we didn't get much of that benefit. Is it really because of the macro or is that we were too optimistic about the ramp of ad opportunity within the Mini Programs? Thank you.

<A - James Gordon Mitchell>: Hi, Alicia. So, first of all, on the Perfect World game, it has been commendably successful and we obviously hope it remains so. I think in terms of the factors that contributed to its success, the game quality is obviously one; the long history of the intellectual property is another. Our ability to target the game to the right audience is a third, and then I think our publishing skills in general are a fourth.

You made a comment that MMO RPG games sometimes have a big bang and then diminish quickly. I think if you actually look at our game portfolio, then you'll see that we have many MMO RPG games that have been successful and revenue generative and profitable for many years. And that would include a TLBB or TMNT board game or new or a number of games. And yeah, and while it's true that compared to a game like Honour of Kings that starts monetization at a low level as it's building audience and then it gradually matures into higher and high monetization over time, role-playing games you often see a burst of activity and spending in the first month and then it consolidates down to a lower level. A, that's something that's true across the industry; and B, the lower level to which the revenue consolidates down to can still be a very attractive level in absolute terms. So that's the role-playing game side.

On the advertising side then, we've said in the past and we'll say again, you shouldn't read too much into changes in the rate of growth year-on-year from one quarter to the next. If you look back at the last five quarters, I think every quarter, we've either accelerated or decelerated, and then accelerated and decelerated, and it's important not to overreact to those.

As you observed, we did begin to put advertising to Mini Programs from the middle of the year, and that resulted in a very strong advertising result for us in the third quarter. And the Mini Programs ad revenue continued to increase at a double-digit rate from Q3 to Q4, but relative to our previous years, I think that, A, we didn't have as much benefit on the video side because of the deferral of certain key content out of Q4 into the following year; and then B, there may have been some macro impact in terms of the very high-ticket price advertising as well.

<A - Jane Yip>: Okay. Thank you.

Operator

Thank you for the question. Next question comes from the line of John Choi from Daiwa Capital Markets. Please go ahead.

<Q - John Choi>: Thank you. I have a question on Cloud. I think this quarter you guys also have done a pretty good job, I think RMB 9 billion for the full year, I think fourth quarter roughly about RMB 3 billion. Could management give us more color, apart from games and video? I know that Internet services, financial, retail, having also stated, I think, Martin kind of emphasized these verticals, but could you kind of give us more color on – the contribution of these verticals in terms of paying customers or revenue? That will be great. And highlight what will be the growth drivers going forward? And if I may have a follow-up, quickly on advertising, given that short-form video continues to be a pretty big success right now, are you seeing any behavior changes from our advertisers that has impacting our advertising business? Thank you.

<A - Chi Ping Lau>: Well, in terms of cloud, I would say, we have actually provided quite a bit of color around the cloud business, right, and it's a combination of – we had more paying customers and as we continued to serve the existing customers, right, they will actually increase the spending with us over time. So, I think these are the drivers. And at the same time, we have been increasing our product portfolio, from just the infrastructure to also pass.

For example, we have been launching our online security cloud service which has been a pretty distinctive to manage for us, because we have been engaged in the online security industry for a long time and that when we package these technologies and capability into a product, into a pass for our users, right, they adopt it. So, I think it's a combination of more paying customers, higher spend with existing customers and also enriching portfolio of products.

In terms of the growth for 2019, I think we continuously work on the areas in terms of signing more customers, in terms of serving the existing customers better so that we can increase their spend. Some of these customers have multiple cloud providers including also their own IDC operation, so over time you want to prove that we have cost competitiveness as well as our service level and the product portfolio so that we can move more of their data center usage into our cloud.

And at the same time, we'll continue to improve our product offering so that we can get into more revenue sources as well as high-margin areas. And finally, we want to build up our relationship with partners, both in terms of distribution as well as in terms of SaaS partners, right, so that we can actually distribute a larger portfolio of SaaS services which are in nature of higher margin to our customers.

<A - James Gordon Mitchell>: On the question around short-form video, it's certainly true to observe that services like [indiscernible] (00:53:13) have grown their traffic very quickly in the last course of 2018 and grown their advertising revenue fairly quickly as well. I would observe that there is some advertiser overlap, but it's not complete advertiser overlap, relative to Weixin Moments, for example, which attracts more brand-conscious advertisers, the short video sites tend to attract more clearly performance-oriented advertisers. Also, if you look at the identities of the top two or three biggest advertisers on those platforms, they would be generally companies that don't advertise on Tencent inventory for competitive reasons anyway.

And I think the bigger picture is that the China advertising market would always have multiple companies growing share. There's never been a point in time and there probably will never be a point in time when we're the only company growing shares. So what's important to us is not who are the other companies growing share at any point in time, but are we actually outgrowing the market.

And I think that if you look the data reported across the industry, there are some successful companies growing advertising revenue in the mid-20% year-on-year and there are others whose advertising revenue is growing in teens, or flat, or even down year-on-year. We grew our advertising revenue at over 30% year-on-year, 38% year-on-year in a season – in a macro-economically difficult quarter.

So, we feel that we're clearly outperforming the market and we look forward to attempting continue to do so given that the tailwinds we enjoy in terms of substantial traffic, substantial traffic growth, information about our users, and ability to target the right ads to them and the technologies that we're increasingly bringing to bear around advertising.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Next question comes from the line of Eddie Leung from Bank of America Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Hey. Good evening. Thank you for taking the question. I have a question on Industrial Internet strategy. Enterprise services seemed to have long education and sales processes. So just curious on how you guys internally prioritize the resource allocation among various, let's say, industry verticals and use cases? I suppose at this early stage, it might be a bit difficult to use concrete ROI analysis? Or am I wrong?

And then, just a follow-up question, again, on Industrial Internet strategy. For the upcoming quarter, you mentioned that there will be a separate segment. So should we assume most of that revenues at the moment are both under the others segment? Thank you.

<A - Chi Ping Lau>: In terms of Industrial Internet, I think, Eddie, you're right in saying that the sales cycle is typically long, and it varies across different industries, right? So, I think what we do is actually taking a longer-term approach, which means that as we identify the industries that has potential, then we will put our resources to target those industries and knowing that it may take some time in order to break into the industry, and – but this is not something that you can actually avoid.

You can never allocate resources, then you'll never break into the vertical. So, that's why what we try to do is, we dedicate the resources. We actually create also the product, right, in order for us to demonstrate our technology as well as capability. And over time, once we can win certain showcase deals within the industry, right, and we can actually start to make a much better sales within the company, so – within the sector.

So, take an example, we know that in the financial sector, there's actually a big need for cloud services, right, but then the requirement for security, the requirement for services is actually very high, right. So, in breaking into the financial sector, what we do is, one, we have a showcase around WeBank, which is very clear from ground up, build up through our Tencent Cloud. And the other one is actually breaking into some of the very key banks, such as Consortium Bank, Associate Bank of China. And so, once we have been able to break into these very large accounts, right, we're then allotted the other financial institutions that would take that as a point of comfort and then they would come into using our services. So, I think that's how we do it.

What was the second question?

<A>: [indiscernible] (00:58:30)

<A - Chi Ping Lau>: Yeah, I think that's true. Your understanding is true. The new segment will be carving out from others to provide more information around that.

<A - Jane Yip>: Thank you. And the next question, please?

Operator

The next question comes from Grace Chen from Morgan Stanley. Please ask your question.

<Q - Grace Chen>: Hi. Thank you. Thank you for taking my question. I just have a quick question about the gaming business, in particular cloud gaming. It would be great if the management can share with us your view about the market potential of cloud gaming in China and how Tencent positions itself to capitalize on cloud gaming. Thank you.

<A - James Gordon Mitchell>: Well, we think that, over the medium term, the potential for cloud gaming is quite interesting, because it will allow people to play more sophisticated graphically-immersive games on low-end devices, whether those be low-end PCs or TV screens or low-end smartphones. And I think that that's true globally. It may be, to some extent, disproportionately true in China given China has an unusual combination of actually very good bandwidth, but relatively low-end PC and smartphone mix compared to some developed markets.

In terms of whether this is an appropriate opportunity for Tencent – and I think it's actually a very appropriate opportunity for Tencent for a few reasons. One is that we are a fairly capable gaming company and this is a natural evolution of games. The second is that we're a company that has increasingly substantial cloud resources. And one of the critical success factors providing cloud stream games, particularly cloud stream interactive games that actually having servers in relatively close physical proximity to the users, because if you're trying to enable people to play a competitive cloud stream game from a central server on the other side of the world or the other side of the country, then no matter how good the bandwidth is, the physical latency means that for fast-paced games involving bullets, it's actually impossible to provide an experience equivalent to what you would get from a client-processed game.

So, we have that distributed server infrastructure across China. We have the game expertise. It's something that we're naturally very excited about, both from an evolution of games perspective, but also from a deepening of our cloud services perspective. And so, it's something that we're looking into closely. But it's also something that, I think, will take a few years to fully materialize. In the initial stage, it may be more about supporting single-player games, where the latency is less of an issue and then gradually upgrade to multi-player games, which is obviously the bigger revenue opportunity over the course of a number of years.

<Q - Grace Chen>: Thank you.

Operator

Thank you. The next question comes from Richard Kramer from Arete Research. Please ask your question.

<Q - Richard Kramer>: Thanks very much. A couple of things. First of all, you mentioned in the release about more accurate targeting of advertising and having merged your platforms to allow for multiple charging modes. Can you comment a bit more specifically about how much of the Weixin data will be available to advertisers for targeting purposes, maybe beyond products like WeChat Moments, and how close the integrated Weixin will be with the rest of the content ads?

And maybe my second question, if I'm looking across your portfolio of services, whether it's music, video, gaming content and others, what sort of prospects do you see for bundling those services into a sort of all-encompassing content bundle, where when someone is taking multiple services, they might be less prone to the churn that you very commonly see in China content services? Thanks.

<A - Huateng Ma>: Yeah. In terms of targeting, look it's very important to note that we don't provide any data to outside parties. Within the targeting, basically, it's a process in which the advertiser would specify what they're looking for, and then we will, within our own ruse figure out to who are the people to target for them within our own network. So there's absolutely no sharing or providing of data outside of our own service, not to advertisers, not to the other traffic partners. So I think that's very important to know, but because we have our mining algorithm that runs within our own firewall, right, so then we can actually provide the kind of advertising targeting and keep on iterating to make it better. So that's how we do it.

And at the same time, as we have pointed out quite a few times right, we do not subscribe to the notion that you need to have a sharing of data among all our different platforms, because I think as a company we actually put our user privacy at the forefront of our concern. So that's why we felt, if you look at the ability for us to target a lot of the benefit would actually come from the fact that we keep on improving our own technology. And when we pool together our technical expertise, it's actually focused on improving our targeting and data analytics technology, so that we can make every single platform better in terms of targeting the new users, but it's not going to be a blindly sharing of the different data across different platforms even internally.

<A - James Gordon Mitchell>: On the portfolio bundling question, it's an interesting topic and it's certainly something that we think about. You linked it to churn reduction, and actually, I'd say that on the churn reduction side, the industry – Tencent within the industry are making good progress anyway and that's partly because we have more regular better content now, so instead of someone subscribing to watch a single Hollywood movie and then churning once they've watched that movie, increasingly it's built around drama series, TV series, so they're more recurring episodic in nature and people tend not to stay for longer. Also, as increasingly providing the subscription of billing through our mobile payment solution and that tends to result in more convenience of payment, therefore higher stickiness, therefore lower churn.

So when we look at the portfolio bundling opportunity, we're looking at it less from a churn reduction perspective and more from a sort of value-enhancement perspective, both to Tencent as the recipient of the consumer's payments but also to the consumer in terms of whether they're actually getting appropriate value and making full use of the content that's available. And I think that's something that is the jury is still out globally. Amazon Prime is doing great bundling in video and music, but then Netflix and Spotify are also doing great providing video and music individually. In a China context, we have 160 million subscriptions now, the majority of them are digital content subscriptions. On the one hand that's a gigantic number, it's bigger than the entire pay television industry in the United States in terms of subscriptions, but on the other hand it's a small number, because it's still only a teens percentage of the population.

So for the immediate future, while we're doing some interesting experiments around bundling, the primary focus is on making each individual product, be it our video subscription service, our music subscription service, our digital services be as strong as they can be and as fully satisfy their user bases as possible within their vertical domain rather than trying to provide a full horizontal solution at a higher price.

<A - Jane Yip>: Thank you. And may we accept the last two questions?

Operator

Certainly. The last question comes from the line of Natalie Wu from CICC. Please ask your question.

<Q - Yue Natalie Wu>: Hi. Good evening. Thanks for taking my question. I have two questions. First one is related with your mobile game. Just wondering for the stronger performance of HoK during Chinese New Year, how much is related towards the seasonality and how much is related with the Battle Pass? Should we expect the part of the – I mean a part of the [indiscernible] (01:07:55) to continue throughout this year if it was to some extent related with the Battle Pass system? And my second question is related with the e-commerce endeavor within WeChat ecosystem. For example, the function of shopping within WeChat based on friends recommendation, which is called [ph] Howchin (01:08:20), that has just been launched. What kind of the strategic resources you are planning to promote this function and how big can that kind of the function grow? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of Honour of Kings, I think we're actually quite happy to see the fact that this game has been actually able to not only sustain its user base, it has actually been able to attract a lot of users [indiscernible] (01:08:58) to come back to the game during the Chinese New Year period. And that's actually mostly due to the fact that we have done a very large upgrade, which improve the entire graphics to a new level. And at the same time, we have improved the matching mechanism. We have improved the tech behind it. So I think it's actually a testimony to the fact that when you have a PVP game that has been popular that hasn't reached such a large user base, whenever you provide a good upgrade, then a lot of people actually come back to play the game.

So I think the most important thing in the pretty good uptick is actually because of this. And then there's the seasonality. And then the Battle Pass, I think, is really a new trial, I don't think that's provided a lot of benefit yet, but over time hopefully the Battle Pass can become another addition to our continued revenue generation. In terms of the e-commerce, I think we are doing a lot of different trials within our platform. I think at this point in time, it's too early to tell. But if at the time when we see more insights, then we can provide an update to our investors.

<A - Jane Yip>: Thank you. And the last question, please.

Operator

This is the last question. It comes from the line of Gregory Zhao from Barclays. Please ask your question.

<Q - Gregory Zhao>: Hi, [indiscernible] (01:10:37). Thanks for taking my question. So my question is about sales and marketing expense. So the press release management value decreased from advertising and the promotion expenses and reduced some less effective marketing campaign. So just want to have a better understanding that in which business category and what kind of marketing campaigns you call your advertising budgets. And one quick follow up on the content cost. So your industry peers, like IG who mentioned on their conference call, they expect the overall online advertising – sorry online video content market to be more rational in 2019 so given the control of the celebrity's income by the government. So just wanted to check what the implication to Tencent Video services, especially on cost and the margin? Thank you.

<A - Shek Hon Lo>: All right. In terms of selling and marketing expenses, I must say that we have done a stringent sort of cost control on a number of matters. Number one, as you know, since we understand that there's latency in the publishing rights approval, so some of the games set for the pre-launch promotion, we have cut down. And number two is we have revealed a lot of different products and some of which are still under research and fine-tuning. And we have decided not to spend too much money at that point in time, but instead, we'll look at the ROIs for some of the campaigns. While we're doing it, if we find out that it's not – if it is not as good as expected, we would cut it immediately.

And there are a lot of different campaigns, including the offline as well as the online because selling and marketing cost is something that we can dial up or down easily, according to how much we would like to spend that. So it is pretty easy for us to control. Say for instance, as Martin has mentioned earlier in some circumstances, if we want to invest further, we can spend more money on the payment platform side whereas if we feel like that it's in good shape, we can lessen it to some sort of extent.

<A - James Gordon Mitchell>: In terms of your question about content costs, then it is correct to observe that the content cost we would pay top-tier drama series, for example, are a little bit lower than they have been in the past. Now of course, there's some caveats attached to that. One is the other format costs continue to increase. The second is that, while the costs we would be paying and capitalizing today are stabilizing or dipping, they wouldn't flow through to a P&L benefit for a year or more given the relatively lengthy production cycle for these top-tier drama series.

And I'd also refer back to the comment I made earlier that to the extent that the companies in the industry aren't showing some of the high quality content that's earlier commissioned or paid for, then they aren't expensing it either, which is good for costs, but they also aren't generating the advertising revenue they would have otherwise generated, which is not so good for revenues. So as usual with the online video industry, there's a lot of moving parts and sometimes they cancel each other out a little bit.

Jane Yip

Thank you. And we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website at www.tencent.com. The replay of this webcast will also be available soon. Thank you, and see you next quarter.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2018 Fourth Quarter and Annual Results Presentation. You may all disconnect now.

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Company Ticker: 700 HK
Date: 2018-11-14
Event Description: Q3 2018 Earnings Call

Market Cap: 2.59TRI
Current PX: 272.20
YTD Change($): -133.80
YTD Change(%): -32.956

Bloomberg Estimates - EPS
Current Quarter: 2.023
Current Year: 8.276
Bloomberg Estimates - Sales
Current Quarter: 84761.813
Current Year: 317688.844

Q3 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Wendy Huang
- Alicia Yap
- Thomas Chong
- Winnie Wong
- John Choi
- Han-Joon Kim
- Grace Chen
- Yue Wu
- Alex Yao
- Jin-Kyu Yoon

MANAGEMENT DISCUSSION SECTION

Jane Yip

GAAP and Non-GAAP Financial Measures

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS.

For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our website

Huateng Ma

Q3 Highlights

During Q3 2018, we registered strong operating results in our businesses and maintained healthy financial metrics

Our advertising, digital content, payment and cloud services sustained robust activity and revenue growth, and now account for the majority of our revenue

Games Business

Stringent Self-Imposed Limitations and Organization

- For our games business, we implemented stringent self-imposed limitations on games playing by minors, which we believed put the game industry on a healthy and more solid foundation for future development
- At the end of the quarter, we upgraded our organization to help enterprises and various industries to benefit from the new trend of industrial Internet through digitization and technology innovation, and to provide consumers with better integrated entertainment and social experiences, as well as to unify our advertising sales platforms
  - We believe this strategic organizational upgrade will position us well for future long-term growth and Martin will discuss in details in the strategic highlights section

Revenues, Net Profits and MAU

- Now let me highlight the key financial numbers and defer the discussion to John's financial section
- Total revenue was RMB 80.6B, up 24% year-on-year and up 9% quarter-on-quarter
- Non-GAAP net profit attributable to shareholders was RMB 19.7B, up 15% year-on-year and flat quarter-on-quarter
- Moving on to our key platforms
- Combined MAU of Weixin and WeChat increased 10.5% year-on-year to 1.08B, benefiting from the increasing use case offered by Mini Programs and Weixin Pay

QQ, AoV and PUBG MOBILE Games

- Smart device MAU for QQ was 698mm, up 6.9% year-on-year
- We strengthened our entertainment-driven features and video content, which appeal to young users increasing their time spend on smart devices
- In particular DAU of QQ KanDian, our newsfeed services exceeds 100mm
- For games, we further increased our smartphone game market share by users and time spent
- We launched several new games increasing our paying user base and contributing to revenue growth
- Our AoV and PUBG MOBILE games enjoyed global popularity

Media Business

- For media business, we maintained our leadership in video, news, music and literature and saw rapid uptake of short and mini videos across our platforms
- For FinTech, we continue to be the market leader in mobile payment by active users
- We are now expanding our FinTech services offering leveraging our large-scale payment platform and core technologies
- For mobile utilities, we maintained our industry leaderships in mobile security, mobile browser and Android app store in China

Chi Ping Lau

Highlights

CSIG

- I will first start by elaborating on a key aspect of our recently announced strategic organizational upgrade, especially on our strategy to extend from consumer Internet into industrial Internet and the creation of our Cloud and Smart Industries Group, CSIG.
  - We see this initiative as a natural extension of our connection strategy from connecting people with people to later on connecting people with content and services and now as a next step to connecting industries with consumers, supply chains and resources

Trends of Mobile Internet Ubiquity

- We view partners in different industries are poised to benefit from the trends of mobile Internet ubiquity, insights from big data and the advent of artificial intelligence technology
  - And we want to position ourselves as a digital assistant to help our partners to really take advantage of these benefits while respecting their independence

Social & Other High Traffic Platforms and Enterprise Services

- We believe we are uniquely positioned to help businesses to embrace the industrial Internet because, firstly, we host over 1B users across our social and other high traffic platforms and are now connecting these users to industries
- Secondly, our enterprise services such as Mini Programs, Official Accounts, WeChat Work and Weixin Pay facilitate communications between consumers and industries and the completion of transactions

Advanced Technologies in Cloud Computing and Internet Ecosystem

- Thirdly, using our advanced technologies in cloud computing, AI, security, LBS etcetera, we help industries to aggregate their data and unlock the value in their data
- Last but not least, together with our strategic partners, we have cultivated a thriving Internet ecosystem, which provides broad industry knowledge, insights, deep consumer understanding, as well as enabling powerful consumer-specific solutions

Cloud Services Business

- Now within this strategic initiative, our cloud services business is the foundation for our industrial Internet solutions and for our Cloud and Smart Industries Business Group
- Our cloud business is rapidly growing in terms of revenue, clients and capabilities
- From Q1 to Q3 2018, our cloud services revenue exceeded RMB 6B, more than doubling year-on-year and gaining market share
  - We reinforced our already strong position in customer verticals, such as games, video and Internet services, while advancing into finance, government, smart retail and industrial verticals

- We grew our paying customers at a triple-digit rate year-on-year, allowing us to establish an increasingly diversified customer base

Initiatives

- At the same time, we are implementing several initiatives to sustain future growth of this business, including, on the technology front, we're integrating our own capabilities such as security, location-based services and face recognition to name a few into our external cloud-based solutions, enabling our customers to benefit from our proprietary technology
  - From a product perspective, we have an expanding portfolio of products offering over 200 cloud products as well as over 70 industry solutions

Cost Perspective and Customer Acquisition

- From a cost perspective, we are combining the procurement scale for our in-house services and our cloud business
- And we are pursuing relentless cost optimization measures in order to provide cost competitive solutions to our customers
- In terms of customer acquisition, we are working with over 4,000 channel partners, including ISVs and strategic partners to build customer-specific solutions
- We're also unifying our sales teams to increase efficiency in acquiring key accounts
  - And we're leveraging the popularity of our services such as Mini Programs to attract SMEs and entrepreneurial customers

Smart Healthcare

- Turning to the next page, I'll use smart healthcare and smart transportation as two examples of how we are helping industries to upgrade and in doing so create business opportunities for ourselves
- Let's start with smart healthcare
- The healthcare industry in China faces numerous challenges in particular under-resourced healthcare providers such as hospitals, patients lacking objective information to enable them to select amongst providers, and poor and infrequent communications between providers and patients

AI Diagnostic Capabilities

- We believe we can provide solutions to address some of these challenges
- These include our AI diagnostic capabilities, our ability to help patients find the right experts and our platform for connecting patients and medical care providers
  - In helping the industry solve these problems, we can extend our cloud services to healthcare providers, we can drive new payment use cases and we can also offer value added services to patients

Mini Programs and AIMIS

- How do we do that? Specifically, we provide products to patients, such as, Mini Programs that allow patients to register for appointments with hospitals or conduct video appointments with specialists online; Weixin Pay settlement for medical treatment expenses; Tencent Medipedia which is an online medical resource that offers patients preliminary understanding of over 1,000 symptoms online via Weixin, QQ and Mobile QQ Browser
- And we also provide services to medical industry such as Tencent AIMIS which applies AI to assist doctors in screening and diagnosing polyps
  - AIMIS has read over 100mm images and served over 1mm patients
- In addition, our security, cloud computing and AI capabilities can help hospitals manage internal staff and external patient relationships more efficiently

Smart Transportation

Driver's Demand, Cloud and Data Services

- Let's now move to smart transportation
- The transportation industry similarly faces some important trends and challenges including driver's demand for in-car connectivity, the rise of electric vehicles, the future of autonomous driving, OEMs desire to connect more closely with their customers and transport-as-a-service via ride-hailing solutions
  - We believe Tencent can help the industry meet these challenges via our in-car software capabilities, our cloud and data services as well as CRM for OEMs and payment solutions for mass transit services

Services and QR Codes

- By helping the industry, we create opportunities for Tencent in areas such as cloud services, the in-car digital content market and acting as a marketing platform for auto sales, auto after-sale services, auto loans and auto insurance
  - Specifically, we provide services to drivers and passengers, including integrating Weixin and our digital content services into vehicles' smart systems, enhancing the in-car experience
- Transit QR codes based on Mini Programs which have served over 50mm passengers in 120 cities

LBS, Cloud-Based and CRM Solutions

- And we provide services to the transportation industry, including Tencent LBS which receive over 60B location requests per day empowering car navigation, Tencent Auto Intelligence system on which we have cooperated with 15 OEMs and over 300 third-party partners for delivering our cloud-based solutions and CRM solutions, and autonomous driving-related services, including high-definition map simulation, cloud computing and security

James Gordon Mitchell

Highlights

Revenues and Online Advertising

- In Q3 2018, our revenue grew 24% year-on-year

- VAS represents 55% of our revenue of which online games contributed 32% and social networks 23%
- Online advertising was 20% of our total revenue and the other segment accounted for 25% of total revenue
- As Pony mentioned, advertising, digital content, payments and cloud generated the majority of our revenue this quarter

Value Added Services, Social Network and Sales

- For value added services, segment revenue was RMB 44B in Q3, up 5% year-on-year and up 5% quarter-on-quarter
- Social network revenue was RMB 18.2B, up 19% year-on-year and up 8% quarter-on-quarter
- Sales of virtual gifts on our live broadcast services and significant uptake of video subscriptions drove the year-on-year and quarter-on-quarter growth
  - More game-related items sales also contribute to the sequential revenue growth

VAS, Video Subscriptions and Online Games

- Our VAS subscriptions increased by 23% year-on-year to 154mm with growth primarily driven by video subscriptions
- Our video subscription account from 79% year-on-year, benefiting from exclusive drama and anime content
- Online games revenue was RMB 25.8B.
- Revenue decreased 4% year-on-year due to fewer paying users in our PC games and slower smartphone game revenue growth, as popular tactical tournament games in China are not being monetized
  - Sequentially our online game revenue increased by 2% as higher contributions from smartphone games more than offset lower revenue from PC games

Social Networks

Video, New Shortcut to Video Feeds and Recommendation Algorithm

- Starting with social networks
- The emerging trend of short and mini videos is contributing substantially to user activity growth within QQ and Weixin
- For content videos, we have grown to over 7B daily short and mini content video views across Tencent platforms
- Content video is particularly popular in QQ KanDian driven by first a new shortcut to video feeds, which facilitates discovery and consumption; second, an enhanced recommendation algorithm targeting relevant content to users

Breadth of Content

- Third, we're broadening our breadth of content, including more professionally generated, professional user generated and user generated content; and fourth through expand video formats beyond our already established position in short videos to quickly expand in mini videos, which are typically less than 20 seconds in length

  - The social video which is primarily created uploaded and shared by one social connections, hundreds of millions of social videos are now uploaded to Weixin each day

- We believe the huge volume of video uploads is a good indicator of our industry leadership in social video
- Users who watch social videos do so primarily inside Weixin group chats and in Weixin Moments where we recently extended the maximum social video duration from 10 to 15 seconds
  - Users who wish to create social videos can use our standalone app Weishi, which provides video shooting and editing tools such as dynamic props, background music, and AI powered beautification

China Industry in Terms of DAU

Video Subscribers and Subscriber Growth

- For long-form video we remain number one in the China industry in terms of DAU, time spent and revenue, benefiting from leadership across a wide range of content, including drama, Chinese anime, variety shows and documentaries
- At quarter-end, we had 82mm video subscribers, up 79% year-on-year and our video subscription revenue similarly rose 79% year-on-year
- Subscriber growth benefited from hit content such as our fancy drama series, Legend of FuYao, which achieved over 14B video views and our historical drama series, Ruyi's Royal Love in the Palace, which generated over 16B video views

Video Advertisement Revenues

- Our video advertisement revenue increased 34% year-on-year benefiting from increased traffic and sponsorships
- Integration with our performance ad platform expanded our advertiser base and increased in-feed revenue
- As far as commercial success, our video content has also achieved critical acclaim
- For example, our animated series, The Land of Warriors won the Best Anime Award in the Chinese Comics and Games Expo
  - And our food documentary, Once Upon a Bite scored a 9.3 rating on the review site Douban

Revenues, Honour of Kings and New Avatar

- For smartphone games total revenue was RMB 19.5B, up 7% year-on-year due to contributions from new action in RPG titles
- Revenue grew 11% quarter-on-quarter, primarily due to new games released at the end of Q2 and during Q3
- In China, Honour of Kings remains the top title in terms of active users in revenue
- We released new avatar personalization items and dance emotions in the quarter, which increased paying users and revenue sequentially

Tactical Tournament Games and China Pipeline

- Our tactical tournament games grew active users quarter-on-quarter, but remained unmonetized
- And we launched several role-playing games associated with popular intellectual properties among which Free Fantasy Online, MT4 and Saint Seiya ranked within the top 10 in China's iOS Grossing Chart during the quarter
  - We have 15 games with monetization approved in our China pipeline, including mainly role-playing and action games associated with established intellectual properties

International Markets

PUBG MOBILE Game

- For international markets, according to App Annie, our PUBG MOBILE game has the second-highest ex-China monthly active user count of any smartphone game globally and its revenue tripled quarter-on-quarter, reflecting a full quarter of monetization and increasing subscriptions for its Royale Pass
  - Arena of Valor ran a widely watched World Cup Final eSports event driving its global DAU to a record high

PC Client Games

Revenues, CrossFire & DnF, eSports Audience and Ring of Elysium on Steam

- For PC client games, revenue was RMB 12.4B, down 15% year-on-year and down 4% quarter-on-quarter
- The year-on-year revenue decline reflects the ongoing trend of users shifting time to smartphone games
  - While our reported revenue declined quarter-on-quarter, our cash sales before deferrals increased, benefiting from positive seasonality and the resilience of our leading titles
- In China, CrossFire and DnF released successful updates in the quarter
- And in November, our eSports audience reached a record high in China, when Invictus Gaming became the first Mainland China team to win the League of Legends World Championships
- Internationally, we launched a tactical tournament game Ring of Elysium on Steam, which ranked among the platform's top 10 games by peak concurrent users following its launch

Initiatives

- We're implementing several initiatives to foster healthy gameplay
- In September, we upgraded our healthy gameplay system to protect players aged 12 years old and below from spending excessive time on games
- We identified these players by real-ID verification combined with facial recognition technology and we opposed a 1-hour game timing per day and prevent logins between 9 PM and 8 AM for these users
  - We implemented the upgraded system in Honour of Kings on a city-by-city basis and are expanding this system nationwide and across our other games

Parental Guidance Platform

- Via our parental guidance platform, we're providing parents with tools to engage with their children and track their in-game activities
- And we're developing functional games intended to assist learning or improve dexterity
- Two months since the implementation of our healthy gameplay system, we believe some children are indeed significantly reducing their gaming time and we have seen millions of parents sign-up for the parental guidance platform
  - We believe these initiatives should position the industry for sustainable and healthy long-term growth

Advertising

Reveneus

- Shifting to advertising, our online advertising revenue was RMB 16.2B, up 47% year-on-year and up 15% quarter-on-quarter
- Our media advertising revenue was RMB 5.1B, up 23% year-on-year and up 8% quarter-on-quarter within which our video ad revenue was up 34% year-on-year and up 13% quarter-on-quarter
- Our news app revenue increased year-on-year as we expanded the advertiser base following the completion of our ad system revamp, but declined quarter-on-quarter due to the end of the NBA season
- Our social and others advertising revenue was RMB 11.1B, up 61% year-on-year and up 19% quarter-on-quarter

Traffic and Inventory

- Increased traffic and inventory in Weixin Moments, Mini Programs, and QQ KanDian and more impressions in our mobile ad networks drove the year-on-year growth
- Increased impressions in click-through for Mini Programs and for Weixin Moments contribute most to the quarter-on-quarter growth
  - We've expanded our long-term advertiser base to Weixin Moments through cooperation with local ad agencies and through converting Weixin Pay merchants into advertisers on our platforms

Payments and FinTech Services

- Moving to our payments and FinTech services, we maintained our leadership in China's mobile payment market measured by MAU and DAU.
- Our average daily transaction volume increased over 50% year-on-year within which our offline daily commercial payment transactions grew 200% year-on-year
  - We're adding new payment services such as cross-border mobile payments, allowing WeChat Pay Hong Kong users to conduct renminbi-denominated transactions in Mainland China

Payment Processing and Settlements

- Our payment processing and settlements are smoothly transiting to the NetsUnion centralized clearing system
- We're also expanding our FinTech services in areas such as wealth management, micro-loans, and insurance

- LiCaiTong's aggregated customer assets surpassed RMB 500B at quarter-end
- WeBank-originated WeiLiDai loan balances grew rapidly and sustained industry-leading healthy non-performing loan rates
    - WeSure, our insurance service within Weixin partnered with insurance companies such as TCEHY and MetLife to customize products for Weixin users

Shek Hon Lo

Financial Highlights

Revenues and Costs

- For Q3 2018, our total revenue was RMB 80.6B, up 24% year-on-year or 9% quarter-on-quarter
- Cost of revenues increased by 35% year-on-year to RMB 45.1B.
- The increase primarily reflected greater cost of payment-related services, higher content and channel costs

Gross Profits

- Gross profit was RMB 35.5B, up 12% year-on-year or 3% quarter-on-quarter
- Net, other gains were RMB 8.8B for Q3 2018
    - This represented increases in valuations of certain investee companies, including a fair value gain from Meituan-Dianping upon its IPO.
- We made impairment provisions for certain investee companies in verticals such as online games, entertainment and e-commerce
- Share of profit of associates and JV was RMB 264mm in the quarter vs. that of RMB 1.5B for Q2 2018
- The quarter-on-quarter decrease was mainly due to one-off share-based compensation expense of an associate
    - On a non-GAAP basis share profit of associates and JV was RMB 2.8B for Q3, which is pretty much at the same level as Q2

Income Tax Expenses and Tax Rate

- Income tax expense was approximately RMB 3.2B, down 35% year-on-year or 10% quarter-on-quarter
- The year-on-year decrease was mainly due to lower taxable income and withholding tax
- The effective tax rate in the period was 12.1%
- Net profit to shareholders was RMB 23.3B, up 30% year-on-year or 31% quarter-on-quarter

Non-GAAP Financial Numbers

Operating Profits and Margins

- I'll walk you through our non-GAAP financial numbers

- For Q3 and after adjustments to non-GAAP, operating profit for the quarter was RMB 22.6B, up 4% year-on-year or 1% quarter-on-quarter
- Operating margin was 28%, down 5.1 percentage points year-on-year or 2.2 percentage points quarter-on-quarter
- Net profit to shareholders was RMB 19.7B, up 15% year-on-year or flat quarter-on-quarter
  - Net margin was 25.3%, down 1 percentage point year-on-year or 2.5 percentage points quarter-on-quarter

Gross Margins

- Let's turn to segment gross margin
- Gross margins for value added services was 56.5%, down 3.4 percentage points year-on-year or 2.5 percentage points quarter-on-quarter
  - The decreases mainly reflected mix shift towards lower margins smartphone games, higher proportion of revenues from licensed titles within PC games and higher content costs of video streaming subscriptions

Online Advertising

- Gross margin for online advertising was 36.7%, broadly stable year-on-year and quarter-on-quarter
- Gross margin for others was 22.8%, up 2.5 percentage points year-on-year or down 2.1 percentage points quarter-on-quarter
- The year-on-year increase was mainly due to growth in fee charge from credit card repayment revenues from micro-loan business and interest income related to restricted custodian deposits
  - On the other hand, the quarter-on-quarter decrease was mainly due to higher proportion of revenue from our lower margin products

Operating Expenses

- Moving onto operating expenses, selling and marketing expenses were RMB 6.6B, up 37% year-on-year or 3% quarter-on-quarter
- The year-on-year increase mainly reflected greater marketing spend on our products and platform such as payment-related services, online video and smartphone games
- The sequential increase was driven by high marketing spend on online video business and payment-related services
  - As a percentage of revenue, selling and marketing expenses was 8.2% for Q3

G&A Expenses, R&D and G&A

- G&A expenses excluding R&D were RMB 4.6B, up 10% year-on-year or 12% quarter-on-quarter
- Under G&A, R&D expenses were RMB 6.3B, up 30% year-on-year or 9% quarter-on-quarter
- Both year-on-year and quarter-on-quarter increase of G&A expenses were mainly due to greater R&D expenses and staff costs
- As a percentage of revenue, total G&A was 13.5% and R&D was 7.8%

Business Growth

- At the end of quarter three, we had over 52,600 employees
- The year-on-year increase of 21% was mainly due to our expanded business growth in particular cloud and payment-related services

Margin Ratios

- Let's go through margin ratios for Q3
- Gross margin was 44%, down 4.6 percentage points year-on-year or 2.8 percentage points quarter-on-quarter, mainly reflecting the revenue mix changes among segments and reduced gross margin of VAS as mentioned previously
- Non-GAAP operating margin was 28%, down 5.1 percentage points year-on-year or 2.2 percentage points quarter-on-quarter, primarily due to lower gross margin
- Non-GAAP net margin was 25.3%, down 1 percentage point year-on-year or 2.5 percentage point sequentially
  - The year-on-year decrease was mainly due to lower operating margin partially offset by the margin picked up from share of profit of associate and income tax expense

CapEx and FCF

- Finally, let me share with you some key financial metrics before rounding up this presentation
- For Q3, the total CapEx was RMB 6B, up 71% year-on-year or down 16% quarter-on-quarter
- Operating CapEx was RMB 5.2B, down 21% quarter-on-quarter, mainly reflecting less spending on service for cloud businesses following pre-stocking in previous quarter
  - Non-operating CapEx was RMB 782mm
- FCF was RMB 26.4B, down 4% year-on-year or up 71% quarter-on-quarter
  - The quarter-on-quarter increase was driven by growth in grossing of online games as a result of positive seasonality in third quarter

Debt, M&A Initiatives and Share Repurchasing

- At the end of September, our net debt position was RMB 29.2B compared to net debt of RMB 35.3B last quarter
- The sequential decrease in net indebtedness was mainly due to FCF generation and proceeds from disposal of certain investee companies, which was partially offset by payments for media content and M&A initiatives
- The fair market value of our listed investee companies excluding subsidiaries of course were approximately RMB 273B, or US$39.7B at quarter-end, up from RMB 171B a year ago
  - During the period from 7th of September to 12th of October 2018, we repurchased 2.8mm shares with an aggregate cost of about US$113mm

QUESTION AND ANSWER SECTION

<Q - Wendy Huang>: I just have two quick questions. First you mentioned that you still have 15 titles in the pipeline with game approval. But I recall that last quarter you also mentioned that you have 15 titles. However, in between the two quarters you actually launched your several new titles. I just wonder what is that actually – how did you actually get approval for the new games that you did between the two quarters, so that we can make up this math?

And secondly, on the Mini Programs, can you give us update on the competition and ecosystem as well as the monetization trend? We noticed that several other companies who also launched a similar type of live program, or the quick app etcetera. And also you mentioned in your prepared remarks earlier that you already start to generate the advertising revenue from Mini Programs. So if you can share some color on those things that will be great. Thank you.

<A - James Gordon Mitchell>: To start with the question about the games in the pipeline, there are several moving parts that impact the number of games we have with monetization approval in our pipeline at any point in time. One obviously, as we publish games, then there's fewer games left in the pipeline. On the other hand, there are ways that we can add games to the pipeline. For example, there might be a independent studio that was working on creating a game 12 months ago and secured [indiscernible] (33:48) that monetization approval 12 months ago. And in the most recent quarter, we were able to persuade them to allow Tencent to be the publisher of that game, so then that game would become a Tencent pipeline game with monetization approval. And I'll pass to Martin for the question about Mini Programs.

<A - Chi Ping Lau>: In terms of Mini Programs, I think, its innovative programming framework for usage within the WeChat ecosystem. And we have invented this framework. And we're actually very happy to see that this framework has been adopted by many different other players in the market, which means that this framework is actually very, very valuable. Now we do believe that the fact that there are more people endorsing this new programming framework, it means that there will be more developers coming into the market which is good. And at the same time I think we do have unique advantages within our own ecosystem. And that includes we have a very large DAU app, which is supporting our own Mini Program framework. We have very frequent usage among our users of the app, i.e., WeChat. We have social recommendation which is a very important way through which Mini Programs are spread across different users.

We have a pretty complete ecosystem, including WeChat payment, which helps the Mini Programs to get paid. And at the same time, we also have developed this QR code, which allows offline merchants and offline operators to promote their Mini Programs using our application and our framework. So, all in all, I think by having a lot of people coming in that's great for helping to cultivate a large developer base and among all the different offers of Mini Programs I think we have a very strong value proposition.

Overall, I think we have seen pretty quick adoption of Mini Programs, the monetization right now is still pretty much associated with mini games, which is a branch within Mini Programs. But at the same time, we also see growth of very diversified applications with the Mini Programs in particular with a lot of retailers. They are quite eager to develop Mini Programs so that they can have their own channel of selling products to their customers and also serve their customers. So we are actually quite excited about the future prospect of Mini Programs.

<Q - Alicia Yap>: I have questions regarding the more stringent implementation of the playing times for the minors and also enforcing the real-ID verifications on Honour of Kings and also other games. Has this process affecting the user time spent, not the minors, but what I mean is the user that is higher than 18 years old where their time spent and engagement activities actually also being impacted. And should we also worry if there's any impact on the revenue growth? Any color there will be great.

And then second, regarding the Tencent latest initiative of moving into this industrial Internet, I understand it is still in the very early process of this transformation. Is that mean, there will be more investment spend in the coming years? And ultimately, will this industrial Internet opportunity be perceived as strong recurring revenue stream, but at a lower margin profile than the consumer Internet that we enjoy in the past? Thank you.

<A - James Gordon Mitchell>: In terms of the healthy gameplay system and as we mentioned in the prepared remarks, the system is impacting the amount of time spent by minors playing our games which is the intention. We don't expect to impact the time spent by older users, but would obviously need to track the progress. And then shifting from time spent to revenue and currently minors contribute earning significant portion of revenue for our mobile games, now obviously depending on how efficiently we execute this, there could some spillover impact to non-minors spending, but again that's not the intention. And if we can focus it on minors then that shouldn't have a substantial impact on our business, because the vast majority of our game revenue comes from older users.

<A - Chi Ping Lau>: In terms of the industrial Internet, I think the initial revenue opportunity is around the cloud business. As you can see we have a fast growing cloud business and also has been gaining market share. The nature of the cloud business is that it does require quite a bit of CapEx because we need to build the IDC as well as to buy the service. And over time, earn recurring revenue on the cloud service fees.

Now this business at the same time is low margin, because it's only staying at the infrastructure level. But the way we look at it is that we look at it as a long-term investment for the future and we felt that over time new business opportunities can actually come out of our cloud and associated industrial Internet opportunities and that will include when we move from ICE infrastructure to PaaS, Platform-as-a-Service and SaaS, then we can actually start generating a higher margin revenue.

At the same time, we also believe that we could have new business model and value-added services built from our connection with the industries. For example, when we talk about the transportation industry, right, if we could actually establish a CRM for OEMs to reach customers then there will be associated marketing revenue, there will be associated value-added services revenue, including referral fees on auto insurance, auto loans. So those will be new business models which will be of higher margin.

And at the same time, we believe that by engaging in the industrial Internet, we can actually bring benefits to our ancillary businesses, for example, our payment business as well as our advertising business. So we look at it in a holistic approach. And just like how we approach consumer Internet, right. In the very, very beginning nobody really generate any revenue from consumer Internet. We start with providing a product which we know that will generate value for the users and over time we start to develop different kinds of business model from that valuable service.

And I think for industrial Internet, it's the same philosophy, right. If we see that we can actually add value to a particular industry and to the partners that we sign up and we know that by bringing technology, by bringing data insights and by bringing connection for them to connect with users, we can actually create value for the users, we can create value for these industrial partners and we can actually facilitate the upgrade of the industry then we know that we will be creating tremendous value and we will be pretty confident that over time we will generate business opportunities and revenue from that value-add.

<Q - Thomas Chong>: I have a question on the online gaming business. Can management provide the quarterly ARPU for MMO advanced casual and smartphone games? And my follow-up question is about the PC games. How should we think about the trend in Q4 or 2019? And my quick follow-up is about the trend in terms of the operating expenses. Can management give us some color about how we should think about the trend going forward? Should we expect we need to incur higher OpEx for new initiative? Thank you.

<A - James Gordon Mitchell>: So that other people have room to ask questions about operating margins or whatever the topic is as well. So just focusing on your two questions, John will speak to the ARPU. But with regard to the PC game business, it's obviously a challenging segment of the industry given the ongoing user time shift migration from PC games to smartphone games. We are aggressively looking for new PC games to publish in China, particularly new PC games that can create new market segments which didn't previously exist in the China market that may have existed in overseas markets. And to the extent we're successful in doing that then we can improve the trends for our PC game business. I would also say that the comparisons for our PC game business in the current and recent quarters are particularly difficult. But overall, the PC game outlook is a fairly conservative outlook given the megatrend of users shifting time to smartphone games.

<A - Shek Hon Lo>: In terms of the ARPU, the MMOG is RMB 530 to RMB 730 and ACG is RMB 160 to RMB 670 and smartphone games is RMB 180 to RMB 190.

<Q - Winnie Wong>: My question is on the impact of the macro headwinds. We saw that in the press release you talked about the increase in advertising revenue were mainly reflected by more advertising inventories in Weixin Moments and also the new advertising formats such as the Mini Programs. So just wanted to see the reasons and also the rationale behind that we're still able to increase the advertising inventory amid the macro headwinds? Thank you

<A - James Gordon Mitchell>: We believe that we deliver above-industry return on investment from our advertising. And historically to a great extent, our advertising has been supply constrained rather than demand constrained. So as we grow our traffic and as we add new inventory within our traffic for example in the last few quarters we have made inventory available in Mini Programs which was the biggest contributor to the quarter-on-quarter ad revenue growth this quarter. Then I think it's natural that we see a flow-through into stronger advertising revenue. On the flipside, there are certain advertiser categories in China that have been hit hard by regulatory measures. And generally speaking our advertising business is under-weighed those categories due to conscious decisions on our part. Looking forward then if the macro environment deteriorates sharply that will naturally have a negative impact on our advertising revenue growth rates, but we believe given our superior performance that we should continue to outperform the industry based on the better than industry returns on investment we deliver to our advertisers.

<Q - John Choi>: I have a question about your margin trend. I could see this quarter the operating margin is at 28% and are constantly coming down. Obviously game growth, which has a high margin and as you guys earlier mentioned advertising, digital content, payment, cloud are now the majority of the business. So going forward in the future, should we be expecting this is going to be the new norm? Or should we be expecting margins to stabilize or even if we expand? Secondly on the game, I just want to follow up, in terms of assuming that the regulatory situation normalizes, where do you see the upside potential on the smartphone game growth? Is it going to be for the ARPU expansion or any types of any growth drivers that you guys see? Thank you.

<A - Chi Ping Lau>: In terms of margin, I think we should probably not take overly-simplistic view of an overall margin, but instead look at the different businesses because our revenue is a collection of businesses of very different natures. For example, gaming obviously it has a higher margin, but there is also a big difference between self-developed games and licensed games. And then if you look at some of the new businesses, right, advertising has got a very high margin, but if you look at video, obviously, it has a low margin. And when you look at payment, which is a pretty large business segment for us we run as a infrastructure service, so it has a relatively low margin. And cloud business at this point in time is also of very low margin. So I think we should probably look at each one of the business segment and analyze the margin accordingly. And the overall margin of the company would be essentially weighted average of all the margins of the respective segments.

So, if there is more gaming revenue in the future, I think the margin will probably go up more. But I think even for some of the – and advertising, for example, if it grows more, then it would have a positive impact on the overall margin of the company. For the businesses which are right now in investment mode and generates very low margin, I think some of them will probably stay like that for a while. But over a longer period of time, we think as we can actually generate some value-added services out of those revenue streams then we may be able to get up to higher margin over a longer term.

<A - James Gordon Mitchell>: In terms of opportunities to enhance our smartphone games revenue then – and I think one can look at it along three dimensions; the ARPU, the paying user ratio, and the total number of users. And our ARPU has substantial upside relative to the industry and part of the reason why we're able to eek out a little bit of growth for our smartphone game revenue in Q3 was because we released some relatively high ARPU role-playing games, which demonstrated that effect.

Our paying user ratio also has substantial upside relative to the industry, but it's to some extent been frozen by the regulatory measures, particularly as some of our new games have very substantial user base, who currently have a 0% paying user ratio. And then our overall game user base – smartphone game user base is already at a very substantial number, but on the other hand, the success of the mini games within Weixin illustrates that there's still a substantial audience of new players, particularly female players who historically were not actively playing smartphone games, but are now beginning to do so. So, we think that in a more benign regulatory environment, there's upside to all three metrics; the ARPU, the paying user ratio and the total number of game players.

<Q - Han-Joon Kim>: For your advertising business, I noticed that we've seen an acceleration of y-over-y growth and I recognize that it's part of the ad inventory that we've talked about. But how should we think about the possibility of maybe continuing this acceleration, particularly as we redefine the business with the advertising and marketing services unit and trying to integrate the various components of ad inventory together to maybe create, generate better ROAS? Thank you.

<A - Chi Ping Lau>: I would say we run the advertising business on consistent and long-term basis, right. So, I think what we have seen today is actually the result of a pretty long data and consistent effort improving our ad system. And we always have been very disciplined in terms of making sure that our advertising quality is high. We have been running at below industry level of ad load because we want to have the right balance between user experience and advertising. And in order to keep on delivering higher ROI to the advertisers and also to make the advertising experience better for the users, we have been investing heavily into building ad system with targeted technology.

And I think what we have seen today is just a result of all these efforts in the past. And going forward, we continue these philosophies and we believe over time, we'll continue to generate more and more revenue from the advertising business. But at the same time, I think we do not want to hurry ourselves and we do not want to do things that generates revenue for the short-term, but harm the user experience or harm the advertisers over the longer term. I think in terms of the AMS, it is a good development obviously. It helps us to now face the advertisers with a single voice. And it would help us to serve those advertisers better. And I think it will be a positive development overall for our service level for advertisers.

<Q - Grace Chen>: Can you share with us your view about the 2019 outlook by the different business segments such as gaming, social network, online marketing, payment and cloud business? Apart from the to be initiatives, what are the other key strategic differences in 2019 vs. this year? I remember this year we talk about heightened investments this year, so if you can share your strategic focus next year that will be great. Also, can you update us with the latest development of the government gaming – the game approval process? Thank you.

<A - Chi Ping Lau>: In terms of 2019 right, we have already done a very big strategic organizational upgrade which is indicative of our focus for the future right. And obviously our existing businesses will continue to put lot of effort in and at the same time in two particular areas in the form of a Cloud and Smart Industries Group and in our Platform and Content Group, we will have a redoubling effort in those areas to build better products and better services to serve our users and our customers. So I think for Tencent we have always been very consistent in terms of pushing ahead with our execution. So as you can see from our organization, we'll continue to push along those lines of businesses. And in terms of regulatory approval I think at this point in time there is not a lot of update. We are waiting for the government to start the approval process for games. And when that's announced then we'll have the update for the market.

<Q - Yue Wu>: Just curious is there any change regarding the revenue-sharing ratio with [indiscernible] (57:28) recently, for example the micro-loan business of WeiLiDai? So could you quantify the impact from the PBoCs regulation on your interest income in last quarter? Just wondering how should we see the future trend of the GP margins for the other revenue line? Thank you.

<A - Chi Ping Lau>: For the first one I don't think we will comment on specific commercial transactions. On the second part of your question, I think it's more important to look at what is still in there because as we previously communicated by the beginning of next year all the interest will be gone. So I think what we can speak to that is that there is a high single-digit number of our current others revenue which is interest from the deposit and that would basically disappear by first quarter next year.

<Q - Alex Yao>: I have a question on the mobile gaming monetization strategy side. Given the uncertainty around new game monetization approval, would you consider change the existing game on monetization or operation strategy? For example, would you consider to increase the existing game title lifecycle by temporarily lowering their monetization? And then in terms of the key initiatives and the future development direction such as the clouds, industrial, et cetera, et cetera given the uncertainty around gaming monetization, would you consider to tweak the investment strategy in terms of the budget spend next year on the back of uncertainties around new game monetization? Thank you.

<A - James Gordon Mitchell>: So on the first question, we believe the way that we monetize our games is entirely compatible and commensurate with great longevity. And I think the fact that a game like Dungeon & Fighter is arguably the highest revenue China PC game now after 10 years in our operation. The fact that League of Legends is – might be the most popular PC game in China after many years of our operation speak to the fact that we're able to speak to the reality, we're able to both monetize games appropriately and also maximize their lifecycle. So no, I think the concept of us reducing the revenue for our existing games because of some kind of expected trade-off with game longevity wouldn't make a lot of sense to us because we think our existing monetization levels are very healthy and long-term sustainable.

<A - Chi Ping Lau>: In terms of the investment for the industrial Internet businesses as well as some of the longer-term projects, I think our philosophy has never been short-term financial number driven. Our philosophy has always been long-term value-driven, right. If we can actually create value for the long run, we will do the right things i.e. make the investments and we will not be swayed by short-term financial considerations.

<Q - Jin-Kyu Yoon>: Just a quick follow-up on kind of advertising in general, you guys just talked about how advertising was especially on the SNS side driven by kind of new outlets and new inventory. But can you just also talk about kind of CPC, CPM pricing trends among the bigger SNS advertising businesses? And perhaps, can you kind of recommend order in terms of revenue contribution? Thanks.

<A - James Gordon Mitchell>: In terms of revenue contribution, we don't go into great detail, but Weixin Moments is the single largest contributor and then Weixin Official Accounts, Weixin Mini Programs are also substantial contributors. But then outside Weixin, mobile ad network has become a very substantial revenue contributor and mobile browser is also a meaningful contributor. And we're in the process of ramping up our new Speed's revenue which is an area where we believe we have traffic equal to or superior than most of our peers. But our revenue is still much lower than our peers and we're in the process of rectifying that discrepancy.

In terms of CPC and CPM, there's enormous variation by property. So for example, Weixin Moments commands a premium CPM relative to almost every other medium in China, because it is uniquely effective at targeting a nation-wide white-collar audience in attractive and engaging [indiscernible] (1:03:32) way. And as we've been increasing the ad load on Weixin Moments, the focus is more around preserving the CPM within a same city basis rather than seeking to try to grow the premium further. Then a property like our video property would be a medium CPM that's increasing over time due to growing advertiser demand at a moderate rate. And then something like a mobile ad network which you start at a very low CPM, but as we apply more technology and as advertisers get more comfortable with our systems and the quality of the clicks we deliver then the CPM and CPC for our mobile ad network would be increasing particularly quickly.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2018-11-14
Event Description: Q3 2018 Earnings Call

Market Cap: 2.59TRI
Current PX: 272.20
YTD Change($): -133.80
YTD Change(%): -32.956

Bloomberg Estimates - EPS
Current Quarter: 2.023
Current Year: 8.276
Bloomberg Estimates - Sales
Current Quarter: 84761.813
Current Year: 317688.844

Q3 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Wendy Huang
- Alicia Yap
- Thomas Chong
- Winnie Wong
- John Choi
- Han-Joon Kim
- Grace Chen
- Yue Wu
- Alex Yao
- Jin-Kyu Yoon

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Tencent Holdings Limited 2018 Third Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

And I will now turn the conference over to your first speaker, Ms. Jane Yip. Thank you. Please go ahead.

Jane Yip

Thank you. Good evening. Welcome to our 2018 third quarter results conference call. I'm Jane Yip from the IR team of Tencent.

Before we start the presentation, we would like to remind you that it includes forward-looking statements which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview, Martin will discuss strategic highlights, James will speak to business overview, and John will go through the financials before we take your questions.

I will now turn the call over to Pony.

Huateng Ma

Okay. Thank you, Jane. Good evening, everyone. Thank you for joining us. During the third quarter of 2018, we registered strong operating results in our businesses and maintained healthy financial metrics. Our advertising, digital content, payment and cloud services sustained robust activity and revenue growth, and now account for the majority of our revenue.

For our games business, we implemented stringent self-imposed limitations on games playing by minors, which we believed put the game industry on a healthy and more solid foundation for future development. At the end of the quarter, we upgraded our organization to help enterprises and various industries to benefit from the new trend of industrial Internet through digitization and technology innovation, and to provide consumers with better integrated entertainment and social experiences, as well as to unify our advertising sales platforms. We believe this strategic organizational upgrade will position us well for future long-term growth and Martin will discuss in details in the strategic highlights section.

Now let me highlight the key financial numbers and defer the discussion to John's financial section. Total revenue was RMB 80.6 billion, up 24% year-on-year and up 9% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 19.7 billion, up 15% year-on-year and flat quarter-on-quarter. Moving on to our key platforms. Combined MAU of Weixin and WeChat increased 10.5% year-on-year to 1.08 billion, benefiting from the increasing use case offered by Mini Programs and Weixin Pay.

Smart device MAU for QQ was 698 million, up 6.9% year-on-year. We strengthened our entertainment-driven features and video content, which appeal to young users increasing their time spend on smart devices. In particular DAU of QQ KanDian, our newsfeed services exceeds 100 million. For games, we further increased our smartphone game market share by users and time spent. We launched several new games increasing our paying user base and contributing to revenue growth. Our AoV and PUBG MOBILE games enjoyed global popularity.

For media business, we maintained our leadership in video, news, music and literature and saw rapid uptake of short and mini videos across our platforms. For FinTech, we continue to be the market leader in mobile payment by active users. We are now expanding our FinTech services offering leveraging our large-scale payment platform and core technologies. For mobile utilities, we maintained our industry leaderships in mobile security, mobile browser and Android app store in China.

With that, I will pass to Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony and good evening, good morning to everybody. I will first start by elaborating on a key aspect of our recently announced strategic organizational upgrade, especially on our strategy to extend from consumer Internet into industrial Internet and the creation of our Cloud and Smart Industries Group, CSIG. We see this initiative as a natural extension of our connection strategy from connecting people with people to later on connecting people with content and services and now as a next step to connecting industries with consumers, supply chains and resources.

We view partners in different industries are poised to benefit from the trends of mobile Internet ubiquity, insights from big data and the advent of artificial intelligence technology. And we want to position ourselves as a digital assistant to help our partners to really take advantage of these benefits while respecting their independence.

We believe we are uniquely positioned to help businesses to embrace the industrial Internet because, firstly, we host over 1 billion users across our social and other high traffic platforms and are now connecting these users to industries. Secondly, our enterprise services such as Mini Programs, Official Accounts, WeChat Work and Weixin Pay facilitate communications between consumers and industries and the completion of transactions.

Thirdly, using our advanced technologies in cloud computing, AI, security, LBS etcetera, we help industries to aggregate their data and unlock the value in their data. Last but not least, together with our strategic partners, we have cultivated a thriving Internet ecosystem, which provides broad industry knowledge, insights, deep consumer understanding, as well as enabling powerful consumer-specific solutions.

Now within this strategic initiative, our cloud services business is the foundation for our industrial Internet solutions and for our Cloud and Smart Industries Business Group. Our cloud business is rapidly growing in terms of revenue, clients and capabilities. From the first quarter to third quarter of 2018, our cloud services revenue exceeded RMB 6 billion, more than doubling year-on-year and gaining market share. We reinforced our already strong position in customer verticals, such as games, video and Internet services, while advancing into finance, government, smart retail and industrial verticals. We grew our paying customers at a triple-digit rate year-on-year, allowing us to establish an increasingly diversified customer base.

At the same time, we are implementing several initiatives to sustain future growth of this business, including, on the technology front, we're integrating our own capabilities such as security, location-based services and face recognition to name a few into our external cloud-based solutions, enabling our customers to benefit from our proprietary technology. From a product perspective, we have an expanding portfolio of products offering over 200 cloud products as well as over 70 industry solutions.

From a cost perspective, we are combining the procurement scale for our in-house services and our cloud business. And we are pursuing relentless cost optimization measures in order to provide cost competitive solutions to our customers. In terms of customer acquisition, we are working with over 4,000 channel partners, including ISVs and strategic partners to build customer-specific solutions. We're also unifying our sales teams to increase efficiency in acquiring key accounts. And we're leveraging the popularity of our services such as Mini Programs to attract SMEs and entrepreneurial customers.

Turning to the next page, I'll use smart healthcare and smart transportation as two examples of how we are helping industries to upgrade and in doing so create business opportunities for ourselves. Let's start with smart healthcare. The healthcare industry in China faces numerous challenges in particular under-resourced healthcare providers such as hospitals, patients lacking objective information to enable them to select amongst providers, and poor and infrequent communications between providers and patients.

We believe we can provide solutions to address some of these challenges. These include our AI diagnostic capabilities, our ability to help patients find the right experts and our platform for connecting patients and medical care providers. In helping the industry solve these problems, we can extend our cloud services to healthcare providers, we can drive new payment use cases and we can also offer value added services to patients.

How do we do that? Specifically, we provide products to patients, such as, Mini Programs that allow patients to register for appointments with hospitals or conduct video appointments with specialists online; Weixin Pay settlement for medical treatment expenses; Tencent Medipedia which is an online medical resource that offers patients preliminary understanding of over 1,000 symptoms online via Weixin, QQ and Mobile QQ Browser. And we also provide services to medical industry such as Tencent AIMIS which applies AI to assist doctors in screening and diagnosing polyps. AIMIS has read over 100 million images and served over 1 million patients. In addition, our security, cloud computing and AI capabilities can help hospitals manage internal staff and external patient relationships more efficiently.

Let's now move to smart transportation. The transportation industry similarly faces some important trends and challenges including driver's demand for in-car connectivity, the rise of electric vehicles, the future of autonomous driving, OEMs desire to connect more closely with their customers and transport-as-a-service via ride-hailing solutions. We believe Tencent can help the industry meet these challenges via our in-car software capabilities, our cloud and data services as well as CRM for OEMs and payment solutions for mass transit services.

By helping the industry, we create opportunities for Tencent in areas such as cloud services, the in-car digital content market and acting as a marketing platform for auto sales, auto after-sale services, auto loans and auto insurance. Specifically, we provide services to drivers and passengers, including integrating Weixin and our digital content services into vehicles' smart systems, enhancing the in-car experience. Transit QR codes based on Mini Programs which have served over 50 million passengers in 120 cities.

And we provide services to the transportation industry, including Tencent LBS which receive over 60 billion location requests per day empowering car navigation, Tencent Auto Intelligence system on which we have cooperated with 15 OEMs and over 300 third-party partners for delivering our cloud-based solutions and CRM solutions, and autonomous driving-related services, including high-definition map simulation, cloud computing and security.

Now I will pass on to James to go over the business review section.

James Gordon Mitchell

Thank you, Martin. Good morning and good evening everyone. In the third quarter of 2018, our revenue grew 24% year-on-year. VAS represents 55% of our revenue of which online games contributed 32% and social networks 23%. Online advertising was 20% of our total revenue and the other segment accounted for 25% of total revenue.

As Pony mentioned, advertising, digital content, payments and cloud generated the majority of our revenue this quarter. For value added services, segment revenue was RMB 44 billion in the third quarter, up 5% year-on-year and up 5% quarter-on-quarter. Social network revenue was RMB 18.2 billion, up 19% year-on-year and up 8% quarter-on-quarter. Sales of virtual gifts on our live broadcast services and significant uptake of video subscriptions drove the year-on-year and quarter-on-quarter growth. More game-related items sales also contribute to the sequential revenue growth.

Our VAS subscriptions increased by 23% year-on-year to 154 million with growth primarily driven by video subscriptions. Our video subscription account from 79% year-on-year, benefiting from exclusive drama and anime content. Online games revenue was RMB 25.8 billion. Revenue decreased 4% year-on-year due to fewer paying users in our PC games and slower smartphone game revenue growth, as popular tactical tournament games in China are not being monetized. Sequentially our online game revenue increased by 2% as higher contributions from smartphone games more than offset lower revenue from PC games.

Starting with social networks. The emerging trend of short and mini videos is contributing substantially to user activity growth within QQ and Weixin. For content videos, we have grown to over 7 billion daily short and mini content video views across Tencent platforms. Content video is particularly popular in QQ KanDian driven by first a new shortcut to video feeds, which facilitates discovery and consumption; second, an enhanced recommendation algorithm targeting relevant content to users.

Third, we're broadening our breadth of content, including more professionally generated, professional user generated and user generated content; and fourth through expand video formats beyond our already established position in short videos to quickly expand in mini videos, which are typically less than 20 seconds in length. The social video which is primarily created uploaded and shared by one social connections, hundreds of millions of social videos are now uploaded to Weixin each day. We believe the huge volume of video uploads is a good indicator of our industry leadership in social video.

Users who watch social videos do so primarily inside Weixin group chats and in Weixin Moments where we recently extended the maximum social video duration from 10 to 15 seconds. Users who wish to create social videos can use our standalone app Weishi, which provides video shooting and editing tools such as dynamic props, background music, and AI powered beautification.

For long-form video we remain number one in the China industry in terms of DAU, time spent and revenue, benefiting from leadership across a wide range of content, including drama, Chinese anime, variety shows and documentaries. At quarter-end, we had 82 million video subscribers, up 79% year-on-year and our video subscription revenue similarly rose 79% year-on-year. Subscriber growth benefited from hit content such as our fancy drama series, Legend of FuYao, which achieved over 14 billion video views and our historical drama series, Ruyi's Royal Love in the Palace, which generated over 16 billion video views.

Our video advertisement revenue increased 34% year-on-year benefiting from increased traffic and sponsorships. Integration with our performance ad platform expanded our advertiser base and increased in-feed revenue. As far as commercial success, our video content has also achieved critical acclaim. For example, our animated series, The Land of Warriors won the Best Anime Award in the Chinese Comics and Games Expo. And our food documentary, Once Upon a Bite scored a 9.3 rating on the review site Douban.

For smartphone games total revenue was RMB 19.5 billion, up 7% year-on-year due to contributions from new action in RPG titles. Revenue grew 11% quarter-on-quarter, primarily due to new games released at the end of the second quarter and during the third quarter. In China, Honour of Kings remains the top title in terms of active users in revenue. We released new avatar personalization items and dance emotions in the quarter, which increased paying users and revenue sequentially.

Our tactical tournament games grew active users quarter-on-quarter, but remained unmonetized. And we launched several role-playing games associated with popular intellectual properties among which Free Fantasy Online, MT4 and Saint Seiya ranked within the top 10 in China's iOS Grossing Chart during the quarter. We have 15 games with monetization approved in our China pipeline, including mainly role-playing and action games associated with established intellectual properties.

For international markets, according to App Annie, our PUBG MOBILE game has the second-highest ex-China monthly active user count of any smartphone game globally and its revenue tripled quarter-on-quarter, reflecting a full quarter of monetization and increasing subscriptions for its Royale Pass. Arena of Valor ran a widely watched World Cup Final eSports event driving its global DAU to a record high.

For PC client games, revenue was RMB 12.4 billion, down 15% year-on-year and down 4% quarter-on-quarter. The year-on-year revenue decline reflects the ongoing trend of users shifting time to smartphone games. While our reported revenue declined quarter-on-quarter, our cash sales before deferrals increased, benefiting from positive seasonality and the resilience of our leading titles. In China, CrossFire and DnF released successful updates in the quarter. And in November, our eSports audience reached a record high in China, when Invictus Gaming became the first Mainland China team to win the League of Legends World Championships. Internationally, we launched a tactical tournament game Ring of Elysium on Steam, which ranked among the platform's top 10 games by peak concurrent users following its launch.

We're implementing several initiatives to foster healthy gameplay. In September, we upgraded our healthy gameplay system to protect players aged 12 years old and below from spending excessive time on games. We identified these players by real-ID verification combined with facial recognition technology and we opposed a 1-hour game timing per day and prevent logins between 9 PM and 8 AM for these users. We implemented the upgraded system in Honour of Kings on a city-by-city basis and are expanding this system nationwide and across our other games.

Via our parental guidance platform, we're providing parents with tools to engage with their children and track their in-game activities. And we're developing functional games intended to assist learning or improve dexterity. Two months since the implementation of our healthy gameplay system, we believe some children are indeed significantly reducing their gaming time and we have seen millions of parents sign-up for the parental guidance platform. We believe these initiatives should position the industry for sustainable and healthy long-term growth.

Shifting to advertising, our online advertising revenue was RMB 16.2 billion, up 47% year-on-year and up 15% quarter-on-quarter. Our media advertising revenue was RMB 5.1 billion, up 23% year-on-year and up 8% quarter-on-quarter within which our video ad revenue was up 34% year-on-year and up 13% quarter-on-quarter. Our news app revenue increased year-on-year as we expanded the advertiser base following the completion of our ad system revamp, but declined quarter-on-quarter due to the end of the NBA season.

Our social and others advertising revenue was RMB 11.1 billion, up 61% year-on-year and up 19% quarter-on-quarter. Increased traffic and inventory in Weixin Moments, Mini Programs, and QQ KanDian and more impressions in our mobile ad networks drove the year-on-year growth. Increased impressions in click-through for Mini Programs and for Weixin Moments contribute most to the quarter-on-quarter growth. We've expanded our long-term advertiser base to Weixin Moments through cooperation with local ad agencies and through converting Weixin Pay merchants into advertisers on our platforms.

Moving to our payments and FinTech services, we maintained our leadership in China's mobile payment market measured by MAU and DAU. Our average daily transaction volume increased over 50% year-on-year within which our offline daily commercial payment transactions grew 200% year-on-year. We're adding new payment services such as cross-border mobile payments, allowing WeChat Pay Hong Kong users to conduct renminbi-denominated transactions in Mainland China.

Our payment processing and settlements are smoothly transiting to the NetsUnion centralized clearing system. We're also expanding our FinTech services in areas such as wealth management, micro-loans, and insurance. LiCaiTong's aggregated customer assets surpassed RMB 500 billion at quarter-end. WeBank-originated WeiLiDai loan balances grew rapidly and sustained industry-leading healthy non-performing loan rates. WeSure, our insurance service within Weixin partnered with insurance companies such as TCEHY and MetLife to customize products for Weixin users.

And with that, I'll pass it to John to go through the financials.

Shek Hon Lo

Hi everyone. For the third quarter of 2018, our total revenue was RMB 80.6 billion, up 24% year-on-year or 9% quarter-on-quarter. Cost of revenues increased by 35% year-on-year to RMB 45.1 billion. The increase primarily reflected greater cost of payment-related services, higher content and channel costs.

Gross profit was RMB 35.5 billion, up 12% year-on-year or 3% quarter-on-quarter. Net, other gains were RMB 8.8 billion for the third quarter of 2018. This represented increases in valuations of certain investee companies, including a fair value gain from Meituan-Dianping upon its IPO. We made impairment provisions for certain investee companies in verticals such as online games, entertainment and e-commerce.

Share of profit of associates and JV was RMB 264 million in the quarter versus that of RMB 1.5 billion for the second quarter of 2018. The quarter-on-quarter decrease was mainly due to one-off share-based compensation expense of an associate. On a non-GAAP basis share profit of associates and JV was RMB 2.8 billion for the third quarter, which is pretty much at the same level as the second quarter.

Income tax expense was approximately RMB 3.2 billion, down 35% year-on-year or 10% quarter-on-quarter. The year-on-year decrease was mainly due to lower taxable income and withholding tax. The effective tax rate in the period was 12.1%. Net profit to shareholders was RMB 23.3 billion, up 30% year-on-year or 31% quarter-on-quarter.

I'll walk you through our non-GAAP financial numbers. For the third quarter and after adjustments to non-GAAP, operating profit for the quarter was RMB 22.6 billion, up 4% year-on-year or 1% quarter-on-quarter. Operating margin was 28%, down 5.1 percentage points year-on-year or 2.2 percentage points quarter-on-quarter. Net profit to shareholders was RMB 19.7 billion, up 15% year-on-year or flat quarter-on-quarter. Net margin was 25.3%, down 1 percentage point year-on-year or 2.5 percentage points quarter-on-quarter.

Let's turn to segment gross margin. Gross margins for value added services was 56.5%, down 3.4 percentage points year-on-year or 2.5 percentage points quarter-on-quarter. The decreases mainly reflected mix shift towards lower margins smartphone games, higher proportion of revenues from licensed titles within PC games and higher content costs of video streaming subscriptions.

Gross margin for online advertising was 36.7%, broadly stable year-on-year and quarter-on-quarter. Gross margin for others was 22.8%, up 2.5 percentage points year-on-year or down 2.1 percentage points quarter-on-quarter. The year-on-year increase was mainly due to growth in fee charge from credit card repayment revenues from micro-loan business and interest income related to restricted custodian deposits. On the other hand, the quarter-on-quarter decrease was mainly due to higher proportion of revenue from our lower margin products.

Moving onto operating expenses, selling and marketing expenses were RMB 6.6 billion, up 37% year-on-year or 3% quarter-on-quarter. The year-on-year increase mainly reflected greater marketing spend on our products and platform such as payment-related services, online video and smartphone games. The sequential increase was driven by high marketing spend on online video business and payment-related services. As a percentage of revenue, selling and marketing expenses was 8.2% for the third quarter.

G&A expenses excluding R&D were RMB 4.6 billion, up 10% year-on-year or 12% quarter-on-quarter. Under G&A, R&D expenses were RMB 6.3 billion, up 30% year-on-year or 9% quarter-on-quarter. Both year-on-year and quarter-on-quarter increase of G&A expenses were mainly due to greater R&D expenses and staff costs. As a percentage of revenue, total G&A was 13.5% and R&D was 7.8%.

At the end of quarter three, we had over 52,600 employees. The year-on-year increase of 21% was mainly due to our expanded business growth in particular cloud and payment-related services.

Let's go through margin ratios for the third quarter. Gross margin was 44%, down 4.6 percentage points year-on-year or 2.8 percentage points quarter-on-quarter, mainly reflecting the revenue mix changes among segments and reduced gross margin of VAS as mentioned previously. Non-GAAP operating margin was 28%, down 5.1 percentage points year-on-year or 2.2 percentage points quarter-on-quarter, primarily due to lower gross margin. Non-GAAP net margin was 25.3%, down 1 percentage point year-on-year or 2.5 percentage point sequentially. The year-on-year decrease was mainly due to lower operating margin partially offset by the margin picked up from share of profit of associate and income tax expense.

Finally, let me share with you some key financial metrics before rounding up this presentation. For the third quarter, the total CapEx was RMB 6 billion, up 71% year-on-year or down 16% quarter-on-quarter. Operating CapEx was RMB 5.2 billion, down 21% quarter-on-quarter, mainly reflecting less spending on service for cloud businesses following pre-stocking in previous quarter. Non-operating CapEx was RMB 782 million. Free cash flow was RMB 26.4 billion, down 4% year-on-year or up 71% quarter-on-quarter. The quarter-on-quarter increase was driven by growth in grossing of online games as a result of positive seasonality in third quarter.

At the end of September, our net debt position was RMB 29.2 billion compared to net debt of RMB 35.3 billion last quarter. The sequential decrease in net indebtedness was mainly due to free cash flow generation and proceeds from disposal of certain investee companies, which was partially offset by payments for media content and M&A initiatives. The fair market value of our listed investee companies excluding subsidiaries of course were approximately RMB 273 billion, or US$39.7 billion at quarter-end, up from RMB 171 billion a year ago. During the period from 7th of September to 12th of October 2018, we repurchased 2.8 million shares with an aggregate cost of about US$113 million.

This concludes our presentation.

Jane Yip

Thank you. And we shall now open the floor for questions. Operator, we will take one question each time. So we'll invite the first question now.

Q&A

Operator

Thank you. [Operator Instructions] Our first question comes from the line of Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you, management. Congratulations on the solid results. I just have two quick questions. First you mentioned that you still have 15 titles in the pipeline with game approval. But I recall that last quarter you also mentioned that you have 15 titles. However, in between the two quarters you actually launched your several new titles. I just wonder what is that actually – how did you actually get approval for the new games that you did between the two quarters, so that we can make up this math?

And secondly, on the Mini Programs, can you give us update on the competition and ecosystem as well as the monetization trend? We noticed that several other companies who also launched a similar type of live program, or the quick app etcetera. And also you mentioned in your prepared remarks earlier that you already start to generate the advertising revenue from Mini Programs. So if you can share some color on those things that will be great. Thank you.

<A - James Gordon Mitchell>: So to start with the question about the games in the pipeline, there are several moving parts that impact the number of games we have with monetization approval in our pipeline at any point in time. One obviously, as we publish games, then there's fewer games left in the pipeline. On the other hand, there are ways that we can add games to the pipeline. For example, there might be a independent studio that was working on creating a game 12 months ago and secured [indiscernible] (33:48) that monetization approval 12 months ago. And in the most recent quarter, we were able to persuade them to allow Tencent to be the publisher of that game, so then that game would become a Tencent pipeline game with monetization approval. And I'll pass to Martin for the question about Mini Programs.

<A - Chi Ping Lau>: Yeah. In terms of Mini Programs, I think, its innovative programming framework for usage within the WeChat ecosystem. And we have invented this framework. And we're actually very happy to see that this framework has been adopted by many different other players in the market, which means that this framework is actually very, very valuable. Now we do believe that the fact that there are more people endorsing this new programming framework, it means that there will be more developers coming into the market which is good. And at the same time I think we do have unique advantages within our own ecosystem. And that includes we have a very large DAU app, which is supporting our own Mini Program framework. We have very frequent usage among our users of the app, i.e., WeChat. We have social recommendation which is a very important way through which Mini Programs are spread across different users.

We have a pretty complete ecosystem, including WeChat payment, which helps the Mini Programs to get paid. And at the same time, we also have developed this QR code, which allows offline merchants and offline operators to promote their Mini Programs using our application and our framework. So, all in all, I think by having a lot of people coming in that's great for helping to cultivate a large developer base and among all the different offers of Mini Programs I think we have a very strong value proposition.

Overall, I think we have seen pretty quick adoption of Mini Programs, the monetization right now is still pretty much associated with mini games, which is a branch within Mini Programs. But at the same time, we also see growth of very diversified applications with the Mini Programs in particular with a lot of retailers. They are quite eager to develop Mini Programs so that they can have their own channel of selling products to their customers and also serve their customers. So we are actually quite excited about the future prospect of Mini Programs.

<A - Jane Yip>: Thank you. And the next question please.

Operator

Our next question comes from the line of Alicia Yap from Citigroup. Please ask the question.

<Q - Alicia Yap>: Hi. Can you hear me? Good evening, management. Thanks for taking my questions. I have questions regarding the more stringent implementation of the playing times for the minors and also enforcing the real-ID verifications on Honour of Kings and also other games. Has this process affecting the user time spent, not the minors, but what I mean is the user that is higher than 18 years old where their time spent and engagement activities actually also being impacted. And should we also worry if there's any impact on the revenue growth? Any color there will be great.

And then second, regarding the Tencent latest initiative of moving into this industrial Internet, I understand it is still in the very early process of this transformation. Is that mean, there will be more investment spend in the coming years? And ultimately, will this industrial Internet opportunity be perceived as strong recurring revenue stream, but at a lower margin profile than the consumer Internet that we enjoy in the past? Thank you.

<A - James Gordon Mitchell>: Good evening, Alicia. In terms of the healthy gameplay system and as we mentioned in the prepared remarks, the system is impacting the amount of time spent by minors playing our games which is the intention. We don't expect to impact the time spent by older users, but would obviously need to track the progress. And then shifting from time spent to revenue and currently minors contribute earning significant portion of revenue for our mobile games, now obviously depending on how efficiently we execute this, there could some spillover impact to non-minors spending, but again that's not the intention. And if we can focus it on minors then that shouldn't have a substantial impact on our business, because the vast majority of our game revenue comes from older users.

<A - Chi Ping Lau>: Okay. In terms of the industrial Internet, I think the initial revenue opportunity is around the cloud business. As you can see we have a fast growing cloud business and also has been gaining market share. The nature of the cloud business is that it does require quite a bit of capital expenditure because we need to build the IDC as well as to buy the service. And over time, earn recurring revenue on the cloud service fees.

Now this business at the same time is low margin, because it's only staying at the infrastructure level. But the way we look at it is that we look at it as a long-term investment for the future and we felt that over time new business opportunities can actually come out of our cloud and associated industrial Internet opportunities and that will include when we move from ICE infrastructure to PaaS, Platform-as-a-Service and SaaS, then we can actually start generating a higher margin revenue.

At the same time, we also believe that we could have new business model and value-added services built from our connection with the industries. For example, when we talk about the transportation industry, right, if we could actually establish a CRM for OEMs to reach customers then there will be associated marketing revenue, there will be associated value-added services revenue, including referral fees on auto insurance, auto loans. So those will be new business models which will be of higher margin.

And at the same time, we believe that by engaging in the industrial Internet, we can actually bring benefits to our ancillary businesses, for example, our payment business as well as our advertising business. So we look at it in a holistic approach. And just like how we approach consumer Internet, right. In the very, very beginning nobody really generate any revenue from consumer Internet. We start with providing a product which we know that will generate value for the users and over time we start to develop different kinds of business model from that valuable service.

And I think for industrial Internet, it's the same philosophy, right. If we see that we can actually add value to a particular industry and to the partners that we sign up and we know that by bringing technology, by bringing data insights and by bringing connection for them to connect with users, we can actually create value for the users, we can create value for these industrial partners and we can actually facilitate the upgrade of the industry then we know that we will be creating tremendous value and we will be pretty confident that over time we will generate business opportunities and revenue from that value-add.

<A - Jane Yip>: Thank you, and the next question, please.

Operator

Our next question comes from the line of Thomas Chong from Credit Suisse. Please ask the question.

<Q - Thomas Chong>: Hi, good morning. Thanks management for taking my questions. I have a question on the online gaming business. Can management provide the quarterly ARPU for MMO advanced casual and smartphone games? And my follow-up question is about the PC games. How should we think about the trend in Q4 or 2019? And my quick follow-up is about the trend in terms of the operating expenses. Can management give us some color about how we should think about the trend going forward? Should we expect we need to incur higher OpEx for new initiative? Thank you.

<A - James Gordon Mitchell>: Hi Thomas. We'll keep your two questions, so that other people have room to ask questions about operating margins or whatever the topic is as well. So just focusing on your two questions, John will speak to the ARPU. But with regard to the PC game business, it's obviously a challenging segment of the industry given the ongoing user time shift migration from PC games to smartphone games. We are aggressively looking for new PC games to publish in China, particularly new PC games that can create new market segments which didn't previously exist in the China market that may have existed in overseas markets. And to the extent we're successful in doing that then we can improve the trends for our PC game business. I would also say that the comparisons for our PC game business in the current and recent quarters are particularly difficult. But overall, the PC game outlook is a fairly conservative outlook given the megatrend of users shifting time to smartphone games.

<A - Shek Hon Lo>: In terms of the ARPU, the MMOG is RMB 530 to RMB 730 and ACG is RMB 160 to RMB 670 and smartphone games is RMB 180 to RMB 190.

<A - Jane Yip>: Thank you and the next question please.

Operator

Our next question comes from the line of Winnie Wong from HSBC. Please ask the question.

<Q - Winnie Wong>: Thank you management for taking my questions. My question is on the impact of the macro headwinds. We saw that in the press release you talked about the increase in advertising revenue were mainly reflected by more advertising inventories in Weixin Moments and also the new advertising formats such as the Mini Programs. So just wanted to see the reasons and also the rationale behind that we're still able to increase the advertising inventory amid the macro headwinds? Thank you

<A - James Gordon Mitchell>: Yes. So we believe that we deliver above-industry return on investment from our advertising. And historically to a great extent, our advertising has been supply constrained rather than demand constrained. So as we grow our traffic and as we add new inventory within our traffic for example in the last few quarters we have made inventory available in Mini Programs which was the biggest contributor to the quarter-on-quarter ad revenue growth this quarter. Then I think it's natural that we see a flow-through into stronger advertising revenue. On the flipside, there are certain advertiser categories in China that have been hit hard by regulatory measures. And generally speaking our advertising business is under-weighed those categories due to conscious decisions on our part. Looking forward then if the macro environment deteriorates sharply that will naturally have a negative impact on our advertising revenue growth rates, but we believe given our superior performance that we should continue to outperform the industry based on the better than industry returns on investment we deliver to our advertisers.

<A - Jane Yip>: Thank you. And the next question please.

Operator

Our next question comes from the line of John Choi from Daiwa Capital. Please ask the question.

<Q - John Choi>: Thank you. I have a question about your margin trend. I could see this quarter the operating margin is at 28% and are constantly coming down. Obviously game growth, which has a high margin and as you guys earlier mentioned advertising, digital content, payment, cloud are now the majority of the business. So going forward in the future, should we be expecting this is going to be the new norm? Or should we be expecting margins to stabilize or even if we expand? Secondly on the game, I just want to follow up, in terms of assuming that the regulatory situation normalizes, where do you see the upside potential on the smartphone game growth? Is it going to be for the ARPU expansion or any types of any growth drivers that you guys see? Thank you.

<A - Chi Ping Lau>: In terms of margin, I think we should probably not take overly-simplistic view of an overall margin, but instead look at the different businesses because our revenue is a collection of businesses of very different natures. For example, gaming obviously it has a higher margin, but there is also a big difference between self-developed games and licensed games. And then if you look at some of the new businesses, right, advertising has got a very high margin, but if you look at video, obviously, it has a low margin. And when you look at payment, which is a pretty large business segment for us we run as a infrastructure service, so it has a relatively low margin. And cloud business at this point in time is also of very low margin. So I think we should probably look at each one of the business segment and analyze the margin accordingly. And the overall margin of the company would be essentially weighted average of all the margins of the respective segments.

So, if there is more gaming revenue in the future, I think the margin will probably go up more. But I think even for some of the – and advertising, for example, if it grows more, then it would have a positive impact on the overall margin of the company. For the businesses which are right now in investment mode and generates very low margin, I think some of them will probably stay like that for a while. But over a longer period of time, we think as we can actually generate some value-added services out of those revenue streams then we may be able to get up to higher margin over a longer term.

<A - James Gordon Mitchell>: In terms of opportunities to enhance our smartphone games revenue then – and I think one can look at it along three dimensions; the ARPU, the paying user ratio, and the total number of users. And our ARPU has substantial upside relative to the industry and part of the reason why we're able to eek out a little bit of growth for our smartphone game revenue in the third quarter was because we released some relatively high ARPU role-playing games, which demonstrated that effect.

Our paying user ratio also has substantial upside relative to the industry, but it's to some extent been frozen by the regulatory measures, particularly as some of our new games have very substantial user base, who currently have a 0% paying user ratio. And then our overall game user base – smartphone game user base is already at a very substantial number, but on the other hand, the success of the mini games within Weixin illustrates that there's still a substantial audience of new players, particularly female players who historically were not actively playing smartphone games, but are now beginning to do so. So, we think that in a more benign regulatory environment, there's upside to all three metrics; the ARPU, the paying user ratio and the total number of game players.

<A - Jane Yip>: Thank you. And the next question please.

Operator

Our next question comes from the line of Han-Joon Kim from Deutsche Bank. Please ask the question.

<Q - Han-Joon Kim>: Great. Thank you for the chance to ask a question. For your advertising business, I noticed that we've seen an acceleration of year-over-year growth and I recognize that it's part of the ad inventory that we've talked about. But how should we think about the possibility of maybe continuing this acceleration, particularly as we redefine the business with the advertising and marketing services unit and trying to integrate the various components of ad inventory together to maybe create, generate better ROAS? Thank you.

<A - Chi Ping Lau>: Well, I would say we run the advertising business on consistent and long-term basis, right. So, I think what we have seen today is actually the result of a pretty long data and consistent effort improving our ad system. And we always have been very disciplined in terms of making sure that our advertising quality is high. We have been running at below industry level of ad load because we want to have the right balance between user experience and advertising. And in order to keep on delivering higher ROI to the advertisers and also to make the advertising experience better for the users, we have been investing heavily into building ad system with targeted technology.

And I think what we have seen today is just a result of all these efforts in the past. And going forward, we continue these philosophies and we believe over time, we'll continue to generate more and more revenue from the advertising business. But at the same time, I think we do not want to hurry ourselves and we do not want to do things that generates revenue for the short-term, but harm the user experience or harm the advertisers over the longer term. I think in terms of the AMS, it is a good development obviously. It helps us to now face the advertisers with a single voice. And it would help us to serve those advertisers better. And I think it will be a positive development overall for our service level for advertisers.

<**A - Jane Yip**>: Thank you. And the next question please.

Operator

Our next question comes from the line of Grace Chen from Morgan Stanley. Please ask the question.

<**Q - Grace Chen**>: Hi, thank you. Thank you for taking my question. Can you share with us your view about the 2019 outlook by the different business segments such as gaming, social network, online marketing, payment and cloud business? Apart from the to be initiatives, what are the other key strategic differences in 2019 versus this year? I remember this year we talk about heightened investments this year, so if you can share your strategic focus next year that will be great. Also, can you update us with the latest development of the government gaming – the game approval process? Thank you.

<**A - Chi Ping Lau**>: I think in terms of 2019 right, we have already done a very big strategic organizational upgrade which is indicative of our focus for the future right. And obviously our existing businesses will continue to put lot of effort in and at the same time in two particular areas in the form of a Cloud and Smart Industries Group and in our Platform and Content Group, we will have a redoubling effort in those areas to build better products and better services to serve our users and our customers. So I think for Tencent we have always been very consistent in terms of pushing ahead with our execution. So as you can see from our organization, we'll continue to push along those lines of businesses. And in terms of regulatory approval I think at this point in time there is not a lot of update. We are waiting for the government to start the approval process for games. And when that's announced then we'll have the update for the market.

<**A - Jane Yip**>: Thank you. And the next question please.

Operator

Our next question comes from the line of Natalie Wu from CICC. Please ask the question.

<**Q - Yue Wu**>: Hi, good evening. Thanks for taking my question. Just curious is there any change regarding the revenue-sharing ratio with [indiscernible] (57:28) recently, for example the micro-loan business of WeiLiDai? So could you quantify the impact from the PBoCs regulation on your interest income in last quarter? Just wondering how should we see the future trend of the GP margins for the other revenue line? Thank you.

<**A - Chi Ping Lau**>: Yes. For the first one I don't think we will comment on specific commercial transactions. On the second part of your question, I think it's more important to look at what is still in there because as we previously communicated by the beginning of next year all the interest will be gone. So I think what we can speak to that is that there is a high single-digit number of our current others revenue which is interest from the deposit and that would basically disappear by first quarter next year.

<**A - Jane Yip**>: And the next question please.

Operator

Our next question comes from the line of Alex Yao from JPMorgan. Please ask the question.

<Q - Alex Yao>: Hi, good evening everyone. Thank you for taking my question. I have a question on the mobile gaming monetization strategy side. Given the uncertainty around new game monetization approval, would you consider change the existing game on monetization or operation strategy? For example, would you consider to increase the existing game title lifecycle by temporarily lowering their monetization? And then in terms of the key initiatives and the future development direction such as the clouds, industrial, et cetera, et cetera given the uncertainty around gaming monetization, would you consider to tweak the investment strategy in terms of the budget spend next year on the back of uncertainties around new game monetization? Thank you.

<A - James Gordon Mitchell>: Alex, so on the first question, we believe the way that we monetize our games is entirely compatible and commensurate with great longevity. And I think the fact that a game like Dungeon & Fighter is arguably the highest revenue China PC game now after 10 years in our operation. The fact that League of Legends is – might be the most popular PC game in China after many years of our operation speak to the fact that we're able to speak to the reality, we're able to both monetize games appropriately and also maximize their lifecycle. So no, I think the concept of us reducing the revenue for our existing games because of some kind of expected trade-off with game longevity wouldn't make a lot of sense to us because we think our existing monetization levels are very healthy and long-term sustainable.

<A - Chi Ping Lau>: Yeah. In terms of the investment for the industrial Internet businesses as well as some of the longer-term projects, I think our philosophy has never been short-term financial number driven. Our philosophy has always been long-term value-driven, right. If we can actually create value for the long run, we will do the right things i.e. make the investments and we will not be swayed by short-term financial considerations.

<A - Jane Yip>: Thank you. And the next question please. Operator, may we take the last question?

Operator

The next question comes from Jin Yoon from New Street Research. Please ask the question.

<Q - Jin-Kyu Yoon>: Hi. Good evening, guys. Just a quick follow-up on kind of advertising in general, you guys just talked about how advertising was especially on the SNS side driven by kind of new outlets and new inventory. But can you just also talk about kind of CPC, CPM pricing trends among the bigger SNS advertising businesses? And perhaps, can you kind of recommend order in terms of revenue contribution? Thanks.

<A - James Gordon Mitchell>: So in terms of revenue contribution, we don't go into great detail, but Weixin Moments is the single largest contributor and then Weixin Official Accounts, Weixin Mini Programs are also substantial contributors. But then outside Weixin, mobile ad network has become a very substantial revenue contributor and mobile browser is also a meaningful contributor. And we're in the process of ramping up our new Speed's revenue which is an area where we believe we have traffic equal to or superior than most of our peers. But our revenue is still much lower than our peers and we're in the process of rectifying that discrepancy.

In terms of CPC and CPM, there's enormous variation by property. So for example, Weixin Moments commands a premium CPM relative to almost every other medium in China, because it is uniquely effective at targeting a nation-wide white-collar audience in attractive and engaging [indiscernible] (1:03:32) way. And as we've been increasing the ad load on Weixin Moments, the focus is more around preserving the CPM within a same city basis rather than seeking to try to grow the premium further. Then a property like our video property would be a medium CPM that's increasing over time due to growing advertiser demand at a moderate rate. And then something like a mobile ad network which you start at a very low CPM, but as we apply more technology and as advertisers get more comfortable with our systems and the quality of the clicks we deliver then the CPM and CPC for our mobile ad network would be increasing particularly quickly.

Jane Yip

Thank you. And we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. The replay of the webcast will also be available soon. Thank you and see you next quarter.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2018-08-15
Event Description: Q2 2018 Earnings Call

Market Cap: 3.10TRI
Current PX: 325.80
YTD Change($): -80.20
YTD Change(%): -19.754

Bloomberg Estimates - EPS
Current Quarter: 2.169
Current Year: 8.677
Bloomberg Estimates - Sales
Current Quarter: 84820.333
Current Year: 326966.400

Q2 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Eddie Leung
- Jin-Kyu Yoon
- Gregory Zhao
- Yue Wu
- Alicia Yap
- Wendy Huang
- Han-Joon Kim
- Karen Chan
- Grace Chen
- John Choi

MANAGEMENT DISCUSSION SECTION

Jane Yip

Non-GAAP Financial Measures

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS

For a detailed discussion of risk factors and non-GAAP measures please refer to our disclosure documents on the IR section of our website

Huateng Ma

Business Highlights

Opening Remarks

- In Q2 2018 we continue to deepen user engagement across our social, games, and media platforms with solid year-on-year growth in daily active users and time spent in our Weixin platform, mobile games, and video platform
- We have also invested heavily in our news feed, short video, and mini video products and have seen significant growth in them

Revenue and Non-GAAP Operating Profit

- Let me highlight the key financial numbers
- Total revenue was RMB 73.7B, up 30% year-on-year and stable quarter-on-quarter
- Non-GAAP operating profit was RMB 22.3B, up 11% year-on-year or down 12% quarter-on-quarter
- Non-GAAP net profit attributable to shareholders was RMB 19.7mm, up 20% year-on-year and up 8% quarter-on-quarter
- John will provide more details in the financial section

MAU

- Moving to our key platforms
- Combined MAU of Weixin and WeChat increased 9.9% year-on-year to 1.06B as we are building a vibrant Mini Programs ecosystem with higher developer and user adoption, further strengthening the user engagement of the platform
- Total MAU for QQ was 803mm
- Smart devices MAU was 709mm, up 7% year-on-year
- Our news feed service, QQ KanDian, further grew its active user and time spent
- Our social network service, Qzone, smart device MAU was 543mm
- In games, we’re strengthening our leadership in mobile and PC
    - We increased our smartphone games market share in terms of DAU
- User time spent and engagement increased in key genres, including tactical tournaments, action shooter, and MOBA
- We also expand our user base globally benefiting from the success of AOV and PUBG MOBILE

Media Business

- For media business we maintained our leadership in online video, news, music services, and literature
- We solidified our leadership in long form video platform with a higher mobile DAU, user engagement, and also larger subscriber base
- In fintech our mobile payment service deepened penetration in verticals such as fast food chains and supermarkets
    - We’ll continue to be the market leader in terms of DAU driven by rapid growth of offline commercial transactions
- In mobile utilities we’ll remain industry leader in mobile security, mobile browser, and Android app store in China

Chi Ping Lau

Q2 Highlights

Opening Remarks

- I would first start the session by addressing a very popular question which is the trend of user engagement in our core platforms especially given the popularity of short videos and mini videos recently in the market
- The quick answer is that we have seen increasing engagement in our social platform, games platform, video platform as well as strong growth in our media feeds

Weixin

- Now starting from social, Weixin recorded solid growth in terms of users, time spent, and activities
- As the largest social communication platform in China, Weixin continues to add daily active users and per user messages, both delivering a double-digit growth rate year-on-year
- In particular, users are spending more time in Moments as well as Mini games within Weixin
- Through increasing popularity of Mini Programs and Weixin Pay, Weixin is getting involved in more vertical use cases online and offline, enabling us to increase the value of our engagement that is not entirely dependent on time spent
- I will elaborate more on Mini Programs in the next two slides

China

- In the area of video, user consumption of long form video content continues to ramp up driven by IP-based original content in drama, variety shows, and Chinese anime
- For mobile, daily active user increased 24% year-on-year, daily video views up 53% year-on-year, and total time spent up 39% year-on-year during Q2, solidifying our position as the leading video platform in China
- In terms of media feeds, our recommended feeds are getting higher hits due to better algorithm and enhanced content offering
  - These media feeds are strategically placed in our large DAU products so as to provide more convenient access to users
- Currently QQ KanDian and Mobile QQ Browser host our largest feeds products and, in aggregate, they increased daily page views by 55% and daily short video views by more than three times year-on-year

Mini Program

- Now moving on to the next two slides, I will discuss the rapid adoption of Mini Programs and how it is enabling our payment business and enriching our O2O ecosystem
- Mini Program is an innovative platform built into Weixin facilitating discovery and consumption of services
- For developers, Mini Program offers an open platform with powerful features to make programming easier and more efficient
  - These programs run immediately upon scanning a unique Mini Program QR code, connecting offline services to online engagement

- Supported by Weixin Pay, advertising, and cloud capabilities, Mini Programs can provide a seamless, closed-loop experience for users
- Since its launch in early 2017 we've done a lot to educate developers and users about the potential capabilities of Mini Programs, including partnering with colleges to host coding classes with students and developers

Mini Games, Tools and Offline Services

- Rapid adoption took off early this year with a growing number of developers creating Mini Programs for their own companies as well as system integrators developing Mini Programs for their clients
- Benefiting from the expanding categories of Mini Programs which include various services such as Mini Games, tools, and offline services, we grew daily active users of Mini Programs to more than 200mm
  - Sharing in our social networks facilitated user acquisition while highly popular Mini Games further accelerated adoption and engagement
- Mini Programs are great for discovery and quick actions and are complementary to full-function native apps by increasing download and traffic to them

Transportation Sector

- In terms of some examples on how Mini Programs expand penetration across different representative use cases, I provided four of them
- Number one in transportation sector
- Our internally-developed transport payment solution called Tencent Smart Transit QR code enables public transport operators to achieve higher processing efficiency, reduce cost, and utilize data for service planning
  - We have rolled out our payment solution in over 90 cities across the country
- Some operators simply adopted our payment QR code while others developed their own Mini Programs with additional functionalities as well as advertising to broaden their revenue streams
- In the area of smart retail, Mini Programs help merchants shorten in-store checkout time, facilitate order for home delivery, and provide targeted product promotions via embedded links to official accounts
  - Many retailers find these capabilities extremely useful as they stick to digitize their businesses and engage with customers online
- Our scan-to-buy function is increasingly adopted in shopping malls, supermarkets, and convenience stores

E-Loyalty Program

- In the restaurant sector pre-ordering in Mini Programs help operators increase efficiency and sales by cutting queuing time, reduce labor cost as customers switch to ordering online
- They can also reward customers with integrated e-loyalty program
- Mini Programs are widely adopted in fast food chains, cafés, and casual eateries across China
- In the Mini Games sector developers can expand user reach and acquire users via multi-channels such as Weixin Game Center, search within Weixin or social referral

- Given its easy-to-play and light experience, Mini Games help developers accumulate users and traffic and monetize via advertising and virtual item sale on Android
- In Q2 we introduced ads in Mini Games and drew enthusiastic responses from advertisers
- Advertising revenue was up 5 times quarter-on-quarter

James Gordon Mitchell

Q2 Highlights

Revenue

- In Q2 2018 our revenue grew 30% year-on-year
- VAS represents 57% of our revenue within which online games contributed 34% and social networks 23%
- Online advertising was 19% of our total revenue and the others segment accounted for 24% of our total revenue
- Within the others segment where revenue was up 81% year-on-year, our payment-related business sustained strong growth as we rapidly expanded our offline commercial payment volume and related services and despite a quarter-on-quarter reduction in interest income from restricted custodian deposits
- Under PBOC's guidelines, we expect that by January next year we no longer generate interest income from restricted custodian deposits, and John will discuss the details in the financial section

Cloud Services

- Our cloud services revenue doubled year-on-year as our paying client base increased significantly with deepened penetration in key sectors including finance, smart retail, and municipal services
- We also invested in and formed strategic partnerships with certain systems integrators to offer customized cloud services and broaden our penetration offline

Value-Added Services

- For value-added services, segment revenue was RMB 42.1B, up 14% year-on-year though down 10% quarter-on-quarter Our social network revenue was RMB 16.9B, up 30% year-on-year but down 7% quarter-on-quarter
- Total VAS subscriptions grew 30% year-on-year to 154mm subscribers as our video subscription count more than doubled
- Our revenue grew strongly year-on-year driven by video subscriptions and the increased monetization of music live broadcast services
  - However, sequentially, game-related item sales reduced sharply following our reported smartphone game revenue reduction which offset growth in digital content revenue and resulted in the net quarter-on-quarter revenue decline

Online Games Revenue

- Our online games revenue was RMB 25.3B

- Revenue decelerated to 6% year-on-year growth and declined 12% quarter-on-quarter
- Non-monetization of popular tactical tournament games in China was the main reason behind the year-on-year and quarter-on-quarter deteriorations
- However, during the quarter we grew our smartphone game DAU in China by a double-digit percentage year-on-year, expanding the foundation for our smartphone game business' long-term growth and creating future monetization opportunities

Social Networks

- In overseas markets our games Arena of Valor and PUBG MOBILE expanded their user bases and monetization
- In social networks we continue to grow our mobile payment activities leveraging our social platforms
- At the end of June we surpassed 800mm mobile payment MAUs
- Our average daily transaction volume increased over 40% year-on-year
- And benefiting from the expansion of use cases, our offline commercial payment volume increased 280% year-on-year
  - Commercial payment volume exceeded half of total transaction volume for the first time
- In overseas markets we prioritized use cases for Chinese outbound travelers such as duty free shopping and tax refunds
- And in Hong Kong we launched a local wallet authorized by the HKMA.

WeiShi

- Shifting to WeiShi, which is our aggregation platform providing mini videos conveniently to our users, both by our existing services as well as by our WeiShi-branded mobile app
- During the quarter, WeiShi aggregated appealing content including clips from our self-commissioned variety show Produce 101 and added innovative features such as artificial intelligence-based beautification tools and online voting functionality
- Thanks to our content library, new features, we saw robust growth in daily mini video views, particularly on KanDian and Qzone as well as in the WeiShi-branded app itself
  - We more than doubled our long-form video subscription base year-on-year to 74mm subscribers as of the end of June

China

- We also continue to lead peers by mobile DAU and daily video views, solidifying our position as the number one online video platform in China
- Among non-game apps, Tencent Video ranked number one in the China iOS Top Grossing Chart and number two in the Global iOS Top Grossing Chart during the period

Drama

- Our growth benefited from exclusive contents in key verticals, including drama series, online variety shows, and Chinese anime
- In drama, Legend of Fuyao, a historical romance created out of a China Literature IP, generated about 14B video views in total and was the most popular exclusive drama series in H1
- For online variety shows, our self-commissioned talent program, Produce 101, achieved over 5B video views, a new record for an online variety show in China
- And in Chinese anime, we've built up experience producing IP-based anime series, which attracted large audience of loyal fans

Product Operations

- And as a result, we more than doubled our anime traffic year-on-year
- For example, Land of Warriors has accumulated over 3.5B video views and is the most popular of its kind since its debut in January
- On the product operations front, we're increasing the appeal of our video subscriptions through initiatives such as allowing users to gift subscriptions to friends and we're extending the distribution of our video subscriptions through cross-promotions with partners

smartphone Games

- For smartphone games, revenue was RMB 17.6B, up 19% year-on-year due primarily to action games and Honour of Kings
- But revenue declined 19% quarter-on-quarter as; first, users shifted time to non-monetized tactical tournament games; second, we launched five out of the seven new games late in the quarter; and third, during the pre-examination season, we prioritized user retention and engagement of several of our big existing titles
  - However, thanks largely to the breakout popularity of our tactical tournament games, we believe our China mobile game market share increased year-on-year and increased quarter-on-quarter in terms of daily active users and time spent

Timi Studio

- Looking ahead, we're working on multiple fronts to reinvigorate our revenue growth, including; first, expanding overseas
- Arena of Valor, a vast arena game developed by our Timi Studio, has over 13mm daily active users outside China with particular popularity in Southeast Asia, and achieved over US$200mm in user spend in H1
- PUBG MOBILE, a tactical tournament game developed by our Quantum Studio, has over 14mm DAU outside China with a particular popularity in Western markets as well as in India, and it's achieved about US$20mm user spending per month in recent months, benefiting from seasonal passes

China's Top Game

- Second, boosting our existing game performance and monetization, in particular, we're seeking the approvals required for monetizing tactical tournament games in order to realize the revenue potential of these games, which we believe will be substantial given their large player bases and intense player activity

- And we're also finding ways to deepen user activity in existing hit titles, such as Honour of Kings, which remain China's top game in terms of users and revenue

ARPU

- Third, launching new games in high ARPU categories
- For example MT4, a role-playing game based on a well-known IP, was consistently ranked top three in iOS China Top Grossing Chart since we launched it in July
- And our in-house developed RPG, Saint Seiya, has ranked top five (sic) [four] in iOS China Top Grossing Chart since we launched it in August

PC Client Games

- Moving to PC client games, revenue was RMB 12.9B, down 5% year-on-year and down 8% quarter-on-quarter
- The year-on-year decline reflected the ongoing trend of users shifting time to mobile games
- On a quarterly basis, revenue was impacted by the same trend as well as weak seasonality
  - However, our leading titles performance showed resilience, supported by loyal user bases as well as eSports and other offline events
- For example, Dungeon & Fighter celebrated its 10th anniversary in June, demonstrating our ability to sustain and grow a game franchise over a decade

DAUs

- We engaged users by in-game marketing activities during the Labor Day holiday and an anniversary celebration [ph] gather (00:19:43) offline, driving up revenue and paying user counts
- League of Legends held its mid-season invitational eSports event in May, in which the Chinese team, RNG, won, benefiting DAUs in China
- League of Legends DAUs were up quarter-on-quarter in China and flat quarter-on-quarter globally despite adverse summer seasonality
  - We look forward to publishing several innovative titles in the coming months and quarters
- For example, we've accumulated over 10mm pre-registrations in China for Fortnite, the tactical tournament game developed by our investee, Epic Games

Online Advertising Business

- Moving on to our online advertising business, revenue in Q2 was RMB 14.1B, up 39% year-on-year and up 32% quarter-on-quarter
- Our media advertising revenue was RMB 4.7B, up 16% year-on-year and up 43% quarter-on-quarter
- Video advertising revenue continues to grow as we generated more sponsorship revenue from popular programs
  - When we self-commission content, we can target the most appropriate advertisers and develop attractive ad formats early in the production process

- Our news advertising revenue declined by a high-single-digit percentage year-on-year from the high base point last year
- But following the completion of our ad system revamp, we resumed news feed ad placement within our news services in Q2 which, along with positive seasonality, contributed to a strong quarter-on-quarter rebound

Weixin

- Our social and others advertising revenue was RMB 9.4B, up 55% year-on-year, mainly due to three factors
  - First, in Weixin, we added a second feed ad per user day in Moments as well as new inventories in Mini Programs
  - Second, we saw robust growth in impressions in and advertiser demand for our mobile ad network
  - And third, we generated more news feed traffic in QQ KanDian, driving up impressions volume
- Sequentially, social and others advertising revenue grew 27% quarter-on-quarter, benefiting from positive seasonality as well as the factors above

Shek Hon Lo

Financial Highlights

Revenue and Gross Profit

- For Q2 2018, our total revenue was RMB 73.7B, up 30% year-on-year or stable quarter-on-quarter
- Gross profit was RMB 34.4B, up 22% year-on-year or down 7% quarter-on-quarter
- Net other gains was RMB 2.5B for Q2
- On a year-on-year basis, it mainly reflected decline in net gains from investee companies and high impairment provision for certain investments
- These two items, however, are all non-GAAP adjustments
- Share of profit of associates and joint venture was RMB 1.5B in the quarter with a share of losses of RMB 319mm last quarter
- The Q-on-Q change was mainly due to increase in profit contribution from Epic due to the success of Fortnite in overseas market

Non-GAAP Basis

- On a non-GAAP basis, share of profit of associates and joint venture was RMB 2.8B for Q2
- Income tax expense was approximately RMB 3.6B, down 9% year-on-year or down 37% quarter-on-quarter, primarily due to lower withholding tax
- Effective tax rate for the quarter was 16.2%
- Net profit attributable to shareholders was RMB 17.9B, down 2% year-on-year or down 23% quarter-on-quarter

Operating Margin

- I will walk you through our non-GAAP financial numbers
- For Q2 and after adjustments to non-GAAP, operating profit for the quarter was RMB 22.3B, up 11% year-on-year or down 12% quarter-on-quarter
- Operating margin was 30.2%, down 5.2 percentage points year-on-year or down 4.2 percentage points quarter-on-quarter
- Net profit to shareholders was RMB 19.7B, up 20% year-on-year or up 8% quarter-on-quarter
- Net margin was 27.8%, down 1.3 percentage points year-on-year or up 1.8 percentage points quarter-on-quarter

Segment Gross Margin

- Let's turn to segment gross margin
- Gross margin for value-added services was 59%, down 1.6 percentage points year-on-year or 4.3 percentage points quarter-on-quarter
- The decrease mainly reflected the revenue mix shift from games to lower-margin digital content subscriptions and live podcast services as well as the rising content cost of such businesses
- Gross margin for online advertising was 37.4%, stable on year-on-year basis or up 6.2 percentage points quarter-on-quarter
- The quarter-on-quarter increase was mainly driven by increased advertising revenue due to positive seasonality
- Gross margin for others was 24.9%, up 2.5 percentage points year-on-year or stable quarter-on-quarter
- The year-on-year increase was mainly due to growth in revenues from micro loan business, interest income related to restricted custodian deposits, and fees charged from credit card repayment

PBOC

- PBOC has gradually stepped up the centralized deposit ratio requirement for third party online payment services providers just like ourselves where we are required to move restricted custodian deposit stock to non-interest-bearing accounts
- The ratio was increased from 32% in March to 42% for Q2 and finally up to 100% by January 2019
- As such, interest income recognized under others segment has dropped to low teens percentage of others segment revenue for Q2 and will continue to impact on segment revenues and margins
- We are seeking to mitigate the impact through various monetization initiatives in our payment and related businesses, this including growing our Internet finance revenue such as micro loans and wealth management products which carry high margins than payment business as well as managing marketing expenses

Operating Expenses

- Moving on to operating expenses
- Selling and marketing expenses were RMB 6.4B, up 74% year-on-year or 14% quarter-on-quarter
- The year-on-year increase mainly reflected increase in marketing spending in our products and platforms such as online games, online media, payment-related services, and mobile utilities
- The sequential increase was driven by seasonality, more advertising, and promotional activities in Q2

G&A

- As a percentage of revenue, selling and marketing expenses increased to 8.6% for Q2
- G&A expenses excluding R&D were RMB 4.1B, up 5% year-on-year or down 7% quarter-on-quarter
- On G&A, R&D expenses were RMB 5.7B, up 35% year-on-year or 14% quarter-on-quarter
- Both year-on-year and quarter-on-quarter increases of G&A expense were mainly due to greater R&D expenses and staff costs
- As a percentage of revenue, total G&A was 13.4% and R&D was 7.8%
- At the end of Q2 we had over 48,600 employees
- The year-on-year increase of 20% was mainly due to our expanded business scope, in particular online games and cloud businesses

Gross Margin

- Let's go through margin ratios for Q2
- Gross margin was 46.8%, down 3.2 percentage points year-on-year or 3.6 percentage points quarter-on-quarter mainly reflecting the revenue mix changes among segments and reduced gross margin of VAS as mentioned previously
- Non-GAAP operating margin was 30.2%, down 5.2 percentage points year-on-year or 4.2 percentage points quarter-on-quarter due to lower gross margin and higher marketing expense
- Non-GAAP net margin was 27.8%, down 1.3 percentage points year-on-year or up 1.8 percentage points sequentially which fell to a lesser extent due to the margin pickup from share of profit of associates and income tax expense as mentioned earlier

CapEx and FCF

- Let me share some key financial metrics with you before rounding up this presentation
- For Q2 total CapEx was RMB 7.1B, up 135% year-on-year or 12% quarter-on-quarter
- Operating CapEx was RMB 6.6B, increased by 183% year-on-year as we reserved more servers to offline business growth
    - Non-operating CapEx was RMB 495mm
- FCF was RMB 15.4B, down 12% year-on-year or up 18% quarter-on-quarter

Net Debt

- At the end of the quarter our net debt position was RMB 35.3B compared to net debt of RMB 14.5B last quarter
- We turned to net debt position in 2018 mainly due to increased strategic M&A investments amounting to $7B in Q1
- We had moderated the pace of M&A activities in Q2, reducing to around $3B debt payments

    - We will continue to review and evaluate the needs in monetizing our investments such as Mobike and Ele.me which we disposed recently

- The fair value of our listed investee companies, excluding subsidiaries of course, were approximately RMB 240B or approximately $36.2B as at quarter end, up from RMB 146B a year ago

QUESTION AND ANSWER SECTION

<Q - Eddie Leung>: I guess the first one is about the current situation of the mobile game approval process in China. Just wondering if you guys could help us to understand if the current situation has affected you and what are some of the measures that we are implementing to handle the situation. And then secondly, a quick question about your video advertising business. I remember last quarter there was a very strong year-on-year growth but it seems like we saw some deceleration in Q2 even on the back of Produce 101. So just curious if the so-called cannibalization from the subscription pieces is a reason and would this be the norm going forward, namely we will be seeing strong subscription growth but perhaps a slowdown in video advertising? Thank you.

<A - Chi Ping Lau>: Okay, Eddie. Thank you very much for your questions. Let me first address your first question regarding mobile game, and more broadly game approval process. Basically what's happening now is that there's a temporary suspension on the GAPP monetization approval so that games without that license cannot really officially start monetization. And that's mainly because of a restructuring of the officiating bodies that is going at the senior government level. So as a matter of fact, a lot of games have not been approved. Now what's happening is that for the games that have been approved before, they can still be launched and be monetized. And as you can see, we do have a lot of games in the pipeline which have been approved for monetization. So we have been launching games with monetization, and right now at least 15 games within our game portfolio have been approved for normal monetization.

Now with respect to new games, the administration is also aware of the fact that because of the restructuring it's now affecting the industry as a whole. So the GAPP has set up a green approval process which means that if you can go through that green channel then you can actually have a one-month monetization testing and that's acted as a relief for the entire industry. Now unfortunately given the fact that our PUBG MOBILE game have already been launched and has reached a very significant size, we do actually need to go through the official GAPP monetization approval process which, at this point in time, we don't have a visibility on when exactly it will restart yet. But we are also aware of the fact that the GAPP is constructive in giving out this temporary monetization period which we hope is an indication that the official approval process will start again.

Now we'll be working very diligently to work with the government in order to get the approval of PUBG MOBILE when the formal approval process restarts. So that's really the situation at this point in time. We do believe it's not a matter of whether these games will be approved for monetization; it's a matter of when exactly we can actually do that.

<A - James Gordon Mitchell>: Eddie, on your second question about video advertising revenue decelerating. Yes, your inference is correct. So actually after a long period where within our media revenue our news-related revenue was extremely weak and our video ad revenue was extremely strong, and in this quarter we saw a little bit of reconvergence on both sides so our video ad revenue decelerated for a few reasons. One is that we took the opportunity this quarter to really work on reducing the discounts offered to ad agencies, and that actually had some meaningful impact which helped our video advertising gross margin by 1 percentage point but didn't help our video advertising revenue.

Second is that some of the big content you alluded to such as Produce 101, while there's certainly advertising sponsorship around it we also took the opportunity to use that popular content to drive our subscription revenue or our voting activities which were [ph] quite cut off (00:36:06) because historically as you know variety shows and so forth don't really lend themselves to the subscription business model. But we think we've made some progress on that front which is important for the future.

Big picture and stepping back, we believe that our overall video advertising revenue grew up probably similar to the industry growth rate in Q2 but our video subscription revenue we knew grew substantially faster than the industry at over 100% year-on-year. And so therefore in aggregate we believe that our video platform grew revenue faster than the video industry year-on-year.

<A - Chi Ping Lau>: Well a last point I want to add is that Produce 101 and content such as Fuyao have exceeded really the initial expectation and a lot of the advertising we sold was actually pre-sold. So I would say some of this content we under-monetized compared to the actual result that we achieved. But for Produce 101, that actually is set up for much better monetization for next season.

<Q - Jin-Kyu Yoon>: I think on the gaming side where overall deferred revenues were down about 10% sequentially, if you could just kind of help us segregate that between what deferred revenues in PC gaming or overall gaming in China looks like vs. memberships and international business. And then my second question is James, I think you mentioned some growth prospects for news feed propelling. Can you just give us some operating metrics beyond that, perhaps MAU, DAUs or even ad loads? Thanks, guys.

<A - Shek Hon Lo>: In terms of deferred revenues, you're right that there are many moving parts inside that, including the prepaid advertising, prepaid monthly subscriptions, the business cooperation agreement with monthly amortization of course, and prepaid tokens and cards. Deferred revenue usually soften after peak season for games, especially for Q2 and Q4. For example, in quarter four 2017 the deferred revenue dropped by roughly 3.5%. And out of the 9.5% drop I would say that about 3.5% more seasonal in nature as evidenced in the drop of about the same percentage in quarter four of 2017. For the remaining about 6% included about RMB 600mm quarterly amortization for business cooperation agreement which accounted for roughly 1.5%. The remainder, say 4.5%, was attributable to games and others. And for games, PC would have a much bigger impact than mobile. Having said that, the year-on-year deferred revenue is stable.

<A - Chi Ping Lau>: So in terms of the media feeds, in our prepared remarks we did talk about our overall strategy. If you look at the reading activities, right, within Weixin which you have an entire ecosystem based on official accounts, and that's something that we for now put aside because it is a very big ecosystem and it generates billions of page views every day and it has been very solid in terms of its overall performance in terms of time spent. But in addition to that, we have been creating media feed products within each one of our large DAU products. So for example, within QQ, it's QQ KanDian; within QQ Browser, there is a news feed. These are, for now, the two largest news feed products for us. And within the media feeds, we try to put in different media formats, including news feed, including short videos and, over time, mini videos.

For now, the metrics that we look at is that usually what happens with these media feeds integrated into our large DAU products is that they tend to have a pretty large DAU, but usually the users would read fewer number of PVs on average and number of VVs on average. Now, we have given you an aggregate number, which is for the two largest products, KanDian and QQ Browser. The total daily page views through these media feeds is up 55% year-on-year and the total number of short video views is up more than three times year-on-year. And in terms of the mini video, which is now curated by WeiShi, it's also distributed through these media feeds. That's the first and most advanced integration is actually through QQ KanDian, and we can see there's a very strong traction in terms of the growth of the viewership on mini video in QQ KanDian. And over time, we'll propagate that mini video feeds to other media feeds in our products, including QQ Browser, video as well as Weixin.

<Q - Gregory Zhao>: The first question is about your advertising. So we see Tencent expand more ad inventories during the quarter. So, can you help us understand how would that affect the pricing of your advertising going forward? At the same time, we also noted some other short video, social, and news apps such as Douyin, Weibo, Toutiao; they also substantially increased their ad inventory. So, can you help us understand the potential impact to the overall online ad industry, the price trend? And also a very quick follow-up on gaming side. So the reason of suspension of your Monster Hunter, is that a one-off issue of gaming content or it's also a signal of more restriction from the government? Thank you.

<A - Chi Ping Lau>: Well, in terms of the advertising, I would say, our advertising inventories, we have been pretty much very restrained, self-restraint in terms of putting out inventories. I think if you look at our social product, Weixin, in the Moments, we now have just expanded our inventory to two advertising per day on the maximum. And that's a fraction of what international competitive products or comparable products are putting out. And even within our new media feeds business, our ad inventory is actually only a fraction of our comparables. So, I think for our product, the advertising business is still very much inventory constrained. And the reason is that, of course, we try to build our advertising business on a consistent basis. And with that, we want to make sure that we make the most and optimal tradeoff between user experience and also pricing and positioning of the advertising. And we also try to make sure that the quality of the advertise is high. So as you can see, we don't really have medical advertisers, we don't really have P2P financial advertisers. And we also try to create this tightness so that we can help the advertisers to put up better quality advertising. So I think that our entire advertising business is actually growing according to our own pace and it's less affected by what's happening in the overall performance at industry. That was the case when there was search advertising, when there was all kinds of different advertising, and that's still the case at this point in time.

Now in terms of Monster Hunter, I would say, it is really a one-off event. The key reason is that we have gotten the approval actually to launch Monster Hunter with monetization. And what happened was the content eventually delivered by the developer does not completely comply with the regulatory requirement. And as a result, we have to suspend the sales of the content and we need to adjust the content alongside with the developer in order to prepare it for approval in the future. Through this process, we have established a tighter communication with the relevant government officials and regulatory body. And we hope this is something that will improve our process going forward.

<Q - Yue Wu>: I have two here. Firstly, I saw very decent growth for the active user of your League of Legends. Just wondering what's the major [ph] constant (00:46:15) for the growth of this revenue. Is it mainly related with those [ph] Ryze skin (00:46:19) reserve in that game? If yes, so when shall we expect to see a meaningful improvement for that? And secondly, can you give us some color on the current contribution for commercial payment and interest income in other revenues item? And should we assume the interest income item to finally go to zero if the centralized deposit ratio goes up to 100%? Thank you.

<A - James Gordon Mitchell>: Yeah. So I think your first question was around League of Legends and we've seen some – as we mentioned in the prepared remarks, we've seen a nice upsurge in interest in the last couple of months for League of Legends, especially in China, which may reflect a degree of patriotism around it, a Chinese team winning a global event in the eSports. So that's exciting for us. On the monetization side, outside China, the game's revenue was actually fractionally up year-on-year last quarter. But inside China, the game's revenue has been a little bit weaker since Q4 2017, and that reflects the phenomenon you mentioned of seeking to replenish [ph] Ryze skin (00:47:46) reserves and so forth. In terms of how quickly we will reverse that phenomenon, obviously it's a work in progress. Obviously, the comps get a little bit easier toward the end of this year.

But I would also say that as we look at the success of other free-to-play PC games globally, such as Fortnite that we've really been positively surprised by the willingness of players with these free-to-play games to participate in voluntary monthly subscription services. I know it sounds a little bit of a contradiction in terms of if someone would choose to subscribe to something which they don't need to subscribe, if you put the right content and the right concepts into the season passes then actually that's very good take up for the season passes in certain environments. So that's a positive sign as well.

<A - Chi Ping Lau>: Yeah. In terms of the deposit interest, right now in this current quarter it accounts for a low teens percentage of our others revenue. And the way that we think about it is that we have already had 42% of the deposit taken away, the interest is already taken away, and we have another 58% to go. And the schedule as announced by PBOC is that it will be pretty much evenly distributed for the next six months for that 58%, so by January of 2019 the entire deposit will be taken away.

Now as John has talked about in the prepared remarks, we would try to mitigate some of these impact by more efficiently managing some of the marketing cost that we have because we are spending actually a lot of money on marketing our payment platform. And as you can see there's a very strong growth in our payment platform especially with respect to offline commercial transactions partly because of the strength of the platform itself but also partly because of the marketing program. And given the loss of the interest, we'll try to optimize the marketing plan and try to pick up the ones that are more efficient.

And at the same time we feel that we can also, over time, deliver more financial services to some of the merchants that are connected by our payment platform. As you can see from the prepared remarks, our commercial transactions especially on the offline side has increased very significantly. And that means our payment platform is now connecting to millions of offline merchants and we believe that these are very, very important assets for us. Over time, we can deliver transaction-based services to them, including financial transactions as well as advertising transactions. So those are things that we'll be doing over time. Now the way I look at this loss of interest income is that it's of course a very painful event, right, and we are halfway through. We'll try to mitigate part of the other half. And once it's all done then basically it becomes a one-time event and it would not affect the trend line of the growth of our payment business.

<Q - Alicia Yap>: I have a couple questions. The first one, wanted to look at when we look at the various initiatives that management put together on the prepared remarks to revise the growth for the gaming business for short-term such as like Q3, which initiative will be the biggest driver? Would that be the enhancing monetization of existing games such as Honour of Kings be the biggest driver or would that be the new revenue contribution from your newly launched games? And if you look back six months ago, do you think that the company or management will still go ahead to launch the two PUBG MOBILE games knowing that monetization may come later or will you actually consider waiting to launch PUBG until the later stage?

For second question, on the advertising opportunity related to Mini Programs, could you help us understand a bit among the different industry vertical is it fair to say most of the incremental advertising revenue would come from the traditional retail and low-cost services brands and merchants? If not, any major vertical that you could highlight and could you help us frame the market size for that? Thank you.

<A - James Gordon Mitchell>: Perhaps I'll try to tackle the first question and I'll pass on to Martin for the second and third.

<A - Chi Ping Lau>: Yes.

<A - James Gordon Mitchell>: So I think the first question was around which of the initiatives that we're now undertaking in our mobile game business to reinvigorate growth will bear fruit in Q3. And I think that sometimes these initiatives take some period of time, and period of time could be months, could be quarters to bear fruit. But in general, we're optimistic that they will bear fruit as we move into next year. Just drilling down one level, having had some understanding of the concern that investors have about Q2 results, I think that one aspect that may not be as well-understood as it might is that really during H1 this year for whatever reason we didn't release as many successful high-ARPU games as we had in previous periods. And that's why I called out that in July and August we released a number of high-ARPU games in categories like role playing games, card games, and those games at least initially appears to be off to a relatively healthy start. So as well as the much debated monetization of tactical tournament games issue, there is also some short-term volatility in terms of the cadence of the balance between the higher ARPU and lower ARPU games. And as Martin said, we have over 12 mobile games we have already secured monetization approval and some of those will be in these higher ARPU categories. And with that, I'll pass it to Martin.

<A - Chi Ping Lau>: Yeah. With respect to the game business right now, I would just say my observation is that the gaming fundamentals is actually as strong as it has been because if you look at our DAU in China, it has a very solid growth compared to last year. We have really become the category leader in tactical tournament which six months ago it was not very apparent. It was a very big segment with another game which has taken the lead. But within the past six months we have taken a complete lead over that genre. And it doesn't really stop in China. If you look around the world, we have also expanded our presence outside of China. Part of it is through Epic which has become the biggest category winner in this tactical tournament genre in the Western world. And at the same time, if you look at our own developed games, both AOV and PUBG MOBILE has achieved more than 15mm DAU outside of China which is a very significant achievement. It also marks a significant step for us to expand our gaming business outside of China. So all these operating metrics are very strong. The only problem that we have is actually for one of our biggest games, PUBG MOBILE, is not monetizing and I think this is something which is a little bit out of control but over time I think we will be able to solve it.

Now with respect to Mini Programs, I think it's really an overall ecosystem in which we are trying to connect our users with many different types of offline activities. And a lot of these are transaction-based, a lot of these would not even get the chance of getting the online engagement if there is no Mini Program because if you really need to download an app, most of the users will be gone. But because of the availability of Mini Programs many of these connections are made. Yes, a lot of the connection is actually between offline and online and a lot of it is due to the retail industry. But I think there's also a lot other interactions too, right? For example, through retail we are also going to touch upon brands. We find that a lot of brands are looking at Mini Program as a way for them to engage with their users. And even though they are not directly having a retail relationship in-store, the brands want to touch a point their customers. They want to understand who are their customers through Mini Program. In the past they were not able to do it; now they are able to do it.

So I think Mini Programs really help, one, all kinds of different services to reach their users online; and two is whenever they have a point of contact, be it offline or online, they can have an additional transaction or additional action that can be taken by the users. And thirdly, Mini Program also allows a lot of social sharing of different kind of interaction, so it allows word of mouth to be spread for different services and brands.

<Q - Wendy Huang>: My first question is about the earnings growth outlook. So this quarter the revenue growth jumped to only 30%, probably the lowest in the past three years, and yet the operating profit growth was only 20%. So you mentioned a lot about the launching of the high-ARPU games and also Mini Programs to be a structural driver in the future. I just wondered when should we expect those things to really bring the earnings growth back to above the 30% level or with a temporary pickup in the game business trend with some macro headwinds where you can show the cost such as G&A to assure better earnings growth?

And secondly, can you give us some clarification around Fortnite, so whether the Fortnite PC has already obtained monetization approval? And also, what's the progress of the Fortnite Mobile development? If Fortnite Mobile is to be launched in the future, does it require a separate approval from the PC version or not? Thank you.

<A - Chi Ping Lau>: Okay. Well I think – so from a revenue growth perspective, the gaming sector is one key area of weakness. And as we have said, a big part of it is because our biggest game is not monetizable, and I think the growth will return when it is monetizable. So it's an event that we are working very hard toward and of course in the meantime there are a lot of things that we'll be doing in order to try to mitigate the problem. But I think the biggest issue is really trying to monetize our biggest game. And at the same time, when we talk about higher ARPU games and when we talk about expanding our presence outside of China and trying to monetize better there, I think there's a number of different measures that we can try to grow our business as well.

In terms of I would say – what's the next question – Fortnite, right? For Fortnite, the current situation is that the PC version of Fortnite has already received the Ministry of Culture and Tourism approval so we can launch the game. We're not right now applying for the green channel approval for monetization for one month with GAPP before any game can be approved for formal monetization. That's still ongoing and when we get that approval then we can start monetizing. So far I think when we look at Fortnite's pre-registration and also in the beta testing, the rate of people's response is actually pretty good. Now with respect to the mobile game, we do need to have a separate approval process for the mobile game which will follow after we have launched the PC version of Fortnite.

<A - James Gordon Mitchell>: Just to supplement Martin on the first question specifically around the relatively slower earnings growth. As Martin had mentioned earlier, there's a couple of substantial factors which are temporarily impacting our earnings growth which we're trying to quantify, and one is the non-monetization of the tactical tournament games which we believe could be very substantial based on what we already see internationally and based on industry logic. And then the second one is the fact that we're halfway through this process of losing the interest income on the deposits which, again, we're halfway through that process. We think we'll find some offsets as we work through H2 that process and that's a finite one-time process.

<Q - Han-Joon Kim>: I just wanted to differentiate the publishing of games in China. So what goes on to WeGame and what goes on to kind of direct publishing into China and how we should think about the evolution or growth of WeGame going forward. And the second question is I think we've introduced the battle pass to our PUBG global version. And I just kind of wanted to get your impression on how you see the evolution and adoption of that battle pass relative to Fortnite's success. So my understanding is the ranking is a bit lower so the impression is that the paying adoption rate for PUBG MOBILE is lower. So just trying to understand the relativity of that context.

<A - James Gordon Mitchell>: Yeah. So let me try to answer both of those. So first with regard to what we would publish vs. what we would sort of platform through the WeGame platform, I think that simplistically in the past one could've said that for a game of a massively multi-player characteristics that our first instinct would be to try to publish it ourselves because there's a great deal of local expertise that require local optimization that's required and local customization. That means simply copy-pasting, translating, and tweaking is not sufficient to make the game be all that it can be in China. When we look back, I think the great part of the success of products like Dungeon & Fighter, which is multi-player; League of Legends, which is multi-player; CrossFire, which is multi-player, all the imported games or games that we published ourselves in China have gone on to great success due to the fact that they're great products, but also to the fact that we've taken on hand the publishing. So that's a typical classic direct publishing experience.

Now, the games which are more single player in nature, perhaps more narratively-driven in nature, then historically they might make more sense to put on a Steam-like platform or on a WeGame platform. And that's initially the pattern that the first successful games on WeGame were products like Don't Starve, which were relatively simpler in nature and required relatively less local optimization. Monster Hunter: World is a really interesting hybrid in that it does have a relatively strong narrative, but at the same time, it's a game that people generally play on a cooperative basis. So, it's cooperative player vs. environmental player vs. gigantic fire-breathing monster experience. And as such, the interest that our users had in it was extremely encouraging for the future. It's just unfortunate that now we need to tweak the product a little more so we can provide it to our users. So, that's in terms of the WeGame vs. direct publishing part.

In terms of the Battle Pass monetization for PUBG MOBILE, we're pretty happy. It's early days. I would say that PUBG MOBILE, as the name suggests, is a mobile game vs. Fortnite, it's console, PC, and mobile. And my guess is that because Fortnite is console plus PC, it's tapping into some younger users who historically might have had a habit of buying X number of packaged software per year and now they're willing to redirect some of that money into the monthly subscription service vs. – because PUBG MOBILE is only mobile and the users are generally comparing it with Clash of Clans or Candy Crush where they don't historically have a habit of buying a dozen packaged software each year. So in that sense, I think that we will see, we are seeing, and we should expect to see a slower build of the monthly Battle Pass revenue in a product like PUBG vs. the really excellent outstanding progress that Epic have made with Fortnite or, for that matter, Electronic Arts have made with the FIFA games.

<Q - Karen Chan>: So my first question is how much of a pipeline buffer do we have until we get more visibility on resumption of new license approval? Does the 15 games in the pipeline that we have already secured license, does that include recently launched titles like MT4? In other words, will that impact any new high-ARPU mobile game title launch in Q4? And also on the PC front, you mentioned that we are in the process of applying for green channel for one-month monetization testing on PC Fortnite. Just wondering at earliest, do we expect some sort of monetization contribution in Q4? Thank you very much.

<A - James Gordon Mitchell>: Yeah. I think we gave a figure for the number of mobile games in our pipeline that have already secured approval, and obviously that figure would include a mix of different kinds of games. And so I suppose if you want to look at it from an ARPU perspective then one can. I think that in terms of Fortnite PC, the green channel, the point we were alluding to is the approval process of Fortnite PC is different from and, to some extent, more in line with historic norms than the approval process with the PUBG games. And so therefore, while it's hard to forecast exact approval process given some of the changes in the regulatory environment, at the same time we think that's an approval process that should be more consistent with historical norms particularly, as Martin said, since we have the Ministry of Culture approval already. And historically, the time lag between Ministry of Culture and GAPP approvals is relatively shorter.

<Q - Grace Chen>: My question – let me switch the gear to your cloud business, which has been growing very fast. In the press release, you talked about Tencent will continue to grow the cloud business through organic growth as well as collaboration and investment opportunities. Can you elaborate about your plan for collaboration? Especially, we've been seeing some news about your collaboration with some international players, such as Google. Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the cloud business, it has been growing very fast. And when we talk about the collaboration, we're more talking about building an ecosystem of system integrators as well as developers who have specific expertise so that they can develop using our cloud solution. So as you can see in some of the announcements, we actually have invested in a number of different system integrators within different vertical industries so that when they design in their solution for their customers they can actually leverage Tencent Cloud and they can convert some of their existing customers from using packaged software into a SaaS solution and then move them onto Tencent Cloud. So that's the cooperation that we're talking about. And I think, overall, it has been going quite smoothly. Now, of course, with some international partners, there also exists such opportunities, right? There are companies who have customers who need exposure to China and we could provide a solution that can help them. So in those cases, we'll also collaborate with the international partners.

<Q - John Choi>: I just have a quick question on your PUBG MOBILE. Assuming the approval goes through, do you guys have a sense like how big this monetization opportunity could be given that I think someone asked about the Battle Pass and other initiatives in overseas market has been falling a bit short. So, are we quite confident that this PUBG, if the monetization goes through, that it will kind of meet internal expectation? And secondly, just quickly on the PC game growth. I know that we had a great year last year, but we're clearly seeing some slowdown for the remaining part of the year. And as we go into 2019 with the new WeGame platform, what kind of growth should we be expecting? Thank you.

<A - James Gordon Mitchell>: So John, in terms of your first question on the PUBG MOBILE monetization, we're pretty optimistic if we're permitted to monetize then we'll achieve healthy monetization. That optimism is founded on, first, the very large DAU base and the very high engagement per DAU; secondly, the intense sort of competition but also cooperation within the game which historically is a good leading indicator of monetization; and thirdly, the global experience of games such as PUBG itself but also Fortnite in which, as you know, we're a substantial shareholder via Epic.

I didn't quite understand your comment about PUBG MOBILE international revenue underperforming. We're actually quite pleased with the early ramp and given the fact that it's very unusual for us to monetize the game first outside China. This is a problem and this is sort of unprecedented in our history. So you can see that it is a top 50 game by revenue ranking in many key markets including the United States and a top two or three game by revenue ranking in some big emerging markets including India. So overall, we're pretty happy with PUBG MOBILE progress outside China and we think if we could monetize inside China then we wouldn't do so at a decent level. And then, sorry, your second question was around the...

<A - Chi Ping Lau>: PC game.

<A - James Gordon Mitchell>: The PC game revenue growth. I think that with mobile game we can point very clearly to certain specific headwinds that we believe can be overcome with time, and therefore we believe that a 19% sequential deceleration in mobile game revenue should not be representative of the long-term forward trend for our mobile game business. I think for PC game business, that is a fundamentally more mature industry and therefore we should be relatively conservative in our expectations in 2019 and beyond. But what's interesting is if you look at results from other game companies, if you look at the commentary from NVIDIA, then the PC game industry globally is actually not a sunset industry at all and it continues to gradually expand.

And I think the difference between China and the rest of the world is that in China the innovation in games is very much focused on mobile games vs. in the rest of the world there continues to be a decent amount of innovation around console and PC, and that innovation is ultimately what drives the game industry revenue growth actually even more than macro trends or installed base. And so the fact that our WeGame platform is bringing some innovative products to China, the fact that consumers are willing to pay RMB 200, RMB 300 upfront for these innovative products I think speaks well for a stable rather than permanently declining PC game industry in the long long-term.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2018-08-15
Event Description: Q2 2018 Earnings Call

Market Cap: 3.10TRI
Current PX: 325.80
YTD Change($): -80.20
YTD Change(%): -19.754

Bloomberg Estimates - EPS
Current Quarter: 2.169
Current Year: 8.677
Bloomberg Estimates - Sales
Current Quarter: 84820.333
Current Year: 326966.400

Q2 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Eddie Leung
- Jin-Kyu Yoon
- Gregory Zhao
- Yue Wu
- Alicia Yap
- Wendy Huang
- Han-Joon Kim
- Karen Chan
- Grace Chen
- John Choi

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2018 Second Quarter and Interim Results Conference Call. At this time, all participants are in listen-only mode. There will be a presentation followed by the question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Thank you. Good evening. Welcome to our 2018 second quarter and interim results conference call. I'm Jane Yip from the IR team of Tencent.

Before we start the presentation, we would like to remind you that it includes forward-looking statements which are underlined by a number of risk and uncertainties and may not be realized in the future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a

short overview, Martin will discuss strategic highlights, James will speak to business overview, and John will go through the financials before we take your questions.

I would now turn the call over to Pony.

Huateng Ma

Thank you, Jane. Good evening, everyone. Thank you for joining us. In the second quarter of 2018 we continue to deepen user engagement across our social, games, and media platforms with solid year-on-year growth in daily active users and time spent in our Weixin platform, mobile games, and video platform. We have also invested heavily in our news feed, short video, and mini video products and have seen significant growth in them.

Let me highlight the key financial numbers. Total revenue was RMB 73.7 billion, up 30% year-on-year and stable quarter-on-quarter. Non-GAAP operating profit was RMB 22.3 billion, up 11% year-on-year or down 12% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 19.7 million, up 20% year-on-year and up 8% quarter-on-quarter. John will provide more details in the financial section.

Moving to our key platforms. Combined MAU of Weixin and WeChat increased 9.9% year-on-year to 1.06 billion as we are building a vibrant Mini Programs ecosystem with higher developer and user adoption, further strengthening the user engagement of the platform. Total MAU for QQ was 803 million. Smart devices MAU was 709 million, up 7% year-on-year. Our news feed service, QQ KanDian, further grew its active user and time spent. Our social network service, Qzone, smart device MAU was 543 million. In games, we're strengthening our leadership in mobile and PC. We increased our smartphone games market share in terms of DAU. User time spent and engagement increased in key genres, including tactical tournaments, action shooter, and MOBA. We also expand our user base globally benefiting from the success of AOV and PUBG MOBILE.

For media business we maintained our leadership in online video, news, music services, and literature. We solidified our leadership in long form video platform with a higher mobile DAU, user engagement, and also larger subscriber base. In fintech our mobile payment service deepened penetration in verticals such as fast food chains and supermarkets. We'll continue to be the market leader in terms of DAU driven by rapid growth of offline commercial transactions. In mobile utilities we'll remain industry leader in mobile security, mobile browser, and Android app store in China.

With that, I will pass to Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony, and good evening and good morning to everybody. I would first start the session by addressing a very popular question which is the trend of user engagement in our core platforms especially given the popularity of short videos and mini videos recently in the market. The quick answer is that we have seen increasing engagement in our social platform, games platform, video platform as well as strong growth in our media feeds.

Now starting from social, Weixin recorded solid growth in terms of users, time spent, and activities. As the largest social communication platform in China, Weixin continues to add daily active users and per user messages, both delivering a double-digit growth rate year-on-year. In particular, users are spending more time in Moments as well as Mini games within Weixin. Through increasing popularity of Mini Programs and Weixin Pay, Weixin is getting involved in more vertical use cases online and offline, enabling us to increase the value of our engagement that is not entirely dependent on time spent. I will elaborate more on Mini Programs in the next two slides.

In the area of video, user consumption of long form video content continues to ramp up driven by IP-based original content in drama, variety shows, and Chinese anime. For mobile, daily active user increased 24% year-on-year, daily video views up 53% year-on-year, and total time spent up 39% year-on-year during the second quarter, solidifying our position as the leading video platform in China. In terms of media feeds, our recommended feeds are getting higher hits due to better algorithm and enhanced content offering. These media feeds are strategically placed in our large DAU products so as to provide more convenient access to users. Currently QQ KanDian and Mobile QQ Browser host our largest feeds products and, in aggregate, they increased daily page views by 55% and daily short video views by more than three times year-on-year.

Now moving on to the next two slides, I will discuss the rapid adoption of Mini Programs and how it is enabling our payment business and enriching our O2O ecosystem. Mini Program is an innovative platform built into Weixin facilitating discovery and consumption of services. For developers, Mini Program offers an open platform with powerful features to make programming easier and more efficient. These programs run immediately upon scanning a unique Mini Program QR code, connecting offline services to online engagement. Supported by Weixin Pay, advertising, and cloud capabilities, Mini Programs can provide a seamless, closed-loop experience for users. Since its launch in early 2017 we've done a lot to educate developers and users about the potential capabilities of Mini Programs, including partnering with colleges to host coding classes with students and developers. Rapid adoption took off early this year with a growing number of developers creating Mini Programs for their own companies as well as system integrators developing Mini Programs for their clients.

Benefiting from the expanding categories of Mini Programs which include various services such as Mini Games, tools, and offline services, we grew daily active users of Mini Programs to more than 200 million. Sharing in our social networks facilitated user acquisition while highly popular Mini Games further accelerated adoption and engagement. Mini Programs are great for discovery and quick actions and are complementary to full-function native apps by increasing download and traffic to them.

In terms of some examples on how Mini Programs expand penetration across different representative use cases, I provided four of them. Number one in transportation sector. Our internally-developed transport payment solution called Tencent Smart Transit QR code enables public transport operators to achieve higher processing efficiency, reduce cost, and utilize data for service planning. We have rolled out our payment solution in over 90 cities across the country. Some operators simply adopted our payment QR code while others developed their own Mini Programs with additional functionalities as well as advertising to broaden their revenue streams. In the area of smart retail, Mini Programs help merchants shorten in-store checkout time, facilitate order for home delivery, and provide targeted product promotions via embedded links to official accounts. Many retailers find these capabilities extremely useful as they stick to digitize their businesses and engage with customers online. Our scan-to-buy function is increasingly adopted in shopping malls, supermarkets, and convenience stores.

In the restaurant sector pre-ordering in Mini Programs help operators increase efficiency and sales by cutting queuing time, reduce labor cost as customers switch to ordering online. They can also reward customers with integrated e-loyalty program. Mini Programs are widely adopted in fast food chains, cafés, and casual eateries across China. In the Mini Games sector developers can expand user reach and acquire users via multi-channels such as Weixin Game Center, search within Weixin or social referral. Given its easy-to-play and light experience, Mini Games help developers accumulate users and traffic and monetize via advertising and virtual item sale on Android. In the second quarter we introduced ads in Mini Games and drew enthusiastic responses from advertisers. Advertising revenue was up 5 times quarter-on-quarter.

Now with that, I'll pass to James to talk about business review.

James Gordon Mitchell

Thank you, Martin, and good morning and good evening to everybody. In the second quarter of 2018 our revenue grew 30% year-on-year. VAS represents 57% of our revenue within which online games contributed 34% and social networks 23%. Online advertising was 19% of our total revenue and the others segment accounted for 24% of our total revenue. Within the others segment where revenue was up 81% year-on-year, our payment-related business sustained strong growth as we rapidly expanded our offline commercial payment volume and related services and despite a quarter-on-quarter reduction in interest income from restricted custodian deposits. Under PBOC's guidelines, we expect that by January next year we no longer generate interest income from restricted custodian deposits, and John will discuss the details in the financial section. Our cloud services revenue doubled year-on-year as our paying client base increased significantly with deepened penetration in key sectors including finance, smart retail, and municipal services. We also invested in and formed strategic partnerships with certain systems integrators to offer customized cloud services and broaden our penetration offline.

For value-added services, segment revenue was RMB 42.1 billion, up 14% year-on-year though down 10% quarter-on-quarter Our social network revenue was RMB 16.9 billion, up 30% year-on-year but down 7% quarter-on-quarter. Total VAS subscriptions grew 30% year-on-year to 154 million subscribers as our video subscription count more than doubled. Our revenue grew strongly year-on-year driven by video subscriptions and the increased monetization of music live broadcast services. However, sequentially, game-related item sales reduced sharply following our reported smartphone game revenue reduction which offset growth in digital content revenue and resulted in the net quarter-on-quarter revenue decline.

Our online games revenue was RMB 25.3 billion. Revenue decelerated to 6% year-on-year growth and declined 12% quarter-on-quarter. Non-monetization of popular tactical tournament games in China was the main reason behind the year-on-year and quarter-on-quarter deteriorations. However, during the quarter we grew our smartphone game DAU in China by a double-digit percentage year-on-year, expanding the foundation for our smartphone game business' long-term growth and creating future monetization opportunities. In overseas markets our games Arena of Valor and PUBG MOBILE expanded their user bases and monetization.

In social networks we continue to grow our mobile payment activities leveraging our social platforms. At the end of June we surpassed 800 million mobile payment MAUs. Our average daily transaction volume increased over 40% year-on-year. And benefiting from the expansion of use cases, our offline commercial payment volume increased 280% year-on-year. Commercial payment volume exceeded half of total transaction volume for the first time. In overseas markets we prioritized use cases for Chinese outbound travelers such as duty free shopping and tax refunds. And in Hong Kong we launched a local wallet authorized by the HKMA.

Shifting to WeiShi, which is our aggregation platform providing mini videos conveniently to our users, both by our existing services as well as by our WeiShi-branded mobile app. During the quarter, WeiShi aggregated appealing content including clips from our self-commissioned variety show Produce 101 and added innovative features such as artificial intelligence-based beautification tools and online voting functionality. Thanks to our content library, new features, we saw robust growth in daily mini video views, particularly on KanDian and Qzone as well as in the WeiShi-branded app itself. We more than doubled our long-form video subscription base year-on-year to 74 million subscribers as of the end of June.

We also continue to lead peers by mobile DAU and daily video views, solidifying our position as the number one online video platform in China. Among non-game apps, Tencent Video ranked number one in the China iOS Top Grossing Chart and number two in the Global iOS Top Grossing Chart during the period.

Our growth benefited from exclusive contents in key verticals, including drama series, online variety shows, and Chinese anime. In drama, Legend of Fuyao, a historical romance created out of a China Literature IP, generated about 14 billion video views in total and was the most popular exclusive drama series in the first half of the year. For online variety shows, our self-commissioned talent program, Produce 101, achieved over 5 billion video views, a new record for an online variety show in China. And in Chinese anime, we've built up experience producing IP-based anime series, which attracted large audience of loyal fans. And as a result, we more than doubled our anime traffic year-on-year. For example, Land of Warriors has accumulated over 3.5 billion video views and is the most popular of its kind since its debut in January. On the product operations front, we're increasing the appeal of our video subscriptions through initiatives such as allowing users to gift subscriptions to friends and we're extending the distribution of our video subscriptions through cross-promotions with partners.

For smartphone games, revenue was RMB 17.6 billion, up 19% year-on-year due primarily to action games and Honour of Kings. But revenue declined 19% quarter-on-quarter as; first, users shifted time to non-monetized tactical tournament games; second, we launched five out of the seven new games late in the quarter; and third, during the pre-examination season, we prioritized user retention and engagement of several of our big existing titles. However, thanks largely to the breakout popularity of our tactical tournament games, we believe our China mobile game market share increased year-on-year and increased quarter-on-quarter in terms of daily active users and time spent.

Looking ahead, we're working on multiple fronts to reinvigorate our revenue growth, including; first, expanding overseas. Arena of Valor, a vast arena game developed by our Timi Studio, has over 13 million daily active users outside China with particular popularity in Southeast Asia, and achieved over US$200 million in user spend in the first half of the year. PUBG MOBILE, a tactical tournament game developed by our Quantum Studio, has over 14 million DAU outside China with a particular popularity in Western markets as well as in India, and it's achieved about US$20 million user spending per month in recent months, benefiting from seasonal passes.

Second, boosting our existing game performance and monetization, in particular, we're seeking the approvals required for monetizing tactical tournament games in order to realize the revenue potential of these games, which we believe will be substantial given their large player bases and intense player activity. And we're also finding ways to deepen user activity in existing hit titles, such as Honour of Kings, which remain China's top game in terms of users and revenue. Third, launching new games in high ARPU categories. For example MT4, a role-playing game based on a well-known IP, was consistently ranked top three in iOS China Top Grossing Chart since we launched it in July. And our in-house developed RPG, Saint Seiya, has ranked top five (sic) [four] in iOS China Top Grossing Chart since we launched it in August.

Moving to PC client games, revenue was RMB 12.9 billion, down 5% year-on-year and down 8% quarter-on-quarter. The year-on-year decline reflected the ongoing trend of users shifting time to mobile games. On a quarterly basis, revenue was impacted by the same trend as well as weak seasonality. However, our leading titles performance showed resilience, supported by loyal user bases as well as eSports and other offline events. For example, Dungeon & Fighter celebrated its 10th anniversary in June, demonstrating our ability to sustain and grow a game franchise over a decade. We engaged users by in-game marketing activities during the Labor Day holiday and an anniversary celebration [ph] gather (00:19:43) offline, driving up revenue and paying user counts. League of Legends held its mid-season invitational eSports event in May, in which the Chinese team, RNG, won, benefiting DAUs in China. League of Legends DAUs were up quarter-on-quarter in China and flat quarter-on-quarter globally despite adverse summer seasonality. We look forward to publishing several innovative titles in the coming months and quarters. For example, we've accumulated over 10 million pre-registrations in China for Fortnite, the tactical tournament game developed by our investee, Epic Games.

Moving on to our online advertising business, revenue in the second quarter was RMB 14.1 billion, up 39% year-on-year and up 32% quarter-on-quarter. Our media advertising revenue was RMB 4.7 billion, up 16% year-on-year and up 43% quarter-on-quarter. Video advertising revenue continues to grow as we generated more sponsorship revenue from popular programs. When we self-commission content, we can target the most appropriate advertisers and develop attractive ad formats early in the production process. Our news advertising revenue declined by a high-single-digit percentage year-on-year from the high base point last year. But following the completion of our ad system revamp, we resumed news feed ad placement within our news services in the second quarter which, along with positive seasonality, contributed to a strong quarter-on-quarter rebound.

Our social and others advertising revenue was RMB 9.4 billion, up 55% year-on-year, mainly due to three factors. First, in Weixin, we added a second feed ad per user day in Moments as well as new inventories in Mini Programs. Second, we saw robust growth in impressions in and advertiser demand for our mobile ad network. And third, we generated more news feed traffic in QQ KanDian, driving up impressions volume. Sequentially, social and others advertising revenue grew 27% quarter-on-quarter, benefiting from positive seasonality as well as the factors above.

And with that, I'll pass it on to John to go through the financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the second quarter of 2018, our total revenue was RMB 73.7 billion, up 30% year-on-year or stable quarter-on-quarter. Gross profit was RMB 34.4 billion, up 22% year-on-year or down 7% quarter-on-quarter. Net other gains was RMB 2.5 billion for the second quarter. On a year-on-year basis, it mainly reflected decline in net gains from investee companies and high impairment provision for certain investments. These two items, however, are all non-GAAP adjustments. Share of profit of associates and joint venture was RMB 1.5 billion in the quarter with a share of losses of RMB 319 million last quarter. The Q-on-Q change was mainly due to increase in profit contribution from Epic due to the success of Fortnite in overseas market. On a non-GAAP basis, share of profit of associates and joint venture was RMB 2.8 billion for the second quarter. Income tax expense was approximately RMB 3.6 billion, down 9% year-on-year or down 37% quarter-on-quarter, primarily due to lower withholding tax. Effective tax rate for the quarter was 16.2%. Net profit attributable to shareholders was RMB 17.9 billion, down 2% year-on-year or down 23% quarter-on-quarter.

I will walk you through our non-GAAP financial numbers. For the second quarter and after adjustments to non-GAAP, operating profit for the quarter was RMB 22.3 billion, up 11% year-on-year or down 12% quarter-on-quarter. Operating margin was 30.2%, down 5.2 percentage points year-on-year or down 4.2 percentage points quarter-on-quarter. Net profit to shareholders was RMB 19.7 billion, up 20% year-on-year or up 8% quarter-on-quarter. Net margin was 27.8%, down 1.3 percentage points year-on-year or up 1.8 percentage points quarter-on-quarter.

Let's turn to segment gross margin. Gross margin for value-added services was 59%, down 1.6 percentage points year-on-year or 4.3 percentage points quarter-on-quarter. The decrease mainly reflected the revenue mix shift from games to lower-margin digital content subscriptions and live podcast services as well as the rising content cost of such businesses. Gross margin for online advertising was 37.4%, stable on year-on-year basis or up 6.2 percentage points quarter-on-quarter. The quarter-on-quarter increase was mainly driven by increased advertising revenue due to positive seasonality. Gross margin for others was 24.9%, up 2.5 percentage points year-on-year or stable quarter-on-quarter. The year-on-year increase was mainly due to growth in revenues from micro loan business, interest income related to restricted custodian deposits, and fees charged from credit card repayment.

PBOC has gradually stepped up the centralized deposit ratio requirement for third party online payment services providers just like ourselves where we are required to move restricted custodian deposit stock to non-interest-bearing accounts. The ratio was increased from 32% in March to 42% for the second quarter and finally up to 100% by January 2019. As such, interest income recognized under others segment has dropped to low teens percentage of others segment revenue for the second quarter and will continue to impact on segment revenues and margins. We are seeking to mitigate the impact through various monetization initiatives in our payment and related businesses, this including growing our Internet finance revenue such as micro loans and wealth management products which carry high margins than payment business as well as managing marketing expenses.

Moving on to operating expenses. Selling and marketing expenses were RMB 6.4 billion, up 74% year-on-year or 14% quarter-on-quarter. The year-on-year increase mainly reflected increase in marketing spending in our products and platforms such as online games, online media, payment-related services, and mobile utilities. The sequential increase was driven by seasonality, more advertising, and promotional activities in the second quarter. As a percentage of revenue, selling and marketing expenses increased to 8.6% for the second quarter. G&A expenses excluding R&D were RMB 4.1 billion, up 5% year-on-year or down 7% quarter-on-quarter. On G&A, R&D expenses were RMB 5.7 billion, up 35% year-on-year or 14% quarter-on-quarter. Both year-on-year and quarter-on-quarter increases of G&A expense were mainly due to greater R&D expenses and staff costs. As a percentage of revenue, total G&A was 13.4% and R&D was 7.8%. At the end of the second quarter we had over 48,600 employees. The year-on-year increase of 20% was mainly due to our expanded business scope, in particular online games and cloud businesses.

Let's go through margin ratios for the second quarter. Gross margin was 46.8%, down 3.2 percentage points year-on-year or 3.6 percentage points quarter-on-quarter mainly reflecting the revenue mix changes among segments and reduced gross margin of VAS as mentioned previously. Non-GAAP operating margin was 30.2%, down 5.2 percentage points year-on-year or 4.2 percentage points quarter-on-quarter due to lower gross margin and higher marketing expense. Non-GAAP net margin was 27.8%, down 1.3 percentage points year-on-year or up 1.8 percentage points sequentially which fell to a lesser extent due to the margin pickup from share of profit of associates and income tax expense as mentioned earlier.

Let me share some key financial metrics with you before rounding up this presentation. For the second quarter total CapEx was RMB 7.1 billion, up 135% year-on-year or 12% quarter-on-quarter. Operating CapEx was RMB 6.6 billion, increased by 183% year-on-year as we reserved more servers to offline business growth. Non-operating CapEx was RMB 495 million. Free cash flow was RMB 15.4 billion, down 12% year-on-year or up 18% quarter-on-quarter. At the end of the quarter our net debt position was RMB 35.3 billion compared to net debt of RMB 14.5 billion last quarter. We turned to net debt position in 2018 mainly due to increased strategic M&A investments amounting to $7 billion in the first quarter. We had moderated the pace of M&A activities in the second quarter, reducing to around $3 billion debt payments. We will continue to review and evaluate the needs in monetizing our investments such as Mobike and Ele.me which we disposed recently. The fair value of our listed investee companies, excluding subsidiaries of course, were approximately RMB 240 billion or approximately $36.2 billion as at quarter end, up from RMB 146 billion a year ago.

Thank you. We will now open the floor for questions.

Jane Yip

Operator, we will take one question each time. Shall we invite the first question?

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] The first question comes from the line of Eddie Leung from Bank of America Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. I guess the first one is about the current situation of the mobile game approval process in China. Just wondering if you guys could help us to understand if the current situation has affected you and what are some of the measures that we are implementing to handle the situation. And then secondly, a quick question about your video advertising business. I remember last quarter there was a very strong year-on-year growth but it seems like we saw some deceleration in the second quarter even on the back of Produce 101. So just curious if the so-called cannibalization from the subscription pieces is a reason and would this be the norm going forward, namely we will be seeing strong subscription growth but perhaps a slowdown in video advertising? Thank you.

<A - Chi Ping Lau>: Okay, Eddie. Thank you very much for your questions. Let me first address your first question regarding mobile game, and more broadly game approval process. Basically what's happening now is that there's a temporary suspension on the GAPP monetization approval so that games without that license cannot really officially start monetization. And that's mainly because of a restructuring of the officiating bodies that is going at the senior government level. So as a matter of fact, a lot of games have not been approved. Now what's happening is that for the games that have been approved before, they can still be launched and be monetized. And as you can see, we do have a lot of games in the pipeline which have been approved for monetization. So we have been launching games with monetization, and right now at least 15 games within our game portfolio have been approved for normal monetization.

Now with respect to new games, the administration is also aware of the fact that because of the restructuring it's now affecting the industry as a whole. So the GAPP has set up a green approval process which means that if you can go through that green channel then you can actually have a one-month monetization testing and that's acted as a relief for the entire industry. Now unfortunately given the fact that our PUBG MOBILE game have already been launched and has reached a very significant size, we do actually need to go through the official GAPP monetization approval process which, at this point in time, we don't have a visibility on when exactly it will restart yet. But we are also aware of the fact that the GAPP is constructive in giving out this temporary monetization period which we hope is an indication that the official approval process will start again.

Now we'll be working very diligently to work with the government in order to get the approval of PUBG MOBILE when the formal approval process restarts. So that's really the situation at this point in time. We do believe it's not a matter of whether these games will be approved for monetization; it's a matter of when exactly we can actually do that.

<A - James Gordon Mitchell>: Eddie, on your second question about video advertising revenue decelerating. Yes, your inference is correct. So actually after a long period where within our media revenue our news-related revenue was extremely weak and our video ad revenue was extremely strong, and in this quarter we saw a little bit of reconvergence on both sides so our video ad revenue decelerated for a few reasons. One is that we took the opportunity this quarter to really work on reducing the discounts offered to ad agencies, and that actually had some meaningful impact which helped our video advertising gross margin by 1 percentage point but didn't help our video advertising revenue.

Second is that some of the big content you alluded to such as Produce 101, while there's certainly advertising sponsorship around it we also took the opportunity to use that popular content to drive our subscription revenue or our voting activities which were [ph] quite cut off (00:36:06) because historically as you know variety shows and so forth don't really lend themselves to the subscription business model. But we think we've made some progress on that front which is important for the future.

Big picture and stepping back, we believe that our overall video advertising revenue grew up probably similar to the industry growth rate in the second quarter but our video subscription revenue we knew grew substantially faster than the industry at over 100% year-on-year. And so therefore in aggregate we believe that our video platform grew revenue faster than the video industry year-on-year.

<A - Chi Ping Lau>: Well a last point I want to add is that Produce 101 and content such as Fuyao have exceeded really the initial expectation and a lot of the advertising we sold was actually pre-sold. So I would say some of this content we under-monetized compared to the actual result that we achieved. But for Produce 101, that actually is set up for much better monetization for next season.

<A - Jane Yip>: And the next question please.

Operator

The next question comes from the line of Jin Yoon from New Street Research. Please ask your question.

<Q - Jin-Kyu Yoon>: Hi. Good evening, guys. I think on the gaming side where overall deferred revenues were down about 10% sequentially, if you could just kind of help us segregate that between what deferred revenues in PC gaming or overall gaming in China looks like versus memberships and international business. And then my second question is James, I think you mentioned some growth prospects for news feed propelling. Can you just give us some operating metrics beyond that, perhaps MAU, DAUs or even ad loads? Thanks, guys.

<A - Shek Hon Lo>: In terms of deferred revenues, you're right that there are many moving parts inside that, including the prepaid advertising, prepaid monthly subscriptions, the business cooperation agreement with monthly amortization of course, and prepaid tokens and cards. Deferred revenue usually soften after peak season for games, especially for Q2 and Q4. For example, in quarter four 2017 the deferred revenue dropped by roughly 3.5%. And out of the 9.5% drop I would say that about 3.5% more seasonal in nature as evidenced in the drop of about the same percentage in quarter four of 2017. For the remaining about 6% included about RMB 600 million quarterly amortization for business cooperation agreement which accounted for roughly 1.5%. The remainder, say 4.5%, was attributable to games and others. And for games, PC would have a much bigger impact than mobile. Having said that, the year-on-year deferred revenue is stable.

<A - Chi Ping Lau>: So in terms of the media feeds, in our prepared remarks we did talk about our overall strategy. If you look at the reading activities, right, within Weixin which you have an entire ecosystem based on official accounts, and that's something that we for now put aside because it is a very big ecosystem and it generates billions of page views every day and it has been very solid in terms of its overall performance in terms of time spent. But in addition to that, we have been creating media feed products within each one of our large DAU products. So for example, within QQ, it's QQ KanDian; within QQ Browser, there is a news feed. These are, for now, the two largest news feed products for us. And within the media feeds, we try to put in different media formats, including news feed, including short videos and, over time, mini videos.

For now, the metrics that we look at is that usually what happens with these media feeds integrated into our large DAU products is that they tend to have a pretty large DAU, but usually the users would read fewer number of PVs on average and number of VVs on average. Now, we have given you an aggregate number, which is for the two largest products, KanDian and QQ Browser. The total daily page views through these media feeds is up 55% year-on-year and the total number of short video views is up more than three times year-on-year. And in terms of the mini video, which is now curated by WeiShi, it's also distributed through these media feeds. That's the first and most advanced integration is actually through QQ KanDian, and we can see there's a very strong traction in terms of the growth of the viewership on mini video in QQ KanDian. And over time, we'll propagate that mini video feeds to other media feeds in our products, including QQ Browser, video as well as Weixin.

<A - Jane Yip>: Okay. And the next question, please.

Operator

Next question comes from Gregory Zhao from Barclays. Please ask the question.

<Q - Gregory Zhao>: Hi, management. Thanks for taking my question. The first question is about your advertising. So we see Tencent expand more ad inventories during the quarter. So, can you help us understand how would that affect the pricing of your advertising going forward? At the same time, we also noted some other short video, social, and news apps such as Douyin, Weibo, Toutiao; they also substantially increased their ad inventory. So, can you help us understand the potential impact to the overall online ad industry, the price trend? And also a very quick follow-up on gaming side. So the reason of suspension of your Monster Hunter, is that a one-off issue of gaming content or it's also a signal of more restriction from the government? Thank you.

<A - Chi Ping Lau>: Well, in terms of the advertising, I would say, our advertising inventories, we have been pretty much very restrained, self-restraint in terms of putting out inventories. I think if you look at our social product, Weixin, in the Moments, we now have just expanded our inventory to two advertising per day on the maximum. And that's a fraction of what international competitive products or comparable products are putting out. And even within our new media feeds business, our ad inventory is actually only a fraction of our comparables. So, I think for our product, the advertising business is still very much inventory constrained. And the reason is that, of course, we try to build our advertising business on a consistent basis. And with that, we want to make sure that we make the most and optimal tradeoff between user experience and also pricing and positioning of the advertising. And we also try to make sure that the quality of the advertise is high. So as you can see, we don't really have medical advertisers, we don't really have P2P financial advertisers. And we also try to create this tightness so that we can help the advertisers to put up better quality advertising. So I think that our entire advertising business is actually growing according to our own pace and it's less affected by what's happening in the overall performance at industry. That was the case when there was search advertising, when there was all kinds of different advertising, and that's still the case at this point in time.

Now in terms of Monster Hunter, I would say, it is really a one-off event. The key reason is that we have gotten the approval actually to launch Monster Hunter with monetization. And what happened was the content eventually delivered by the developer does not completely comply with the regulatory requirement. And as a result, we have to suspend the sales of the content and we need to adjust the content alongside with the developer in order to prepare it for approval in the future. Through this process, we have established a tighter communication with the relevant government officials and regulatory body. And we hope this is something that will improve our process going forward.

<A - Jane Yip>: And next question, please.

Operator

Next question comes from Natalie Wu from CICC. Please ask your question.

<Q - Yue Wu>: Hi. Good evening. Thanks for taking my question. I have two here. Firstly, I saw very decent growth for the active user of your League of Legends. Just wondering what's the major [ph] constant (00:46:15) for the growth of this revenue. Is it mainly related with those [ph] Ryze skin (00:46:19) reserve in that game? If yes, so when shall we expect to see a meaningful improvement for that? And secondly, can you give us some color on the current contribution for commercial payment and interest income in other revenues item? And should we assume the interest income item to finally go to zero if the centralized deposit ratio goes up to 100%? Thank you.

<A - James Gordon Mitchell>: Yeah. So I think your first question was around League of Legends and we've seen some – as we mentioned in the prepared remarks, we've seen a nice upsurge in interest in the last couple of months for League of Legends, especially in China, which may reflect a degree of patriotism around it, a Chinese team winning a global event in the eSports. So that's exciting for us. On the monetization side, outside China, the game's revenue was actually fractionally up year-on-year last quarter. But inside China, the game's revenue has been a little bit weaker since the fourth quarter of 2017, and that reflects the phenomenon you mentioned of seeking to replenish [ph] Ryze skin (00:47:46) reserves and so forth. In terms of how quickly we will reverse that phenomenon, obviously it's a work in progress. Obviously, the comps get a little bit easier toward the end of this year.

But I would also say that as we look at the success of other free-to-play PC games globally, such as Fortnite that we've really been positively surprised by the willingness of players with these free-to-play games to participate in voluntary monthly subscription services. I know it sounds a little bit of a contradiction in terms of if someone would choose to subscribe to something which they don't need to subscribe, if you put the right content and the right concepts into the season passes then actually that's very good take up for the season passes in certain environments. So that's a positive sign as well.

<A - Chi Ping Lau>: Yeah. In terms of the deposit interest, right now in this current quarter it accounts for a low teens percentage of our others revenue. And the way that we think about it is that we have already had 42% of the deposit taken away, the interest is already taken away, and we have another 58% to go. And the schedule as announced by PBOC is that it will be pretty much evenly distributed for the next six months for that 58%, so by January of 2019 the entire deposit will be taken away.

Now as John has talked about in the prepared remarks, we would try to mitigate some of these impact by more efficiently managing some of the marketing cost that we have because we are spending actually a lot of money on marketing our payment platform. And as you can see there's a very strong growth in our payment platform especially with respect to offline commercial transactions partly because of the strength of the platform itself but also partly because of the marketing program. And given the loss of the interest, we'll try to optimize the marketing plan and try to pick up the ones that are more efficient.

And at the same time we feel that we can also, over time, deliver more financial services to some of the merchants that are connected by our payment platform. As you can see from the prepared remarks, our commercial transactions especially on the offline side has increased very significantly. And that means our payment platform is now connecting to millions of offline merchants and we believe that these are very, very important assets for us. Over time, we can deliver transaction-based services to them, including financial transactions as well as advertising transactions. So those are things that we'll be doing over time. Now the way I look at this loss of interest income is that it's of course a very painful event, right, and we are halfway through. We'll try to mitigate part of the other half. And once it's all done then basically it becomes a one-time event and it would not affect the trend line of the growth of our payment business.

<A - Jane Yip>: Thank you. And the next question please.

Operator

Next question comes from Alicia Yap from Citigroup. Please ask your question.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my questions. I have a couple questions. The first one, wanted to look at when we look at the various initiatives that management put together on the prepared remarks to revise the growth for the gaming business for short-term such as like 3Q, which initiative will be the biggest driver? Would that be the enhancing monetization of existing games such as Honour of Kings be the biggest driver or would that be the new revenue contribution from your newly launched games? And if you look back six months ago, do you think that the company or management will still go ahead to launch the two PUBG MOBILE games knowing that monetization may come later or will you actually consider waiting to launch PUBG till the later stage?

For second question, on the advertising opportunity related to Mini Programs, could you help us understand a bit among the different industry vertical is it fair to say most of the incremental advertising revenue would come from the traditional retail and low-cost services brands and merchants? If not, any major vertical that you could highlight and could you help us frame the market size for that? Thank you.

<A - James Gordon Mitchell>: Perhaps I'll try to tackle the first question and I'll pass on to Martin for the second and third.

<A - Chi Ping Lau>: Yes.

<A - James Gordon Mitchell>: So I think the first question was around which of the initiatives that we're now undertaking in our mobile game business to reinvigorate growth will bear fruit in the third quarter. And I think that sometimes these initiatives take some period of time, and period of time could be months, could be quarters to bear fruit. But in general, we're optimistic that they will bear fruit as we move into next year. Just drilling down one level, having had some understanding of the concern that investors have about the second quarter results, I think that one aspect that may not be as well-understood as it might is that really during the first half of this year for whatever reason we didn't release as many successful high-ARPU games as we had in previous periods. And that's why I called out that in July and August we released a number of high-ARPU games in categories like role playing games, card games, and those games at least initially appears to be off to a relatively healthy start. So as well as the much debated monetization of tactical tournament games issue, there is also some short-term volatility in terms of the cadence of the balance between the higher ARPU and lower ARPU games. And as Martin said, we have over 12 mobile games we have already secured monetization approval and some of those will be in these higher ARPU categories. And with that, I'll pass it to Martin.

<A - Chi Ping Lau>: Yeah. With respect to the game business right now, I would just say my observation is that the gaming fundamentals is actually as strong as it has been because if you look at our DAU in China, it has a very solid growth compared to last year. We have really become the category leader in tactical tournament which six months ago it was not very apparent. It was a very big segment with another game which has taken the lead. But within the past six months we have taken a complete lead over that genre. And it doesn't really stop in China. If you look around the world, we have also expanded our presence outside of China. Part of it is through Epic which has become the biggest category winner in this tactical tournament genre in the Western world. And at the same time, if you look at our own developed games, both AOV and PUBG MOBILE has achieved more than 15 million DAU outside of China which is a very significant achievement. It also marks a significant step for us to expand our gaming business outside of China. So all these operating metrics are very strong. The only problem that we have is actually for one of our biggest games, PUBG MOBILE, is not monetizing and I think this is something which is a little bit out of control but over time I think we will be able to solve it.

Now with respect to Mini Programs, I think it's really an overall ecosystem in which we are trying to connect our users with many different types of offline activities. And a lot of these are transaction-based, a lot of these would not even get the chance of getting the online engagement if there is no Mini Program because if you really need to download an app, most of the users will be gone. But because of the availability of Mini Programs many of these connections are made. Yes, a lot of the connection is actually between offline and online and a lot of it is due to the retail industry. But I think there's also a lot other interactions too, right? For example, through retail we are also going to touch upon brands. We find that a lot of brands are looking at Mini Program as a way for them to engage with their users. And even though they are not directly having a retail relationship in-store, the brands want to touch a point their customers. They want to understand who are their customers through Mini Program. In the past they were not able to do it; now they are able to do it.

So I think Mini Programs really help, one, all kinds of different services to reach their users online; and two is whenever they have a point of contact, be it offline or online, they can have an additional transaction or additional action that can be taken by the users. And thirdly, Mini Program also allows a lot of social sharing of different kind of interaction, so it allows word of mouth to be spread for different services and brands.

<A - Jane Yip>: And the next question please.

Operator

The next question comes from Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you. My first question is about the earnings growth outlook. So this quarter the revenue growth jumped to only 30%, probably the lowest in the past three years, and yet the operating profit growth was only 20%. So you mentioned a lot about the launching of the high-ARPU games and also Mini Programs to be a structural driver in the future. I just wondered when should we expect those things to really bring the earnings growth back to above the 30% level or with a temporary pickup in the game business trend with some macro headwinds where you can show the cost such as G&A to assure better earnings growth?

And secondly, can you give us some clarification around Fortnite, so whether the Fortnite PC has already obtained monetization approval? And also, what's the progress of the Fortnite Mobile development? If Fortnite Mobile is to be launched in the future, does it require a separate approval from the PC version or not? Thank you.

<A - Chi Ping Lau>: Okay. Well I think – so from a revenue growth perspective, the gaming sector is one key area of weakness. And as we have said, a big part of it is because our biggest game is not monetizable, and I think the growth will return when it is monetizable. So it's an event that we are working very hard toward and of course in the meantime there are a lot of things that we'll be doing in order to try to mitigate the problem. But I think the biggest issue is really trying to monetize our biggest game. And at the same time, when we talk about higher ARPU games and when we talk about expanding our presence outside of China and trying to monetize better there, I think there's a number of different measures that we can try to grow our business as well.

In terms of I would say – what's the next question – Fortnite, right? For Fortnite, the current situation is that the PC version of Fortnite has already received the Ministry of Culture and Tourism approval so we can launch the game. We're not right now applying for the green channel approval for monetization for one month with GAPP before any game can be approved for formal monetization. That's still ongoing and when we get that approval then we can start monetizing. So far I think when we look at Fortnite's pre-registration and also in the beta testing, the rate of people's response is actually pretty good. Now with respect to the mobile game, we do need to have a separate approval process for the mobile game which will follow after we have launched the PC version of Fortnite.

<A - James Gordon Mitchell>: Just to supplement Martin on the first question specifically around the relatively slower earnings growth. As Martin had mentioned earlier, there's a couple of substantial factors which are temporarily impacting our earnings growth which we're trying to quantify, and one is the non-monetization of the tactical tournament games which we believe could be very substantial based on what we already see internationally and based on industry logic. And then the second one is the fact that we're halfway through this process of losing the interest income on the deposits which, again, we're halfway through that process. We think we'll find some offsets as we work through the second half of that process and that's a finite one-time process.

<A - Jane Yip>: Next question please.

Operator

Next question comes from Han-Joon Kim from Deutsche Bank. Please ask your question.

<Q - Han-Joon Kim>: Great. Thank you very much for the chance to ask questions. I just wanted to differentiate the publishing of games in China. So what goes on to WeGame and what goes on to kind of direct publishing into China and how we should think about the evolution or growth of WeGame going forward. And the second question is I think we've introduced the battle pass to our PUBG global version. And I just kind of wanted to get your impression on how you see the evolution and adoption of that battle pass relative to Fortnite's success. So my understanding is the ranking is a bit lower so the impression is that the paying adoption rate for PUBG MOBILE is lower. So just trying to understand the relativity of that context.

<A - James Gordon Mitchell>: Yeah. So let me try to answer both of those. So first with regard to what we would publish versus what we would sort of platform through the WeGame platform, I think that simplistically in the past one could've said that for a game of a massively multi-player characteristics that our first instinct would be to try to publish it ourselves because there's a great deal of local expertise that require local optimization that's required and local customization. That means simply copy-pasting, translating, and tweaking is not sufficient to make the game be all that it can be in China. When we look back, I think the great part of the success of products like Dungeon & Fighter, which is multi-player; League of Legends, which is multi-player; CrossFire, which is multi-player, all the imported games or games that we published ourselves in China have gone on to great success due to the fact that they're great products, but also to the fact that we've taken on hand the publishing. So that's a typical classic direct publishing experience.

Now, the games which are more single player in nature, perhaps more narratively-driven in nature, then historically they might make more sense to put on a Steam-like platform or on a WeGame platform. And that's initially the pattern that the first successful games on WeGame were products like Don't Starve, which were relatively simpler in nature and required relatively less local optimization. Monster Hunter: World is a really interesting hybrid in that it does have a relatively strong narrative, but at the same time, it's a game that people generally play on a cooperative basis. So, it's cooperative player versus environmental player versus gigantic fire-breathing monster experience. And as such, the interest that our users had in it was extremely encouraging for the future. It's just unfortunate that now we need to tweak the product a little more so we can provide it to our users. So, that's in terms of the WeGame versus direct publishing part.

In terms of the Battle Pass monetization for PUBG MOBILE, we're pretty happy. It's early days. I would say that PUBG MOBILE, as the name suggests, is a mobile game versus Fortnite, it's console, PC, and mobile. And my guess is that because Fortnite is console plus PC, it's tapping into some younger users who historically might have had a habit of buying X number of packaged software per year and now they're willing to redirect some of that money into the monthly subscription service versus – because PUBG MOBILE is only mobile and the users are generally comparing it with Clash of Clans or Candy Crush where they don't historically have a habit of buying a dozen packaged software each year. So in that sense, I think that we will see, we are seeing, and we should expect to see a slower build of the monthly Battle Pass revenue in a product like PUBG versus the really excellent outstanding progress that Epic have made with Fortnite or, for that matter, Electronic Arts have made with the FIFA games.

<A - Jane Yip>: Thank you. And due to the time constraint, we will take the last three questions from the phone.

Operator

The last three questions comes from the line of Karen Chan from Jefferies. Please ask your question.

<Q - Karen Chan>: Thank you very much for taking my question. So my first question is how much of a pipeline buffer do we have until we get more visibility on resumption of new license approval? Does the 15 games in the pipeline that we have already secured license, does that include recently launched titles like MT4? In other words, will that impact any new high-ARPU mobile game title launch in the fourth quarter? And also on the PC front, you mentioned that we are in the process of applying for green channel for one-month monetization testing on PC Fortnite. Just wondering at earliest, do we expect some sort of monetization contribution in the fourth quarter? Thank you very much.

<A - James Gordon Mitchell>: Yeah. I think we gave a figure for the number of mobile games in our pipeline that have already secured approval, and obviously that figure would include a mix of different kinds of games. And so I suppose if you want to look at it from an ARPU perspective then one can. I think that in terms of Fortnite PC, the green channel, the point we were alluding to is the approval process of Fortnite PC is different from and, to some extent, more in line with historic norms than the approval process with the PUBG games. And so therefore, while it's hard to forecast exact approval process given some of the changes in the regulatory environment, at the same time we think that's an approval process that should be more consistent with historical norms particularly, as Martin said, since we have the Ministry of Culture approval already. And historically, the time lag between Ministry of Culture and GAPP approvals is relatively shorter.

<A - Jane Yip>: Next question, please.

Operator

Next question comes from Grace Chen from Morgan Stanley. Please ask your question.

<Q - Grace Chen>: Hi. Thank you for taking my question. My question – let me switch the gear to your cloud business, which has been growing very fast. In the press release, you talked about Tencent will continue to grow the cloud business through organic growth as well as collaboration and investment opportunities. Can you elaborate about your plan for collaboration? Especially, we've been seeing some news about your collaboration with some international players, such as Google. Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the cloud business, it has been growing very fast. And when we talk about the collaboration, we're more talking about building an ecosystem of system integrators as well as developers who have specific expertise so that they can develop using our cloud solution. So as you can see in some of the announcements, we actually have invested in a number of different system integrators within different vertical industries so that when they design in their solution for their customers they can actually leverage Tencent Cloud and they can convert some of their existing customers from using packaged software into a SaaS solution and then move them onto Tencent Cloud. So that's the cooperation that we're talking about. And I think, overall, it has been going quite smoothly. Now, of course, with some international partners, there also exists such opportunities, right? There are companies who have customers who need exposure to China and we could provide a solution that can help them. So in those cases, we'll also collaborate with the international partners.

<A - Jane Yip>: Okay. And then last question, please.

Operator

The last question comes from John Choi from Daiwa Capital Markets. Please ask your question.

<Q - John Choi>: Thanks for taking my question. I just have a quick question on your PUBG MOBILE. Assuming the approval goes through, do you guys have a sense like how big this monetization opportunity could be given that I think someone asked about the Battle Pass and other initiatives in overseas market has been falling a bit short. So, are we quite confident that this PUBG, if the monetization goes through, that it will kind of meet internal expectation? And secondly, just quickly on the PC game growth. I know that we had a great year last year, but we're clearly seeing some slowdown for the remaining part of the year. And as we go into 2019 with the new WeGame platform, what kind of growth should we be expecting? Thank you.

<A - James Gordon Mitchell>: So John, in terms of your first question on the PUBG MOBILE monetization, we're pretty optimistic if we're permitted to monetize then we'll achieve healthy monetization. That optimism is founded on, first, the very large DAU base and the very high engagement per DAU; secondly, the intense sort of competition but also cooperation within the game which historically is a good leading indicator of monetization; and thirdly, the global experience of games such as PUBG itself but also Fortnite in which, as you know, we're a substantial shareholder via

Epic.

I didn't quite understand your comment about PUBG MOBILE international revenue underperforming. We're actually quite pleased with the early ramp and given the fact that it's very unusual for us to monetize the game first outside China. This is a problem and this is sort of unprecedented in our history. So you can see that it is a top 50 game by revenue ranking in many key markets including the United States and a top two or three game by revenue ranking in some big emerging markets including India. So overall, we're pretty happy with PUBG MOBILE progress outside China and we think if we could monetize inside China then we wouldn't do so at a decent level. And then, sorry, your second question was around the...

<A - Chi Ping Lau>: PC game.

<A - James Gordon Mitchell>: The PC game revenue growth. I think that with mobile game we can point very clearly to certain specific headwinds that we believe can be overcome with time, and therefore we believe that a 19% sequential deceleration in mobile game revenue should not be representative of the long-term forward trend for our mobile game business. I think for PC game business, that is a fundamentally more mature industry and therefore we should be relatively conservative in our expectations in 2019 and beyond. But what's interesting is if you look at results from other game companies, if you look at the commentary from NVIDIA, then the PC game industry globally is actually not a sunset industry at all and it continues to gradually expand.

And I think the difference between China and the rest of the world is that in China the innovation in games is very much focused on mobile games versus in the rest of the world there continues to be a decent amount of innovation around console and PC, and that innovation is ultimately what drives the game industry revenue growth actually even more than macro trends or installed base. And so the fact that our WeGame platform is bringing some innovative products to China, the fact that consumers are willing to pay RMB 200, RMB 300 upfront for these innovative products I think speaks well for a stable rather than permanently declining PC game industry in the long long-term.

Jane Yip

Thank you. We are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. And the replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2018 Second Quarter and Interim Results Conference Call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2018-05-16
Event Description: Q1 2018 Earnings Call

Market Cap: 3.52TRI
Current PX: 370.00
YTD Change($): -36.00
YTD Change(%): -8.867

Bloomberg Estimates - EPS
Current Quarter: 2.014
Current Year: 8.910
Bloomberg Estimates - Sales
Current Quarter: 77778.368
Current Year: 335724.367

Q1 2018 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Grace Chen
- Alex Yao
- Karen Chan
- Piyush Mubayi
- Eddie Leung
- Alicia Yap
- Wendy Huang
- Gregory Zhao
- Jin-Kyu Yoon
- Thomas Chong
- Yue Wu

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2018 First Quarter Results Conference Call. At this time, all participants are in listen-only mode. There will be a presentation followed by the question-and-answer session. [Operator Instructions] I must advice you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Good evening. Welcome to our 2018 first quarter results conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our corporate website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview. Martin will discuss over value added services and social network. James will speak to online games and advertising, and John will discuss the financials before we take your questions. I would turn the call over to Pony now.

Huateng Ma

Okay. Thank you, Jane. Good evening, everyone. Thank you for joining us. In the first quarter of 2018, we launched several successful products and further deepened our engagement with users across our social games and media platforms. We continue investing actively in our strategic priority areas such as video, payment, cloud, AI and smart retail to fulfill our mission of enhancing the quality of life via internet services.

For the first quarter of 2018, total revenue was RMB 73.5 billion, up 48% year-on-year and up 11% quarter-on-quarter. Non-GAAP operating profit was RMB 25.3 billion, up 36% year-on-year and up 16% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 18.3 billion, up 29% year-on-year and up 5% quarter-on-quarter. And John will provide more details in the financial section.

Moving on to our key platforms. Combined MAU of Weixin and WeChat increased 11% year-on-year to RMB 1.04 billion as Mini Programs continue to gain wider adoption among users and developers. Total MAU for QQ was 805 million. Smart devices MAU was 694 million, up 2% year-on-year. Our news feed service, KanDian within QQ, continued to grow user traffic and time spent.

Our social network services, Qzone smart devices MAU was 550 million. In games, we maintained our leadership in mobile and PC, in particular on mobile. QQ Speed Mobile became one of the top three grossing smartphone games in China soon after its launch in last December. Our in-house developed tactical tournament games achieved great popularity both in China and internationally.

We also expand the number and variety of Mini Games within Weixin. For our media business, we maintained our leadership in online video, news, music services and literature to cater to users' short-session entertainment desire. Our standalone mini video app, WeiShi, will feature its content in our other news feed type of product.

In FinTech, our mobile payment service continue to lead by MAU and DAU and sustained strategic growth in offline commercial transactions. In mobile utilities, we maintained our leading positions in China in mobile security mobile browser and Android app store. Martin and James will discuss further in business review.

Chi Ping Lau

Thank you, Pony. And good evening and good morning to everybody. In the first quarter of 2018 our revenue grew 48% year-on-year. Of which the vast segments represented 64% of total revenue, and of which, online games contributed 39% and social networks 25%. Online advertising was 14% of total revenue. Others segment accounted for 22% of total revenue. In the others segment, FinTech delivered triple-digit year-on-year revenue growth, mainly driven by fast growing offline commercial transaction fees collected from merchants, as well as cash withdrawal fees collected from consumers to cover bank handling charges.

Cloud services revenue more than doubled year-on-year, as we expanded our cloud services market share in the games and video industries and rolled out customized solutions, catering to financial and municipal services clients. We're also attracting an increasing number of smart retailers, such as supermarket, chain stores and leading fashion retailers, to adopt our cloud solutions, as they transition businesses to Internet and mobile.

Now, diving into the value-added services, segment revenue was RMB 46.9 billion in the first quarter, up 34% year-on-year or 17% quarter-on-quarter. Social networks revenue was RMB 18.1 billion, up 47% year-on-year and up 16% quarter-on-quarter. The year-on-year revenue growth was primarily driven by the rapid uptake of video subscriptions, benefiting from our exclusive video content, increased penetration in music live broadcast services and more item sales in smartphone games. Within the quarter, video subscription revenue grew 85% year-on-year. Sequentially, the increases in game-related item sales, video subscriptions, and monetization of WeSing were the main contributors to growth.

As of quarter end, our total VAS subscriptions increased by 24% year-on-year to 147 million with the growth primarily coming from our content subscription services. Online games revenue was RMB 28.8 billion, up 26% year-on-year and 18% quarter-on-quarter. Year-on-year revenue growth was driven by smartphone games including Honour of Kings and QQ Speed Mobile.

PC games revenue were broadly stable reflecting players time shifting to mobile. Sequentially, new smartphone games such as QQ Speed Mobile and MU Awakening contributed to revenue growth. Leading PC titles benefited from seasonal promotion activities as well during the quarter. With four highly popular tactical tournament games in our portfolio, we've built global leadership in this competitive genre, which we'll talk about more on a later slide.

In social networks, on the Weixin front, the launch of Mini Games has achieved significant success. Hence, it's benefited the overall Mini Program ecosystem as a whole with smart retail Mini Programs as one example. Mini Games have enjoyed rapid expansion in the first quarter after opening up their platform for game developers. Currently, we have over 500 Mini Games on the platform.

We believe Mini Games are meaningfully expanding our game audience with over one third of Mini Games players not being previous players of Tencent mobile game apps. They facilitate new players to discover game apps. Some users start by playing Mini Game version of app-based game and then progress to downloading the game app. Mini Games also serve as an entry point for users to learn and extend their usage of other Mini Programs. We have started light monetization of Mini Games via advertisement and some virtual item sales.

Leveraging on growing consumer adoption of Mini Programs, we introduced our Scan-to-Buy solution. The solution integrates Mini Programs with Weixin Pay, allowing customers to pay for their goods on smartphones, increasing checkout efficiency. Supermarket chains such as Walmart and Yonghui are among early adopters of the solution. Our DAU and daily transaction volume for the retailer category of Mini Programs increased 50% quarter-on-quarter. We believe Mini Program is synergistic with the overall app ecosystem because it encouraged many otherwise non-app developers to embrace the mobile Internet. And some of these developers would eventually come on to develop native apps.

Turning to QQ, which has been quite successful in building its content ecosystem in recent years, its news feed service, KanDian, is benefiting from the significant synergies between a social platform and a content platform. In the first quarter of this year, KanDian achieved over 80 million DAU and grew its video views three times year-on-year. Monetization is still at an early stage and we see upside potential given the strong advertiser demand for feeds ad inventory.

During the quarter, we have also relaunched our mini video app WeiShi. WeiShi offers users a wide range of high-quality professional user-generated content or PUGC from the market as well as from our licensed digital content libraries such as music, games, sports and variety shows. In addition to broadcasting the content in the app itself, WeiShi also distributes content to our feed verticals such as KanDian and Mobile QQ Browser. We believe WeiShi will be able to leverage our access to proprietary content, distribution capability via our platform apps, as well as linkage to user social graph over time.

Now, I would like to turn to James to talk about games.

James Gordon Mitchell

Thank you, Martin. Tactical tournament games have become phenomenally popular both internationally and in China across PC, console, and mobile devices. I'll talk a little bit about how we've capitalized on this new opportunity by utilizing our in-house game development skills, our relationships with IP owners, our investee company portfolio, and our publishing platform. Our in-house game studios in China have developed two titles based on their well-known PUBG IP, one reflecting the original PC gameplay and one featuring a design for mobile experience. The two games achieved breakout popularity in China with combined DAU exceeding 50 million users. Outside China, combined DAU grew to over 10 million users, and we've just started monetization.

We expect these games to negatively impact our financials in the short-term as we are not yet monetizing the games in the China market but we are incurring marketing and operating expenses. However, we believe they represent a substantial revenue opportunity once we commence domestic monetization.

Our investee studio, Epic Games, based in North Carolina has developed and operates Fortnite, which has become a global success. Fortnite has over 40 million monthly active users and is the most watched game currently on Twitch. And it's already achieving healthy monetization by the sales of seasonal battle passes which unlocks skins and decorative items.

Fortnite's iOS mobile version ranks as the top grossing game in the U.S. iOS chart in April. During the second quarter, we have started preregistration for Fortnite's PC version in China. Our licensor PUBG Corporation has enjoyed global success on PC and Xbox with its PlayerUnknown's Battlegrounds game, which has sold over 45 million copies globally in the past 12 months. And we're also working toward publishing a localized China PC version of PlayerUnknown's Battlegrounds.

Moving on to smartphone games as a category, revenue was RMB 21.7 billion, up 68% year-on-year and up 28% quarter-on-quarter. Within the quarter, key titles grew stronger year-to-year in DAUs, paid user, and ARPU as competitive mid-core games gained players mind share and time share. Sequentially, seasonal promotions during the Chinese New Year and our new game, QQ Speed Mobile, contributed to revenue growth.

During the first quarter, we operated the top two revenue grossing titles in China, namely Honour of Kings, which grew DAUs by double-digits year-on-year. Sales of special skin items drove ARPU and strong revenue growth. We're beta testing new play modes and content for Honour of Kings with the aim of growing its user base and creating educational value for younger players. And, secondly, QQ Speed Mobile, which demonstrated our ability to migrate an internally developed franchise, QQ Speed, from PC to mobile and to expand the franchise's audience during that migration.

The mobile DAU for this game is seven times higher than the highest ever achieved PC DAU and over 40% of the users of QQ Speed Mobile and user franchise not having previously played the PC version of the game. For PC client games, revenue was RMB 14.1 billion, flat year-on-year and up 10% quarter-on-quarter. Active users declined year-on-year due to continued time shift to mobile as smartphone games are providing an increasingly comparable experience versus PC games. However, core user engagement with our key PC titles remains firm.

During the quarter, content updates and seasonal promotions during the Chinese New Year contributed to the sequential revenue growth. Dungeon & Fighter, which will celebrate the 10th anniversary of its China launch in June, delivered a record revenue quarter, demonstrating our capability for sustaining the longevity of our key game franchises.

We'll continue to invest in new franchises and in genre leadership in areas including tactical tournament games where we're going to publish Fortnite and PlayerUnknown's Battlegrounds into the China market, sports games where we'll release updates of FIFA and NBA 2K, and sandbox games where we have three licensed titles in our pipeline. As young people are spending an increasing amount of time on live broadcast platforms discovering games and watching eSports events, we're deepening cooperation with the market-leading streaming platforms including Douyu and Huya to better promote our games.

Shifting to advertising, our first quarter revenue was RMB 10.7 billion, up 55% year-on-year and down 14% quarter-on-quarter. Mobile contributed over 90% of our advertising revenue. Our media advertising revenue was RMB 3.3 billion, up 31% year-on-year though down 20% quarter-on-quarter. Within the media advertising revenue, our video advertising revenue was up 64% year-on-year due to more pre-roll ads benefiting from the growth in video views and also from our enhanced capability to develop creative ad formats within our original content. Our video and news revenue both decreased quarter-on-quarter due to negative seasonality.

Our social and other advertising revenue was RMB 7.4 billion, up 69% year-on-year and down 10% quarter-on-quarter. Year-on-year revenue growth was due to the expanded advertising base boosting ad fill rates in Weixin Moments plus higher CPCs from Mobile Ad Network. The quarter-on-quarter revenue decline was due to negative seasonality, although QQ KanDian revenue increased sequentially due to traffic growth.

To cater to unmet advertiser demand, in late March we increased the ad load in Weixin Moments to two ads, a maximum of two ads per user day, which remains extremely conservative compared to our global peers. As both our social and feed ad loads are only small fractions of those of industry benchmarks, we believe there's a long runway to continue growth in our social and other advertising category.

Digging further into our video business, we believe a sustained rapid growth in operating and financial metrics reinforcing our industry leadership in the online video market in China, whether measured by mobile DAU or subscriptions both daily active users and user time spent on mobile grew strongly year-on-year and mobile video views increased over 60% year-on-year. To recap, total video revenue including advertising and subscriptions was up 75% year-on-year. [indiscernible] (00:18:40) subscription revenues grew 85% year-on-year and our advertising revenue grew 64% year-on-year. Our original content initiatives enjoyed proven success across multiple verticals. To call out a few best in industry examples: our ongoing idle selection variety show Produce 101 has become the number one online variety show measured by average views per episode in China to-date. Our original animated series Land of Warriors has set a new record for Chinese anime in terms of video views per episode. We have a rich catalog and a richer pipeline of proven IPs including The King's Avatar and Battle Through the Heavens. We actively managed the content creation and production of movie, Forever Young, which has become a box office hit.

And with that, I'll pass it to John to go through the financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the first quarter of 2018, our total revenue was RMB 73.5 billion up 48% year-on-year or 11% quarter-on-quarter. Cost increased by 51% to RMB 36.5 billion for the first quarter on a year-on-year basis. The increase primary reflected greater channel cost, cost of payment related services, as well as content cost.

Gross profit was RMB 37 billion up 46% year-on-year or 18% quarter-on-quarter. Net other gains were RMB 7.6 billion for the first quarter, mainly represented non-GAAP adjusted in relation to gains and losses from the investees of RMB 7.8 billion, which comprised fair value gains as a result of increase in valuation of certain investments in verticals such as video clip sharing, news feeds, online games, and video content creation, as well as the disposal or disposal gains arising from the capital activities of some certain investee companies.

Share of losses of associates and joint ventures was RMB 319 million in the quarter versus that of RMB 120 million for the fourth quarter of 2017. On a non-GAAP basis, share of losses of associates and joint venture was RMB 98 million for the first quarter compared to profit of RMB 495 million for the fourth quarter of 2017. Income tax expense was approximately RMB 5.7 billion up 57% year-on-year or 84% quarter-on-quarter. The year-on-year increase was mainly due to greater withholding tax provided and higher profit before income tax.

The Q-on-Q increase was primarily due to the absence of a reversal of income tax expense for a certain subsidiaries in China, which will confirm to enjoy a lower tax rate in the fourth quarter of 2017 as well as greater withholding tax. The effective tax rate in the period was 19.3%. Net profit to shareholders was RMB 23.3 billion, up 61% year-on-year or 12% quarter-on-quarter.

I will walk you through our non-GAAP financial numbers. For the first quarter and after adjustments in non-GAAP, operating profit for the quarter was RMB 25.3 billion, up 36% year-on-year or 16% quarter-on-quarter. Operating margin was 34.4%, down 3 percentage points year-on-year or up 1.5 percentage points quarter-on-quarter. Net profit to shareholders was RMB 18.3 billion, up 29% year-on-year or 5% quarter-on-quarter. Net margin was 26%, down 3 percentage points year-on-year and 1.7 percentage points quarter-on-quarter.

Let's turn to segment gross margin. Gross margin for VAS was 63.3%, up 2.4 percentage points year-on-year or 4 percentage points quarter-on-quarter. The year-on-year increase was mainly driven by higher gross margin achieved for video and music subscription businesses as a result of operating leverage effect. The quarter-on-quarter increase was mainly due to the same reason, as well as higher gross margin for smartphone games business as a result of higher proportion of self-developed games.

Gross margin for online advertising was 31.2%, down 3.6 percentage points year-on-year or 6 percentage points quarter-on-quarter. The year-on-year decrease was mainly due to higher traffic acquisition cost of Ad Network. The weak seasonality in the first quarter lead to a decrease in revenue impacting the margin in the quarter.

Gross margin for others was 25.4%, up 3.5 percentage points year-on-year and 2.6 percentage points sequentially. This gross margin improvement was mainly driven by the policy of charging service fee for user's credit card pre-payment in December 2017.

Moving on to operating expenses, selling and marketing expenses were RMB 5.6 billion, up 76% year-on-year or down 8% quarter-on-quarter. The year-on-year increase mainly reflect increased marketing spending on products and platform such as payment-related services, smart phone games and news feed apps. This sequential decrease was mainly driven by seasonally less advertising activities in the first quarter of the year.

As a percentage of revenue, S&M expenses decreased to 7.6% for this quarter, from 9.1% for the fourth quarter of 2017. G&A expenses (sic) excluding R&D were RMB 4.4 billion, up 30% year-on-year or up 10% quarter-on-quarter on the G&A. Research and development expenses were RMB 5 billion, up 39% year-on-year or 5% quarter-on-quarter. Both quarter-on-quarter and year-on-year increases were mainly due to greater staff cost and R&D expenses. As a percentage of revenue, total G&A was 12.8% and R&D was 6.8%.

At the end of the first quarter, we had about 46,000 employees, which represented an increase of 17%, in the area of cloud and online game businesses. Let's go through margin ratios for the first quarter. Gross margin dipped 0.9 percentage points year-on-year to 50.4%, mainly due to increasing contribution from other segment, which carried lower margin. Gross margin was up 3 percentage points sequentially, which was driven by higher segment gross margins.

Non-GAAP operating margin was 34.4%, down 3 percentage points year-on-year, primarily reflecting lower gross margin, reduced dividend income and increasing selling and marketing expenses. Quarter-on-quarter change was up 1.5 percentage points, driven by higher gross margin, less selling and marketing spending, which were partially offset by lower dividend income. Non-GAAP net margin was 26%, down 3 percentage points year-on-year, mainly due to lower operating margin. Non-GAAP net margin was down 1.7 percentage points quarter-on-quarter, mainly due to high income tax expense, which was partially offset by higher operating margins.

Finally, let me share with you some financial metrics before winding up this presentation. Total CapEx was RMB 6.3 billion, up 200% year-on-year or 27% quarter-on-quarter. Operating CapEx was RMB 3.9 billion, increased by 126% year-on-year, mainly due to the increased number of servers for expanded businesses, particularly cloud businesses. Nonoperating CapEx was RMB 2.4 billion, up over 5 times on a yearly basis, mainly due to the recognition of spending on land use rights in Beijing in the first quarter of 2018.

Free cash flow was RMB 13 billion, down 46% year-on-year and quarter-on-quarter. The sequential decrease mainly reflected decline in operating cash flow due to payments of year-end bonuses, timing of payments of certain expenditures arising from our payment-related services and tax expenses, as well as payment of land use rights.

At the end of March, our net debt position was RMB 14.5 billion compared to net cash of RMB 16.3 billion at the end of 2017. While our cash flow from operation remains solid, the change in net debt position, which resulted from higher notes payable, was mainly due to increased strategic M&A investments. The fair value of our listed companies, excluding subsidiaries of course, were approximately RMB 213 billion or $33.9 billion as at the end of the quarter compared with RMB 211 billion as at 2017 year-end.

Thank you. We shall open the floor for questions.

Q&A

<A - Jane Yip>: Operator, we will take one question from each participant. May we have the first question please?

Operator

The first question comes from the line of Grace Chen from Morgan Stanley. Please ask a question.

<Q - Grace Chen>: Thank you. Thank you very much for taking my question. My question is about your gaming business. We know Tencent already dominates the gaming market in China, so we are interested in understanding your strategy for the overseas expansion.

In terms of the game distribution overseas, would you distribute by yourself or would you rely on overseas partners to do the distribution? And how would you manage dynamics with the overseas partners? And the follow up question is about eSports. How would you capitalize on the opportunities from eSports for Tencent in China overseas market, especially Tencent has the top game IPs that are very suitable for eSports? Thank you.

<A - James Gordon Mitchell>: Okay. I think, Grace, as far as publishing our games internationally, in the past we took the view that the games we developed in China that was suitable for the China market might not be suitable for the rest of the world due to different cultures and behaviors. What we have seen in the past two years is that there is some evidence now that games created in China can enjoy global residence.

And I'm thinking particularly about the success of our stimulating battlefield game which has enjoyed a very strong download activity, very positive player reception since we launched it in the Western world a couple of months ago and launched it in Japan today actually. Also, the success of our Arena of Valor game which is a battle arena game based on Honour of Kings which has built up a large and loyal user base in Western market. So, I think what you're seeing is that we are focusing on this opportunity more going forward.

In terms of your question around whether we publish ourselves or rely on partners, the answer varies to some extent depending on geography. So, for example in Southeast Asia, as you may know, our affiliate company Sea corporation or Garena publishes some of our games successfully. And the answer will also depend to some extent on the nature of the game. So, we're in the process of iterating and finding out the best solution, but we're very happy with Arena of Valor, and with simulating battlefield in particular. And we were very happy with some of our local publishing partners such as Sea corporation.

With regard to eSports, you are correct to observe that some of our games particularly League of Legends have become a very widely watched eSports in their own right. Up until this point in time, our focus is still largely on utilizing the eSports as a way of boosting engagement among existing users of the game and also to some extent driving interest among in the new players of these games.

We are aware that there should be, that there could be and there should be substantial monetization opportunities around eSports and we've made some experiments in that direction with League of Legends in particular. But in general, our philosophy is still to use eSports primarily as a way of rewarding the players of these games, restimulating interest among lapsed players of the games and stimulating interest among new players of the games.

Operator

Thank you. The next question comes from the line of Alex Yao from JPMorgan. Please ask your question.

<Q - Alex Yao>: Hi. Good evening, management, and thank you very much for taking my question. I have a follow-up question on the gaming business. On the PC side, we understand the last year, first quarter base was a bit tough and you delivered a flat PC gaming revenue in this quarter. How do you think about the monetization outlook for PC gaming for the rest of the year?

And then, on the mobile gaming side, while you drive gamer growth through the tactical tournament games, what's the monetization strategy before you monetize those large DAU games? And, also, what's holding you back in monetizing the mobile survival shooting game? Thank you.

<A - Chi Ping Lau>: I think on the PC game and as we have repeatedly saying, there is a shift in terms of user time from PC to mobile. So, I think there is a seasonal boost in terms of our PC revenue in the first quarter. But I think if you look into the future, I would say the shift of the user time from PC to mobile will continue, and I think that that revenue will probably be under pressure because of this issue.

Now, in terms of the tactical tournament game, I think we're very happy to report that we have really nailed this genre, which is probably the biggest opportunity after the mobile opportunity in the gaming industry in the past five years. And we have gained a lot of user base, both through our self-developed mobile game in cooperation with our partner, as well as through our large strategic investment in Epic.

Now, in terms of the mobile game that's operating in China, it's pending regulatory approval for monetization. So, there is going to be an uncertain amount of time before we can start monetizing. Now, we do believe this is a matter of when. And so, we are working very hard to try to get the regulatory approval. But for the moment, right, you know, since it's not monetizing and it's a very big DAU, the financial result will have to wait.

But as it comes to tactical tournament as a genre, we believe that what Fortnite has done is a good example, right? Through seasonal passes, a number of different item monetization, Epic has been able to achieve quite satisfactory monetization in that game genre. And we believe when the time comes when we can actually monetize, there should be pretty significant opportunity around monetization.

Operator

Thank you. Next question comes from the line of Karen Chan from Jefferies. Please ask your question.

<Q - Karen Chan>: Thank you, management, for taking my questions. So, just a follow-up on the games, since we have already started preregistration for Fortnite in China. So, do we have any target timeline on that? And also my second question would be, we noticed that there has been recent rollout of new app formats within Mini Game like short video ad, any update on monetization progress so far? And how big of a monetization potential should we be expecting from Mini Game on both advertising and in-game item purchase? Thank you very much.

<A - Chi Ping Lau>: In terms of Fortnite, we have indeed started preregistration and we're in the process of getting approval of the game for launch in China. The timing is not completely set yet, so I think we'll have to wait for the next announcement to ascertain the time for the launch.

Now, with respect to monetization on Mini Games, I think we are testing the water in terms of monetizing the Mini Games and over time I think we do want to create an ecosystem in which the app developers, the Mini Game developers can actually generate revenue, right, so that that ecosystem will become prosperous. So, we would more look at this as an opportunity for us to make sure that the Mini Games ecosystem is strong and vibrant. It is going to create some revenue for us, but I think a lot of the revenue opportunity we do want to make sure that it's for the ecosystem itself.

Now, in terms of the item sales, at this point in time, it's only opened in limited extent on Android. So, I think again it's more of a testing of the monetization system so that we can generate some revenue for the Mini Games developers.

Operator

Thank you. The next question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask your question.

<Q - Piyush Mubayi>: Thank you for taking my questions. How should we think of the range of monetizations of the PC games we've seen in the overall number that we saw reported for the first quarter? And, I mean, the range being Dungeon & Fighter's number versus what the rest of the universe implies? If you could just shed some color on that, it would be great. Thank you.

<A - James Gordon Mitchell>: Piyush, could you rephrase the question perhaps just so we're clear what you're asking?

<Q - Piyush Mubayi>: So, it appears through Nexon's filings that Dungeon & Fighter did well in the first quarter. And if you take that revenue line out of your PC revenue reported for the quarter, it appears that the rest of the PC portfolio you have has not performed as well. So, how would you explain the range of performances between these two sets of games?

<A - James Gordon Mitchell>: Well, I think that there's a few variables to think about when you're drawing that comparison. The Dungeon & Fighter is an incredibly important game for us, and we're very pleased with its ongoing success. But one variable is that, typically, the developer of a game will report revenue on a sort of cash-in-that-quarter basis versus we will defer that cash in that quarter over the amortization period. So, there may be a time lag between spikes in revenue that a developer reports versus spikes in revenue that a publisher reports.

A second factor is that there are some specific PC games where we have a catalogue of virtual items and, at times, we put that catalogue to work more aggressively. In other times, we seek to restock that catalogue. And for some of our PC games we're in the restocking process this year.

And then thirdly, as Martin mentioned, the PC game industry as a whole is under pressure in China because of the increasing quality of mobile games. Now, it is very gratifying to us that Dungeon & Fighter is doing so well and is particularly gratifying to us that it's doing so well in its 10th year of life. But for other games there can be more revenue volatility because of that headwind from users playing mobile games.

Operator

Thank you. The next question comes from the line of Eddie Leung from Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Hey, guys. Good evening. I have a question on the competitive environment about mobile news. So, how do you think about your positioning in the segment right now versus a year ago, given certain changes in some of the apps and how do you think about the industry structure in the future? Will it be concentrated or fragmented? Any insights would be helpful.

And then, may I just have a quick follow up on the operating cash flow. Could you share a little bit more color about the year-on-year decline in the operating cash flow? You mentioned a couple of factors. So, I'm just wondering that which one would be the most important ones. Thank you.

<A - Chi Ping Lau>: Eddie, I think what you meant is really the news feed industry and I would say that the news feed industry had actually sort of experienced a lot of new developments in the past year. I think broadly speaking when we started – before the news feed come into play, right, here's the news app, and there's also official account, which is within WeChat. And both of them were very vibrant and especially the official account, it actually gave rise to a large number of self-media, which then the news feed industry actually took. And by providing machine learning capability and providing customized feeds, it's a more efficient way of providing content to users. And that news feed industry started with text and photo, and that's the content format.

Now, if you look at in the past year, I think the text and photo format has really reached a peak in terms of daily users and engagement. And then there is a new format coming out, which is short video and that has captured quite a bit of user time. And then another media format actually came around which is the mini video, right. Short video is a content format in which it ranges from one to five minutes, whereas a mini video is a vertical video format which usually it's 15 to 30 seconds. And that's where we stand in terms of sort of the evolution of the entire industry.

Now, if you look at Tencent, I think in news itself, right, as a media, we continue to lead the industry with our news app, with our WeChat, and QQ plugin. Our official account continues to generate a lot of page views every day.

Now, in terms – but we also recognize the importance of having a news feed, which can actually provide information in all sorts of different media content to users on a customized basis. So, that's why we have been curating our own news feeds within our different social and media platforms. And most notably, we have done it very successfully through KanDian. And as we have disclosed in the prepared remarks, our KanDian DAU is already in the 80 million DAU category and has grown very strongly from last year.

And in addition to the distribution platform, right, and we're also working on the multiple media format front, and we have started to provide much more short video through our news feed, be in KanDian or our mobile browser or top stories within WeChat, as well as on news apps and Kuai Bao. And at the same time, we have just relaunched our mini video platform, WeiShi. And I think the mission of WeiShi is really to provide short – mini video, this format content to the different distribution platforms within our own social apps and browser apps.

And I think as we have said, WeiShi, we believe it has the advantage of – in addition to get the PUGC content in the market, we can also get access to our long video and music and sports and variety show. We have a lot of very exclusive content that can be reformatted into mini video format. And at the same time for WeiShi, it's not just for its own distribution, it will be distributing across all our different news feed platforms. So, we will be putting quite a bit of investment into WeiShi, and we feel pretty good about its prospect over time.

<A - Shek Hon Lo>: In terms of the operating cash flow, if we compare year-on-year basis, the biggest impact would be the payments-related type of thing followed by the tax, as well as the year-end bonuses. I'll explain a little bit here. In terms of the payment fees in relation to – the fees in relation to payments, the reason for having such a big amount of payment this quarter was because, usually, we accrued all this on a monthly basis while the payment from time to time might be different. In some years, it might end of the year and, in some years, it might be first quarter. So, there's a bit of deferral in payment this year. That's why we see a dip in the operating cash flow in relation to this.

And for the tax, usually, of course, we accrue it on a monthly basis and we pay some of the provisional tax during the year. And, usually, after the closing of year, there will be a larger payment that will take place in quarter one and this impacts the operating cash flow for this quarter. And, of course, for the bonus payments, as you see we have more people this year versus last year. And the total staff cost actually increased by 29% year-on-year. So this is quite natural that it will increase year-over-year.

Operator

Thank you. The next question comes from the line of Alicia Yap from Citi. Please ask your question.

<Q - Alicia Yap>: Hi. Good evening, management. Congrats on the strong result. Thanks for taking my questions. I have a question related to the overall Mini Program ecosystem. We are increasingly hearing from various of your partners regarding helping the brands or the merchants on their existing platform to set up Mini Program official account within the WeChat ecosystem. Should we be worry that that could be too crowded among brands and retail eventually? Are there any checks and balances that the company will be putting in place to ensure the user experience balance is well in control?

And for that part, in addition to payment settlement fee income and maybe potential some advertising revenue, what could be other potential monetization opportunity from those retail official account? Thank you.

<A - Chi Ping Lau>: Well, in terms of Mini Programs, I think the original design mission is actually for the Mini Programs to be very light. It's very easily discoverable by users. It can be invoked very easily, used very easily. And then, once the usage is done it disappears, right. So, I think that's the design philosophy. And as a result, you can see, right, we have not provided a long-term position for the Mini Programs that you have used. We try to hide it from the user interface but in order to provide an easy access we do have this pull down menu for recently used Mini Programs.

So, I think it should not suffer from the problem of overcrowdedness. And especially we are trying to enable each one of the Mini Programs to have its own way to reach its customers. And I think the most natural way for Mini Program to really spread is, one, the provider has got these access paths with the users. And, two, is through social recommendation, and we believe that it would be the most natural way for Mini Programs to be spread across the social network.

Now, in terms of the monetization, I think at this point in time we are thinking less about monetizing Mini Programs directly. We're more thinking about how do we enable the ecosystem to grow stronger over time. And we believe that if the Mini Program ecosystem really grow strongly then a lot of our existing monetization models will benefit, right. For example, payment will benefit. For example, our advertising system will actually benefit. And as a result, what you felt, that's a more natural way for us to benefit our other existing businesses, and also our cloud business will also benefit as a result of Mini Programs proliferating.

Finally, we also felt that Mini Program is a very good and synergistic way for us to promote apps. If you look at Mini Games, we believe that Mini Games will help to promote the discovery as well as the download of a lot of heavier native app games. And in addition, as I said earlier, we believe that a lot of companies and developers who otherwise will not be developing a standalone native app will now be able to develop a very light Mini Program first. And if they can get enough users, then they will move on to developing the native app, which we believe is also a good way for us to enrich our overall ecosystem.

Operator

Thank you. The next question comes from the line of Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you. Just a few quick questions. Firstly is on payments. So, this quarter, payment achieved a triple-digit growth and also the gross margin record high at 25%. But with all the regulations actually effective April 1 and also the competition from Alipay heating up, how should we expect the revenue momentum as well as the margin trend for the August 1, i.e. the payment [ph] line (00:52:50)?

And also on the eCommerce front, currently you are having lots of new retail partners. For example, in retail wallet, you're having both [indiscernible] (00:53:03) and Vipshop. So, what's your different strategy or approach when you are dealing with the different partners in the same areas? Thank you.

<A - Chi Ping Lau>: I think in terms of payment, right, we are pretty pleased to see that there's an increased adoption of our payment solution in the offline world. And we do believe that our market share has been quite substantial and sustained. Now, in terms of the competition, yes, it's a fact – a matter of fact that the competition is actually very heavy. And there have been a lot of subsidies provided in the market by our market peers and as a result, we actually have to follow suit. So, we are already spending quite a bit of money in terms of subsidy. And a part of it affects our overall take rate and part of it is actually in the promotional expenses within our financials.

So, we do believe this level of subsidy will continue in the near-term future because it is indeed a very big opportunity, and we expect all industry participants to be investing heavily in this market. But on the other hand, we also believe that the fact that there's a lot of subsidies and promotional expenses will help to expand the market, which benefits everybody. And at the same time, we believe that because of our unique positioning within social payment and within convenience for users and we have a pretty distinctive advantage in the market.

Now, in terms of e-commerce partners, right, we do offer entry points in our wallet to different e-commerce partners. I think each one of these e-commerce partners have got their pretty distinctive positioning of the merchandise they produce, as well as the way they market their products. And so, what we are doing really is providing the entry point and be an enabler. We will help them to make their distinctive feature more distinctive. And if there is a word of mouth effect that can be generated from their distinctive positioning and their merchandise, our social network helps to magnify that word-of-mouth effect.

Operator

Thank you. The next question comes from the line of Gregory Zhao from Barclays. Please ask a question.

<Q - Gregory Zhao>: Hi, management. Thanks for taking my question and congratulation on the strong quarter. So, my question is a follow-up question about the user time spent, so just a large picture question about the industry. So, while we see WeChat, Weixin, QQ, Honour of Kings and some other of your flagship apps are taking a lot of user time spent, so we're also seeing a variety of new functions and also competitors in the areas like long video, short video, and other entertainment sections. They're also taking some user time spent, so can you help us understand overall the industry dynamics of the user time spending shift and such as how the increasing time spent on gaming and/or short video may affect each other and as well as the long video and other entertainment functions? Thank you.

<A - Chi Ping Lau>: Well, I think, first of all, overall I feel that the amount of time that people spend online have been increasing.

Now, with respect to specific apps, I think you're probably referring to the short video and mini video if I have to take a guess. And, I would say, with respect to this type of apps, our observation is that, number one, it's mainly a content business. So it doesn't have much impact on our social user activity. And most of this content is actually in the category of PUGC, which straddles between PGC, professionally generated content, and UGC. And, as you know, we are traditionally very strong in terms of the PGC as evidenced in our leadership in news, in video, in music and in literature and sports.

And I think the PGCs actually don't get affected that much. If you look at our video platform as an example, we have mentioned that our video views actually grew by 60% year-on-year. So, it has been growing in terms of both DAU, as well as overall average time spent per user.

So, I think my guess is that short video and mini video is actually taking some time from the non-Internet time of users, one. And two, it's getting some time from the more PUGC content platforms.

<Q - Gregory Zhao>: Thank you.

Operator

Thank you.

<A - Jane Yip>: Thank you. Because of time constraint, may we accept the last three questions?

Operator

The next question comes from the line of Jin Yoon from Mizuho. Please ask the question.

<Q - Jin-Kyu Yoon>: Hi. Good evening, guys. Now that you've invested quite a bit in the video content, including short form video and revamped the news feed, how should we look at the trajectory of the kind of the news feed going forward in terms of potentially what you're looking in terms of revenues or ad loads or any color behind your outlook on news feed would be great. Thanks.

<A - Chi Ping Lau>: On news feed, it's definitely a strategic important business for us because we know that this is an efficient way of providing content to users. And, very clearly, we have a distribution strategy which is tying the news feed to our large Internet platforms, including our social platform and other content platform. And we also have a content strategy which is trying to get the best PUGC content within photo and tags, within short video and within mini video while, at the same time, leveraging our unique access to some of our exclusive content tied in with our long video as well as the PUGC content ecosystem.

I think it's actually a long-term strategy of pushing ahead. We definitely sort of feel that there's a lot of potential in this area. We continue to make investment in this area and, over time, this would help us to provide better content to our users, this will help us to also generate advertising inventories. At this point in time, the ad load in our existing news feeds is actually relatively low. It's only a fraction of our industry peers. And we'll definitely increase it over time, but I think in line with our – of our philosophy, whenever there's a product, we want to make sure that the user experience comes first, so we will be ramping up our ad loads on a measured basis. Overall, I think we look at it as a very long-term investment and we'll continue to make progress in this area.

Operator

Thank you. The next question comes from the line of Thomas Chong from Credit Suisse. Please ask your question.

<Q - Thomas Chong>: Hi. Thanks, management, for taking my questions. My first question is about the online video landscape. Given our strong revenue growth in Q1, going forward, do we see any chance for cooperation with other peers?

And my second question is about the trend for the deferred revenue, which we see the growth rate is a bit soft in Q1. Just want to see if any reason on that front?

And my third question is about the trend for the operating expenses for this year. And finally, I just want to get a sense about...

<A - James Gordon Mitchell>: I think that's probably enough questions, otherwise you won't have time for your colleagues to ask anything. In terms of the online video landscape, so as you're probably aware, we do indeed frequently share content, swap content, co-purchase content with some of the other big online video platforms. That's particularly true for content that is monetized through advertising and particularly true for expensive or high profile content such as recent movie releases.

On the other hand, we are increasingly investing in proprietary content and I mentioned some of the more successful in-house content such as Produce 101. That content, which we normally wouldn't share, can be potentially beneficial for driving subscriptions because then the users know that if they want to see that content, they should come to a given platform, and it develops loyalty and payment behavior and engagement with that platform. So, that's on the online video front. John, on the revenue.

<A - Shek Hon Lo>: Yeah. In terms of the deferred revenue, I don't think it's really soft given that every quarter we still have to amortize some of the business cooperation agreement for some of the companies just like JD or whatever. And right now, there's an increase of about 8% quarter-over-quarter. So, quite normal I would say.

<Q - Thomas Chong>: Great.

Operator

Thank you. This is the last question. Natalie from CICC, please ask your question.

<Q - Yue Wu>: Hi. Thanks for taking my question. My question is regarding the online gaming business. Just wondering how should we think of the future performance of some of the pillar games such as Honour of Kings lifespan, monetization upside versus sustainability of the robust revenue growth, et cetera? And also how should we compare the gross profit margin profile between the self-developed mobile games and licensed PC games?

Thank you.

<A - James Gordon Mitchell>: So, I apologize because we didn't hear all of the questions completely clearly, so if you need to clarify, please do. But I think one part of the question was related to the lifespan of some of our big games and the second part of the question is related to the gross profit margins of our games. Historically, as you would expect for games where we licensed the game code, the software, then gross margins would typically be substantially lower versus games where we create the software and IP in-house, and then for games where we license in the IP but create the software in-house, the gross margins would be in between the two, but typically closer to self-developed games.

For mobile games versus PC games, there's historically been less gross margin variation than there has for licensed versus self-developed games. During 2017, the gross margins on our mobile game portfolio did experience some downward pressure because we began sharing revenue with selected App Store partners in situations where the App Store belongs to the handset manufacturer. So, that had some impacts on our gross margin dynamic. But, in general, a self-developed mobile game would still be higher gross margin than a licensed PC game. So, I hope that answers the second half of your question.

And then, in terms of the first half of your question around the life cycle or life span of games, the mobile game industry is really too young for anyone to have an informed point of view at this point in time. But it is interesting to note that within mobile games, the top 10 mobile games in the Western world today include many titles such as Candy Crush and Clash of Clans that have been top 10 titles for several years now. And if we look at the PC game industry then as we noted in our prepared remarks Dungeon & Fighter is now entering its 10th year of life in China and is one of the most successful perhaps the most successful PC game in China by revenue.

League of Legends has been in the market for many years and remains highly successful. And then globally our games such as Counter-Strike have been kind of evergreen and persistently successful for over a decade. So, part of why the game industry is attractive industry is because on the one hand you have these phenomena that really energize players, bring new players into the industry, create a great deal of popular excitement like Fortnite and the tactical tournament games. But on the other hand, you have games like a Counter-Strike or a League of Legends or a Dungeon & Fighter or a Clash of Clans that build up a large and stable user base over a long period of time and appear to sustain and build that user base loyalty over a very long life cycle.

Jane Yip

Thank you. We are closing the call now. If you wish to check out our press release and other financial information, please visit the IR Section of company website. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating Tencent Holdings Limited 2018 first quarter results conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2018-03-21
Event Description: Q4 2017 Earnings Call

Market Cap: 3.26TRI
Current PX: 342.40
YTD Change($): +28.40
YTD Change(%): +9.045

Bloomberg Estimates - EPS
Current Quarter: 1.930
Current Year: 8.471
Bloomberg Estimates - Sales
Current Quarter: 84505.571
Current Year: 313880.556

Q4 2017 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Grace Chen
- Eddie Leung
- Alex Yao
- Gregory Zhao
- John Choi
- Thomas Chong
- Alicia Yap

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2017 Fourth Quarter and Annual Results Conference Call. At this time, all participants are in listen-only mode. There will be a presentation followed by the question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip, from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Good evening. Welcome to our fourth quarter and annual results 2017 conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our official website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview, Martin will discuss strategic highlights, James will speak to business overview and John will go through the financials before we take your questions.

I would now turn the call over to Pony.

Huateng Ma

Thank you, Jane. Good evening, everyone. Thank you for joining us. In 2017, we delivered a strong set of financial results. For the fourth quarter of 2017, total revenue was RMB 66.4 billion, up 51% year-on-year and 2% quarter-on-quarter. Non-GAAP operating profit was RMB 21.9 billion, up 46% year-on-year or 1% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 17.5 billion, up 42% year-on-year and 2% quarter-on-quarter.

For the full year of 2017, total revenue was RMB 237.8 billion, up 56% year-on-year. Non-GAAP operating profit was RMB 82 billion, up 41% year-on-year. Non-GAAP net profit attributable to shareholders was RMB 65.1 billion, up 43% year-on-year.

Our platforms also continued to gather steam. Combined MAU of Weixin and WeChat increased 11% year-on-year to 989 million in 2007 (sic) [2017] and exceeded 1 billion after the 2018 Chinese New Year. Total MAU for QQ was 783 million. Smart devices MAU was 683 million, up 2% year-on-year. KanDian, the news feed within QQ, achieved higher user engagement and traffic.

For our social network, Qzone, smart devices MAU was flat quarter-on-quarter at 554 million. In games, we have maintained our leadership in mobile and PC. On mobile, we had recently launched several popular new titles, including QQ Speed Mobile and two mobile games based on the popular survival shooting game, PUBG.

For our media business, we strengthened our video content and capabilities, moving us to the first place in China in terms of DAUs and subscriptions. In mobile payment, we continued to lead by MAU and achieved a rapid growth in offline commercial transactions. In mobile utilities, we maintained our leading position in China in mobile security, mobile browser and Android app store.

With that, I will pass to Martin to discuss statistic highlights.

Chi Ping Lau

Thank you, Pony, and good evening and good morning to everybody. I'll first give you an overview of our annual strategic highlights for the full year of 2017. Starting from our social vertical, we grew the user base of Weixin and WeChat to a combined MAU of approximately 1 billion. Mini Programs gained popularity following the launch of enhanced features in Mini Games. QQ deepened engagement with teenagers through personalized news feed and AI-assisted photo and video features.

Our social advertising business delivered strong year-on-year revenue growth as more advertisers came on board. In the gaming vertical, we expanded our smartphone games' franchise and gained market share in terms of DAU, user time and revenue. During that year, Honour of Kings achieved mass adoption in China and enjoyed initial success in South East Asia.

We further increased market share in RPGs and established our leadership in strategy and car-racing genres. In PC client games, our operational expertise and content updates rejuvenated key titles such as DnF despite the challenging overall market environment. We achieved late-mover success in survival shooting games through the launch of two PUBG mobile titles right before Chinese New Year and built a solid foundation for this emerging genre.

Our invested company, Epic Games, also launched Fortnite, which has achieved great results in the global market. In media and content, total monthly subscriptions grew strongly year-on-year, in particular Tencent Video became number one in China by mobile DAU and subscriptions with faster growth rate than our industry peers.

Tencent Music Entertainment Group operated China's top three music apps by DAU, including QQ Music, Kugou and WeSing. In the content feeds business, we upgraded Tencent Open Media Platform to centralize the content library and facilitated content curation for distribution through our matrix of apps, including our news app, browser and our social apps.

In our ecosystem, our mobile payment service grew rapidly, driven by commercial transactions. Offline daily commercial payment volume more than doubled year-on-year. Our cloud services continued its rapid growth, maintained sector leadership in games and video verticals and expanded their customer base in finance and government sectors. We continue to increase our investment in AI and deploy the technologies in areas, including medical imaging, diagnosis and translation tools. We embraced a decentralized smart retail approach to support offline retailers with customer traffic, customer connectivity and technology.

Next, I will give you an update on a few of our newer strategic initiatives. Starting with mobile payment, we have sustained our market leadership in an intensely competitive environment. We believe we are the largest mobile payment platform in China in terms of both monthly active users and daily active users.

Social payment is a differentiating feature of our payment platform. At the beginning of the launch, the platform would leverage the red envelope gifting to cultivate user habits and convert them to utilize our platform for additional services. Red envelope penetration is approaching maturity, but are seeing strong growth in users using our platform for peer-to-peer money transfer, that has become the main driving force behind the growth of our social payment.

On the other hand, commercial payment has been increasing rapidly. We further increased penetration and coverage to more than 30 industries, such as restaurants, transportation, convenience store, gas station and hospitals. By the fourth quarter of 2017, our daily offline commercial volume more than doubled compared to the previous year.

We are, at the same time, boosting merchant adoption through self-service platforms, through our relationships with traditional merchant acquirers as well as key channel partners such as Meituan-Dianping. We're empowering small merchants and store managers with technologies such as business analytic tools to enhance their operational efficiency.

We're increasingly providing financial services to our payment user base. Our wealth management platform, LiCaiTong, grew total AUM to over RMB 300 billion as of January 2018. We also helped WeBank distribute its micro-loan product, Weilidai, over our social platform. As at the end of 2017, Weilidai was managing an outstanding loan balance of over RMB 100 billion.

Next, I'll talk about Mini Programs, which has significantly increased users, user engagement and use cases during the past several months. Mini Program daily active users have reached over 170 million. And as of January, we had more than 580,000 Mini Programs running on our platform. Along with expanding user base, user engagement also increased.

The new feature on top of the chat screen, displaying recently used Mini Programs, has facilitated user revisits and grew traffic to the Mini Program ecosystem significantly. Mini Games, which attract a lot of daily active users, has also helped developing user habit to use Mini Programs on a frequent basis. Mini Programs QR codes, which are increasingly placed in offline locations, also helped drive popularity of the ecosystem.

Overall, the top five use cases in Mini Programs are retail, eCommerce, local life services, municipal services and Mini Games. There're increasingly more developers who are proficient in creating Mini Programs and more universities and teaching institutes are offering coding classes for Mini Programs.

We view Mini Programs as a simple and innovative way to connect service providers with consumers. It's a light feature embedded in Weixin to facilitate discovery, sampling and the download of native apps. Mini Programs are good complement to native apps, particularly in three ways. Number one, the light feature suit industries that require online and offline integration; number two, complex and heavy apps can provide users with convenient access to selected popular functions; and number three, low-frequency services that need to increase exposure can leverage Mini Programs platform.

In the next two slides, I will discuss our smart retail strategy, which has attracted quite a bit of attention. Smart retail is driven, in our view, by three major trends: number one, increasing integration of online and offline user behavior due to the proliferation of smartphones; number two, widespread use of mobile payment by consumers in offline premises;

and number three, the emergence of AI and big data technologies.

By contributing our social traffic user ID and advanced technologies, we empower retailers in a decentralized way. What it means is that we help them to strengthen their capabilities, enabling to serve their customers better in channels that they own and control. Our smart retail solution will create value for consumers, retailers and ourselves as a whole.

To consumers, they can enjoy a seamless shopping experience, spending across online and offline premises, as well as a widening range of personalized services via retailers' Official Accounts and Mini Programs. To retailers, they can strengthen their brands online and offline as well as improve their customer lifecycle management and personalization.

To Tencent, our payment, advertising and cloud services can all benefit from our increased presence in the retail vertical. In addition, adding offline data, particularly transaction data to our online data bank enables us to be better in targeting our users as well as in providing product recommendation.

Our smart retail solution will empower retailers in three major ways. First, help them to acquire users and retain customers better. Our social platform will enable retailers to bring some of our large user base to their offline stores via a number of different tools, including LBS ads, nearby Mini Programs, Official Accounts and tailored gift cards. We can help retailers strengthen their engagement with customers and extend their connection from offline to online via the Mini Program QR code or e-coupons. They can continue to engage with customers even after they have left the store, enhancing revisits and repeated purchase. Our advanced technologies enable retailers to develop personalized recommendation and marketing to target consumers and increase conversion.

Second, it enhances customer shopping experience. Our indoor maps navigation system enables shoppers to easily locate stores. Our QR code allows them to quickly access product information and Weixin Pay facilitates fast checkout. Our ecosystem partners, like JD and like Meituan, can support retailers to deliver products to customers more efficiently offline and our WeChat work enables more effective after-sale services.

Thirdly, it increases operational efficiency for the retailers. Our AI-based cloud service help to upgrade retailers' IT infrastructure. Our big data analytic tools can help retailers optimize their marketing plans and supply chain and will also enhances retailer CRM system by leveraging our social network, unified ID system, Official Account, Mini Programs and eLoyalty Cards.

Finally, looking into 2018, I would say 2017 was a stellar year for Tencent and I would say many of the achievements achieved in the 2017 are results from investments that we have been making years ago. This demonstrates the importance of forward-looking investment for Tencent. So, therefore, for the year of 2018, we're planning to step up further our investment in a number of key areas.

For video, we are stepping up our investment in long-form and short-form content to sustain and expand our industry leadership. For payment, we're providing subsidies to merchants and sustain market growth as well as to users to increase mindshare. For cloud services, we're investing in infrastructure and also in people to enable us to better serve vertical industries. For AI, we're strengthening our talent pool in fundamental research as well as applications. For smart retail, we're building up teams to drive cooperation with key retail industry partners and in some cases, investing in certain partners to facilitate their digital transformation.

We believe these investments will probably negatively impact our near-term profitability, but would generate long-term value and new growth opportunities for the future.

And with that, I will pass to James to talk about business review.

James Gordon Mitchell

Thank you, Martin. Good morning or afternoon or evening as the case may be. In the fourth quarter of 2017, our revenue grew 51% year-on-year. VAS represents 60% of our revenue within which online games contributed 37% and social networks 23%. Online advertising was 19% of our revenue and the others segments accounted for 21% of our revenue within which payment related services delivered triple-digit year-on-year revenue growth.

For Value Added Services, segment revenue was RMB 39.9 billion in the fourth quarter, up 37% year-on-year, though down 5% quarter-on-quarter. Social networks revenue was RMB 15.6 billion, up 45% year-on-year and up 2% quarter-on-quarter with the growth mainly driven by video subscription and live broadcast services. Our total VAS subscriptions increased by 22% year-on-year to 135 million subscriptions and benefiting particularly from the video product.

Our online games revenue was RMB 24.3 billion, up 32% year-on-year and down 9% quarter-on-quarter. On a year-on-year basis, revenue growth was mainly driven by mobile games. Sequentially, our PC game revenue declined due to negative seasonality and the longer-term trend of users migrating to mobile. Our mobile game revenue also declined sequentially due to lower monetization from role playing and shooting games and from the timing of new game launches.

For Weixin, we enhanced the ePass function that enables users to store their verified electronic identities such as Social Security cards, student campus cards and driver's license for the convenient handling of administration on their smartphones. For example, a user who has bound his Social Security Number to his ePass, can then use his smartphone to book an appointment with the local hospital, and pay the medical fee online. Our upgraded book-keeper service, which facilitates tracking and analysis of in-store sales has become one of our most used Mini Programs, especially for small businesses.

For QQ, we deployed machine learning to upgrade the tools allowing our users to create amusing photo, audio and video-based messages. These features are particularly popular among teenagers, contributing to increased MAU.

Our news feed service, KanDian, continues to enhance its recommendation algorithm, boosting user time spent and video views.

Looking at PC client games, for the fourth quarter, revenue grew 13% year-on-year, but dropped 13% quarter-on-quarter to RMB 12.8 billion. Active users of PC client games declined quarter-on-quarter due to increasing time spent on mobile games. Revenue dipped due to fewer users, but also to negative seasonality. We operated fewer marketing activities during the fourth and the third quarter. Looking forward, our revenue from PC games is likely to be under continued pressure due to the PC to mobile shift.

Within this challenging environment, we seek to further strengthen our market position, first, by better serving core PC gamers with enhanced live operations and content updates; second, by popularizing games streaming and eSports streaming. For example, Riot hosted this year's League of Legends for a Championship Series in Beijing and we saw 43% year-on-year audience growth for the event; thirdly, by identifying and partnering with breakout games that can reenergize the overall PC game market, as PUBG and Fortnite had recently done; and finally, by discovering innovative types of games open up new PC game niches, especially those niches not any more suited to a PC than a smartphone environment.

For smartphone games, our fourth quarter revenue was RMB 16.9 billion, up 59% year-on-year, but down 7% quarter-on-quarter. The sequential decline reflected several factors, including, first, for our shooting game, CrossFire Mobile, [indiscernible] (20:15) survival shooting mode, which drove a sharp increase in the game's player base, but adversely affected its revenue as many of the existing players moved into the new mode which we're not yet monetizing; second, for our role playing games, revenue from several substantial titles, including Legacy TLBB and Dragon Nest declined, reflecting the maturation cycles; and third, for the portfolio as a whole, we launched some of the bigger new games relatively late in the quarter.

The performance of some of these new games [ph] is quite instructive though (20:47). QQ Speed is an internally developed PC game that leads the racing car genre in China. One of our internal studios created a smartphone interpretation of that IP called QQ Speed Mobile, which we published at the end of last year. That game has attained over 20 million daily active users with robust monetization, ranking among the top few grossing games in the iOS App Store since launch and is successfully expanding the racing car genre from PC to mobile.

Moving on to PlayerUnknown Battlegrounds (sic) [PlayerUnknown's Battlegrounds] or PUBG, it's globally popular survival shooting game on PC, we secured a license from Bluehole to develop and to operate the PC game in China, but also to develop mobile games based on the PUBG IP. Two of our internal studios created a couple of smartphone PUBG games, which we released just last month.

Both games have achieved rapid user adoption and robust user retention with our PUBG: Exciting Battleground becoming the clear leader in the genre with over twice as many daily active users as any competing game in China.

For now, we're purely focused on expanding these two games' user base and have not yet commenced monetizing. We believe the success of these games speaks to our teams' capabilities in identifying emerging user needs, nurturing our own or our partners' key intellectual properties, developing best-in-category mobile games based on those properties and then publishing those mobile games to large engaged audiences.

So, online advertising, our fourth quarter revenue was RMB 12.4 billion, which was up 49% year-on-year and up 12% quarter-on-quarter. Mobile contributed about 90% of our advertising revenue. Our media advertising revenue was RMB 4.1 billion, up 22% year-on-year and flat quarter-on-quarter. Our video advertising revenue grew at healthy rates year-on-year and quarter-on-quarter and successful content increased user traffic and advertisers invested to reach the growing audiences. But our news advertising revenue declined year-on-year and quarter-on-quarter as we revamped our news feed ad system and focused on optimizing the content we displayed on news feed products.

Our social and others advertising revenue was RMB 8.3 billion, up 68% year-on-year and up 19% quarter-on-quarter. Year-on-year revenue growth benefited on the demand side from a larger advertiser base and from us providing advertisers with enhanced targeting. And on the supply side, from increased ad impression volume, especially from Weixin Moments, Weixin Official Accounts and our mobile ad network. Sequential revenue growth benefited from eCommerce positive seasonality as well as some of the factors I mentioned earlier. We continue exploring new ad formats such as cost-per-click ads inside Weixin Official Accounts, which link users directly to reach the Mini Programs.

We are particularly pleased with the operating progress in our video business where we believe we have achieved China market leadership based on several metrics, including mobile DAUs, the number of subscriptions and the advertising subscription revenue. For the fourth quarter of 2017, Tencent Video's average mobile DAU grew 44% year-on-year to 137 million users. Benefiting from DAU growth, our video ad revenue increased 68% year-on-year to RMB 2.7 billion.

At the end of 2017, the number of Tencent Video subscriptions had increased 121% year-on-year to 56 million and in February, grew further to approximately 63 million. Our video subscription revenue grew 149% year-on-year to RMB 2.2 billion in the fourth quarter. We believe our video market share gains stem from several factors, including the following.

First, our original and licensed content; during 2017, we sharply increased investments in original content, at times utilizing IP generated by our video content generation businesses such as China Literature and Tencent Games. We also continued to identify and purchase the rights to category-leading drama series, variety shows, animations, movies, documentaries and so forth.

Secondly, our platform capabilities; our large, highly engaged user base generate substantial demand for video consumption and video sharing. We have got a sophisticated content scheduling system that go with our personalized recommendations enable us thus to alert users to a fast flowing stream of new content relative to their personal needs, which enhances user retention for our video service in general and our subscription service in particular. To deepen user engagement and time spent on our platform, we nurture fan-celebrity interactions in Doki, a new social community within our Tencent Video app.

Third, our partnerships with adjacent businesses; upstream, we've made dozens of equity investments and established a new entrant content studios, which provides us with reliable content output and to some extent hedges us [indiscernible] (25:21) content cost inflation. Downstream, we've partnered with a number of major TV set manufacturers. We pre-installed our TV launches on their sets, accelerating the growth of our over-the-top video streaming to TV set service, but we believe we're also the China market leader.

I'll now pass on to John to go through the financials.

Shek Hon Lo

Hello, everyone. For the fourth quarter of 2017, total revenue was RMB 66.4 billion, up 51% year-on-year or 2% quarter-on-quarter. Gross profit was RMB 31.5 billion, up 33% year-on-year and down 1% quarter-on-quarter.

Net other gains were RMB 7.9 billion for the fourth quarter of 2017. It primarily reflected net deemed disposal gain relating to the IPOs of Yixin, Sea and Sogou, subsidies and tax rebates as well as dividend income for certain investee companies.

Share of losses of associates and joint venture was RMB 120 million in the quarter compared to share of profits of RMB 818 million for the third quarter. On a non-GAAP basis, share of profits of associates and joint venture was RMB 495 million in the quarter versus RMB 802 million for the third quarter.

Income tax expense was approximately RMB 3.1 billion, up 30% year-on-year or down 37% quarter-on-quarter. The year-on-year increase was mainly due to greater profit before tax. The quarter-on-quarter decrease was mainly due to reversal of income tax expense for certain subsidiaries in China which were qualified for high tech enterprise in quarter four to enjoy lower corporate income tax.

Effective tax rate for the quarter was 12.6%. Net profit attributable to shareholders was RMB 20.8 billion, up 98% year-on-year or 16% quarter-on-quarter.

For the full year of 2017, total revenue was RMB 237.8 billion, up 56% versus last year. Gross profit was RMB 116.9 billion, up 38%. Operating profit was RMB 90.3 billion, up 61% versus 2016. Net profit attributable to shareholders was RMB 71.5 billion, up 74% year-on-year. The effective tax rate for the year was 17.8%.

I will walk you through our non-GAAP financials. For the fourth quarter and after adjustments to non-GAAP, operating profit for the quarter was RMB 21.9 billion, up 46% year-on-year or 1% quarter-on-quarter. Operating margin was 32.9%, down 1.2 percentage points year-on-year and broadly stable quarter-on-quarter.

Net profit to shareholders was RMB 17.5 billion, up 42% year-on-year or 2% quarter-on-quarter. Net margin was 27.7%, broadly stable year-on-year and up 1.4 percentage points quarter-on-quarter.

Let's turn to segment gross margin. Gross margin for Value Added Services was 59.3%, down 3.9 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year decrease was mainly due to higher channel cost of smartphone games paid to third-party app stores, including handset manufacturers and revenue mix change to lower-margin products such as digital content services.

Gross margin for online advertising was 37.2%, down 9.4 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year change was mainly due to increased video content cost and higher traffic acquisition costs due to a rapid growth of our advertising network business.

Gross margin for others was 22.8%, up 2.4 percentage points year-on-year and 2.5 percentage points sequentially. The year-on-year and quarter-on-quarter improvement were mainly due to gross margin improvement of payment related services as a result of larger base.

For the full year 2017, gross margin for VAS decreased 5 percentage points to 60.1%. Gross margin for online advertising decreased 6.2 percentage points to 36.7% and gross margin for others increased 5.9 percentage points to 21.9%.

Moving on to operating expenses, selling and marketing expenses were RMB 6 billion, up 35% year-on-year or 25% quarter-on-quarter. The year-on-year increase mainly reflected greater marketing spending on products and platforms such as online games, online media and payment related services. The sequential increase was primarily driven by greater marketing spending on products and platforms such as payment related services and online media as well as seasonal marketing and promotional activities for our online games.

As a percentage of revenue, selling and marketing expenses increased to 9.1% for the fourth quarter versus 7.4% for the third quarter of 2017.

Total G&A expense were RMB 8.8 billion, up 28% year-on-year and down 3% quarter-on-quarter. Under G&A, R&D expenses were RMB 4.8 billion, up 33% year-on-year and down 1% quarter-on-quarter. The year-on-year increase mainly reflected higher staff cost. The quarter-on-quarter decrease was mainly due to true-up of our bonus forecast at year-end.

As a percentage of revenue, total G&A was 15% and R&D was 7%. At the end of the fourth quarter, we had about 45,000 employees. The year-on-year increase of 16% was mainly due to our expanded business group.

On a full-year basis, selling and marketing was RMB 17.7 billion, up 45% and represented 7% of revenue. R&D expenses were RMB 17.5 billion, up 47% and represented 7% of revenue. Total G&A, excluding R&D, was RMB 15.5 billion, up 47% and represented 7% of revenue as well.

Let's go through margin ratios for the fourth quarter. Gross margin dipped 6.5 percentage points year-on-year to 47.4% mainly due to decrease in VAS segment gross margin and increase in contribution from others segment which carried lower margin. Gross margin was down 1.2 percentage points sequentially.

Non-GAAP operating margin was 32.9%, down 1.2 percentage points year-on-year, primarily reflecting lower gross margin, partially offset by higher ad gains and lower selling and marketing and G&A expense as a percentage of revenue. Quarter-on-quarter, change was flat.

Non-GAAP net margin was 27.7%, down 0.6 percentage point year-on-year, up 1.4 percentage points quarter-on-quarter, mainly due to lower income tax expense.

On a full-year basis, gross margin was 49.2%, down 6.4 percentage points; non-GAAP operating margin was 34.5%; non-GAAP net margin was 27.9%.

Turning to earnings per share and proposed dividend for 2017, for the full year, GAAP basic EPS was RMB 7.598 and diluted was RMB 7.499. Non-GAAP basic EPS was RMB 6.92 and diluted was RMB 6.83. Subject to the approval of shareholders at the AGM to be held on 16th of May 2018, we are proposing an annual dividend of HKD 0.88, representing an increase of 44% from last year.

Let's share some of the key financial metrics with you before rounding up this presentation. For the fourth quarter, the CapEx was RMB 5 billion, up 75% year-on-year and 42% quarter-on-quarter. Operating CapEx was RMB 3.8 billion, increased by 69% quarter-on-quarter mainly due to increased number of servers for cloud and Weixin businesses. Non-operating CapEx was RMB 1.1 billion. For the full year of 2017, total CapEx increased 12% year-on-year to RMB 13.6 billion.

Free cash flow reached RMB 24.2 billion, up 41% year-on-year or down 12% quarter-on-quarter. The quarter-on-quarter decrease was mainly due to lower operating cash flow and higher operating CapEx. On a full-year basis, free cash flow was RMB 93.4 billion, up 70% year-on-year.

At year-end, our net cash position was RMB 16.3 billion, down 10% year-on-year or 13% quarter-on-quarter. The sequential decline primarily reflects the payment for M&A initiatives, partly offset by free cash flow generation. The fair market value of our listed associates and available-for-sale financial assets, of course, excluding subsidiaries, were approximately RMB 210.8 billion or about $32 billion as at year-end.

Thank you. We shall open the floor for questions.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] First question comes from the line of Grace Chen from Morgan Stanley. Please ask the question.

<Q - Grace Chen>: Hi, thank you. Thank you for taking my question. I have two questions. My first question is about your accelerated investments in eCommerce and various offline retailers. Can you share with us your insight about how your recent offline investments ranging from Yonghui, Carrefour, Wanda and Heilan Home, how these investments would help realize your smart retail strategy and we can expect there will be more investments in offline retailers to come? So, can you help us understand what will be your key considerations for more offline investments in the future? So that's my first question.

And my second question is on the other business segments, payments and cloud have been growing very fast. So, this segment made up 21% of total revenue already in the fourth quarter and we also noticed that gross margin for this segment in a quarter also improved to 23%, so – which I think should be the highest ever. Can you help us understand the drivers for the margin improvements in the quarter and also share with us the monetization progress of the payment business specifically, given the rising contribution from this segment, which should have a bigger impact on the blended margin going forward? Thank you.

<A - Chi Ping Lau>: Okay. Thank you. In terms of smart retail, I would say as we had pointed out in our prepared remarks, smart retail is an important strategic initiative for the company to enable retailers and also allow Tencent to get a stronger presence within the retail vertical. And we believe that this is going to benefit our payment, it's going to benefit our advertising as well as cloud services. And at the same time, it will allow us to help retailers to leverage as well as to benefit from the increasing online and offline integrated user behavior of the users, given that smartphones are being used in a very ubiquitous way by the users.

Now, with respect to the investment itself, right, what we try to do there is really – it's an add-on to our smart retail strategy. If you look at our smart retail strategy, we have solutions that we're developing to enable different types of retailers, merchants. And when we started working with them, right, some of the retailers and some of the players would tell us that, look, we may have a specific project that we want to explore with you, it's very strategic in nature. They would like us to help them on the digital transformation, but sometimes the value of the project is very hard for us to figure out exactly how to divide up the value that's created.

So, in those situations, right, and usually it's a pioneering type of cooperation, we'll say, okay, maybe one way to overcome this uncertainty in terms of how do we add value to each other is that we take a stake in you, right, so that we show our commitment and at the same time, we would benefit if you benefit. So, that's more of a special case in smart retail rather than a general practice. In a lot of times, when we look at retailers, we may be able to benefit from their digital transformation and we want to invest and they say, oh, no, we don't need the capital. So, there are a lot of cases like that in which we basically work with them on a commercial basis.

So, I would say retail is an important sector that we believe, given our traffic, given our technologies, we can actually help them to create more value and we can create more value through commercial cooperation. We can also create value through sometimes investing if they find a situation that if they need capital and want us to invest.

<A - James Gordon Mitchell>: In terms of your second question about our other revenue line, so the primary driver of the revenue line and of the – revenue growth in that revenue line and of the gross margin for that revenue line is our payments and financial services business.

And you asked about the monetization, so there's a few drivers. One is the consumer withdrawal fees that are tied to usage of Tenpay, particularly for money transfers. Second one is the merchant fees that is tied to usage of Tenpay for commercial transactions. Third one is interest income on the float, which is subject to regulatory changes and the fourth one is building up adjacent financial services such as the Weilidai micro-loan.

And the improvement in gross margin you have seen reflects a few factors. One is overall scale benefits and second one is a gradual revenue mix shift towards and potentially higher margin products and then the third one is us putting levers on individual products. So, I think during the quarter, we mentioned we adjusted some of the levers around using Tenpay to settle credit card outstanding liabilities.

Now, on the flip side, we think this is a very early stage growth market and we see ability for us to sustain and extend the market share gains we've recently been enjoying. So, we intend to invest – reinvest very aggressively in our payment business during 2018 to further drive adoption and that may have a negative impact in margins. I think that both we as market participants and U.S. market observers focused a great deal on the short-term dynamics of subsidies and competition and margins and so forth.

But sometimes, it's important to step back and look at the bigger picture, which is that China is arguably the most successful mobile payment market in the world. And part of the reason for that success is because there are two big strong companies competing to really drive mobile payments adoption. And so, while the competition has caused our margins to be volatile in the past and will cause our margins to be volatile in the future, we think that we, together with our competitors and our customers and our merchants, are creating a really big interesting market opportunity over time here that is an example to the world.

<A - Jane Yip>: The next question, please.

Operator

Next question comes from the line of Eddie Leung from Merrill Lynch. Please ask the question.

<Q - Eddie Leung>: Hi, good evening. Thank you for taking my questions. I have a question on more of the contents line. Could you share your thought, first, on the industry development of short form video and self-media? We have seen Tencent being very strong in professional content. So, just wondering how you think about the potential cannibalization on user time between professional content versus this type of more user generated content and what's our strategy going forward? Thank you.

<A - Chi Ping Lau>: Yeah. That's a good question, Eddie. And I think, number one, there's definitely a very strong growth in terms of short video content and I would say it's content – around content feed. So, basically, when you have a feed, you can actually put self-media content, news, magazine type of content, interest type of content as well as short video. But what we have seen is that the growth of this market is more of an incremental to the growth of the professional content. So, as an example is that while all the growth happens within the content feed industry, right, our Tencent Video business continues to break new records in terms of DAUs and user time and subscriptions. So, I would say it's a new opportunity.

And in terms of this new opportunity, if you look back, right, self-media was really almost created by WeChat when Weixin came up with the Official Account and that allows a lot of different types of content owners to have a channel, so that they can sign up subscribers and start pushing their content to the subscribers.

Now, some of our industry peers actually took advantage of that and created content feed and that's arguably a more efficient way for users to read and explore a new content. So, as a result, that market start to bloom and at the same time, when content feeds become more and more popular, then short video becomes a very important content type for the content feed business.

Now, for us, I think in response to this very, very big incremental market opportunity where we have been doing a number of different things, number one, we have actually launched a number of different products with content feed front-end and that would include our Kuaibao, that would include our news and video and that's in our traditional media business, but we have also put it into our social platform. So, if you look at KanDian, if you look at [ph] Kenaikan (46:01), which is on WeChat, KanDian, which is on QQ and also our browser has got these content feeds front-end and we have seen very strong growth in a lot of these front-end content feed business, in particular for KanDian, which has a very strong growth in the past year.

And in addition to the front-end where we are actually working on the backend content side and, of course, we have Official Account, which is already a very strong content ecosystem, but at the same time, we are also launching our Tencent Open Platform – media open platform, which tries to integrate the acquisition acquiring of all the different types of content, including self-media, including news, interest-based content and short video and use that as a way, so that we can distribute across all our front-end content feed business and that has seen a very strong progress.

And so, I think it is – and at the same time, we are also developing our targeting technology, so that we can support our front-end content feed with more personalized content. So, across the board, I think it is a great opportunity for us. We have a lot of user touch points and we believe that if we can really get the content integrated and developed, distributed and with an ad technology well distributed, then we can actually grab a very significant part of the new market and at the same time, right, these content feeds is actually great venues for putting performance-based ad as well. So, over the longer term, that would become a revenue opportunity for us as well.

Now, in the meantime, we felt it's such a great opportunity that we need to invest more into the content acquisition. So, that's why we pointed out in our prepared remarks that this year we're going to step up in a pretty aggressive way in acquiring video content be it long form or short form.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Next question comes from the line of Alex Yao from JPMorgan. Please ask the question.

<Q - Alex Yao>: Hi. Good evening, everyone. Thank you for taking my question. So, you guys mentioned in the prepared remarks that 2018 will be a year of more aggressive investment. While vast majority of the investment areas were already in place way before 2017, I'm just wondering what triggers you to make the decision to more aggressive in 2018. Is there a change in the competitive landscape in those markets and the areas or is it something related to Internet macro such as the slowdown of mobile traffic?

The second question is more or less related to the first one. In the past, you guys have been quite balanced operationally and financially speaking. As you turn more aggressive in investment in 2018, what will you increase monetization to potentially elevate the financial impact from these investments? Thank you. I'll stop here.

<A - Chi Ping Lau>: Yeah. I think in terms of the aggressive investment, I think there are a number of factors, which is driving this decision. Number one, of course, is the amount of opportunity that we see. We built a company that – on the principle that we want to go for long-term large opportunities and that's what we focus on.

So, as we continue to explore and develop our different verticals where you found that the amount of long-term opportunity that's available is actually increasingly bigger and we believe that it's actually very important at this stage for us to make the necessary investments, so that we can actually achieve a better market position and grab up – and accelerate the development of our business.

And secondly, I would say, is clearly in a lot of the areas, we actually do well, so that it's actually worth for us to double-down in terms of our investment, so that we can accelerate the growth. For example, in video, right, last year was a banner year for us in which we have worked on the multi-year journey, so that we became the absolute leader in the market by the end of year, last year, and we enjoyed a much faster growth in terms of our DAU, in terms of subscriptions and that's why we felt that if we increase our investment in 2008 and in 2009 (sic) [2018 and in 2019], we're going to reap much bigger benefits for the future.

And finally, I would say, obviously, we have a very strong profit growth, so we can really afford to make such investments and we felt that every dollar invested today is going to generate much more for the future.

In terms of monetization, I would say we don't monetize for the sake of monetization, right. We have always been pretty measured in terms of our monetization. We focus much more on how much is monetized above than how much is monetized. So, if you look at – an example is our advertising, right. I think our performance ads business on the social front has got a lot of potential for inventory growth, but I think we have been pretty measured and disciplined in terms of adding inventories, so that we maintain a great user experience and at the same time, we only monetize more with our – at the growth of our technical capabilities.

And another example is in our content feeds business, our ad load is actually much lower than our industry peers, which we felt there is room for us to grow, but then at the same time, we'll be doing it in a measured and disciplined way. The other example is in this survival shooting game genre in which I would say if you look at the amount of success that we have achieved with the two PUBG mobile games, we have a very large DAU which is not monetized yet and we felt pretty good about this, right.

In the future, when you have such an engaged user base, we believe there is a lot of potential for us to monetize, but in the meantime, it's actually much more important for us to keep on improving the user experience, the game content – adding game content, so that we can really solidify our position.

<A - Jane Yip>: The next question, please.

Operator

Next question comes from the line of Gregory Zhao from Barclays. Please ask the question.

<Q - Gregory Zhao>: Hi, management. Thanks for taking my question. My first question is about your social eCommerce. In the past year, we saw very strong growth momentum of the social eCommerce and in terms of both generic growth and social influence, could you help us understand how WeChat can benefit from this trend and what's the potential monetization opportunity to WeChat?

And my second question is a follow-up question to payment. So, in the past Q4 and the Chinese New Year gala, we saw that Alipay increased its investment in marketing and user acquisition. So, what will be your strategy and response to the competition and will follow that strategy and how should we think about implication to your margin going forward? Thank you.

<A - Chi Ping Lau>: Yeah, I think around social commerce, right, we found this is an important way through which people shop for products, right. So, you can do it offline, you can do it online in centralized eCommerce sites, but at the same time, you can also engage in social commerce and it allows smaller merchants to be able to find their users through social channel, but there is also a lot of interaction between social commerce and a shopfront, right.

So, if you look at [ph] Jingdong, I take as (55:23) for example, it has both a centralized storefront and social commerce. If you look at JD, I think, it has a very strong centralized shopfront and it's also getting better in terms of leveraging social traffic to increase their engagement of users.

So, we felt social commerce, if done well, is actually a net addition to the user experience for our users, but it's actually very important to make sure that the quality of the products are actually well maintained. So, in the past, we have seen there – a lot of companies which tried to leverage social eCommerce in the wrong way, in terms of over spanning the users, in terms of providing bad products and those are the kind of things that we want to weed out.

So, I would say we have a lot more work to do in order to cultivate the good kind of social commerce, but at the same time, we need to protect our users against abusing social commerce in a bad way.

Now, in terms of Alipay, right, I would say, yes, we have seen a significant increase in terms of our peers' subsidy level. And starting from the beginning of this year, we have also rolled out a pretty aggressive program of providing subsidies to merchants and users and has received a great result. So, I would say going back to what James said, right, in a market where the opportunities is much bigger than what we see today in which there is a lot of growth opportunity, then it makes a lot of sense for any player, right, to invest more, so that we can expand the market further, even if we cannot grab share from each other, right. So, that's why we have said we would be investing more in this year in the payment platform, so that we can capitalize a faster growth in the overall market and hopefully, we can also grab more share.

<Q - Gregory Zhao>: Thank you very much.

<A - Jane Yip>: Operator, we will take the last three questions.

Operator

Your next question comes from the line of John Choi from Daiwa. Please ask the question.

<Q - John Choi>: Good evening, guys, and thanks for taking my question. I have two questions here. First of all, I noticed that Tencent completed the revamp of the news feed ad system and also are launching a unified advertising platform to integrate all their inventories across the news feed products. So, I mean should we expect a notable increase in terms of the revenue from the media advertising in the coming quarters, since this has been behind us?

And second is on the Mini Programs. I was wondering that it's been a little bit more than a year since the Mini Programs has been launched. We now have 170 million DAU. What have you guys seen in terms of the user behavior change within the retail for these users and how do you think you could further monetize or seize the opportunity in the Mini Programs in the coming years? Thank you.

<A - Chi Ping Lau>: Go ahead, answer the ad question.

<A - James Gordon Mitchell>: Yeah. So, I think on the news feed side, we have a number of tasks ahead of us. It's obviously a relatively competitive market with Jinri Toutiao as a dynamic first mover that keeps pushing in new directions, including short video. And on our side, there's a number of products that incorporate news feeds.

And in the near term, our primary focus is really on the content we show to those users in the news feed. It's on securing more better content, it's on surfacing the right content, so the right user is in a more targeted fashion. We have been in the process of centralizing and upgrading our advertising capabilities, but I think you'll see those advertising capabilities put to work in a measured step-by-step function. You'll probably see it first in our KanDian news feed, which fits within QQ that's already very popular and relatively well-established and a relatively stable platform. Then you may see it extend to some of our other news feed distribution channels such as the Kuaibao app or the news feed product within our mobile browser.

And over the medium to longer term, we're also ramping up new news feed products such as the [ph] Kenaikan (01:00:11) product within Weixin, but generally speaking, we're more focused on the product today than we are on the monetization.

<A - Chi Ping Lau>: Yeah. In terms of Mini Programs, right, we are very encouraged by the recent development of Mini Programs. As you know, we launched the Mini Program more than a year ago. In the very beginning, there was a lot of fanfare, a lot of expectation, but then, it was actually off to a slower start. I think the main reason at that time was really we need the time for education as well as also for us to build up the necessary infrastructure supporting Mini Programs.

After a whole year of development, we actually have seen the first breakout growth in Mini Programs and that's mainly capitalized by, I would say, three things. One is the accumulation of Mini Programs and the increasing adoption of that in the offline world. That's the slow build-up. But then, toward the beginning of this year, we have launched Mini Games, which is, I would say, an easy way for people to get to know what Mini Programs is, right. Not everybody would have run into a Mini Program QR code offline, but everybody can sample a Mini Game and that's a great way to educate the users about the ecosystem.

And we also provide this in the chat screen, we have this put on menu for most recently used Mini Programs, which allowed people to access Mini Programs that they have used in a very convenient way.

And the two new measures, really I would say catalyzed the latent and build-up growth of Mini Programs that are already in place and the three factors added together has brought Mini Programs to a new height. And I think, going forward, we continue to view Mini Programs as a way for service providers to engage with users in a very light and convenient way. And particularly it would help offline, online integration, it would help apps which are complicated, right, to serve their users in a very simple and fast and convenient way. And it would also help offline – some long-tail services, which used to be very hard for them to convince users to download their apps, right, now they can actually provide their services directly to the users and get a chance to have their app downloaded if users like their app. So, we'd say it would be a platform for all kinds of innovation to happen and it would also become a service ecosystem for WeChat.

<A - Jane Yip>: And the next question, please.

Operator

Next question comes from the line of Thomas Chong from Credit Suisse. Please ask the question.

<Q - Thomas Chong>: Hi. Thanks, management, for taking my questions. I have two questions about the online gaming space. First, can management comment about the mobile games and the PC games industry landscape for this year, given the emergence of our PUBG games?

And my second question is about a more housekeeping question, can management provide us with the ARPU for PC and mobile games? Thank you.

<A - Shek Hon Lo>: Okay. [ph] Thomas, I'll attempt (01:04:09) the second question. The ARPU for MMOG is RMB 400 to RMB 660; for ACG, it's RMB 120 to RMB 590; and for these platform games, it's RMB 150 to RMB 160.

<A - James Gordon Mitchell>: In terms of the outlook for PC games and mobile games, in the end, it really comes down to the quality of the games being released and the quality of the content upgrades and live operations activities for the existing games. But to get a little bit more granular than that, I think for the – the PC game industry in China is clearly undergoing a maturation consolidation phase, because incremental users are spending more time on mobile games and less time or no time on PC games. And so, that's a headwind that everyone in the PC game industry, including Tencent, faces. And at certain points in 2017, we benefited from particularly strong content upgrade on game X or from particularly popular skins on game Y, but there is some volatility to those content upgrades and skin releases.

And I think we were somewhat fortunate in 2017, which creates a tough comparison for 2018. But what's interesting is if you look at the PC game industry outside China, then it's generally still growing at a decent single-digit rate. And that growth again is driven by breakout new products and that's both very massive scale of new products such as PUBG and Fortnite, but also new products that invigorate in particular niches like the Monster Hunter game or the Dark Souls game.

So, we think that, at some point, the PC game industry in China would have consolidated down to the core PC gamers who play PC games for a reason. And at that point, the growth opportunity will then belong to those companies who are still properly servicing those players with great new games and strong existing game content upgrades. So, that's on the PC game side.

On the mobile game side, we believe that the number of mobile gamers in China is still increasing as the smartphone installed base expands and as the quality of smartphones and the quality of the games themselves improves. Now, there is some volatility as new genres were introduced to the market. If you look at PC games, when League of Legends first came to market and you can see this particularly clearly in Korea actually where the habit of playing PC games in internet café is most established. Then, the immediate impact of League of Legends was to actually depress the PC game industry in Korea, because people shifted from high ARPU existing titles such as role playing games into League of Legends, which initially didn't really have an ARPU.

So, in the same way, it's possible that the China mobile game industry since late last year when the survival shooter genre exploded onto mobile has experienced a similar negative shift where people who were previously playing higher ARPU games such as role playing games have shifted into these survival shooter games, which in some cases start off with no monetization and that is indeed the case with our survival shooter games.

If your focus is very much on quarter-to-quarter revenue trends and that's absolutely something that you should be thinking about and concerned about, if your focus is more on the long-term industry potential, then it shouldn't be a undue concern, because in our experience whenever you have games that are highly engaging, that attracted a substantial user base with great enthusiasm, then sooner or later and usually sooner, someone within the industry figures out how to monetize those games effectively and the rest of the industry follows fairly quickly.

And you can already see with the survival shooter games, we are a very substantial investor in excellent North Carolina based game studio called Epic Games. They released a survival shooter game in the middle of last year called Fortnite Battle Royale. Fortnite Battle Royale is completely free to download and play and I encourage those people who are gamers, who don't already do so, to try it. But then, in the last few months, they've been innovating around Battle Pass concept and that actually has achieved a very healthy monetization within a free-to-play framework for that particular survival shooter game.

So, again, the timing of monetization in a new genre such as survival shooting game can be uncertain, but longer term, probability of monetization is very high and if that's the case, which we think it is, then we believe that the mobile game industry has a very bright future ahead of it.

<A - Jane Yip>: Thank you. And the last question, please.

Operator

This is the last questions, Alicia Yap from Citigroup. Please ask the question.

<Q - Alicia Yap>: Hi. Thank you. Good evening, management. Thanks for taking my questions. Two follow-up questions. One is actually related to your recent RMB 1 billion investment into both Douyu and Huya. So, can management share with us the rationale for the investment and how management sees the overall landscape and the growth opportunity for the game live broadcasting industry going forward?

And would there be more synergies if Tencent ultimately seek consolidated stakes in this company, which potentially could complement the slight lower monetizations of the survival games in the future?

And then second question is on the margins. So, given management comment of stepping up the investment, any color in terms of what would be the percentage point of the margins are under pressure this year and will this mainly for 2018 or would that drag further into 2019? Thank you.

<A - Chi Ping Lau>: Well, I think in terms of the game broadcasting, right, we felt it is a great standalone business emerging as well as having great synergies with our gaming business. And we're seeing an increasing number of our gamers spending more and more time on the broadcast communities.

So, we felt there is a lot of synergies that the broadcasting sites can have with us, including it's an extension of the user – gamers' usage time. It also allows a lot of gamers who don't have the time to play the game to stay abreast of the games they like. And it also is a great way for people to engage in community activities, right. So, I think over time, games broadcast can also support an eSports industry and we'll see there is games, which is like sports, there will be sports fans who are beyond that the number of people who play the sports and they will be watching ESPN, for example, and these broadcast sites and you will be like these media and at the same time, these platforms, because they add communities and interactive, they can facilitate more communities being formed around games and I mean interests.

So, we believe these broadcasting sites can not only allow us to build more synergies with our games, it would also develop new business models both in conjunction with our games as well as on their standalone basis. So, they will be attractive standalone business on their own and at the same time, there will be synergies with our games.

I think it's at an early stage of development. The industry would benefit from having multiple entrepreneur teams who are innovating in the industry. So, we felt it's important for us to support a number of these companies and develop our own integration with them.

And in terms of the margin, I don't think we can actually provide you with that quantitative details, but I think it's fair to say in each one of the investment areas, we look at it much more on how much future value we can build and if it's going to generate very strong return for the future, we would make the investment.

Jane Yip

Thank you and we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2017 fourth quarter and annual results conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2017-11-15
Event Description: Q3 2017 Earnings Call

Market Cap: 3.83TRI
Current PX: 403.40
YTD Change($): +213.70
YTD Change(%): +112.652

Bloomberg Estimates - EPS
Current Quarter: 1.801
Current Year: 6.787
Bloomberg Estimates - Sales
Current Quarter: 68336.857
Current Year: 238111.913

Q3 2017 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Wendy Huang
- John Choi
- Gregory Zhao
- Eddie Leung
- Alex Yao
- Alicia Yap
- Natalie Wu
- Jin-Kyu Yoon
- Chi Tsang
- Thomas Chong

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by, and welcome to the Tencent Holdings Limited 2017 Third Quarter Results Announcement Conference Call. At this time, all participants are in listen-only mode. There will be a presentation followed by the question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Thank you. Good evening. Welcome to our third quarter results 2017 conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on the IR section of our website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a

short overview, Martin will discuss strategic highlights, James will speak to business overview, and John will go through the financials before we take your questions.

I would now turn the call over to Pony Ma.

Huateng Ma

Okay. Thank you, Jane. Good evening, everyone. Thank you for joining us. During the third quarter of 2017, we recorded strong user traction and revenue growth across games, digital content, online advertising and payment businesses.

Our video platform gained audience and revenue market share, becoming China's top online video platform in terms of mobile daily active users and monthly subscriptions. In November, we listed our online literature platform in Hong Kong. The successful listing reflects the value of our years of investment in the business. We believe our multi-faceted digital content businesses are synergistic with each other, and allow us to deliver unique content to our users. We will continue to invest in our platforms and technologies to strengthen our content ecosystem.

Now, let me highlight the key financial numbers for you. John will provide more details in the financial section. Our revenue was RMB 65.2 billion, up 61% year-on-year. Non-GAAP operating profit was RMB 21.6 billion, up 44% year-on-year. Non-GAAP net profit to shareholders was RMB 17.1 billion, up 45% year-on-year.

Moving to our online platforms, combined MAU of Weixin and WeChat increased 16% year-on-year to 980 million. Daily text messages increased 25% year-on-year, indicating increased engagement. Total MAU for QQ was 843 million, within which smart devices MAU was 653 million, down 3% year-on-year due to fewer causal users, while engagement with core users increased. Smart device MAU for users below 21 years old was up year-on-year. PCU, including PC and mobile, increased 9% year-on-year to 272 million. Popular features within QQ, such as KanDian news feeds, increased average user time spent within QQ.

For social network, Qzone smart device MAU was 552 million. In games, we maintained our leadership in mobile and PC as measured by users and revenues. We expanded our game genres strengthened into strategic games. And on our media business, good users and traffic at healthy rates and we sustained leadership in the news, video, music and literature categories, while developing new verticals such as live streaming and comics. In mobile utilities, we remained the China industry leader in mobile security and mobile browser and Android app store.

With that, I will pass to Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony. Good evening and good morning, everybody. In this section, I would like to give you an update on our video business, which has consistently gained audience market share over the past few quarters. As of September, we believe Tencent Video has achieved leadership in terms of average daily active mobile users. We have achieved this by leveraging our large and highly-engaged user base, which are active in consuming content and, at the same time, making progress in two important areas. Firstly, we have a comprehensive content strategy, which I'll elaborate in a minute. Secondly, our expertise in content curation, program scheduling and content recommendation allowed us to make users engaged on a continuous basis on our platform

Driven by traffic growth, our online video revenue increased more than 100% year-on-year in the third quarter of 2017, within which our video advertising revenue grew over 70% year-on-year, our video subscriber base more than doubled year-on-year to exceed 43 million, driving equally strong subscription revenue growth. As you can see recently, App Annie ranked Tencent Video number one in terms of China's iOS top grossing chart for the entertainment category.

In terms of our video content strategy, we do have a comprehensive video content strategy, which I would like to summarize in a succinct way as follows. For drama, which is the most popular and revenue-generated type of content, we invest in exclusivity that elevates our brand as well as drives subscription and ad revenue. We target the content to right users within our large user base, and have successfully expanded young female user base in recent quarters.

For variety show, we have accumulated expertise in co-producing differentiated shows tailored to young audience. For example, we co-produced a very popular singing contest called The Coming One, which is the most viewed talent show in our platform during the third quarter.

For animation, we cooperated with leading domestic studios and also commissioned top tier anime studios to create anime based on Chinese online literature IP. These anime in turn can support our game business. For example, we're creating a game based on a famous literature IP called, (sic) Fighter of the Destiny. And later we created a Tencent-commissioned anime, and over time we took that and turned it into a TV drama series.

For movie, we have a rich library comprised of domestic and Hollywood studio productions. Leveraging our locked-in user base and data analytics, we can target and alert potential viewers when a new movie become available in our platform.

For documentary, we partnered with leading studios globally and, in some cases, co-financed their productions. Recently, we released Blue Planet II, a highly acclaimed and exclusively licensed documentary from BBC. We believe we're increasingly recognized as a preferred online partner for publishing niche, but highly influential content in China.

Within our expanding content catalogue, we are optimizing the proportion of licensed and original content, especially in the past few quarters. We have invested quite heavily in original content. For example, our original content Candle in the Tomb Season I and II were ranked most-watched drama series by video views and attracted over 10 million monthly subscriptions.

To succeed in original content, we invest heavily to expand our talent pool and accumulate key IP collection. Internally, we established production teams comprising producers, screenwriters and editors, and introduced a review mechanism to better manage the selection and production of original content. Externally, we have invested in a number of leading studios which are specialized in producing different content genres.

We draw on our other businesses, especially China Literature, to source differentiated IPs and in turn, we amplify user exposure to popular video content by creating several media formats, in particular, games developed out of the same video IP.

Our investment in original content generates benefits for us in a number of ways. First, we can tailor content to cater to our online audience whose preferences often differ from traditional TV audience. Second, we have total control over the content on a long-term basis. Third, it allows us to have a share in the upstream profit pool of content production. And fourth, we can use high quality exclusive original content to educate our users to pay for monthly subscriptions.

While the online video sector as a whole is still making losses, we will continue to invest for the long run. We view online video business as a strategic priority, given it is a high engagement product; in terms of time spent, it is second only to social. Online video is an important component of our cross media IP strategy and also our investments has generated positive traction in terms of market share and revenue growth.

So, with that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Good evening and good morning. In the third quarter of 2017, our total revenue grew 61% year-on-year. VAS represented 65% of total revenue, of which online games contributed 41% and social networks 24%. Online Advertising was 17% of total revenue. And the Others segment accounted for 18% of total revenue, within which payment-related services and cloud services delivered triple-digit year-on-year revenue growth rates. The Others segment revenue in aggregate increased 143% year-on-year and increased 25% quarter-on-quarter.

For Value Added Services, segment revenue was RMB 42.1 billion in the third quarter, up 51% year-on-year and up 14% quarter-on-quarter. Social networks revenue was RMB 15.3 billion, up 56% year-on-year and up 18% quarter-on-quarter. Video streaming subscriptions, music live broadcast activities revenue and game-related item sales were the main contributors to the year-on-year and the quarter-on-quarter growth rates. Total VAS subscriptions, including our VIP products, our video products, our music products and so forth increased by 19% year-on-year to 125 million subscriptions.

Online games revenue was RMB 26.8 billion, up 48% year-on-year and up 13% quarter-on-quarter. Increased uses in monetization for our key smart phone games and new smart phone game releases, as well as expansion packs for our major PC games, drove the year-on-year and quarter-on-quarter growth.

Turning to social networks, we introduced a Smart Transport solution for Weixin users. By generating a mini program QR code in their phones to be scanned at the point of transaction, users can instantly pay for public transport fares even in areas where they don't have Internet access.

In mini programs, we continue to enrich functionalities, most recently adding new tools that empower retailers to integrate offline and online resources to grow their businesses more efficiently. According to our latest survey, the top 5 mini program categories by monthly visits include transportation, online shopping, tools, lifestyle services, and IT services.

For QQ, we're strengthening content curation, particularly for our younger user base. Daily active users and time spent in our news feeds service, KanDian, continued to increase. Recently, we introduced a pop-up feature, Topics, to help users discover trending content more easily.

Our eSports app, Penguin eSports, is also seeing rapid growth in live broadcast views and exceeded 10 million daily active users. This app leverages Tencent's leadership in games and eSports tournaments, facilitating interactions among gamers and promoting the development of eSports.

Looking at PC client games, revenue grew 27% year-on-year and grew 7% quarter-on-quarter to RMB 14.6 billion. Active users declined year-on-year for our overall PC game portfolio due to users' increasing time spent on smart phone games. However, ARPU has generally increased year-on-year and quarter-on-quarter, driven by key titles, including League of Legends, Dungeon & Fighter and CrossFire.

Touching on a few of these important titles, League of Legends for the first time held its League of Legends World Championship in China. The finale in Beijing in early November attracted over 60 million unique viewers, placing it amongst the most-watched live sports events of any kind this year in China.

FIFA Online 3 recorded solid revenue growth, as its paying ratio increased, benefiting from synchronization between in-game events and offline activities such as the China national team's World Cup qualifying games and the European leagues' season kick-offs.

Dungeon & Fighter received enthusiastic user feedback for its latest content update and gift packs, and we have commissioned a cartoon series based on Dungeon & Fighter which accumulated over 500 million video views since launch. A new game, Maple Story 2 began open-beta testing in September.

For smart phone games, revenue was RMB 18.2 billion, up 84% year-on-year and up 23% quarter-on-quarter. Active users and ARPU grew year-on-year and quarter-on-quarter, driven particularly by our mid-core games. During the period, we released six games, three developed in-house and three licensed.

Within the competitive player genre of games, Honour of Kings e-Sports continue to gain popularity, and Contra Return recorded its first full quarter of monetization. In the strategy genre, we released Kings of Chaos during the quarter, which brought us to leadership in the category. Kings of Chaos ranked number eight in iOS China's top grossing chart in September. In the role-playing game genre, we released two games based on originally PC intellectual properties, Legend of XuanYuan Mobile and (sic) Journey to the Fairyland Mobile during the quarter, and both received strong responses from gamers.

We have recently seen very strong user interest in an emerging genre of games, survival shooters. Overnight, we released a survival shooter expansion pack called Deserted Island for our CrossFire Mobile game. And later this month, we'll release a new survival shooter game, Glorious Mission. Each of these titles has already accumulated over 20 million registrations within their first week of availability.

For Online Advertising, our revenue was RMB 11 billion, up 48% year-on-year and up 9% quarter-on-quarter. Mobile contributed about 90% of our advertising revenue. Our media advertising revenue was RMB 4.1 billion, up 29% year-on-year and broadly stable quarter-on-quarter. Our video platform contributed most to this year-on-year and quarter-to-quarter revenue growth. Popular drama series such as Nothing Gold Can Stay and our self-commissioned variety shows such us talk show, drove substantial increases in video traffic and revenue.

However, our news ad revenue declined year-on-year versus the high base from the Olympics last year and was also soft quarter-on-quarter as we reduced advertising inventory in our KuaiBao news feed product, while we revamped its advertising system. We have several of the leading news feed products in China, but we're currently focused on optimizing their user experience, which should in turn increase long-term user on a revenue market share.

Our social and others advertising revenue was RMB 6.9 billion, up 63% year-on-year and up 14% quarter-on-quarter, contributed primarily by Weixin properties, our Android-based app store, YingYongBao, and our ad network. The ad fill rate in Weixin Moments increased, benefiting from stronger advertising demand from existing and new advertisers, as the number of Weixin Moments' advertisers grew over 30% quarter-on-quarter.

And with that, I'll pass on to John.

Shek Hon Lo

Hello, everyone. For the third quarter of 2017, our total revenue was RMB 65.2 billion, up 61% year-on-year or 15% quarter-on-quarter. Cost of revenues increased by 81% to RMB 33.5 billion for the third quarter of 2017 on a year-on-year basis. The increase primarily reflected greater sharing and content cost, cost of payment-related services, as well as channel costs. Gross profit was RMB 31.7 billion, up 45% year-on-year or 12% quarter-on-quarter.

Net other gains were at RMB 3.9 billion, which primary consists of deemed disposal gains arising from the capital activities of certain investee companies, including the IPO of ZhongAn Insurance, fair value gains of certain investments in verticals such as healthcare as well as subsidies and tax rebates. Share of profit of associates and joint venture was RMB 818 million for the quarter compared to share of losses of RMB 619 million for the third quarter of 2016.

Some of our investee companies registered profits, including one-off gains for the third quarter of 2017 compared to losses for the third quarter of 2016. Income tax expense was approximately RMB 5 billion, up 103% year-on-year or 26% quarter-on-quarter. The increase was mainly due to greater profit before income tax and withholding tax. The effective tax rate for the quarter was 21.7%. Net profit attributable to shareholders was RMB 18 billion, up 69% year-on-year or down 1% quarter-on-quarter.

I'll walk you through our non-GAAP financial numbers. After adjustment to non-GAAP, operating profit for the quarter was RMB 21.6 billion, up 44% year-on-year or 8% quarter-on-quarter. Operating margin was 33%, down 4 percentage points year-on-year and 2 percentage points quarter-on-quarter. Net profit to shareholders was RMB 17.1 billion, up 45% year-on-year or 4% quarter-on-quarter. Net margin was 26%, down 3 percentage points year-on-year and 3 percentage points quarter-on-quarter as well.

Let's turn to segment gross margin. Gross margin for Value Added Services was 59.9%, down 5.3 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year decrease was mainly due to higher channel cost of smart phone games paid to third-party app stores, including Tencent manufacturers and iOS and revenue mix change to lower-margin products such as digital content services.

Gross margin for Online Advertising was 36.3%, stable year-on-year and down 1.5 percentage points quarter-on-quarter. The sequential change was mainly due to reduced inventory as we revamped KuaiBao advertising system.

Gross margin for Others was 20.3%, up 2.2 percentage points year-on-year and down 2.1 percentage points sequentially. The year-on-year increase was mainly due to gross margin improvement of payment-related services as a result of larger base. The sequential decrease was because of mix shift in funding channels, as some funding channels incurred higher handling fee rates.

Moving on to operating expenses, selling and marketing expenses were RMB 4.8 billion, up 47% year-on-year or 31% quarter-on-quarter. The year-on-year increase mainly reflected greater spending on products and platforms such as online games and online media, as well as higher staff cost. The sequential increase was primarily driven by greater marketing spending on our mobile apps and seasonal promotional activities launched during summer holidays. As a percentage of revenue, selling and marketing expenses decreased to 7% for the third quarter of 2017 from 8% for the third quarter of 2016.

Total G&A expenses were RMB 9.1 billion, up 54% year-on-year or 11% quarter-on-quarter. Under G&A, R&D expenses were RMB 4.8 billion, up 53% year-on-year or 14% quarter-on-quarter. The year-on-year increase mainly reflected higher staff cost. As a percentage of revenue, total G&A was 14% and R&D was 7%. At the end of the quarter, we had about 43,500 employees. The quarter-on-quarter increase of 7% was mainly due to enrollment of over 1,500 graduates.

Looking at the margin ratios for the third quarter, gross margin was 48.6%, down 5.4 percentage points year-on-year or 1.4 percentage points quarter-on-quarter, mainly due to decrease in VAS segment gross margin and increase in contribution from low-margin Others segment. Non-GAAP operating margin was 33.1%, down 4.1 percentage points year-on-year, primarily reflecting lower gross margin. Sequential decrease of 2.3 percentage points was mainly due to lower gross margin and high selling and marketing expenses.

Non-GAAP net margin was 26.3%, down 3.2 percentage points year-on-year and 2.8 percentage points quarter-on-quarter. Year-on-year decrease was mainly due to lower operating margin, partially offset by the increase in share of profit of associates. Quarter-on-quarter decrease was mainly due to lower operating margins.

For the third quarter, total CapEx was RMB 3.5 billion, down 4% year-on-year or up 16% quarter-on-quarter. Operating CapEx was RMB 2.3 billion, up 11% year-on-year and down 2% quarter-on-quarter, and it represented 3% of the total revenue. Non-operating CapEx was RMB 1.2 billion, down 24% year-on-year and up 78% quarter-on-quarter.

Free cash flow was RMB 27.5 billion, up 94% year-on-year and 57% quarter-on-quarter. Year-on-year and quarter-on-quarter increases were mainly contributed by higher cash flow generated from online games and on advertising business.

Our net cash position at quarter-end was RMB 18.9 billion or $2.8 billion, up 125% year-on-year or down 11% quarter-on-quarter. The sequential decline was mainly due to payments for M&A initiatives and investments, as well as licensed content purchase, partly offset by free cash flow generation. Fair market value of our listed associates and available-for-sale financial assets was approximately $25.8 billion as at quarter-end, compared to $21.5 billion as at last quarter-end.

Thank you. We shall open the floor for questions.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Your first questions comes from the line of Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you for taking my question. First, congratulations on very strong game revenue growth. So, given that you have launched the survival type of game recently as well, and also those games are gaining very strong traction, can you also comment on the impacts on recent regulations on these type of new games?

And secondly, I think this year is a very fruitful year for Tencent because you started to spin off lots of your investees such as the China Literature, Sogou as well as Easou. So, can you maybe comment on your strategy on your investees in the longer term? Thank you.

<A - Chi Ping Lau>: Wendy, question, what was the game that you referred to?

<Q - Wendy Huang>: The survival type of game.

<A - Chi Ping Lau>: Okay. I think survival game is definitely a very popular category and important category and we have been tracking it from the PC side already. And we have a constant dialogue with the original IP of the survival game producer and have been trying to establish relationship.

At the same time, what we have seen is there have been mobile survival games that have been launched in China and we have our own set of games which are in the pipeline. There will be a whole series of survival games. And the most immediate ones are going to be – one, within our CrossFire Mobile, there's going to be a survival mode. And as James also mentioned in the prepared remarks, we have licensed a game called Glorious Mission which is of a survival nature. And both of these games have actually achieved more than 20 million pre-registrations, each one of them. So, that indicates there's a lot of players' enthusiasm toward this type of title.

Now, over the long run, I think what we are seeing is just the beginning of this genre. And we felt this genre in itself, it's more of a resemblance to the shooters genre. And if you look at the shooter genre, it has remained – the most dominant games have remained more or less the same for about 10 years. So, I think that points to why there's a lot of enthusiasm when you have a new interpretation of the genre that comes up.

And we felt there's a long latent demand for some kind of innovation in the genre. And what we felt is over time, obviously, we would like to work with the original IP in this genre. But at the same time, there'll be adaptations and differentiated game plays coming out of this bigger survival concept, and we're going to have a whole pipeline of games that will be targeting this broader genre.

In terms of our investment strategy, right, I would say, Tencent actually pursue an open platform collaboration strategy, right? As a result, since 2010, we have been continuously stepping up our effort in investing in different companies, which can have a synergistic operation with our own business. And at the same time, because we have our traffic, we have our whole set of infrastructure services, we also have the mindset of helping these investee companies, right?

So, over the past few years, we have seen many of these investing companies benefited from the industry growth from their own effort as well as from the collaboration with us, and some of these companies now have reached the stage that they can actually pursue an IPO. So, we are very glad to see that and we felt over time, there will be more and more of our investee companies which reach that kind of maturity that they can be IPO-ed in the market.

In addition to that, right, China Literature is a slightly different story. This is a company which is a spin-off. We do control a majority stake in the company, but at the same time, if you look at its history, right, it is a company that has been formed outside of Tencent despite of our controlling stake and we have also made acquisitions and merger along the process.

So, that's why it is a company that has a more specific situation that supports a case where IPO – a spin-off and an IPO. I would say for the majority of our businesses which have been homegrown and organic, there's actually more reason for them to stay together, so that they can reinforce each other in a synergistic way. So, I don't think spin-off is going to be – especially of our 100% owned business is going to be a norm for us going forward.

<A - Jane Yip>: Thank you. And the next question, please.

<Q - Wendy Huang>: Great. Thank you.

Operator

Your next questions comes from the line of John Choi from Daiwa. Please ask your question.

<Q - John Choi>: Good evening, and thanks for taking our question. And congratulations on a great set of results. I have two questions here. Could you, first of all, elaborate on your recently launched content platform unified into your Penguin accounts? And how this basically will kind of fold into your content creation strategy that you guys just mentioned? And should we be expecting more or less unified account in terms of ad infrastructure system going forward?

And secondly, could management also give us some more details about the recent investment into Snapchat? That will be very helpful. Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the content creation platform, I think the starting point is that we do have quite a number of news feed products within our overall group, and the first and the most foremost one is actually a Official Account system within WeChat. And in addition to that, we have a news feed product within QQ which is called KanDian which has seen significant growth.

We have news feed products in our News, which is a leading news app and as well as our newly – as well our KuaiBao product, which is based on interest-based recommendation engine. And we also have a browser which has news feed as well. So, we have multiple news feed products. And I would say, on one hand, the Official Account is actually quite a self-sufficient and unique platform in itself, a lot of content providers who want to operate their own Official Account and has their own spend system. That would continue to stay.

But at the same time, there's a whole host of information sources that we have been using for different news feed products within our group and we want to consolidate all of these into a common content platform, which is the Penguin content platform, so that we can maintain a one-stop shop user experience, as well as interface ad management system with the content providers. And I think that's essentially the idea.

Now, the ad system is a different story, right? As John has talked about, we have been also consolidating our advertising platform attached to different feeds products into a common social and performance ad platform and that has led to some destruction in terms of the ad business in some part of that news feed. But over time, we believe when we consolidate that advertising system, it will be much more efficient. It will be much more convenient for the advertisers to be using.

The second one is on Snap. I think, if you look at Snap, right, we have actually invested in Snap in the very early days of its growth, right? So, I think, there's a long history in terms of our engagement with the company. And along the years, we have always been very impressed with the progress, with the innovative nature of the company and the founders, and we have a very good relationship with them. And as a result, right, we have been a long-term shareholder.

And recently, as we can see, there's an opportunity for us to acquire shares at a pretty attractive price in our mind. And when we look at Snap's business, we continue to feel that there's a lot of engagement with the young users. There's a lot of innovativeness in the company's product and there's a lot of potential for them to build its business further. So, that's why we have taken up more share and try to establish closer relationship and over time, we're trying to see whether we can do something more strategic with them.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Your next questions comes from the line of Gregory Zhao from Barclays. Please ask your question.

<Q - Gregory Zhao>: Hi, management. Thanks for taking my question, and congratulations on a strong quarter. So, my first question is about AI. Recently, Tencent announced the AI IN ALL strategy. So, can you help us better understand how AI can help improve our existing business to specifically like gaming, advertising and the social network? And what other business you think AI can help potentially like improve the efficiency?

And my second question is about our financial services. So, we saw our financial services such as payment, wealth management and the insurance all show very strong momentum in the domestic market. So, my question is about our expansion to overseas market, do we have any plan to compete with international players such as Visa, MasterCard and PayPal to expand in like the U.S. and European markets targeting those domestic users? And if the answer is yes, what's our plan to acquire these local users? Thank you.

<A - Chi Ping Lau>: Yeah. I think for AI IN ALL, the concept is really a number of thought, right? Number one is, we believe AI can actually help our various businesses. And I think in the last quarter, we have actually sort of walked through the multiple examples in which AI can help. I think it can help, for example, our content business by providing a better recommendation to our users. It can help our advertising business because it can help on the targeting of the ads. It can help our financial business because it can help us to cater our offers to our users and, at the same time, analyze creditworthiness of our users in a better way. So, it's really sort of across the board. Many of our products and services can actually benefit from AI.

But at the same time, I think it's also a concept that we want to make our AI technology available to all of our partners and all of our industry customers through cloud services, because we see AI as an enabling service that can help multiple industries to get more efficiency, to understand their users, understand the data better. So, that's why we would like to offer AI capability through our cloud business to a lot of our own partners, customers, so that they would also enjoy the benefit of our AI investment as well as advancement.

Now, in terms of overseas business, I think for our payment business, the initial growth on the overseas front will be serving the Chinese users that are going increasingly abroad. There are many, many Chinese users who are going on travel or going on business. And we felt, by following their footstep, we can actually establish a presence in the different countries and serve them better.

In terms of globally, right, I think we much more pursue a partnership strategy. We felt each one of the market for financial businesses is actually quite heavily, locally regulated and there's a lot of expertise that local players have already built. So, it would be much rather instead of saying, oh, we're going to go out and compete with them, it's much better if we can go out and cooperate with them and form partnerships, so that we can leverage their expertise, we can bring in our own expertise, as well as our flow from China and bring to a mutually beneficial outcome.

<Q - Gregory Zhao>: Thank you. It's helpful.

<A - Jane Yip>: And the next question, please.

Operator

Your next questions comes from the line of Eddie Leung from Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Hi. Good evening. Firstly, about time spent of users, you have been sharing user trends for a long time. Could you also talk about the development of time spent of users across various applications of Tencent in the past year or two, especially given your investment in digital content?

And then secondly, just a quick follow-up question on the inactive users on QQ and Qzone. How much of the decrease was due to migration to Weixin? Thanks.

<A - Chi Ping Lau>: Well, in terms of time spent of users, right, I think the short and quick answer is, it has been growing up in a – across the board pretty much. And I think, the key factor has been, I think people are using their handsets more and especially when we look at, for example, platform-like products such as Weixin, such as QQ, such as our browser, when you have a platform-oriented business which can provide more and more content as well as different types of services to the users, right, then there's a tendency for people to spend more time.

I think, the Official Account system within Weixin is a very important example. And I think, the other thing is really about as we – as the content format turn into more video-oriented, people tend to spend more time on it. And the third is, as recommendations technology keeps on improving, right, then there's a better chance that you can actually provide a better content to the users and as a result, you can keep them longer. So, I think, it's a number of these factors. And now, of course, right, within our games there has been a very strong increase in terms of both the DAU as well as time spent on our very successful titles.

In terms of the inactive users on QQ, I would say it's a combination of certain factors, right? There are people who have been relatively inactive and then they have switched over to Weixin, a lot of them were spending time on both products, right? And certain users would gravitate toward a platform more. So, in this case, as people get a little bit older, then they may be spending more time on Weixin, whereas what we have seen is for QQ the positioning among younger users had really been strengthened over time and there's more engagement with the young users.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Your next questions comes from the line of Alex Yao from JPMorgan. Please ask your question.

<Q - Alex Yao>: Hi. Thank you, management, for thanking my question and congrats on a very solid quarter. First of all, I would like to follow up on the survival shooter game because in some of the game drivers on both PC and mobile, it could form a winner-takes-all situation for example in both PC and in mobile. Mobile, winner takes all, even the shooter game is pretty much a winner takes all. Do you think this on the mobile survival shooter game driver will also become a winner-takes-all market structure in China? And then how do you think about the current competitive landscape than some of the industry peers around your mobile shooter game in the past few days?

And second question is about Weixin Moments fill rate. Is the improvement driven by technology or is it driven by your efforts to penetrating into different demographic or geographic that doesn't have advertiser demand in the past? Thank you.

<A - James Gordon Mitchell>: So, on your first question about whether the survival shooter games would be winner take all or not, I think the short answer is it's too soon to say. I mean, even for the traditional first-person shooter games on PC, you're right that in China our CrossFire game has a very good market share, but then our [ph] Nijan (47:41) game and our Call of Duty Online game also have decent market share. And if you look outside China, then Call of Duty, Battlefield, Grand Theft Auto to some extent, Titanfall, there's a whole range of successful first-person shooter games on the PC and console outside China.

I think that if you look at the history of this survival shooter genre, then it's actually a recipe on history that we have been following through Arma, through DayZ, through a number of predecessor games. And the most recent iteration is PlayerUnknown Battleground on PC and that's very successful. But there's also a game from one of our investee companies, Epic, called Fortnite Battle Royale that's proven popular on both PC and on consoles.

So, I think with PC games, it's too soon to say. It may be that in the future, if the traditional first-person shooter games incorporate these battle arena Battle Royale activities as a mode of operation within the game, it may be that the stand-alone games are triumphant, it may be that they both prosper at the same time. That's on the PC.

With mobile, I think that the industry is at a much earlier stage of development, partly because there isn't the same history of first-person shooter games on mobile for the survival shooter games to grow out of, and partly because it's harder to get the controls right, get the ability to look around or hear things behind you on mobile than it is on PC today. So, the short answer is it's too soon to say.

The second question that you asked is with regard to the advertising?

<A - Huateng Ma>: Moments, right?

<Q - Alex Yao>: Yes.

<A - Huateng Ma>: So, on Moments ads, well, there is a combination of both, right? There is improved technology in terms of targeting. We have also increased our presence within local market, right, to allow smaller, but more local advertisers to leverage our system to reach their smaller catchment of users. And I would say it goes hand in hand, right, because of the better targeting technology, you can actually allow smaller advertisers to target a smaller group of users and still deliver a good result. So, I think it goes both hand in hand as we said.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Your next questions comes from the line of Alicia Yap from Citigroup. Please ask your question.

<Q - Alicia Yap>: Hi. Thank you. Good evening, management. Congratulations on the strong set of results, and thanks for taking my call. I have two questions. First is related, a follow-up on the smart phone games. Just curious, does some of the newly launched games such as Contra and King of Chaos have a shorter defer schedule? Just trying to reconcile the 84% growth in the smart phone games revenue this quarter. Is that due to a lot of the defer got released from the past quarter together with some of the shorter defer cycle for this newly launched game? And then, internally, in terms of the survival games, what type of monetization you guys are expecting?

Second question is related to the – in your press release, you noted that related to the cloud and AI, you will be looking for collaborations and investment opportunity in the technology area that could complement to your cloud service. So, just can you elaborate a little bit because I thought Tencent already have very strong technology and won a lot of awards [indiscernible] (51:41) previously. Are you referring to specific industry know-how or more collaborations with like application software developers? So, in other words, what are the areas that you hope to strengthen in your cloud and AI area? Thank you.

<A - Huateng Ma>: Regarding the drivers of smart phone game growth, this quarter of course we had new games which have a shorter life cycle because they haven't got the track record and history to prolong the deferral. But at the same time, most importantly, it's Honour of Kings for this quarter, they are more instant consumption items rather than deferral items. So, as a result, you can see that while the smart phone games grew by quite a lot, at the same time, the deferral – deferred revenue didn't grow a lot, this quarter only few percent quarter-over-quarter.

<A - James Gordon Mitchell>: On the survival game monetization, I think if you look at the successful PC products in the market, initially they monetized by selling the software upfront to the users and tens of millions of people globally including in China who have paid to download those games. And then more recently, they've begun layering in loot boxes. Looking forward, I think that a key element of the survival games is that they are intended to be relatively fair competitive experiences.

And so, I think, it's reasonable to assume that the natural monetization would be more of an upfront or decorative nature rather than more of a take the in-game advantage nature. That's something that we're quite accustomed to because that's largely true of the battle arena games as well.

<A - Huateng Ma>: On cloud and AI, I think you have touched upon the right idea, right? I think, in terms of core technology, we do have a lot of investment and we felt we're pretty strong. But as we try to leverage this technology to adapt them for the benefit of different industries, we actually require a lot of different partners. So, that's the kind of investment, I think, we are mostly referring to.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Your next questions comes from the line of Natalie Wu from CICC. Please ask your question.

<Q - Natalie Wu>: Hi, good evening, management. Thanks for taking my question, and congratulations on a very solid quarter. My question is regarding the survival shooter game, Glorious Mission. I'm just wondering given Tencent's very strong game R&D capability, why would you still license this game to another domestic studio?

And also, for the mini program in Weixin, wondering any consideration for monetization given the e-commerce category have already been the top vertical for that function as you just mentioned? Thank you.

<A - James Gordon Mitchell>: So, as far as Glorious Mission being a licensed game, I think if you look at our history, we really seek to serve the players with the content that's most appropriate to them and most attractive to them, and different players will have slightly different needs. So, if you take – again, looking back at the first-person shooter genre, out of which survival shooters have grown, then we published CrossFire that serves a certain user need. We published [ph] Nijan itself (55:40) that serves a slightly different user need. We published Call of Duty Online, that's a more sophisticated game involving more tactics and more aiming down the scope and so forth.

So, you should assume that within this survival shooter genre, we have a number of titles in the pipeline. Some of those would be licensed. Some of those would be developed. But more importantly, different games will serve different audiences in different ways. And, hopefully, in doing that, we can seek to please the aggregate player base as much as possible.

Your second question was about mini programs and monetization of mini programs within e-commerce, I mean, I think that, as you probably know, there's a number of e-commerce companies that have embraced the Weixin ecosystem through Official Accounts, through mini programs, through viral marketing and so forth. Some of those have grown extremely swiftly. That includes well-known incumbent companies such as JD.com, also some emerging companies that have enjoyed dramatic growth rates such as [ph] Ping Doto (56:52). So, at this stage, our focus is really about facilitating those companies being able to reach out to users and facilitating users being able to find the products that are attractive to them.

<Q - Natalie Wu>: Great. Thank you.

<A - Jane Yip>: Thank you. And operator, may we have the last three questions?

Operator

Your next questions comes from the line of Jin Yoon from Mizuho Securities. Please ask your question.

<Q - Jin-Kyu Yoon>: Hi. Good evening, guys. I think, James, in your prepared remark, I think you said that news feed revenues were down year-over-year. If you could give us some color behind that and then how much of that is just kind of a one-quarter impact versus kind of a long-lasting into the fourth quarter and perhaps the early part of next year.

And second of all, was that potential revenues from news feed going away? Have you seen that kind of revenues going to other aspects of performance base? Thanks.

<A - James Gordon Mitchell>: Well, I think that – what I said was that if you look at our media advertising revenue, then we have seen very strong growth in video. Video was up over 70% year-on-year, but we have seen weaker trends both year-on-year and quarter-on-quarter for the news category. And within that, one reason for the weaker year-on-year growth in the news was that a year ago, we had the Olympics. So, that always brings in substantial revenue and substantial associated cost and this year, there's no Olympics.

And then, the second factor is that we had run some moderate amount of monetization within our news feed products, including KanDian, including KuaiBao, including Tencent News. And as Martin mentioned, in the last few months, we have really decided to focus our resources on getting the underlying infrastructure and user experience right. One part of that focus is the Penguin accounts we talked about whereby we encourage and nurture the creation of interesting content by small professional content generators, and then we find the most effective means to distribute that content to users through our various channels.

And in the course of focusing on the content side of the equation, we have chosen to de-emphasize temporarily the revenue generation side of the equation. And on the revenue generation side, we're more looking at how to optimize the back end to create a scalable platform that can really build something impressive and sustainable in the future. All of which means that, yes, our news feed advertising revenue has been adversely affected as a result. I don't think that we would necessarily see other categories of our advertising benefiting, I don't think we'd really see that substitution effect.

<Q - Jin-Kyu Yoon>: Got it. And do you expect that to linger into the fourth quarter as well, any significant revenue impact in the fourth quarter?

<A - James Gordon Mitchell>: Yeah. That would linger into the fourth quarter. This is a multi-quarter initiative. It's actually a number of initiatives. One initiative is really getting the content equation right, so that there's proprietary or fresh content that appears on our platforms before it appears elsewhere. And another set of initiatives is just around building out the core advertising platform.

If you look back in the past, you may remember we went through a similar process with the advertising inside our social networks where we actually took the GuangDianTong platform that we built for QQ and applied that progressively to Weixin Official Accounts, Weixin Moments and elsewhere. So, that's where we are right now, we're in the process of building that advertising infrastructure back end and again looking back at the GuangDianTong experience, that was a multi-quarter construction, if you will. But once the construction had reached a certain level of stability and maturity, then we're able to grow our revenue much more sustainably than if we just rushed into it.

<A - Jane Yip>: Thank you. And the next question, please.

Operator

Your next questions comes from the line of Chi Tsang from HSBC. Please ask your question.

<Q - Chi Tsang>: Great. Good evening. Congratulations on a very nice set of results. I wanted to ask you about two things. Firstly, on your finance, what sort of progress you're making in terms of consumer loans and also selling other financial services to your users?

And secondly as it relates to AI, there's been some sort of press announcements about you guys working on autonomous driving. Can you give us a sense of what sort of progress you're making? And I know you're working on a number of AI projects, how does autonomous driving stack up in terms of priority? Thank you.

<A - Chi Ping Lau>: In terms of our fintech products, right, I would say the initiatives can be summarized into different categories. The first one is WeBank, and I think WeBank has been operating quite well and the loan outstanding has been growing on a pretty nice trajectory.

The second one is our online wealth management platform, Licaitong, and I think we are seeing quite a strong traction in Licaitong. And we have been able to offer both the more standardized money market products as well as other type of fixed income products to our users. And I think both the number of users as well as the average ticket size, AUM per person has been growing nicely.

In the recent months, we have launched WeSure which is an online insurance gateway. And what it does have is an insurance distribution license and what we intend to do is actually leverage that gateway to work with other insurance companies, such as leading companies within the sector as well as our investee company, for example, ZhongAn Insurance, right, because they are the insurance companies, original products and our gateway is actually a distribution platform, so that we can actually help our partners to sell their insurance progress better and customize their products better to our users.

In terms of autonomous driving, I think it's very, very early days for us. We do have an overall initiative working with auto companies and with strategic partnership with them, and we have maps. We have our in-car solutions, which include all sorts of entertainment and speech recognition and services that we can install within cars. And autonomous driving, I would say as a starter, assisted driving will be a system that we'll be developing as an option for our automobile companies – partners to choose from.

<A - Jane Yip>: Thank you. And last question, please.

Operator

Last questions comes from the line of Thomas Chong from Credit Suisse. Please ask your question.

<Q - Thomas Chong>: Hi. Thanks, management, for taking my questions and congratulation on a strong set of result. I have two quick questions. The first one is about the ARPU for PC and mobile games. And my second question is about cloud. Can management provide some color about the number of paying customers, if any? Thank you.

<A - Huateng Ma>: All right. In respect of the ARPUs for MMOG, it's from RMB 350 to RMB 670. And for advanced casual games, it's RMB 110 to RMB 500. And for the platform games, it's between RMB 170 to RMB 180 for the quarter.

<A - James Gordon Mitchell>: And I'm sorry. Your second question was about the number of paying customers for which products?

<Q - Thomas Chong>: For cloud?

<A - James Gordon Mitchell>: Yeah. Unfortunately, we don't disclose that number at this point in time.

<Q - Thomas Chong>: Got it.

Jane Yip

Thank you. And we are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company website. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2017 third quarter results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2017-08-16
Event Description: Q2 2017 Earnings Call

Market Cap: 3.70TRI
Current PX: 388.20
YTD Change($): +74.20
YTD Change(%): +23.631

Bloomberg Estimates - EPS
Current Quarter: 2.169
Current Year: 9.601
Bloomberg Estimates - Sales
Current Quarter: 88363.800
Current Year: 401619.982

Q2 2017 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Chi Tsang
- Eddie Leung
- Alicia Yap
- Alex Yao
- Wendy Huang
- Grace Chen
- Eileen Deng
- Ming Xu
- Piyush Mubayi

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2017 Second Quarter and Interim Result Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Good evening. Welcome to our second quarter and interim results 2017 conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties. It may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance, prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on our IR website.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a brief overview. Martin will discuss strategic highlights. James will speak to business overview and John will go through the financials before we take your questions.

I will now turn the call over to Pony Ma.

Huateng Ma

Okay. Thank you, Jane. Good evening, everyone. Thank you for joining us. During the second quarter of 2017, we have delivered a strong growth across our revenue segments including smartphone games and PC games, payment-related services, online advertising and digital content subscription and sales.

Let me highlight the key financial numbers for you. Total revenue was RMB 56.6 billion, up 59% year-on-year and 14% quarter-on-quarter. Non-GAAP operating profit was RMB 20 billion, up 36% year-on-year and 8% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 16.4 billion, up 45% year-on-year and 15% quarter-on-quarter. John will provide more details in the financial section.

Moving on to online platforms. Combined MAU of Weixin and WeChat increased 19% year-on-year to 963 million. Total MAU for QQ was 850 million within which, smart devices' MAU was 662 million, down 4% year-on-year due to fewer casual users, while engagement with core users increased. Specifically, PCU including PC and mobile increased 8% year-on-year to 268 million.

In addition, smart device MAU for users aged 21 years or below was up year-on-year, demonstrating QQ's increased popularity among younger users. Popular features within QQ such as Kandian news feeds increased average user time spend within QQ.

For social networks, Qzone smart devices MAU was 586 million. In games, we maintained our leadership in mobile and PC as measured by users and revenues. Our media business grew users and charted at healthy grades. And we've retained leadership in the core news, video, music, and literature categories while developing new categories such as online comics.

In mobile utilities, we remain the China industry leader in mobile security, mobile browser, and Android apps and [indiscernible] (04:51).

With that, I will pass to Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony, and good evening, good morning to everybody. I'm going to elaborate our thoughts in this strategic revenue on artificial intelligence which is a hot topic. We have been investing heavily in AI, but relatively quietly as we view AI as an essential capability that enhances user experience and empowers us to capture the new exciting opportunities to grow our business for the future.

We're confident that our existing strength in computing, power, data, engineering technologies as well as use cases coupled with our proactive build up of AI talent will give us a favorable position in this strategic initiative especially a wide and diversified business scope creates a variety of use cases for AI research and application across a range of AI fundamental research areas such as machine learning, computer vision, speech recognition and natural language processing. We will be persistent but patient with our AI investment because we believe it is a long-term initiative. And we do not necessarily require our research to generate revenue directly in the short-term.

On the other hand, we believe AI will significantly benefit all of our existing products, services, and businesses in many ways. For example, in consumer-facing products, AI enhances user experience as we understand more about the users. For enterprise-related businesses, AI optimizes demonetization as we sharpen our targeting technology. For our ecosystem, our investee companies and cloud partners can leverage our strong AI capability, allowing all of us to achieve mutual benefits.

Now, on the next page I will give you three more specific examples on how we can apply AI to our existing products and services. These three examples are performance ads, information-based services, and Fintech businesses. For performance ads, we applied AI technology throughout the process of ad placement, from understanding users' preferences, contextual and ad content to ranking the bidding price, optimizing the display formats and, eventually, to matching the most appropriate appetizers. This increases the ROI for advertisers while, at the same time, enhancing the reading experience for our users.

For information-based services including news apps, video, music, and app store, AI enables us to have a better knowledge of users' interest. This will help us to make more relevant and customize recommendation to users so that they can access their favorite content more efficiently. Across Tencent platforms, there are multiple digital content access points which we believe will all benefit from the smarter recommendation engine.

For Internet finance businesses including mobile payment, wealth management, and microloans, we use AI to protect the user's behavior in financial activities more precisely. This will help us to provide the most suitable products to the most appropriate users and, in the process, minimize the risk involved.

On top of these existing business lines, I would also like to give you some example on our selected breakthroughs to-date developed by our AI teams in-house. This include our Computer Go chess master, Go FineArt, face recognition technology and medical imaging AI product. Early this year, FineArt won the UEC Cup, a global Computer Go tournament. FineArt was developed by our AI lab in less than a year.

We have accumulated in this process significant know-how in the development of FineArt. And the strategy and reinforced learning AI technology behind FineArt can be applied to many other use cases in the future. Our face recognition technology also scored excellent results with the world-leading face detection dataset and benchmark, FDDB. We have gradually applied this technology in a variety of different ways.

For example, firstly enhanced and enriched the features of our photo editing app Pitu, which has become the number 2 app of its kind in China. Secondly, enable users to complete identification online for financial services and government municipal affairs. Thirdly, assist in the search for children and elderly reported missing helping many families in the process.

In addition, we have recently released our first medical imaging AI product, [ph] MIAIS (10:04), which applies deep learning to detect early signs of disease in images generated by various medical imaging technologies, including endoscope, CT and MRI. We believe this tool can help increase the accuracy and efficiency of early detection and diagnosis. These areas may not generate revenue immediately, but we think they're important and beneficial for advancing our AI know-how, which will benefit us in the long run.

So, with that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Thank you, Martin. Good morning, good afternoon, and good evening to everyone. In the second quarter of 2017, our total revenue grew 59% year-on-year. VAS represents 65% of our revenue, within which online games contributed 42% and social networks 23%. Online advertising was 18% of revenue.

The Others segment accounted for 17% of total revenue. Within this Others segment, payment-related services and cloud services drove the year-on-year growth, both sustaining triple-digit revenue growth rates. Payment-related services, revenue from coproduced TV shows and movies and cloud services contributed strongly to the quarter-on-quarter revenue growth.

For value-added services segment, revenue was RMB 36.8 billion in the second quarter, up 43% year-on-year and up 5% quarter-on-quarter. Social networks' revenue was RMB 12.9 billion, up 51% year-on-year and up 5% quarter-on-quarter. From a year-on-year perspective, digital content services including our video subscription business, music, gifting, and subscription businesses and literature transaction business were the primary revenue growth drivers.

From a quarter-on-quarter perspective, increased revenue from digital content services includes live broadcast, and for virtual items, smartphone games more than offset decreased revenue from our legacy-privileged subscriptions such as the Qzone Yellow Diamond product.

Online games revenue was RMB 23.9 billion, up 39% year-on-year and up 5% quarter-on-quarter. From a year-on-year perspective, revenue grew primarily due to small smartphone end users with the higher proportion of those users making payments, as well as increased ARPU from our key PC game titles. From a quarter-on-quarter perspective, user growth in our established as well as new smartphone games growth with sequential revenue increase.

Turning to social networks situation, we made it easier for users to access Mini Programs by our initiatives such as enabling keyword search and location-based search for the relevant Mini Programs. These initiatives significantly increase the number of unique visitors and interactions with Mini Programs. Weixin Pay grew commercial transactions at a rapid rate in cooperation with channel partners such as Meituan-Dianping, as well as major commercial banks, we added a substantial number of offline merchants. Our average daily commercial payment transaction volume more than doubled year-on-year driven by strong growth in offline commercial transactions.

For Q2, we continue to enhance functionalities most suitable for young Internet users such that while overall MAU declined, smart device MAU for under 21 year-olds increased year-on-year, and daily time spent also rose. Some of you may have experienced Kandian, an algorithmic news feed service embedded inside QQ will enhance the recommendation technology and added social sharing features. As a result, DAU and time spent for Kandian increased significantly and Kandian has become an important destination within the QQ app.

For our live streaming app, now we enriched our offering via content verticals such as campus live, cosplay and outdoor game shows. We also distribute these content verticals to QQ, Qzone in our video and music apps, providing an attractive breadth of users to professional and amateur content creators.

Looking at PC client games, revenue grew 29% year-on-year, driven by unusually strong performance from our key established titles. Revenue declined 3% quarter-on-quarter due to seasonality. Average revenue per user broadly increased year-on-year and quarter-on-quarter, particularly for League of Legends and Dungeon & Fighter.

Active user accounts generally declined year-on-year due to the ongoing trend of some users shifting a percentage of their playing time to mobile games. League of Legends released some popular updates with new skins and drove user activity and spending. We also ran festival promotions, eSports tournaments, and a variety show around the game, which enabled users to connect with the game in multiple ways so as to further deepen their engagement. All these activities reinforce League of Legends' position as an immersive and hardcore game, appealing to the most professional players.

Dungeon & Fighter outperformed the industry to grow active users year-on-year and increase paying users riding on successful expansion packs. As our first case study for cross-media intellectual property strategy, Dungeon & Fighter published its first [indiscernible] (15:11) animation series following on with themed comic books and novels. We believe these initiatives broaden user engagement and contribute to D&F's impressive longevity.

For smartphone games, revenue was up 54% year-on-year and up 14% quarter-on-quarter, surpassing that from PC games. Active user accounts also increased year-on-year, mainly driven by mid-core games. In the quarter, we released five new titles including one puzzle game, one ARPG, one massively multiplayer role playing game and one strategy game.

In player versus player competitive games, we brought up strong products, publishing expertise, and substantial audiences for key titles in genres such as battle arena, shooting, sports and board games. And these types of games with big player base tends to virally attract new users as well as providing better matching and liquidity for existing users, creating a virtuous cycle of new player activation and existing player retention.

For role-playing games, we utilize our knowledge of user behavior, our game and content are into communities and are targeting technologies to highlight the most appropriate role-playing games to the most suitable users, which has contributed to us gaining market share in the action role-playing game and massively multi-player role-playing game subcategories.

Our published role-playing games, Dragon Nest Mobile from Shanda, JX Mobile from Kingsoft and Legacy TLBB Mobile from Changyou were all ranked in the iOS top 10 grossing apps in China during the period.

For console-style games, we had licensed from Konami, the right to develop a mobile version for China of its classic console IP, Contra. We launched this game Contra Return in the second quarter and it generated an enthusiastic response from players, ranking number 4 in China's iOS top grossing chart in June.

For online advertising, our revenue was RMB 10.1 billion, up 55% year-on-year and up 47% quarter-on-quarter, with mobile contributing over 85% of this revenue. Our media advertising revenue was RMB 4.1 billion, up 48% year-on-year and up 62% quarter-on-quarter.

Popular video content and improved video content distribution resulted in a substantial increase in our video traffic, and thus, our video advertising revenue, which was the primary driver of this rapid growth.

The second quarter is seasonally stronger for our media advertising than the first quarter. And this year, drama series such as Ode to Joy Season 2, [ph] Insurgents (17:38) and self-commissioned variety show such as Go Fridge Season 3, boosted our user engagement and traffic, contributing to an unusually rapid quarter-on-quarter improvement in media advertising compared to the first quarter, when some of our strongest video content was prioritized for video subscribers.

For our media news products, we are primarily focused on enhancing our newsfeed algorithms and our news advertising revenue grew at a slower rate than our video advertising revenue. Our top-five brand-type advertising categories during the quarter included food and beverage, transportation, online services, online games and consumer electronics.

Our social and other advertising revenue was RMB 6 billion, up 61% year-on-year and up 39% quarter-on-quarter, driven by higher field rates in Weixin Moments and Weixin Official Accounts, by more advertisers buying mobile browser advertisements from us and by more advertising impressions coming to us from our affiliate ad network. We extended our self-service platform capabilities to facilitate nationwide buying and we enabled more of the official accounts to carry advertisements, benefiting creators of those official accounts.

And now, I'll pass it to John to go through the financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the second quarter of 2017, our total revenue was RMB 56.6 billion, up 59% year-on-year, or 14% quarter-on-quarter. Gross profit was RMB 28.3 billion, up 28% year-on-year, or 11% quarter-on-quarter.

Net other gains were RMB 5.1 billion. We recorded net other gains totaling RMB 5.1 billion for the second quarter of 2017, which mainly consists of fair value gains as a result of significant increase in valuations of certain investment in verticals, including bike-sharing and Fintech, as well as deemed console games arising from capital activities of certain invested companies. Particularly, the IPO of Korean mobile game publisher Netmarble, they are partially offset by impairment provision charges for certain investing companies. Share of profit of associates and joint venture was RMB 498 million in the quarter on a non-GAAP basis.

We generated profits of RMB 947 million in quarter two, comparing to losses of RMB 206 million in the second quarter of 2016. Income tax expenses were approximately 43% year-on-year or 9% quarter-on-quarter. Effective tax rate for the quarter was about 18%. Net profit to shareholders was RMB 18.2 billion, up 70% year-on-year or 26% quarter-on-quarter. I will walk you through our non-GAAP financial numbers, which provide a useful reference to evaluate the operating results of our organic businesses.

After adjustment to non-GAAP, operating profit for the quarter was RMB 20 billion, up 36% year-on-year or 8% quarter-on-quarter. Operating margin was 35%, down 6 percentage points year-on-year and 2 percentage points quarter-on-quarter. Net profit attributable to shareholders was RMB 16.4 billion, up 45% year-on-year or 15% quarter-on-quarter.

Net margin was 29%, down 3 percentage points year-on-year and partly stable quarter-on-quarter. Let's turn to segment gross margin. Gross margin for value added services was 60.6%, down 6.1 percentage points year-on-year, mainly due to higher channel cost of smartphone gains, paid to third-party outsource, including handset manufacturers.

And revenue mix changed to low margin products such as digital content services. Quarter-on-quarter change was broadly stable.

Gross margins for online advertising was 37.8%, down 7.5 percentage points year-on-year due to increased video content investment. Sequential increase of 3 percentage points reflect a stronger seasonality in the second quarter. Gross margin for others was 22.4%, up 11.8 percentage points year-on-year and broadly stable sequentially. The year-on-year increase was mainly due to gross margin improvement of payment-related services.

Moving on to operating expenses. Selling and marketing expenses were RMB 3.7 billion, up 55% year-on-year or 16% quarter-on-quarter. The year-on-year increase was mainly due to higher marketing and promotional spending on products such as online games, payment-related services and online media as well as higher staff cost. The sequential increase mainly reflected seasonally more advertising and promotional activities in the second quarter versus the first quarter. Selling and marketing expense was 6% of quarterly revenue.

Total G&A expense were RMB 8.2 billion, up 54% year-on-year or 17% quarter-on-quarter. On the G&A, R&D expenses was RMB 4.2 billion, up 54% year-on-year or 18% quarter-on-quarter. The year-on-year increase mainly reflected higher staff cost. As a percentage of total revenue, total G&A was 14% and R&D was 7.5%.

At the end of the second quarter, we had over 40,000 employees. Year-on-year growth of 29% was mainly due to: number one, organic head count increase; number two, one-off inclusion in our head count of some outsource manpower who engage in our customer support work; and three, the business combination of our music businesses. Excluding the later two factors, head count grew by 16% year-on-year.

Looking at the margin ratios for the second quarter. Gross margin was 50%, down 7.3 percentage points year-on-year, mainly due to decrease in VAS segment gross margin and increasing contribution from low margin in other segment.

Gross margin dipped 1.3 percentage point sequentially reflecting change of revenue mix. Non-GAAP operating margin was 35.4%, down 5.8 percentage point year-on-year, primarily reflecting lower gross margin, partially offset by an increase in net other gain. Sequential decrease of 2 percentage points was mainly due to lower gross margin and high G&A expense. Non-GAAP net margin was 29.1%, down 3.1 percentage points year-on-year and broadly stable – sequentially, sorry.

For the second quarter, total CapEx was RMB 3 billion, doubled year-on-year and up 43% quarter-on-quarter. Operating CapEx was RMB 2.3 billion, up 124% year-on-year and 36% quarter-on-quarter and it represented about 4% of total revenues. Non-operating CapEx was RMB 683 million, up 47% year-on-year or 73% quarter-on-quarter.

Free cash flow was RMB 17.5 billion, up 80% year-on-year and down 28% quarter-on-quarter. Sequential decrease was mainly due to weaker seasonality for our PC client games.

Our net cash position at quarter end was RMB 21.3 billion or $3.1 billion, down 12% year-on-year or 23% quarter-on-quarter, sequential growth in net cash flow is mainly due to payment of final dividends for 2016. Fair market value of our listed associates and available for sale, financial assets was approximately RMB 146 billion or $21.5 billion at that quarter end.

Thank you. We shall now open the floor for questions.

Jane Yip

Operator, we will take one main question and one follow-up question each time. May we have the first question, please?

Q&A

Operator

Certainly. We'll now begin the question-and-answer session. [Operator Instructions] Your first question comes from Chi Tsang of HSBC. Please ask your question.

<Q - Chi Tsang>: Hi. Good evening. Thank you so much. I was wondering if you could discuss online video for a few minutes. In particular, how do you think this business will evolve over the next few years in terms of things like paying subscriber ratio, ARPU and margins. And what do you think it'll take for this business to reach breakeven? Thank you very much.

<A - Huateng Ma>: On online video, I think it's going to take quite some time, unfortunately, for the business to breakeven. I think dynamics at this point in time is that number one, there's a lot of usage. More and more people are watching online video at a longer and longer time on a daily basis. And at the same time, advertising revenue has been increasing, and there's also an increasing of willingness for consumers to pay. So, the subscription number as well as revenue has been increasing quite rapidly.

On the other hand, the flip-side of this is the cost of content has been increasing even faster. So, what we see is that over time, we believe – the content will continue to increase, but that the rate will probably be lower and that subscription as it continued to increase would deliver a higher revenue per active user.

So, we will get closer to a more equilibrium between cost and revenue at some point in time, but I think, unfortunately, at this point of time, the net loss of the business is still increasing although depending on how much revenue we generate from advertising as well as from subscription, the increase rate could be slower than before.

<Q - Chi Tsang>: Thank you.

Operator

Yes. And the next question comes from Eddie Leung of Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. Two questions. The first one is about your advertising business. It is quite obvious that traffic has been growing very rapidly. You also added some advertising inventories. I'm just curious if you could talk a little bit about the trends on the conversion rate or click per rate as well as pricing, how important are they in terms of driving advertising growth in the past, let's say your one or two quarters besides the traffic and inventories. And then secondly, I'm also curious to hear your thought on the usage of a user-generated video in solution networks. How important do you think this trend can be? And any update would be great. Thanks.

<A - Huateng Ma>: In terms of the advertising, I think most of the growth has actually been some the click through rates as well as the improvement in targeting technology, as a result the pricing achieved has been higher. There is some help from the other two factors which is slight increase in terms of the inventory and an increase in terms of the general traffic. But I think from the inventory angle, we have achieved a second ad for some cities, but within the 24-hour period, not everybody is seeing two ads.

So, compared to our international peers, I think the amount of inventory is still relatively small, and at the same time, the traffic increase has been most significant around Moments. But then, if you look at our performance ads, it's across a pretty large number of different properties, right? So, the traffic growth in the other areas might not be as great as the Moments' traffic increase.

Now, in terms of user-generated video, I think there has been a pretty large amount of user-generated content, video content in our social network. It has already been in the case and it has been increasing. But, at the same time, I think as you would notice, there are a lot of other apps, which are also hosting these user-generated content including our investee company, Kuaishou, as well as a lot of the news apps right now, which has customized the content for people. In addition to text and a picture, they are also adding short video to the overall content.

And, of course, you also have the video apps, which are not only having the professionally-made content but also user-generated content. So, the user-generated content has already been spread over many, many different platforms in China. And, I think, everybody has been seeing a general growth in this.

I think, overall, it's definitely good in terms of user engagement. It's a little bit tough to make advertising revenue from that because usually these videos are relatively short, and depending on how aggressive you are in terms of balancing user experience and monetization, I think if you really care about user experience, then the chance of putting advertising on these extra videos are more limited.

Operator

Thank you. Next question is from Jin-Kyu Yoon of Mizuho Securities. Please ask your question.

<Q – [077J0S-E Jin-Kyu Yoon]: Yes. Thanks very much for your time. Can we just go back to video revenues again? So, as subscriptions ramp, I assume that people are going to be watching less ads. Is there a potential – are you seeing any impact where those potential video ads could be more directed towards social going forward? Have you seen that trend or is that even a possibility? And just a follow-up on that, any commentary on the Unicom investment today? Thanks.

<A - James Gordon Mitchell>: I think on the video side in different quarters of the year, our biggest and best content appears in different monetization windows. So, in the first quarter, we mentioned that the drama serial, The Ghost Blows Out the Candle was prioritized for subscribers and that coincided with a very sharp upsurge in subscription revenue. Now, in the second quarter, some of our biggest content was including Go Fridge Season 3, [ph] Insurgents (34:55) and Ode to Joy and so forth was made available to the advertisement consuming viewers.

And so, while our subscription revenue continued to increase quarter-on-quarter, the rate was not as sharp. On the other hand, you can infer from our media advertising revenue that video advertising revenues are very sharp at the seasonal uptick quarter-on-quarter, supported by strong content.

So, as you would expect, video in the short term is a content-driven business. We have stated in the past that as an increasing proportion of our video users become subscribers, then, those subscribers become subject to fewer video ads. Now, the video advertising doesn't completely disappear, and if you watch some of our already hallmark content like The Ghost Blows Out the Candle, we have sponsorships and so on that appear on the screen during the program. But I think you're also asking whether the video advertising gets displaced elsewhere and I think that's difficult to say.

At this point, my guess is that the big advertisers have a certain budget for television, and then, for online video. And then, they have a separate budget for social and a separate budget for such and so forth. And then, the migration between those buckets happens relatively slowly, typically at the beginning of each year, rather than happening on a month-by-month basis.

<A - Huateng Ma>: So, on China Unicom right now, I would say the mixed ownership reform scheme of China Unicom, in our view, is very monumental step in the economic development of the country. And as such, we are actually very honored to participate in the scheme. And, on the business side, we have always been seeking more and more and deeper and deeper cooperation with telcos because we believe they are very important ecosystem partners by ours.

And in this particular case, with China Unicom, right, you're at a very important juncture of their business development. We are very happy to be involved in this strategic manner. And in terms of business cooperation, we've already got a lot of cooperation with the China Unicom, including, most recently, the joint launch of broadband card called [ph] Tawang card (37:15), which provides unlimited data bandwidth for Tencent apps. And that has been a very, very great success and we help China Unicom to sign up a lot of new users.

So, we actually look forward to, with this strategic partnership, to look forward to developing more and more cooperation with China Unicom. And we believe, if you look at the participants right here, there are a lot of different potential – there's some partners who can bring potential skills and resource into China Unicom, and we think it is beneficial to the entire industry and we look forward to a deeper relationship with China Unicom. And we also hope to have a deeper relationship with all the telcos across the board.

Operator

The next question comes from Alicia Yap of Citigroup. Please ask your question.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my questions and congratulation on another strong quarter. I have two questions. Number one is related to your AI technology. You mentioned some of the recent breakthrough achievement by your team in this area. I wanted to get management's opinion on a broader view as almost all large Internet companies are investing heavily in the AI technology. So, in your view, what are the most important competitive strength and advantage that could set each company different from their peers? And what are the competitive strength for Tencent AI?

And then, separately, for this AI. I understand you may help in better targeting, improving user experience and benefit overall monetization over time. But then, besides benefiting internal business, in the longer term, will AI also help your platform partners? Any chance that AI could become a service that you can license to your external partners that help enhance your monetization even more in the longer term?

And then, second question is on advertising. Just can you share briefly what are some of the initial tractions and contribution from the video ad format that's within your Weixin properties? What are the user feedback and the click through on those video ads? And are these video ad format mainly consumed by bigger brands and the first tier city at this stage? Thank you.

<A - Huateng Ma>: Okay. In terms of AI revenue, I think all the large Internet companies would benefit from this. To some extent, it's a little bit like the mobile Internet, in which when mobile Internet came around, a lot of users can use mobile Internet on a more frequent basis and for the companies who can develop their mobile apps in a successful way; then, you can benefit from that big trend. And I think, AI is to some extent similar in nature. But, of course, a lot of it, since it's early days, a lot of it depends on whether you are able to develop the technology. Who can develop the technology better? We have highlighted in our prepared remarks that there are a few things, which are very important in AI that improved AI talent, that improved the ability to have a lot of data, and a lot of used cases. And of course, where the computing power and engineering capability are also very important.

So, if you look at Tencent, we believe, for us, we have a very wide and diversified business scope, not only in our own businesses, we have a very broad line of business, but at the same time, in our ecosystem. We have a lot of partners in the form investee companies in the form of commercial partnership and in the form our cloud business customers.

So, because of the availability of these used cases, it provides the best venue for our AI and our engineering talent to develop AI technologies. And at the same time, I would say we are very patient in our overall approach and we take a long-term perspective, so that we would not be too eager to say, "Oh, you have to generate revenue in a very short term," but believe me when we get all these technologies, it will benefit our existing business almost immediately. And at the same, when we keep on advancing our technology and developing new applications, it would help us to open up new business areas as well as help our partners to open up new business areas.

In terms of providing AI as a service, I think this is definitely one direction that we're going into in our cloud business already. We're seeing a lot of demand on that and we haven't been able to sign up a lot of customers because of our ability to offer them AI capability and that's just the beginning. Over time, I think we would do a much go on that.

I think in terms of advertising, you're talking about the video ads on Moments. I think, right now, video ads on Moments is still a very small part of our overall revenue.

<A - Jane Yip>: The next question please.

Operator

Next question comes from Alex Yao of JPMorgan. Please ask your questions.

<Q - Alex Yao>: Thank you, Management, for taking my question and congrats on another solid quarter. My first question is about the payments. The payment MAU exceeded RMB 600 million in December last year. I think consumer adoption for the payment has come to an end. Can you talk about the rationale of payment subsidy strategy that you guys introduced in the second quarter and continue into the third quarter?

And then related to the – can you talk about the implication of official introduction of net union, the Wang'Lian, recently. How will this change the economic interest of [indiscernible] (43:56) as a players payment value chain?

And then, second question is on the SNS, for QQ casual users who reduced their usage of QQ and Qzone, are they migrating to Weixin and the Moments or something else? With such a mixed operating metrics between QQ and Weixin, do you think your position in China's SNS and communication market as equally strong or is your position slightly changing? Thank you. I stop here.

<A - Huateng Ma>: Yeah. On payment, I would say, again, the overall strategy for our payment service is to provide an infrastructure service for our own business, as well as for our ecosystem partners. And as a result, it's not a business that we would want to make a profit. It's not the target to make a profit from it. So, that's the overall guiding principle.

And as a result, right now, we do want to reinvest the revenue and the potential profit that we can make from this business into growing the coverage, the usage of the service.

So, one of the important aspect of payment is we want to not only cover the transactions online, but also in O2O services as well as offline. So, a lot of the marketing expenses are directed in that direction. We want to support commercial transactions in O2O area, as well as in offline scenario. And at the same time, I want to point out that there is an increasing competition also in this area. So, that's why we do expect our investment into this payment business to increase over time.

Now, in terms of Nets Union, Nets Union is a back-end clearing system, which allows third-party online payment companies to connect to the different banks, be a one centralized clearing system. And, I think, the PBOC wanted to have this system, so that they can have more control over the routing of the payment services.

And we have been actively working with Nets Union in developing their system. With the way we look at this system, is it's a back-end system; we are still responsible for the front-end connection with the consumers, as well as the connection with the merchants. But the connections to the bank would eventually go through the Nets Union. So, for us, the important thing is to make sure that Nets Union system can handle the amount of transactions that we handle in a reliable way. And we have dedicated a pretty large team of people to be working full time at Nets Union in the formation of the company and we have provided a lot of technology and modules to enable it to be functional in a very short time and we are the first transaction that go through the entire system. And it's now experimenting with some payment traffic and we're the biggest provider of such payment traffic right now.

So, we believe it can ensure the very stable and reliable operation of Nets Union then it will be beneficial to us.

Operator

The next question comes from Wendy Huang of Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you. My first question is also about Others and Payment business. So, your total Others increased by 177% year-over-year. Can you give some color which one is growing faster whether it is payment or cloud business? And also, the gross margin for this business seems stabilized at 22% level. So, is this Other business already actually contributing to the bottom line? If not yet, when do you expect it to be a meaningful contribution to the earnings?

Second question is can you help us to understand the future driver of your game business from both pipeline perspective and ARPU perspective? So, you just launched the five new games in the second quarter. What's the pipeline look like for the rest of the year? And also, PC game revenue increased by 29% year-over-year. You mentioned in the presentation earlier that it's mainly driven by the ARPU. So, what's the ARPU right now and where do you see the ceilings? Thank you.

<A - Chi Ping Lau>: Okay. On the Others category, I would say the following. It's mostly constituted of the payment business revenue, as well as the cloud revenue. And both of the two business grew at triple-digit with the payment business growing faster slightly. So, in terms of margin, bear in mind this is gross margin and there's a lot of marketing expenses related to both the payment business as well as the cloud business relations embedded in the sales and marketing. And hence, a pretty big growth, year-on-year growth rate in marketing expenses. At the same time, there's also the human resource related to these businesses, which are embedded in the G&A. So, I would not go as far as saying, they're making meaningful contribution to our earnings yet.

<A - James Gordon Mitchell>: As far as the smartphone games are concerned, I think that with regards to the pipeline, you could refer to our activities at the recent ChinaJoy conference and see that there's a number of titles that we have to release in the coming months that we're quite optimistic about. But the bigger point to make here is that smartphone game playing in China is still at a relatively early stage of growth. And if you look at, for example, our smartphone game daily active users in the second quarter, it grew over 40% year-on-year. And of course, part of that is driven by new games that we've released in the last several quarters.

But another part of that is driven by the increased popularity of games that we released in one, two, three years ago. So, we'll continue to explore new market segments in smartphone games. I think we've done a good job of really cultivating the big DAU moderate ARPU, player-versus-player competitive games like sports, shooting, and so forth. We've started to do a good job of colonizing the small DAU, high ARPU role playing games segment that we talked about. And then, we're also trying to develop new games segment opportunities such as the console games that we discussed. So, that's on the smartphone games.

In terms of the PC game ARPU, I'll hand that to John.

<A - Shek Hon Lo>: Actually, with reference to the description we have made in relation to increased ARPU from PC game titles. Our ARPU for MMOG is within RMB 370 million to RMB 560 million for the quarter, and advanced casual game revenue is RMB 400 million to RMB 440 million this quarter, which increased quarter-over-quarter and year-over-year.

<A - Jane Yip>: The next question, please.

Operator

Sure. The next question is from Grace Chen of Morgan Stanley. Please ask your question.

<Q - Grace Chen>: Hi. Thank you for taking my question. My question is also about the advertising business. We understand Tencent has been focusing on enhancing capabilities such as targeting technology, while releasing ad inventories on a measured pace. As you just mentioned that Tencent is doubling ad inventory in Moments, in some cities. So, can you share with us your thoughts about what you consider as the key factors to determine how fast you would increase ad inventory and is there a time line in your plan to roll out the [ph] Allo (53:19) increase nationwide?

Apart from the increased monetization in Moments, in Weixin Moments, we also understand Tencent has many other properties with great potential to increase monetization such as Tencent Video, Tencent News, Tian Tian Kuai Bao. So, can you also share with us your monetization plan in these properties as well? Thank you.

<A - Chi Ping Lau>: Yes. I think ultimately the question is really a balance between user experience and monetization. And we do want to make our targeting better and better and better. And so far, I would say we're erring on the very conservative side in terms of releasing our inventories. And I think it would be a function of when do we feel more comfortable in terms of achieving a level of user experience that when people see the ads, right, they would not be turned off, but rather they see it as a pretty, delightful experience.

At the same time, I think we're also doing a lot of education and joint partnership with the advertisers, so that we want to increase the quality of the advertising because we felt, if we can have better and better targeting technology and at the same time, we have better and better advertising content, then the user experience of seeing advertising would be better for the users.

Right now, I just have to say there's really no urgency for us to put a lot of inventories out. And we do have some luxury of working on our technology and making sure that our user experience is the best-in-kind among our industry peers.

Operator

Moving on, the next question is from Alan Hellawell of Deutsche Bank. Please ask your question.

<Q - Eileen Deng>: Thank you, management. Congratulations on the strong quarter. This is Eileen Deng from Deutsche Bank, asking question on behalf of Alan Hellawell. I wanted to ask with details of mixed ownership recently having been announced, are we expecting any further government involvement in our business in, for instance, gaming or social networking? And do we see growing regulatory risk on that front? Thank you.

<A - Chi Ping Lau>: Well, I think mixed ownership is actually a direction for the government to embrace more market governance for state-owned enterprise. So, I think that has no implication on more regulatory pressure on our business. In a way, it's actually the other direction. It's hoping that the market force can help state-owned enterprise to be more competitive.

<A - Jane Yip>: So, due to time constraint, may we have the last two questions from the floor.

Operator

Certainly. The next question is from Ming Xu of UBS. Please ask your question.

<Q - Ming Xu>: Thanks. Good evening, management, and congratulation on a strong quarter. So, two questions, firstly on the payment and finance business. We read a lot of news regarding the strong loan growth of [indiscernible] (57:11) from WeBank. So, I'm just wondering, could you share with us, except for your stake in WeBank, how should we think about the revenue opportunity from this strong growth [indiscernible] (57:24) for Tencent? And what's the current revenue size inside from this business?

And second is, for the gaming business, I noticed in your slide, you mentioned that you used your targeting technology to acquire users for RPG games. Could you maybe elaborate on that? Thanks.

<A - Chi Ping Lau>: Well, in terms of WeBank, in addition to the ownership we have in WeBank, we also have a platform fee in which we charge to WeBank because we do offer a lot of value add to WeBank in terms of acquired customers as well as helping them to assess the credit. So, as their business grow over time, we will book a revenue from them and at the same time we have an equity participation in their profit.

<A - James Gordon Mitchell>: In terms of games and targeting, I think if you look at game playing globally, particularly on the personal computer, it's moved from being media driven, it's being increasingly community driven. 20 years ago people discovered new games on the PC in the U.S. and Europe through computer magazines. Now they're discovering them through reddit, through Twitch, and through those kinds of more communal venues. And some of the same trends are underway in China and what we're trying to do is working with the game developers to make sure that we target their games to the users who are likely to be most receptive.

So, when a company like Shanda releases a mobile game like Dragon Nest Mobile, which is a mobile port of a somewhat successful PC game, and they share with us something about who played the PC games, then we can effectively catch up with those users 5 or 10 years on mobile and recommend this game to them on mobile and that's something that's highly effective.

Similarly, if we know that there are certain users who are particularly interested in, for example, Japanese animations, then we can target games with a Japanese animation style at those users and so forth. So, that's part of what we were referring to and we were talking about the ability to target the role-playing games to the most appropriate users.

There are some games which, we think, have kind of transcendent appeal and can bring all sorts of different people on board, and we continue to market those broadly and widely. But there are other games that will resonate most with a very narrow but deep audience. And so, for the second class of games, we want to help the developers by reaching that narrow but deep audience rather than waste the developers' time and money by trying to reach a much broader, shallower audience who will display an inferior retention rate. So, that's what we were talking about.

Operator

The last question is from Piyush Mubayi of Goldman Sachs. Please ask your question.

<Q - Piyush Mubayi>: Thank you for the opportunity. First, specifically on HoK. What is the amortization that you are following right now because that seem to be one area where we didn't get meaningfully surprised on the revenue side?

Second, a question for Martin on AI. You talked about how it could transform your performance advertising and Fintech businesses with better targeting. How quickly do you think that can get manifested in these two businesses for example?

And very quickly also on payments, how much traffic in payment does Meituan drive? Thanks.

<A - Shek Hon Lo>: In relation to the amortization of Honor of Kings, it's about nine months.

<A - Chi Ping Lau>: Okay. In terms of AI's impact on the Fintech business and advertising, I would say it's ongoing process, right. And in the past, we had been already doing a lot of optimization, but those are more rule-based optimization. And when we now start to add deep learning to the process, we can see that the headroom can be improved by a lot. But at the same time, it takes time to develop the technology and also have it work into our entire system. So, I would say, some of the impact have already been seen. But over time, there will be more to be explored and to be captured.

In terms of Meituan, I think that's a business which has grown quite significantly. And as a result, we also benefit from that. But at the same time, I think the significance of adding that ecosystem partner is that they are very deeply engaged with the food and beverage industry with all kinds of restaurants around the nation. And as a result because of that coverage, we are able to have direct coverage through them, right, of most of the restaurants in China. And I think that's a very important aspect of our cooperation. So, not only they generate transaction for us in their core business, but they also help us to get access to a lot of third-party restaurants, which also adds to our total number of transactions.

Jane Yip

Thank you, operator. We are closing the call now. If you wish to check out our press release and other financial information, please visit our IR website. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating Tencent Holdings Limited 2017 second quarter result announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2017-05-17
Event Description: Q1 2017 Earnings Call

Market Cap: 3.70TRI
Current PX: 388.20
YTD Change($): +74.20
YTD Change(%): +23.631

Bloomberg Estimates - EPS
Current Quarter: 2.169
Current Year: 9.601
Bloomberg Estimates - Sales
Current Quarter: 88363.800
Current Year: 401619.982

Q1 2017 Earnings Call

Company Participants

- Jane Yip
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- John Shek Hon Lo

Other Participants

- Alan Hellawell
- Alicia Yap
- Eddie Leung
- Alex Yao
- John Choi
- Richard Kramer
- Grace Chen
- Chi Tsang
- Ming Xu
- Thomas Chong
- Natalie Wu

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by, and welcome to the Tencent Holdings Limited 2017 First Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There'll be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Jane Yip from Tencent. Please go ahead, Ms. Yip.

Jane Yip

Thank you. Good evening. Welcome to our first quarter 2017 results conference call. I'm Jane Yip from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in the future for various reasons.

Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of risk factors and non-GAAP measures, please refer to our disclosure documents on tencent.com/ir.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a

short overview, Martin will review our value-added services, James will be on online advertising, and John will discuss the financials before we take your questions.

I will now turn the call over to Pony.

Huateng Ma

Thank you, Jane. Good evening, everyone. Thank you for joining us. In the first quarter of 2017, we delivered a strong set of operational and financial results of cost games, payments, digital content and advertising.

Let me run through the key financial numbers for you. Total revenue was RMB 49.6 billion, up 55% year-on-year and 13% quarter-on-quarter. Non-GAAP operating profit was RMB 18.5 billion, up 37% year-on-year and 24% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 14.2 billion, up 42% year-on-year and 15% quarter-on-quarter. John will provide more details in the financial section.

Operationally, our key path forward is to continue to grow robustly. Combined MAU of Weixin and WeChat increased 23% year-on-year to RMB 938 million. Total MAU for QQ was RMB 861 million. Within which, the overall smart device's MAU for QQ was RMB 678 million, down 0.4% year-on-year. While daily active users of mobile QQ who were aged 21 or below, increased by double-digit year-on-year, indicating QQ continues to be very popular among young users.

For our social networks, Qzone smart device's MAU was RMB 605 million. In games, we've deepened penetration in multiple genres and organized several eSports tournaments in the first quarter, to increase community stickiness. We expanded our revenue market share in both PC and smartphone games.

For our media platforms, we believe our video, news, literature and music services are each the largest in China measured by usage. In mobile utilities, we solidified our lead by monthly active users for mobile security, mobile browser and Android app store.

Martin and James will discuss further in business review.

Chi Ping Lau

Thank you, Pony, and good morning and good evening to everybody. In the first quarter of 2017, our total revenue grew 55% year-on-year, as Pony has talked about. Our VAS represented 71% of total revenue, of which online games contributed 46% and social networks 25%. Online advertising was 14% of total revenue. Others segment accounted for 15% of revenue, of which payment-related services and cloud services contributed to both year-on-year and quarter-on-quarter revenue growth, and they both grew triple digits year-on-year.

Then take a look at value-added services. The segment revenue was RMB 35.1 billion in the first quarter, up 41% year-on-year and 20% quarter-on-quarter. Social networks revenue was RMB 12.3 billion, up 56% year-on-year and 15% quarter-on-quarter. Digital content revenue drove year-on-year and quarter-on-quarter growth.

Total subscriptions increased by 10% year-over-year to RMB 119 million, driven by video and music subscriptions and partially offset by decreases in subscription count as we shifted users from QQ VIP to Super VIP which offers more privileges. As a result, the blended ARPU for subscription products actually increased.

Online games revenue was RMB 22.8 billion, up 34% year-on-year and 24% quarter-on-quarter. In PC games, due to strong performance of expansion pack and Chinese New Year promotions this year, the year-on-year revenue growth accelerated from the last quarter. The sequential growth benefited from positive seasonality.

In smartphone games, key titles continued to perform robustly and contributed to both year-on-year and quarter-on-quarter growth. The successful launch of new games, such as Dragon Nest Mobile, also contributed significantly to sequential growth.

Turning to social networks. Weixin is increasingly playing an important role in the commercial world. For Weixin Mini Programs, we launched more developer-friendly features to generate more organic traffic to Mini Programs. For example, in April we introduced a new scannable code which can be found offline or inside Official Accounts to lead traffic to Mini Programs. We also allowed service providers to embed links in Official Accounts to access Mini Programs, and we enabled users to discover Mini Programs from nearby merchants using the Look Around feature. In March, we introduced Weixin Index, which allows users and merchants to analyze the popularity of keywords within Official Accounts and in-app search.

For our other major social property QQ, it is increasingly focused on serving younger Internet users to enhance its appeal to this audience. We upgraded the viewing feature of QQ's Kandian newsfeed, to recommend personalized content to young QQ users based on their interest graphs and applying big data analysis. We also expanded our QQ Smart Campus service to support the administration of college student affairs, facilitate school-student communication, make paying tuition fees more straightforward, and host job listings. Almost 900 treasury institutions have signed up to QQ Smart Campus.

Now, a bit more on our gaming business, looking at PC client games. The revenue was up 24% year-on-year and quarter-on-quarter, benefiting from activities such as a well-received expansion pack for DnF and popular Chinese New Year promotions for League of Legends. Active user accounts generally declined year-on-year, as players continued to shift time from PC to mobile and from in-game to other game-related activities such as forums, game video streaming, and offline eSports events. But this quarter, we saw a seasonal improvement in active user accounts for games with new content such as DnF.

The ratio of paying users to total users increased, in particular, for sports and action games. For example, in FIFA Online 3, we added several famous soccer players which stimulated more in-game purchases. While we view the strong performance of PC games in the first quarter as a pleasant surprise rather than a new trend and expect performance to return to prior trends later, we believe the strong first quarter performance illustrated that, while the popular content can indeed energize PC game activity and revenue if they are launched right.

For smartphone games, the revenue was up 57% year-on-year and 21% quarter-on-quarter. Our key titles such as Honour of Kings and CrossFire Mobile expanded paying user accounts and increased user activity during Chinese New Year. In the quarter, we released eight new games including two casual and six mid-core games. We reinforced our lead in multiple game genres. In the genre of mobile, Honour of Kings expanded its user base and increased user engagement via in-game competition, video broadcast and video replay on multiple platforms. We believe Honour of Kings is one of the most popular mobile games globally by daily active users.

In FPS, CrossFire Mobile enlarged its user base, leveraging our operational expertise and marketing knowhow from PC shooting games.

Seasonal gift pack promotions boosted user activities and ARPU. In RPG, we deepened penetration in key subcategories, leveraging licensed IP games with Dragon Nest Mobile in the action subcategory, JX Mobile in the MMO subcategory and Fantasy Zhu Xian Mobile in the turn-based subcategory. We now operate three highly popular RPGs in the China market, representing a major step forward in our mobile gaming strategy.

Now, I will invite James to talk about online advertising.

James Gordon Mitchell

Thank you, Martin. Our online advertising segment revenue was RMB 6.9 billion, up 47% year-on-year, and down 17% quarter-on-quarter. Mobile contributed over 85% of our advertising revenue. Under our prior classification, brand advertising revenue was RMB 2.1 billion, down 1% year-on-year and down 31% quarter-on-quarter, while performance advertising revenue was RMB 4.8 billion, up 87% year-on-year and down 8% quarter-on-quarter.

Given we're seeing advertisers increasingly buying performance format advertising within traditionally brand-oriented properties such as costs per click ads in our news app's newsfeed, the distinction between brand and performance is becoming decreasingly useful. Starting this quarter, we'll therefore classify online advertising revenue by the type of ad property rather than by ad pricing models.

Under the new classification scheme, media advertising revenue includes advertising carried on our news, video and music properties, which was historically mostly brand format, but is now becoming increasingly performance-driven, especially for newsfeeds within our news apps. Social and other advertising revenue includes advertising on our social properties Weixin and QQ, app store, browser and ad networks which was mostly performance format in the past and continues to be so.

Using this new classification, media advertising revenue was RMB 2.5 billion, up 20% year-on-year, due to more inventories created by traffic growth in our video and news app together with the increased ad loads in our newsfeeds. Sequentially, media advertising revenue decreased 26% quarter-on-quarter because of 1Q seasonality.

Social and other advertising revenue was RMB 4.4 billion, up 67% year-on-year driven by higher ad-fill rates in Moments, better click-through rates in Official Accounts, and more advertisers buying our app store advertisements. Revenue declined 11% quarter-on-quarter because the fourth quarter is the peak season for e-commerce advertising.

Leveraging partners such as JD.com, 58.com and Meituan-Dianping as well as advertising agencies, we have substantially expanded our social advertiser base, especially among offline merchants buying Moments advertisements, and we have enhanced location-based targeting capabilities from Moments advertisements which allows retailers to target customers who are physically closer to their shop locations.

And with that, I'll pass on to John to discuss our financials.

John Shek Hon Lo

Thank you, James. Hello, everyone. For the first quarter of 2017, our total revenue was RMB 49.6 billion, up 55% year-on-year while 13% quarter-on-quarter. Gross profit was RMB 25.4 billion, up 37% year-on-year or 8% quarter-on-quarter. Net other gains were RMB 3.2 billion; it was due to net disposal, deemed disposal, gain on investees, semiannual dividend income from Supercell and subsidies and tax rebates which were partly offset by donations made to the Tencent Charity Fund and impairment provision charges for certain investee companies.

Share of losses of associates and joint ventures was RMB 375 million in the quarter on a non-GAAP basis. We generated profits of RMB 199 million in first quarter 2017, comparing to losses of RMB 339 million in first quarter 2016, or profits of RMB 391 million in fourth quarter 2016. Income tax expenses were at RMB 3.7 billion, up 43% year-on-year and 52% quarter-on-quarter. The effective tax rate for the quarter was 20.1%.

Net profit attributable to shareholders was RMB 14.5 billion, up 58% year-on-year, or 37% quarter-on-quarter.

After adjustment to non-GAAP, operating profit for the quarter was RMB 18.5 billion, up 37% year-on-year and 24% quarter-on-quarter. Operating margin was 37%, down 5 percentage points year-on-year and up 3 percentage points quarter-on-quarter.

Net profit to shareholders was RMB 14.2 billion, up 42% year-on-year, or 15% quarter-on-quarter. Net margin was 29%, down 3 percentage points year-on-year and up 1 percentage point quarter-on-quarter.

Let's turn to segment gross margin. Gross margin for value-added services was 60.9%, down 4.7 percentage points year-on-year, mainly due to revenue mix change due to low-margin products including digital content subscriptions; the sequential decline of 2.3 percentage points, mainly due to higher content costs, especially for our video subscription services. Gross margin for online advertising was 34.8%, down 8.9 percentage points year-on-year due to increased video content investment.

Sequential decline of 11.8 percentage points reflected lower revenue generated during weak seasonality in the first quarter. Gross margins for others was 21.9%, up 14.9 percentage points year-on-year or 1.5 percentage points quarter-on-quarter. The year-on-year increase in gross margin was due to the charging of cash withdrawal fees from the beginning of March 2016.

Moving on to operating expenses. Selling and marketing expense was RMB 3.2 billion, up 55% year-on-year or down 29% quarter-on-quarter. The year-on-year increase was mainly due to higher marketing and promotional spending for games, video, and news apps, as well as staff costs. Sequentially, it reflected slowdown in promotion and marketing activities during Chinese New Year holidays.

Selling and marketing represented 6% of quarterly revenue. Total G&A expenses was RMB 7 billion, up 61% year-on-year and 1% quarter-on-quarter. Under G&A, R&D expense was RMB 3.6 billion, up 54% year-over-year and broadly stable quarter-on-quarter. The year-on-year increase mainly reflected high staff costs. As a percentage of quarterly revenue, total G&A was 14% and R&D was 7%.

At the end of the first quarter, we had just over 39,000 employees. Year-on-year growth of 26% was mainly due to one-off inclusion in our head count of some outsourced manpower who engage in our customer support mainly in quarter three 2016 and were previously classified as consultants. And the business combination of music streaming [Technical Difficulty] (18:29). Excluding these two factors, head count grew by 13% year-on-year.

Looking at the margin ratios for the first quarter, gross margin was 51.3%, down 6.8 percentage points year-on-year, mainly due to increasing contribution from other segment, which carry lower margin and decreased value-added services gross margin. Other segment revenues accounted for 15% of total revenue now, compared to 7% the same quarter of last year. Gross margin dipped 2.6 percentage points sequentially, primarily reflecting lower gross margins of value-added services and online advertising businesses.

Non-GAAP operating margin was 37.4%, down 4.7 percentage points year-on-year, primarily reflecting lower gross margin, partially offset by an increase in net other gains. Sequential increase of 3.3 percentage point was mainly due to lower selling and marketing expenses and higher net other gains, which was partly offset by lower gross margin.

Non-GAAP margin was 29%, down 2.7 percentage points year-on-year and broadly stable quarter-on-quarter.

For the first quarter, total CapEx was RMB 2.1 billion, down 49% year-on-year, and 26% quarter-on-quarter. Operating CapEx was RMB 1.7 billion, up 27% year-on-year, or down 20% quarter-on-quarter. The sequential decrease was mainly due to less purchase of servers in first quarter of 2017 as we purchased more servers in the fourth quarter of 2016 for the peak season during Chinese New Year.

Non-operating CapEx was RMB 395 million, down 86% year-on-year mainly due to the fact there was no [indiscernible] (20:22) purchase in first quarter of 2017 as opposed to first quarter of 2016. Sequential decrease of 44% was because of slower construction work for our new offices during Chinese New Year holidays.

Free cash flow was RMB 24.2 billion, up 74% year-on-year and 41% quarter-on-quarter. This sequential increase was mainly due to seasonally strong operating cash flow generated from mobile PC client games and smartphone games.

Our net cash position at quarter end was RMB 27.6 billion, or $4 billion, up 1% year-on-year and plus 52% quarter-on-quarter.

Sequential increase in net cash was driven by free cash flow generation, partly offset by payments for M&A initiatives and licensed content.

Fair market value of our listed associates and available-for-sale financial assets were approximately RMB 112 billion or $16.2 billion at the quarter end. Thank you.

Jane Yip

Thank you. We shall now open the floor for questions. Operator, we would take one main question and one follow-up question each time. Shall we invite the first question now?

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Your first questions comes from Deutsche Bank, Mr. Alan Hellawell. Please ask your question.

<Q - Alan Hellawell>: My first question relates to subscriptions. I would love to just get a sense as to what our subscription base is now? And then I heard passing reference from John about digital content subscription being lower margin. I hope I was correct in that and would love to get a little more context about that. And specifically with video, if we were again to try to construct a hypothetical video P&L with advertising and subscriptions as inputs to revenue, has loss margin narrowed? And would we expect margin to improve year-after-year going forward? Thank you. I'll save my follow-up.

<A - James Gordon Mitchell>: So, Alan, we disclosed a total subscription count which includes both subscriptions for our traditional privilege services such as QQ VIP, and Super QQ, as well as subscriptions for our digital content services such as our streaming music, streaming video, literature and so forth.

And as a general rule, the privilege subscriptions have been declining partly because we have been consolidating the Super QQ and the VIP QQ together into the Super VIP QQ package. But that decrease in privilege subscriptions has been more than offset by growth in our digital content subscriptions around video, music, literature and so forth. And the combination of the overall subscription base increased, plus the mix shift from privilege subscriptions which are generally lower ARPU to digital concept subscriptions which are higher ARPU, plus the mix shift within privilege subscriptions from lower ARPU to the higher ARPU Super VIP package together have resulted in the fairly rapid growth that we're experiencing in our digital subscriptions revenue.

In terms of the margin it varies by digital subscription products, but in general the incremental margin on a digital subscription is lower than the incremental margin on a virtual privilege because the virtual privileges are generally piggybacking on our social networks and carry low incremental expense versus the digital content subscriptions carry incremental cost related to movie studio output deals to record label output deals and so forth.

In terms of the margins for the video business in recent quarters, we have taken a number of amortization charges against our video program library. And that's had some impact on both the advertising gross margin and this quarter on the value-added services gross margin. For the first quarter for the first time, our digital subscription video revenue exceeded our video advertising revenue, although that's partly a seasonal factor because the first quarter is seasonally weak for advertising and seasonally strong for consumer digital spend. So, we wouldn't necessarily expect that to be the case in subsequent quarters.

Finally, I'd just add, as we often do, the video product for us is very much in investment mode. It is heavily loss-making and we expect it to remain loss-making for the foreseeable future. But it's gratifying that while we are incurring those losses, we're also seeing growth in traffic, growth to some extent in video advertising revenues and then more substantially growth in video subscription revenues.

Operator

Your next questions comes from Alicia Yap of Citigroup. Please ask your question.

<Q - Alicia Yap>: Hi. Thank you. Good evening, management. Congrats on the strong results. I have a questions relating to the cloud and the AI. So, we noticed that Tencent Cloud is actually stepping up investment in penetrating into more industry vertical and also oversea expansions, and also recently, Tencent YouTu Lab actually breaks the world record in the facial recognitions test. So can management share with us what is your current thinking about the Tencent Cloud growth opportunity in the coming years? And also your investment target in the AI, and do this initiative actually has any connections or rationale behind your recent public market purchase of the Tesla shares? So, any comment or color will be appreciated.

And second on the housekeeping questions, just – what is the company deferred revenue policy on the average duration? Is there a difference for PC game versus mobile games? Thank you.

<A - Chi Ping Lau>: Okay. In terms of cloud – well, thank you for being very observant on a lot of our releases. I think certainly you are right in observing that we have really stepped up our effort in cloud. And the reason is we view cloud business as a very strategic piece of our business, in terms of it providing infrastructure to support a broader ecosystem of Internet penetration. The way we see it is, as more and more users become Internet-enabled and mobile-Internet-enabled, all industries, including companies and corporates, governments, will have to embrace Internet businesses in much bigger way. And as a result, there will be a number of infrastructure businesses that will be very important for them to make that transition, and cloud business is one of them. So that's why we have really been stepping up our investment. And corresponding to that, we have actually been growing our business very rapidly.

As indicated in our prepared remarks, our cloud business continues to grow in triple digit. And looking forward, we do believe that we can actually scale – continue to scale up the cloud business. We have a lot of – we have very big scale infrastructure which offers efficiency, as well as cost-effectiveness for our client. At the same time, because of our very long history of developing all kinds of different technologies for our own use, now, as we step into the cloud business, we'll increasingly open up these technologies and capabilities to support our cloud customers.

And going forward, I think these capabilities will help us to sign up more and more customers. And obviously, sort of the bigger gap in terms of the cloud business is actually in terms of sales force and marketing, and this is sort of something that we had been building on an instrumental basis to give us the capability to cover more customers, to support more channel partners, and at the same time, to do a better job in marketing our brand name and services.

As it relates to AI, we view AI as, one, a core capability for us to continue to build our own businesses, right? AI actually touch a point – a lot of our existing businesses in the area of advertising for increasing our targeting capability in the area of our newsfeeds and information to allow us to customize and personalize our offerings to our users in the area of online finance to help us to target users with the right profile.

So, by developing artificial intelligence and these core technologies, it will benefit our core business. AI can also help us to get into new businesses in the future, and we are actively developing these capabilities. And finally, AI, as we continue to build our cloud business, right, it will become a core capability that we'll be opening up to our cloud partners as well as our ecosystem partners. So that's the way we look at it.

As it relates to Tesla, I think it's somewhat related to AI, but what we feel is that new automobiles as they become more and more connected with the Internet as well as it becomes smarter in terms of control and autopilot – assisted pilot and over time autopilot, an automobile is becoming a smart device. And there will be much more connection between the physical world and the virtual world.

So that's the reason why we felt we want to partner with the leading company in such fields, right, in order for us to get on with this capability as well as to figure out whether we can learn something new or whether we can actually build some businesses together.

Now, as it relates to deferred revenue, I think John will answer that question.

<A - John Shek Hon Lo>: In relation to the deferral methods for virtual game items, on the PC side, basically, for most of the games it's within six to nine months, whereas for some special categories just like the MOBA, type of games, it might be up to 12 to 18 months.

And on the mobile side, generally, game items have been amortized over three to six months and more on the three months side. Whereas for a special category of games, again, such as MOBA, it might be up to now, 9 to 12 months.

<**A - Jane Yip**>: Thank you. May we have the next question, please?

Operator

Your next questions comes from Eddie Leung of Merrill Lynch. Please ask your question.

<**Q - Eddie Leung**>: Good evening. We have heard that some social media mentioned that they would focus more on short-form video as a format for social users to communicate. So, just wondering what your thought are on this trend and any information or operating metrics that you could share with us that you have seen a change in user behavior on the Tencent platform would be helpful.

And then, finally, just a housekeeping question, wondering if John can share with us the ARPU of various types of games. Thank you.

<**A - Chi Ping Lau**>: Yeah. In terms of short-form video, I think certainly, it definitely is picking up. I think short-form video is really an extension of photo, and we have seen short-form video growing very rapidly across all our properties.

In terms of the social platform, the short-form video has been growing very quickly, particularly with QQ which cater to a young user base. I think the new generation are much more accustomed to be sharing short-form video, so that's growing very quickly. At the same time, we also believe that short-form video is increasingly going to be a form of media consumption, so across a lot of our media properties including our news, Kuaibao, as well as Tencent Video, the short-form video has also been growing very quickly.

<**A - John Shek Hon Lo**>: In terms of ARPU for MMOG, [ph] the quarterly (34:37) ARPU ranges from RMB 320 to RMB 520 in the quarter; ATG RMB 100 to RMB 370; and smartphone games within RMB 125 to RMB 135.

<**A - Chi Ping Lau**>: Thank you. And the next question, please?

Operator

Thanks. The next question comes from Alex Yao of JPMorgan. Please ask your question.

<**Q - Alex Yao**>: Hi. Good evening, everyone. Thank you for taking my question. I have a question regarding the music business. You guys apparently have a majority of the market share after the acquisition of China Music Group. Can you talk about the difference between music and video in terms of marketing structure, content supply-demand relationships, and the long-term monetization as well as the profitability outlook?

My follow-up question is, the video industry move towards original content production and direction. How do you think the competition in terms of content budget will impact the industry and your profitability? Thank you.

<**A - James Gordon Mitchell**>: So, in terms of the music industry market structure, there is a number of competitors in the music streaming business in China, but they're not necessarily the same companies as in the subscription video business. So, for example, NetEase has a relatively clear strong position in music streaming in China, and we actually sub-license music to NetEase.

I think I would also say that the music industry has been plagued more recently by piracy. And so, in the music industry, a great deal of what we're trying to do with the cooperation of Warner Music, Sony Music, now Universal Music, as well as with the cooperation of our downstream partners, such as NetEase, is try to shift user behavior away from the pirate model and toward the paid model because if we can do that, we can make the pie bigger for everyone.

And you may be aware that China is undoubtedly the world's largest music market in terms of music listening, but it's historically the world's 20th largest market in terms of music industry revenues. So, there is a great deal of work for us to do, but we're pleased with the progress so far.

Looking at the content supply in music versus in video then, I think in video, 80% of the content is from primarily mid-sized domestic suppliers and 20% is from foreign suppliers supplying English language or Korean language or Japanese language video content into the Chinese market.

For the music industry, quite different, in that you have a handful of global music labels including Universal, Warner and Sony that not only have very strong English language music presence, but also have a decent Chinese language music presence, particularly in Taiwan, Hong Kong, and more recently in Mainland China itself. So, there are those three relatively larger labels that account for a decent double-digit chunk of total music supply in China.

And then there is a long tail of many small domestic record labels, as well as a few Korean and Japanese record labels that account for the majority of the music that's streamed in China. So, quite a different content supply structure, but we're quite pleased. As I mentioned, we have excellent relationships with the three global music labels, as well as very strong relationships now with many of the smaller domestic and Korean music labels as well. So that's the music industry structure.

With regards to the video industry, you're correct to observe that we and our peers in the industry are increasingly commissioning our own content. This has several advantages. One advantage is the ability to schedule the content when we choose, so that we can space out the most important programs through the year. Another is if we commission the content, we can decide whether to put it into the pay window or into the free window or how to allocate the time between the pay and the free windows.

And that's something that worked very well for us in the first quarter, and it's part of the reason why you saw our video subscription revenue grow several hundred percent year-on-year and overtake our video advertising revenue.

In terms of costs, to some extent, it means we have more visibility over our cost structure, but obviously there is a very substantial expense associated with commissioning the content directly as opposed to sub-commissioning it from a TV broadcaster. So, when we and our peers talk about video industry costs increasing sharply this year, then a substantial component of that cost increase is indeed the commissioning of original TV content.

<Q - Alex Yao>: Thank you.

Operator

Thank you. Your next questions comes from Jin Yoon of Mizuho Security. Please ask your question.

<A - Jane Yip>: May we have the next question, please?

Operator

Certainly. Your next questions comes from John Choi of Daiwa. Please ask your question.

<Q - John Choi>: Good evening and thanks for taking my question. I have a question on the mobile games. Basically, I think management did share that the paying accounts has one of the – been the key factors of a strong performance. But as we go forward, how should we be thinking of the key drivers? Obviously, it seems that the RPG genre is doing a lot better with three strong games. Should we be expecting ARPU be the major force or should we be expecting the paying accounts to increase or the paying ratio to follow?

And just quickly on the Weixin Moments advertising, I was wondering if management could share with us where are we at right now because it seems to us that the expansion pace of the advertising is a little bit weaker than what the market has previously expected. So any color on that will be very helpful. Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the mobile games, I think, obviously, the most important thing is actually to be able to come up with successful games on a ongoing basis, but if you look at our overall strategy, I have always been saying we have been very strong in casual games and we wanted to develop a genre of player-versus-player mid-core games. And we are growing our RPGs by working with our partners as well as doing internal development. So, on each one of these initiatives, right, I think we have made progress in the past year.

So, if we look at player-versus-player games, right, typically, I would say they have a longer lifespan because it's like a competitive sports, right? Every time you play the game, the game experience is actually very different. It's sort of not that much content-driven.

And then sort of in the area of RPGs, I think we are at the beginning of developing the strategy. We have a few games which have been popular. We will continue to work with our partners as well as leverage our own development to come up with RPG games.

Now, whether the games will be successful I think will be tested out over time. So, I think that's what we have been doing on mobile games.

Now, in terms of performance ads, right, I would say we continue to look at performance ads as a long-term opportunity, and we will be solving this problem and exploiting this opportunity in that manner, which means that we'll focus a lot on building our own capability in terms of understanding the user's needs, in terms of perfecting our targeting technology, in terms of developing the right ad format so that it has the best tradeoff between response as well as user experience.

And of course, right, there is a component of releasing more inventories, but that's something which is sort of very easy to do. That's exactly why we do not want to do it in a very fast manner. So, what we have been focusing on is really sort of making sure that we get all the capabilities right, so that we can actually – based on existing inventories, we can actually do a better and better job, and we can sign up more advertisers.

And over time, we will release inventories on a measured basis. In fact, we have increased our inventories a little bit, but not that much. But I think what we continue to focus on is that we want to make sure that our user experience is not compromised. And by having a better targeting capability, we can actually take in more advertising without compromising user experience, and that's something that we're going to be focused on.

Operator

Thank you. Your next questions comes from Richard Kramer of Arete Research. Please ask your question.

<Q - Richard Kramer>: Thank you very much. I guess just a quick follow-on to that as my follow-up. Is there any plan now that you're lapping the high growth rates in Moments to consider potentially increasing the ad loads there? And do you see additional formats as you've seen other large Internet or social networking companies do, do you see other formats you could start to introduce which would further increase pricing? And my main question was really on payments, clearly one part of the...

<A - Chi Ping Lau>: Let me just intercept you on that. I think -

<Q - Richard Kramer>: Okay.

<A - Chi Ping Lau>: I don't know how you get the impression that the Moments ads is actually entering into slow growth, and at the same point we need to overload our users with more inventories.

I think this is not the right interpretation. I think number one, the performance ads at large is actually growing at a rate which we felt is actually quite encouraging. And two, we are far from being sort of approaching the end of improving our own capabilities, so that we have to keep on increasing the ad inventories. So, I just want to make sure that nobody gets misled by your statement.

<Q - Richard Kramer>: No, I think maybe it was misinterpreted a little bit. I think the point is that you are reaching the year-on-year comparisons and they are still at quite high levels, but I'm wondering if there are ways to further improve the performance of the performance-based ads by adding new formats.

<A - Chi Ping Lau>: Yeah. I think the performance is actually quite good already. So,...

<Q - Richard Kramer>: Okay.

<A - Chi Ping Lau>: ...we should be overloading our users with a lot of ad loads.

<Q - Richard Kramer>: Okay. And my second question was on payments. And I guess, it's clearly part of the other business which is growing at a very high rate. Do you expect it to be permanently sort of an enabling service for your other social network services? Or do you see a standalone role for it, which would include maybe some more distinct disclosure of how the adoption has been fairing and the user base and the range of services that we could provide since it's mentioned in a very cursory way in the release. Thanks.

<A - Chi Ping Lau>: Well, I think from a business perspective, we view our payment business as an infrastructural service for our ecosystem. That's not just for our social network, but also for all sorts of different activities within our ecosystem and with our partners. So, it should cover four aspects of our users' everyday life when they're shopping online, when they are subscribing to content, and then when they are shopping offline, when they are experiencing different kinds of offline services. So, I think that's the positioning.

And from, I would say, business perspective, we do not view it as a profit center for the foreseeable future. We want to make sure that we continue to build our coverage in terms of both users as well as user frequency, as well as merchant coverage, so that we can really make our payment services as a biggest service for our users.

Now, in terms of the payment service, essentially it has a number of different components. One is social payment, and that would include our very famous Red Packet. There is a money transfer aspect when people can transfer money back and forth in a very cost-effective as well as convenient way. And then there's an online commercial transaction, where – if people shop on e-commerce sites or if they order for delivery food, they can actually use our payment service. And then there's also an offline merchant component in which merchants can leverage our payment platform to get paid.

So, a lot of different retail outlets and restaurants as well as offline services like DD, you can actually define how payment solutions are featured. And even in some of the hawker stalls, when they are not covered by any POS, if you just get a QR code, you can actually get paid using our payment service. And I think these are the different categories of payment services that we offer.

Operator

Thank you. Your next question comes from Grace Chen of Morgan Stanley. Please ask your question.

<Q - Grace Chen>: Yeah. Thank you. Thank you for taking my question. My question is about your successful mobile game, Honour of Kings. Can you help us better understand the design of the game and other factors that help contribute to the success of this game?

And also, can you help us compare the key metrics of Honour of Kings with all the games, maybe League of Legends, in terms of the lifecycle paying ratios and ARPU? And I believe that Honour of Kings is now a substantial contributor to the overall mobile games, and how does the mix change has been affecting the key gaming performance metrics that we discussed above? Thank you.

<A - Chi Ping Lau>: I think Honour of Kings is definitely a very successful game, and I think the success stemmed from the fact that the game format is very attractive game format as proved in League of Legends, when you have all sorts of different characters, five-on-five team play against each other, players versus player. I think this MOBA genre is actually an attractive game format.

I think secondly is the fact that technically we actually solved the very difficult challenge of having a real-time fighting on mobile, and it actually overcomes a lot of latency within mobile network. That's a key breakthrough. And I think we also benefit finally from our longstanding operating experience in the MOBA category. And if you look at the way we manage eSports, the way we actually manage the promotion and how do we sort of talk to the different gaming groups, this is what we have accumulated over years of operating the MOBA genre.

And as we said, we believe Honour of Kings right now is one of the highest DAU game – mobile game globally. And I think at this point in time, it's relatively early in terms of its life cycle. We want to make sure that we continue to develop the game, continue to add exciting features and content, so that we will keep our users happy. And I think that's the focus at this point in time.

Operator

Thank you. Your next question comes from Chi Tsang of HSBC. Please ask your question.

<Q - Chi Tsang>: Great. Thank you. And good evening, and thanks for taking my questions. I had two things I wanted to ask you about. Firstly, I was wondering if you can comment on some of the different habits of WeChat users in Tier-1, Tier-2 cities as well as sort of the lower-tier cities. And particularly I'm curious about things like time spent, sort of the different types of services or content that the different user groups are consuming in these different areas.

And secondly, I was wondering if you can give us an update in terms of online finance. The business is separate from your payment business. In particular, things like WeBank, things like lending, things like asset management, any sort of update on that would be very useful. Thank you so much.

<A - Chi Ping Lau>: Well, I think in terms of the different behavior across different cities, I would say, number one, the lower-tier cities has got still more users using QQ as opposed to Weixin. And I think if you look at the user behavior just on social network, I would say, there are more business-related activities. So if you look at e-commerce, first tier and second tier cities, people are more active on those type of services. And then, lower-tier cities, people are less active on that.

And then in terms of what kinds of official accounts that people read, there's some differences in terms of the interest of people. I think that's, broadly speaking, what it is. But in terms of the amount of time that people spend, I think it's actually pretty similar across the board. People spend quite a bit of time on WeChat.

Now, in terms of online finance, I think we continue to make progress in each category of our online finance business. Obviously, the flagship is our online payment service which we'll continue to grow in terms of our user base, number of transactions.

In terms of finance, I think we have been building WeBank on a continuous basis. And I think its flagship product [indiscernible] (55:31) actually seeing good traction. We are able to leverage our big data capability as well as our ubiquitous touch point with users, to offer these consumer loans on a very convenient basis to users and it's growing on a nicely rate.

And finally, in terms of our – and I think on WeBank, we just want to reemphasize the way we manage WeBank is that we have a very broad partnership with all sorts of different banks, because the way we fund WeBank right now is that – while WeBank is in charge of originating the loans, a lot of these consumer loans were actually joint loans made in conjunction with a pretty large number of banks, so that we have a profit sharing with the banks that are partnering with us.

And finally, the loan quality that WeBank is lending to is actually quite good from a delinquency ratio perspective. So, that means our big data analysis is actually quite effective in controlling risk. In terms of our asset management platform, Licaitong, our asset under management continues to grow, but we also want to do it in a very measured basis because we felt that it's very important for us to control the quality of the investment products that we offer.

In China, there's a broad base of different types of wealth management products. When we looked at the whole list, there are a lot of ones which we felt are too risky to offer to our users. So, that's what we have been trying to do. On one end, we have been trying to make sure that we source that wealth management products of the right quality and on the user end we have been trying to do a lot of user education, so that users will make decisions on educated basis instead of blindly investing in wealth management products which offer supposedly high yield, but in fact it's actually a risk that they cannot take. So, that's progressing pretty well.

<A - Jane Yip>: Thank you. And due to the time constraint, we would take the last three questions from the floor.

Operator

Your next question comes from Xu Ming of UBS. Please ask your question.

<Q - Ming Xu>: Thank you, management, and congrats on the strong earnings. So I have two questions. First is on the finance side. So we noticed recently a series of regulatory events. So for example, you were not granted the credit rating license and also you and your main competitor was fined a little amount by the Central Bank. So just want to understand, do you think this is a separate event or does it indicate a changing regulatory attitude? And what's the impact to your finance and payment business?

And a follow-up is on the advertising side. So, you announced a reorganization of the advertising business management in early 2Q. So, is there any update on that front you can share with us, and when can we see a pickup in your like the brand ad business? Thanks.

<A - Chi Ping Lau>: In terms of financial regulations, I think it is indeed a very important area that we have to focus on a lot. And in terms of the fine, it's actually in relation to the real name policy required by the PBOC. And on that front, I think we treat the fines and the penalty very seriously and we are making a lot of changes as required by PBOC. The key issue for us and I think for Ali is that, our user base is way beyond any measure.

So, the number of users using our payment service is in the hundreds of millions number. And when we need to turn all these people into real name basis, we put in a lot of different measures. But still it takes time for us to do the conversion and we need to balance between how fast we can actually do it versus the user experience and user complain. We were under a lot of pressure when we tried to step up our measure, had to turn people into real name users with all sorts of different certification.

So, I think that's something which corresponds to a time last year when we were not able to turn people into real name fast enough, and I think a lot of the issues were rectified. But the credit rating license is another thing. I think there is, to some extent, a question of whether there is a business that can be built in China by offering credit rating services. I personally think a third-party credit rating service which charge financial institutions money is probably not a very advanced model. It's a model that existed long time ago. And at the same time, if you look at PBOC, it is actually providing a better and better overall credit rating infrastructure for the entire country.

So, I think that's the reason why the license was eventually not granted yet to anyone because there is a question of how do we define the scope and what value would it create for the overall financial industry. So those are two different separate events. But I think you're right in saying, when we get into financial services, regulations are very important and we'll build up our infrastructure to talk to the regulators much more often, and we'll step up our effort in compliance.

Operator

Thank you. Your next question comes from Thomas Chong of Bank of China International. Please ask your question.

<Q - Thomas Chong>: Hi. Thanks management for taking my questions. I have a quick question about our overseas strategy in games, payment and cloud. Do we have a priority in which area we particularly focus in over the next few years? Thanks.

<A - Chi Ping Lau>: Yeah. I think, gaming definitely will be a key area of our focus. I think as you can see, we are already at this point in time, through our investments and acquisitions – we're already pretty big in terms of global gaming exposure. And I think we'll continue to build that presence through investments and acquisitions. At the same time, we are also going to launch our self-developed games over time into the overseas market.

Obviously, this is something which we need to take much longer time to learn the lessons and to build the infrastructure, to find the right games, and so and so forth. So, that would take some time for us to do. But gaming, overall, is definitely going to be number one priority. I think payment – at this point in time, we'll continue to leverage the fact that Weixin Payment is already very big and there are a lot of users. And a lot of these users are traveling abroad and they're spending abroad, and having – would definitely follow that trend.

Now, in terms of building presence of our payment services in different local markets to serve local people, I think each local market has got a different set of regulations and a different set of interaction protocol with financial institutions. So, that has to be done on a case-by-case and on a much longer-term basis.

I think with our cloud business, at this point in time we're very focused in building our presence in China. And at the same time, we know that a lot of our customers actually have a presence outside of China and that's something that we'll build up in terms of infrastructure, in terms of our sales force in order to serve their needs outside of China market, and that would be the first layer of our strategy. Over time, when we build enough presence in different markets, we'll start serving local clients.

Operator

Thank you. Your next question comes from Natalie Wu of CICC. Please ask your question.

<Q - Natalie Wu>: Hi. Thank you for taking my question. Just wondering can management update us what's the current split in terms of mobile game revenue between iOS and Android handsets. And especially on the Android handset, how much percentage of your mobile game revenue is generated from those distributed by external channel or third-party app stores? Is there any notable change in the latest several quarters?

And very quickly, just regarding the Weixin Payment. Just wondering about the promotion program for restaurant merchants that Weixin Payment just announced earlier this month. How much budget Tencent propelled for this program, and what kind of margin impact should we expect regarding payment promotion this year? Thank you.

<A - James Gordon Mitchell>: So in terms of the mobile game split between iOS and Android, it bounces around a little bit quarter-to-quarter. But generally speaking, Android is a larger proportion of our total and then iOS is a significant double-digit, but minority proportion of total mobile game revenue.

Interestingly, there's also a very high variance by genre of games. For example, shooting games tend to over-index very heavily toward Android versus our role-playing games tend to over-index a little bit toward iOS, which I think is also true for the industry as a whole that the iOS owners are more prone to spending money in role-playing games versus the Android are more prone to playing and spending money in shooting games, racing car games, battle arena games and so forth.

Now, within the majority that's Android, historically we've relied largely on our own app store in order to get our games to critical mass, and now we're in a position where we have several games that are actually at very substantial mass through our own channels, and we want to further increase the ubiquity in China in order to facilitate doing that. We're actually working more aggressively with third-party Android app stores than we have in the past.

So as you probably know from looking at other mobile game developers that rely entirely on third-party app stores, as you rely more on the third-party app stores, you have to incur some cost of revenue inside them to promote you, and therefore there's some margin drag impact that we've started to experience and we'll continue to experience in our mobile game business, as we increasingly utilize third-party app stores as well as our own higher-margin distribution channels. So, that's on the mobile games side.

In terms of Weixin,...

<A - Chi Ping Lau>: In Weixin Payment, we are putting up quite a big initiative around the restaurant vertical, and the reason is because it is a vertical that's very competitive. And what we're doing is leveraging our relationship with

Meituan-Dianping who has a very strong coverage among restaurants. And at the same time, we can offer significant promotional budget as well as discount for users, so that we can actually get back some of these restaurant customers, because in the past, half a year to a year, I think we in fact have lost some market share in the restaurant category, not the fast food, but the more people sit-down dinner type of restaurant category. So we are, indeed, putting aside a pretty good budget to get back on the competition front.

Operator

Thank you. There's no more question on the queue. Ms. Yip, please begin your closing remarks.

Jane Yip

Thank you, operator. We are closing the call now. If you wish to check out our press release and other financial information, please visit the IR section of our company's website at tencent.com. The replay of this webcast will also be available soon.

Thank you, and see you next quarter.

Q4 2016 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Wendy Huang
- Alicia Yap
- Eddie Leung
- Alan Hellawell
- Jin-Kyu Yoon
- John Choi
- Piyush Mubayi
- Ming Xu
- Thomas Chong
- Chi Tsang
- Natalie Wu

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2016 Fourth Quarter and Annual Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation, followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to our annual results conference call for the year of 2016. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and non-GAAP measures, please refer to our disclosure documents on www.tencent.com/ir.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview, Martin will discuss strategic highlights, James will speak to business review, and John will go through the financials before we open the floor for questions.

I'll now turn the call over to Pony. Please.

Huateng Ma

Thank you, Catherine. Good evening. Thank you for joining us. In 2016, we delivered another set of solid financial results. MAU continue to invest in our social platforms, digital content, and ecosystem and new technologies, which will increase our long-term competitiveness and drive future operational success.

Let me update you on our key achievements in four strategic areas. In social, we've driven the user engagement on our social platforms, Weixin and QQ. We recently launched Weixin Mini Programs, which facilitates convenient service delivery for our users. For QQ, we introduced live broadcast to enhance social experience and integrate AR technology to our popular red envelopes campaign.

In games, our smart phone games further expand product profile and achieved strong revenue growth. During the year, we launched many successful titles. In particular, our in-house title, Honour of Kings, is the most popular mobile game in China, with DAU exceeding 50 million. We expand our global footprint via strategic partnerships and investments. In PC games, we increased our market share by focusing on serving core gamers and extending lifecycles of our blockbusters.

In media and content, our news, video and sports platforms generate significant user growth. Our digital content monthly subscriptions more than doubled year-on-year. In music, we solidified China's online music streaming market last year. And our new WeSing app is now by far the highest DAU karaoke app in China.

In our ecosystem, we're strengthening our support to partners by ramping up our infrastructure services. Our mobile payment increased market share and daily transactions. YingYongBao and Mobile QQ Browser widened their leads against peers and doubled their revenues year-on-year. And our cloud services extend its capabilities and customer base and tripled revenues year-on-year.

Operationally, we maintain clear leadership in core operating platforms. Weixin and WeChat combined MAU exceed 889 million, up 28% year-on-year. Total MAU for QQ rose 2%year-on-year to 868 million, within which smart devices MAU was 652 million, up 2% year-on-year.

For Qzone, smart devices MAU grew 4% year-on-year to 595 million. For smart phone games, we solidified our lead in several key genres, especially in PvP games and deepening our penetration in RPG genre. For PC client games, we remain the industry leader by revenues and user bases. For our media business, we saw rapid growth in traffic and users for activities such as sports and music. In mobile utilities, we continue to lead by a monthly active users for mobile security, mobile browser, and your app store in China.

Financially, we delivered a strong set of results. For the fourth quarter of 2016, total revenue was RMB 43.9 billion, up 44% year-on-year and 9% quarter-on-quarter. Non-GAAP operating profit was RMB 14.9 billion, up 30% year-on-year, or down 1% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB 12.3 billion, up 38% year-on-year and 5% quarter-on-quarter.

For the full year of 2016, total revenue was RMB 152 billion, up 48% year-on-year. Non-GAAP operating profit was RMB 58 billion, up 39% year-on-year. Non-GAAP net profit attributable to shareholders was RMB 45 billion, up 40% year-on-year.

I'll now invite Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony, and good evening and good morning to everybody. I am going to update you on the four areas which we have achieved new developments in 2016 and early 2017, fortifying our ecosystem and benefiting our users and partners.

Starting with mobile payment, we achieved over 600 million monthly active users as at the end of 2016, and our daily payment volume nearly doubled year-on-year to over 600 million transactions a day. For social payments, during the 2017 Chinese New Year period, our users exchanged over 46 billion Weixin red envelopes, up over 40% year-on-year.

For commercial payments, we're driving user penetration by creating more online and offline use cases, in particular high frequency transaction activities. And we're driving merchant penetration by signing up flagship partners in key verticals, such as retail, restaurants, and we have also proliferate our coverage of long-term merchants through channel partners.

For example, Starbucks recently enabled Weixin Pay in their 2,600 stores in China. As a result of all these efforts, our commercial payment volume tripled year-on-year. Our mobile payment platform also serves as an important channel for our wealth management platform, LiCaiTong, and our banking affiliate, WeBank, to distribute Internet finance products. We believe our user benefits from greater availability of such products and our partners benefit from targeted access to our user base through our payment platform.

Moving on to news and content services, we are China's market leader on mobile and PC news service ranked by daily active users, and we have also grown our user engagement and revenue significantly during the year. We provide news content to users through a number of different apps and online channels.

In the app front, Tencent News and Kuaibao are two standalone apps with complementary use cases. Tencent News provides series and deep news content based on the combination editorial and machine recommendations. Kuaibao delivers personalized reading content to users based on deep learning of each individual's interest graph. To enrich the diversity of our content library, we launched an open platform in early 2016 to facilitate content creators publishing article. This has benefited Kuaibao in particular, which DAU has grown to over 20 million, triple times of the beginning of the year in 12 months' time.

In addition to our news apps, we operate news channels which reach a broader user base. These include Weixin and Mobile QQ plug-in, Official Account, Mobile QQ Browser news feeds, and also our QQ Kandian. These channels deliver relevant news or broader content in a customized way to our users, who can then share with their social graph through chats or Moments. Our news and content traffic increased significantly during 2016. This substantial user traffic and the ability to target users are highly appealing to advertisers, which allowed us to increase the monetization of our news services through a combination of brand and performance advertising. In 2016, our mobile news advertising revenue grew more than 100% year-on-year.

Moving onto cloud services, we see substantial market opportunities accompanying our Connection strategy. Starting from primarily serving game developers, Tencent Cloud is now a clear leader in the online game space and live video broadcasting space, and is increasingly penetrating verticals including O2O, Internet finance, with municipal services as well as enterprise. A unique advantage we have is that Tencent has a solid foundation of technologies in areas such as security, payment, big data analytics, photo processing, mini programs, and artificial intelligence. Utilizing these technologies, Tencent Cloud provides tailored solutions for various customers and industries.

For example, we have customized solutions with specialized data centers to satisfy internet finance customers' needs to comply with regulations and with additional security. In addition, we expanded our cloud service sales force significantly in the year of 2016 and divided it by industry and geographic focus to better serve our customers. We also quadrupled our range of channel partners, which helped us to acquire more customers. As a result, in the year of 2016, our cloud service customer base and revenue more than tripled year-on-year. Looking ahead, we'll further expand our overseas infrastructure and continue to invest heavily in cloud services in terms of talent, technologies, infrastructure, and products.

Finally, I would like to share our thoughts about mini programs, which has attracted quite a bit of attention when it was first launched in the beginning of the year. We view mini programs as an enhancement of our Official Account system designed to connect offline service providers with users online.

For service providers, mini programs allow them to present QR codes at their offline channels, which convert into an online interaction when users scan the QR codes. For users, mini programs enhance convenient and fast sampling of interactive experiences, such as O2O services. Users will discover a service via mini programs, may choose to dig further and experience other functions, in which case they will then download the service provider's native application. Hence, mini program is complementary to both Official Account and existing app ecosystem, acting as an intermediary step in the process of user acquisition for app downloads.

One of very good example of the usage of mini program is with Mobike, which is a bike sharing app in China. Mobike users can access its mini program when they scan QR codes that sit on their bikes. Once users initiate the mini program, they can use basic features, such as registration, deposit paying, and renting bikes. For those who want to have more comprehensive services, they can download the app and experience the full suite of mobile application capabilities.

As a result, after Mobike launched its mini program, it saw a sharp increase in users for both its mini program and its native app. We are excited about the user experience that can be created with mini programs, and the benefit they bring to service providers and users. In line with Tencent's philosophy, we will build our mini programs ecosystem at a measured pace to ensure the quality and variety of service offerings that will match our standards.

Now I'll turn to James to talk about business review.

James Gordon Mitchell

Thank you, Martin, and good morning, good afternoon, good evening as the case may be. In the fourth quarter of 2016, our revenue grew 44% year-on-year. Value added services represented 66% of our revenue, within which online games contributed 42% and social networks 24%. Online advertising was 19% of our total revenue, and the other segments accounted 15% of total revenue, up from 5% in the fourth quarter of last year. For the full year, revenue grew 48%.

Looking into value added services, revenue in the fourth quarter was RMB 29.2 billion, up 27% year-on-year and up 4% quarter-on-quarter. Social network revenue was RMB 10.7 billion, up 51% year-on-year and up 9% quarter-on-quarter. Sales of digital content and game-related items were the main drivers for the year-on-year and quarter-on-quarter revenue growth. In particular, digital content revenues more than tripled year-on-year.

Online games revenue was RMB 18.5 billion, up 16% year-on-year and up 2% quarter-on-quarter. The increase is mainly driven by player-versus-player and role playing smart phone games. For the full year, our VAS revenue was up 34%, our social networks revenue up 54%, and our online games revenue up 25%.

Turning to social networks, for QQ we use location-based technology to help NOW users discover interesting content broadcast by people in their neighborhoods contributing to increased DAUs for NOW. During the Chinese New Year, our QQ red envelope campaign also used NOW's location technology to guide users to pick up augmented reality red envelopes distributed by participating merchants. Over 250 million QQ users joined the five-day event, opening over 2 billion red envelopes.

For Weixin we introduced mini programs, which Martin has already discussed, and we integrated our Enterprise Accounts into our Enterprise Weixin app, with a unified set of management tools to facilitate synchronization. This unification allows enterprises to manage their internal communication and administration matters with greater efficiency.

Moving to PC client games, for the full year 2016, our PC client game revenue increased 9%. But just sticking to fourth quarter, historically in years such as 2013 and 2014, our PC game revenue typically declines quarter-on-quarter in the fourth quarter due to fewer student vacation days and fewer special events versus the third quarter.

In 2015, our PC game revenue was un-seasonally strong in the fourth quarter due to new item types in one of our biggest games, but in 2016 the usual negative seasonality from 3Q to 4Q reasserted itself, which resulted in a 2% quarter-on-quarter revenue decline and a rather modest 4% year-on-year revenue growth rate.

PC game average daily active users decreased 13% year-on-year, reflecting, first, users continuing to shift a portion of their gaming time from actual game play to engaging with game content in other mechanisms, such as forums, videos, and eSports events. And secondly, users for some titles moving part of their playing time from the PC edition to a mobile edition at the same IP. Taking CrossFire as an example, since we introduced the mobile version of CrossFire in late 2015, we have seen some impact on our PC version DAUs, but the total unique CrossFire DAUs combining PC and mobile are substantially higher than what we had for PC alone.

Looking at the global games market, the PC is still a vibrant platform, especially for hardcore gamers, and we believe that should remain the case in China too. We continue to operate some of the most popular games in the China market, while seeking to nurture niche genres, such as battle combat and sports, as well as developing an eSports ecosystem.

For smart phone games, revenue in the fourth quarter was RMB 10.7 billion, up 51% year-on-year and up 8% quarter-on-quarter, and revenue for the full year was RMB 38.4 billion, up 80% year-on-year. According to App Annie, we became the top publisher globally in iOS. And we believe that our Android app store presence is generally stronger than our iOS App Store presence. Strategically, we made progress along several dimensions within smart phone games.

First, we maintained our leadership in casual games and introduced new casual genres, such as a fishing game and a chess game. Second, we've been developing big DAU audiences from biggest player-versus-player games. Honour of Kings surpassed 50 million daily active users, and we launched Freestyle Basketball, which has become among the top three mobile sports games in China. Third, we deepened our penetration in the important role-playing game category via titles such as JX Mobile, Fantasy Zhu Xian Mobile, and Dragon Nest Mobile, all consistently ranked in China's Top 10 iOS grossing chart since their launches. Looking forward, we believe we've assembled a rich pipeline, including both well-known IPs, such as NBA, Contra and TLBB, as well as a range of new IPs.

Moving onto online advertising, segment revenues for the fourth quarter was RMB 8.3 billion, up 45% year-on-year and up 11% quarter-on-quarter. Our brand advertising revenue was RMB 3.1 billion, flat quarter-on-quarter and up 11% year-on-year. User traffic created more inventory for our mobile news feeds and video, but our brand advertising revenue is being impacted by two negative factors.

First, many traditionally brand oriented advertisers are increasing the purchase in performance ads, which shifts revenue from our brand to our performance category. And second is our video subscriber base growth, we have less opportunity to have pre-roll and mid-roll ads before and during our video content, shifting revenue from our brand ad to our social networks subscriptions category. Our top five brand advertiser categories were online services, and particularly e-commerce, automobile, food and beverage, personal care, and consumer electronics.

Our performance advertising revenue was RMB 5.2 billion, up 77% year-on-year and up 18% quarter-on-quarter, benefiting from positive seasonality and e-commerce in the fourth quarter. More advertisers joined our self-service ad platform, especially after we launched neighborhood ads in September. The total number of Moments advertisers has more than doubled in the past four months. Weixin Moments and Official Account ads were the biggest contributors to the sequential and year-on-year growth, and we also added more inventory in our app store Qzone and Mobile QQ Browser products. For the full year, our online advertising was RMB 27 billion of revenue, up 54% year-on-year.

Looking more closely at Tencent Video, we continue to invest in premium content, which can contribute significantly to user growth in time spent. In addition to high profile licensed premium content, we're increasingly investing in original premium content, leveraging our ecosystem access to upstream IPs from literature and games, as well as cross-platform user insights, we can create original content that is unique and exclusive to our platform. While there is a time lag between commissioning, creating, and then screening our original content, we did put some of our original content on air during late 2016, including two big budget drama serials, a few animated TV shows, and several variety programs. Original content has proven particularly effective at growing our video subscription base, which increased over 300% year-on-year in the fourth quarter to over 20 million subscriptions. Specifically, iResearch ranked our Gui

Chui Deng or Candle in the Tomb TV series, which is based on a number of novels published by our online literature business, has achieving the highest user coverage of any online-only drama serial during the fourth quarter.

And with that, I'll pass on to John to speak to our financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the fourth quarter of 2016, our total revenue was RMB 43.9 billion, up 44% year-on-year or 9% quarter-on-quarter. Gross profit was RMB 23.6 billion, up 33% year-on-year or 8% sequentially. Operating profit was RMB 13.9 billion, up 28% year-on-year or down 4% quarter-on-quarter. Share of losses of associates and joint venture was RMB 522 million in the quarter, down from RMB 1.3 billion year-on-year or RMB 619 million sequentially.

On a non-GAAP basis, we generated profits of RMB 391 million in the quarter, comparing to losses of RMB 164 million year-on-year, or RMB 107 million in the third quarter. Income tax expense was RMB 2.4 billion, up 20% year-on-year or down 2% quarter-on-quarter. Effective tax rate was 18.6% for the fourth quarter and 19.7% for the full year.

Net profit attributable to shareholders was RMB 10.5 billion, up 47% year-on-year or down 1% quarter-on-quarter. For the full year of 2016, total revenue was RMB 151.9 billion, up 48% from 2015. Gross profit was RMB 84.5 billion, up 38% from 2015. Operating profit was RMB 56.1 billion, up 38% from 2015. Net profit attributable to shareholders was RMB 41.1 billion, up 43% year-on-year.

For the fourth quarter, on a non-GAAP basis, operating profit was RMB 14.9 billion, up 30% year-on-year or down 1% quarter-on-quarter. Net profit attributable to shareholders was RMB 12.3 billion, up 38% year-on-year and up 5% quarter-on-quarter. Operating margin was 34%, down 4 percentage points year-on-year or 3 percentage points quarter-on-quarter. Net margin was 28%, down 1 percentage point year-on-year or 1 percentage point quarter-on-quarter as well.

For the full year of 2016, on a non-GAAP basis, operating profit was RMB 38.2 billion (sic) [RMB 58.2 billion], up 39% from 2015. Operating margin was 38%, down 3 percentage points. Net profit attributable to shareholders was RMB 45.4 billion, up 40%. Net margin was 30%, down 2 percentage points.

Let's turn to segment gross margin for the quarter. Gross margin for value added services was 63%, broadly stable year-on-year or down 2 percentage points quarter-on-quarter. This sequential decline reflected mainly revenue mix shifts and increase in share-based compensation relating to 18th anniversary bonus shares.

Gross margin for online advertising was 47%, down 5 percentage points year-on-year, reflecting increased investment in video content. Sequentially, it rose 10 percentage points as a result of event driven content costs in the third quarter, such as Rio Olympics and Voice of China [ph] came off season (25:53).

For the full year 2016, gross margin for value added services was broadly stable at 65% compared to last year. Gross margin for online advertising decreased 6 percentage points to 43%, mainly due to a greater video content investment.

Moving on to operating expenses. Selling and marketing expense was RMB 4.5 billion, up 48% year-on-year or up 36% quarter-on-quarter. The year-on-year and quarter-on-quarter increases were mainly due to higher marketing and promotion spending for games and Weixin Payment businesses. Selling and marketing expense represented about 10% of quarterly revenue.

Included under G&A, research and development expense was RMB 3.6 billion, up 45% year-on-year or 14% quarter-on-quarter. Total G&A expense was RMB 6.9 billion, up 45% year-on-year or 17% up Q-on-Q. R&D represented about 8% of quarterly revenue and total G&A was 16%.

Share-based compensation was 4% of quarterly revenue. In celebration of the company's 18th anniversary, we awarded 300 shares to every employee. The first 100 shares was vested in November of 2016, and the remaining 200 shares in the following two years. In relation to this exercise, we booked stock-based compensation expenses of over RMB 500 million in the quarter.

On a full year basis, selling and marketing expense was RMB 12.1 billion, up 52% from 2015 and represented 8% of revenue. R&D expense was RMB 11.9 billion, up 31% from 2015 and represented 8% of revenue. Total G&A expense was RMB 22.5 billion, up 33% over 2015 and represented 15% of revenue. As at quarter end, we had approximately 39,000 employees, up 27% year-on-year or 2% quarter-on-quarter.

Let's go through margin ratios for the fourth quarter. Gross margin dipped 4.5 percentage points year-on-year to 53.9%, mainly due to increase in contribution from the other segments, which carried lower margin as well as continued increased video content cost. Gross margin was stable sequentially. Non-GAAP operating margin was 34.1%, down 3.8 percentage points year-on-year, reflecting lower gross margin. Sequential decrease of 3.1 percentage points was mainly due to seasonal increase in selling and marketing expenses, less dividend received from the investee companies and donation made to Tencent Charity Fund in quarter four. Non-GAAP net margin was 28.3%, down 1.3 percentage points year-on-year and 1.2 percentage points quarter-on-quarter.

On a full year basis, gross margin was 55.6%, down 3.9 percentage points. Non-GAAP operating margin was 38.3%, down 2.3 percentage points. Non-GAAP net margin was 30.3%, down 1.6 percentage points.

Turning to earnings per share and proposed dividend for 2016. GAAP basic EPS was RMB 4.383 and diluted EPS was RMB 4.329. Non-GAAP basic EPS was RMB 4.844 and diluted EPS was RMB 4.784. Subject to the approval of shareholders at its Annual General Meeting to be held on 17th of May, 2017, we are proposing an annual dividend of HKD 0.61 per share.

Let me share some key financial metrics with you before rounding up this presentation. For the fourth quarter, total CapEx was RMB 2.8 billion, up 51% year-on-year or down 22% quarter-on-quarter. Operating CapEx was RMB 2.1 billion, non-operating CapEx was RMB 709 million. For the full year of 2016, total CapEx increased 57% year-on-year to RMB 12.1 billion.

Free cash flow reached RMB 17.2 billion, up 6% year-on-year or 21% quarter-on-quarter, mainly due to increasing operating cash flow from our games business. On a full year basis, free cash flow was RMB 55 billion, or US$8 billion, up 50% year-on-year.

As at year-end, our net cash position was about RMB 18.1 billion, down 5% year-on-year and up 117% quarter-on-quarter. The year-on-year decrease was mainly due to payments for M&A, license content, and dividend payments, partially offset by free cash flow generated from operations during the year. The substantial increase mainly reflected approximately RMB 7.8 billion recouped from Supercell financing arrangement in the fourth quarter, when we compare with quarter three.

The fair market value of our listed associates and available-for-sale financial assets were approximately RMB 89 billion.

This concludes our presentation. Thank you.

Catherine Chan

Thank you, John. We shall open the floor for questions now. And before you ask your questions, please tell us your name and also restrict yourself to one question, and we'll start to queue for second round questions if we have time. Operator, shall we take the first question, please?

Q&A

Operator

Thank you. We would now begin the question-and-answer session. [Operator Instructions] First question comes from the line of Wendy Huang from Macquarie. Please go ahead.

<Q - Wendy Huang>: Thanks, management, and congratulations on the very solid results, especially the progress you made on the payment front. So, with your payment daily transactions now exceeding 600 million, what kind of breakdown are you seeing between the online versus offline? And also can you provide some color of the transactions breakdown between the virtual items versus physicals and services?

And also your other [indiscernible] (32:48), which include payment, achieved gross margin 20%, so when do you see actually the payment to breakeven or make some breakthrough on the monetization side and what kind of a take rate you are currently charging towards your merchants?

And finally still regarding the payment, I think in light of the recent upcoming online clearing platform implemented by PBOC, how do you see actually this new online clearing platform to actually change Tencent's payment ecosystem and also market share in the longer term? Thank you.

<A - Chi Ping Lau>: Okay. Let me take that question. In terms of payment transactions, we have achieved, as we said, more than 600 million daily transactions. And if we have to rank, right, the basic ranking is sort of social payment, which include red packets, and then online payment, and then offline payment, so that's the sequence. And we felt this is sort of consistent with the way we leveraged to make our payment platform a ubiquitous platform. We actually leverage the red packets to allow users to have a very unique experience and very high frequency experience, and leveraging that we were able to deliver commercial transactions to online service providers. And subsequently, sort of, in the course of last year we were able to leverage that to convince a lot of offline merchants to use our payment solution. And as a result, we proliferated the payment platform on a offline basis. So that's the breakdown as you can see.

In terms of magnitude, as we said, the total number of transactions close to double on a year-on-year basis, and on the other hand the commercial transactions, which we include both online and offline commercial transactions, actually tripled on a year-on-year basis. So you can have a sense of the magnitude of the growth among the different segments.

Now, in terms of the monetization of the payment platform, we actually view payment as a infrastructure service for our ecosystem and our intention is actually to leverage our payment platform to engage our users, to solve the pain points between merchants and users. As a result, we can actually sort of allow our users to conduct more activities on the platform and we can also allow lot of our partners to get paid from the users, as a result benefit at the platform. So our main motivation is not actually to make money. If you remember, around this time of last year, we were actually sort of making losses, quite a bit of losses from our payment platform, and then subsequently we made some adjustments, so that we were able to recoup some of the costs associated with bank charges. And now you can see sort of we do make some gross margin, but at the same time, we actually sort of put in a lot of investments at the marketing level, at the infrastructure level, at the people level. So, by and large, we consider sort of payment at this point in time as to a infrastructure service rather than a service that generates profit for us. And I think sort of that status we'll maintain for quite some time.

And finally, you are right in pointing out that sort of there is going to be a new system put in place by PBOC, and I think there are two things. One is sort of on the technical level, we are actually sort of helping PBOC quite a bit in terms of organizing the new platform, and also sort of contributing our own technology to help the PBOC platform to develop. And over time we expect some transactions would actually sort of be migrated to the centralized platform. We believe, if there is a central clearing platform that sort of is very scalable, I think it's actually sort of good for the entire industry.

The second one is actually related to part of the float of the users, which need to be deposited with PBOC. Right now, I think, sort of roughly 12% of the float is actually required to be deposited with PBOC, on which actually sort of we do not receive any interest. We believe over time this number may increase, but at the same time I think sort of the government is also cognizant of the fact that a lot of the payment solution providers actually sort of rely on some of this interest to actually recoup some of the costs. So that's why, I think, there will be measured schedule in terms of increasing that deposit number.

<A - Catherine Chan>: Okay. Thank you, Martin. Operator, shall we take the next question, please?

Operator

Certainly. Next question is from the line of Alicia Yap from Citigroup. Please go ahead.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my questions. My questions is related to advertising. Just wanted to get a sense how much of the decelerations of the brand advertising revenue growth is attributed to the shifting of the ad inventory from the brand to the performance-based versus the impact from the soft macro and also the impact from the subscription cannibalization? So appreciate if management could share some color, the upcoming trend of the brand ad growth outlook as well.

On the performance-based ad side, can management share some feedback on the recent small scale adoptions, what are short-form video ad format in Weixin, so any plans for broader rollout on the video format in the future, then also the ad inventory increase in the coming months? Thank you.

<A - James Gordon Mitchell>: Okay. In terms of the brand advertising question, the answer differs by the type of inventory you are thinking about. So, for our online video advertising revenue, the deceleration is likely primarily due to the growing percentage of video MAUs that are also video subscribers, which entitles them to skip most forms of in video in-feed or pre-feed advertising. On the other hand, if you look at our news advertising revenue, which is actually our biggest brand ad category, or if you look at our mobile browser or our mobile app store, which are very fast growing categories, then the primary change is the mix shift from inventory being allocated to brand into inventory being allocated to performance. And so, for those products, the overall advertising revenue is growing quite quickly, but is just that the brand proportion is declining as the performance proportion ramps up.

In terms of the overall macro, I mean, it's always nice to blame one's challenges on the macro environment, but in reality the Chinese macro economy, I think, has been fairly healthy in the last few months. So it will be kind of an easy escape for us, but not necessarily a correct attribution for us to say that the brand advertising slowdown was due to macro reason. So I think it's less due to macro and more due to the two substitution effects.

In terms of the second question around advertising on short-form video within Weixin, I mean, clearly there is a global trend toward putting more advertising around short-form video, especially on social networks, and equally, clearly, it's a trend that being Tencent we would follow with a high degree of carefulness, so as to not upset our users and so as to provide good environment and click-through rate for our advertisers. So we are seeing very rapid growth in video views within our social networks, but [ph] we're cognizant (41:51) that putting in a heavy ad load around those short-form videos could both be irritating to users and for those users who are on wireless data and Wi-Fi plans, costly for those users as well. So we're moving forward at a measured pace.

<A - Catherine Chan>: Thank you. Operator, next question, please.

Operator

Next question comes from the line of Eddie Leung from Merrill Lynch. Please go ahead.

<Q - Eddie Leung>: Hi, guys. Thank you for taking my questions. I have a question more on the potential impact of certain applications on your social apps. So we have seen more and more of your peers launching short-form video content, as well as mobile news feed apps. So wondering if you have seen any cannibalization of these type of new applications on your social apps and how you are going to deal with any problem. Thank you.

<A - Chi Ping Lau>: I think you are right in pointing out that sort of new short-form video and news feeds are becoming sort of very popular product category among a lot of industry players. As a matter of fact, if you look at our – especially in my prepared remarks, right, we talk about news and content services, we have also launched a number of these products within our – both in terms of sort of individual app, like Kuaibao as well as in our various different products as a product feature, and as a result actually sort of our overall page views on text, on photos, pictures, as well as on short video has actually increased quite substantially across our platform.

So I think it's a phenomena that clearly the mobile handset is actually bringing to the industry by having a new way for distributing content, not just based on editorial way or social way. It's actually based on machine learning. You can actually sort of map the interest graph of users better and, as a result, you can actually sort of increase the amount of user engagement on those content, and also sort of by having a platform of more diversified content, right. There can be sort of a lot of different writers writing articles and shooting short video of different kinds, and then if you have a platform to include this content, then sort of it would also increase the user engagement.

So I would say this is an industry phenomena and we actually sort of have also rolled out products and services to – as well as overall content platform to benefit ourselves from this. And as a result, actually, our total page views across all these formats have actually increased quite substantially, as well as our revenue has actually increased quite substantially too. So it's actually sort of positive for us.

<A - Catherine Chan>: Thank you. Operator, next question, please.

Operator

Next question is from the line of Alan Hellawell from Deutsche Bank. Please go ahead.

<Q - Alan Hellawell>: Thank you very much. Just a question on ads. If we hypothetically couple together video subscription revenues and ad revenues, do we see any [ph] trappings (45:52) of a potential improvement in that P&L from what has been a chronically negative margin business? And related to that – or as far as ads go, could you just give us an update on the number of P4P advertisers we have on the platform now and what we can expect throughout 2017? Thank you.

<A - James Gordon Mitchell>: I think if you take the video advertising subscription revenue together, they're growing at a relatively healthy rate, albeit the mix has, obviously, shifted fairly substantially from advertising being the growth driver to subscription as being the primary growth driver. We're not focused on profitability for our video business this year. And I think that in the longer-term, it is correct to observe that globally video subscription business has a much higher margin than video advertising businesses. ESPN or CNN achieves a three to five times higher margin than CBS or ABC. But at this point in time, I think we and our peers in the market are investing to grow the video subscription business, particularly by purchasing original content, which we alluded to in the remarks earlier. So for the foreseeable future, you should expect the video business to remain loss making, although in the longer run the subscription aspect should be breakeven sooner and become more profitable than the advertising aspect. In terms of the number of pay-for-performance advertisers, we don't necessarily disclose that every quarter, I'm afraid.

<A - Catherine Chan>: Okay. Thank you. Next question, please.

Operator

Next question from the line of Jin Yoon from Mizuho Securities. Please go ahead.

<Q - Jin-Kyu Yoon>: Hi. Good morning, guys – or good evening, guys. Just a question on your mini apps. I know that Martin gave a little bit of an update on the – in your prepared remarks, but just wanted to just kind of ask what metric should we follow in terms of how to gauge the performance of that business going forward? And second of all, a follow-up to that is, can you give us an update in terms of like how many partners you are working with, what are the monetization opportunities in the near-term and, at the same time, what verticals are most active in that particular field? Thanks.

<A - Chi Ping Lau>: Yeah. I think if I have to reiterate mini app programs, I think sort of the purpose is actually to solve a pain point in the ecosystem, in the sense that a lot of offline service providers, when they actually sort of can access users, it's very difficult for them to provide a sampling of their services online to these users. And they sort of get people to sign on to our existing infrastructure, which is an Official Accounts. The Official Accounts sort of can allow the sending of content, but certainly not really sort of readily available interactive services. And if the service provider want to induce the users to download an app, the barrier of entry is actually quite high. So, by leveraging mini programs, the service provider can actually sort of help the users to sample the online interaction very quickly. And as a result provide value to the users and at the same time if the users actually like the service, they can actually go ahead and download the [ph] maiden (49:52) app.

So, I think that's sort of what we're trying to provide. And as a result, I would say, if you look at the type of service providers, it's essentially sort of mostly offline service providers, who can actually provide some kind of interactive services online. And if you look at sort of our purpose of launching this service, this platform, it's actually sort of to solve a pain point. Then sort of I think – it's not actually for short-term profit. I don't think so mini program would actually sort of generate any significant financial return to us, but it would actually help our ecosystem to be more convenient for both users and service providers. And I would believe that sort of from a long-term perspective, we can actually help users and service providers to connect with each other in a more seamless way, then sort of will benefit as a platform. I think that's really sort of what our intention is. So, as you see or how do you actually monitor the performance of this platform, I think, Jin, you're looking at some of the use cases that's in the market, I think, it's actually a better way to observe it.

If you look at Mobike, I think very clearly they had benefited a lot from this mini program, and we actually hope in the near-term to just work with different service providers and to establish some really great pilot projects, and then sort of demonstrate the value proposition of mini programs, and as a result help more and more service providers to get on this platform.

<Q - Jin-Kyu Yoon>: Great. Thank you.

<A - Catherine Chan>: Yeah, next question, please. Thank you.

Operator

Next question comes from the line of John Choi from Daiwa Capital Markets. Please go ahead.

<Q - John Choi>: Good evening and thank you for taking my question. I just have a question on the AI, artificial intelligence. Which are the areas that Tencent is considering when it comes to AI investment? And also from the management's perspective, where does Tencent stand in terms of other players within the industry, given that AI is becoming such an important part of technology these days?

And just quickly on cloud, I remember that on the prepared remarks it seems like Tencent is willing to invest more. So, could you kind of elaborate which areas the management sees in terms of potentials within the cloud opportunities for Tencent in the long-term? Thank you.

<A - Chi Ping Lau>: In terms of AI, we actually view AI as a core technology across all our different products. So, what we're trying to do is actually in each one of our businesses, we encourage our team to apply – to build up the talent pool as well as to apply the core technologies around AI, machine learning and deep learning and, at the same time, at the corporate level, we've also established an AI lab, which is more research based, so that they can actually focus on the more basic building blocks around AI. And if you look at sort of the areas of AI that we are investing in, it would include areas such as speech recognition, it will include picture and photo recognition, computer vision, natural language processing, and all sorts of deep learning as well as basic architecture for deep learning platform.

And the way we look at this technology is also [indiscernible] (54:05) in order to build long-term competitiveness, you don't only need sort of the people as well as sort of the mathematical and computational expertise. But at the same time you also need a lot of data, you also need a lot of usage scenario, so that you can actually apply this AI technology and, as a result, you can actually sort of keep progressing.

So, I think, if you look at our actual products, right, around content recommendation, around our advertising, around our photo processing app, there are actually a lot of existing products which will benefit from AI. We're also sort of investing in more pure research projects. You may notice that our Go chess player, FineArt, has recently won the championship in UEC competition. That's an example of our research project. And at the same time, in the future we believe that AI technology can also allow us to explore new areas, such as personal assistant, such as maybe even sort of autonomous driving. So these are the areas that we will focus on.

Now in terms of cloud, we believe that, at this point in time, we have a lot of internally developed technologies, which we can actually sort of package into the cloud and share with the broader community and ecosystem. So if you look at, for example, we are the leader now in gaming cloud, as well as in video cloud. And the reason we were able to actually sort of come from behind and sort of took the leadership is because of the fact that we have a lot of core technologies in those fields, which we share with our ecosystem. And over time, we're going to package more and more of our service – our technologies around big data, around scalable system, around security, and mini programs, payment platform in order to benefit our cloud customers. And we're also building up our sales and distribution channel in order to scale-up our business.

We believe that, at this point in time, we want to sort of keep on investing in infrastructure as well as our sales and distribution channel, so that we can actually sort of build the scale of our business. Over time, if we can actually sort of package more and more of our [ph] current (57:02) technology into PaaS or SaaS solutions for our customers, then that will be another added layer of opportunity for us to generate more value added for our customers and also more on monetization opportunity for ourselves.

<A - Catherine Chan>: Okay. Thank you very much for your question. Operator, next question, please.

Operator

Certainly. The next question is from the line of Piyush Mubayi from Goldman Sachs. Please go ahead.

<Q - Piyush Mubayi>: Thank you for taking my question. May I just ask a question about the gaming revenues, which appear to have slowed down and exited the year at a slower run rate than we've seen for the previous three quarters. Could you give us any sort of indication of whether we should expect this to be the run rate into 2017? And also if you could touch – you've talked about four new PC games, six new mobile game launches for 2017, and you've named them all. Could you give us a sense of how big we could expect these to be or any other color that would help us gauge the size? And there are concerns that – I think you said on the press call that the restriction on Korean games won't impact you. Thank you.

<A - James Gordon Mitchell>: Yeah. So, I'm not sure this answer will be all that helpful for you. But in terms of the game revenue growth in fourth quarter 2016, as we mentioned, if you look back at prior years, historically, Tencent's PC game revenue is seasonally strong in Q3, when there are summer holidays and events around the summer holidays, and seasonally weaker in Q4. 2015 was an exception to that pattern, because of some specific new items within our biggest game. Then in 2016 we kind of reverted to that pattern with PC games descending from Q3 to Q4, which was different from 2015, and makes for a tough year-on-year comp, but in line with what's happened in U.S. prior to 2015. So I think that's all we can really say about the fourth quarter PC game revenue growth deceleration.

In terms of how successful the new games prove to be, obviously, we hope that they are as successful as possible. In terms of the impact of the regulations around Korean games, for those Korean games that are already operated in China, and for those new Korean games which are not yet operated, but already been approved, as best we can tell at this point in time it should be business as usual. Now there may be other Korean games that were hoping to source in the future, and if they are delayed, then that would potentially be unhelpful, but set against that, A, Korea is just one of many sources for games along with China itself, the U.S., Europe and so forth for us. And then, B, in our experience, it's often the case that delaying a game, spending a few more months or quarters tuning it, results in a bigger, better game once we do finally publish the product as opposed to rushing it to market as soon as possible.

<A - Catherine Chan>: Thank you. Operator, next question, please.

Operator

Certainly. Next question is from the line of Ming Xu from UBS. Please go ahead.

<Q - Ming Xu>: Thank you, management. I have a question on the margin impact from the video and cloud. So your competitors both have – the two competitors announced a very aggressive content budget for the online video in 2017. And also we recently read from the – read one news about one of the very aggressive bid from you on the government cloud program. So my question is, firstly, can you maybe give us more color on your online video content cost for this year? And secondly, so what kind of revenue or market share you target for your online video and cloud service business? And thirdly, to achieve those target, what kind of margin drag or loss can you tolerate? Thanks.

<A - Chi Ping Lau>: These two businesses are definitely sort of areas that we invest in. I would say sort of video loss is sort of actually quite a bit bigger than cloud business loss. But on video, as we have repeated sort of multiple times before, we actually view video as a very important part of our overall customer experience, because it actually provides a lot of engagement with our users on a very large scale. So as a result, we felt this is actually an area that, despite the fact that it's losing us quite a bit of money, we actually view that it's important for us to invest in.

And as you point out, in order to stay competitive in this market, and we actually sort of have to spend quite aggressively on the content, and I think that's exactly what we have been doing and we'll continue to do. On a medium-term basis, we felt the loss would actually increase, because the cost of content has actually increased much more than the revenue increase in the market, despite the fact that you can see advertising revenue has been increasing, and then subscription revenue has been increasing even more.

I think, over time, as we continue to do original content, as we continue to increase our monetization around subscription, and at the same time if we can actually participate in the creation of the original content and share some of the upside in terms of content, then the economics may actually sort of move toward the more positive side, but I think that would happen in a few years, not these few years.

In terms of cloud, the point that you mentioned is really sort of more of an isolated case. I think what we do now is actually in some of the smaller orders we actually allowed our sales people to make on the spot decisions on how to bid for projects, and I think, like it or not, our frontline people decided to make that bid. I think it's much more of an isolated case. And given it is a small order and, frankly, it has attracted a lot of attention in the ministry and probably pays back from a media value perspective, but I think on a longer term basis, we don't view undercutting price as the core strategy for us in cloud. Of course, we will provide a very, very competitive price in the market, but, as I said, in our cloud service, over time, we believe that it's actually the value-added-ness that would actually differentiate cloud service providers, and we are confident that with our technology, we can actually do that.

<A - Catherine Chan>: Thank you. Operator, in the interest of time, we will take the last three questions, please.

Operator

Certainly. The next question is from the line of Thomas Chong from BOCI. Please go ahead.

<Q - Thomas Chong>: Hi. Thanks management for taking my questions. I have two quick questions. The first one is about Honour of Kings. Can management give us some color about the performance in the months of January and February? And are we seeing accelerating trend for mobile games in the first quarter?

And my second question is more on a broader basis. Can management give us some color about the ARPU for MMO, advanced casual and smart phone games in the fourth quarter? And my final question is about the operating expenses trend, in particular the sales and marketing trend in 2017. Thanks.

<A - Chi Ping Lau>: Yeah. I think, on Honour of Kings, I think if you – in the market you can feel that sort of in January and February it has become more popular among the users. I think that's the extent we can give you, because sort of on a financial basis we don't actually provide guidance, and we'll continue with this tradition. Now, with the margin question, I'll pass to John.

<A - Shek Hon Lo>: Yeah. In relation to the ARPUs for MMOG, the quarterly ARPU is within RMB 310 to RMB 450. And for advanced casual game, it was within RMB 100 to RMB 365, whereas for smart phone games, we treat it as one portfolio, it ranges from RMB 145 to RMB 155 per quarter.

In relation to the selling and marketing expenses, I think at this point in time it is not really growing at a very quick rate, taking into account that year-on-year growth it's only increased by about 36%, which we consider not to be very significant, especially when selling and marketing costs are basically discretionary in nature. And if there are opportunities, we'll invest heavily on it, where certainly in normal circumstances, I think, you will grow quite organically.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Next question is from the line of Chi Tsang from HSBC. Please go ahead.

<Q - Chi Tsang>: Great. Hi, everybody. Thanks so much for taking my question. I wanted to ask about WeChat Moments user experience. Can you share with us what sort of metrics you're monitoring to sort of measure user experience? What trends you're seeing and how people are spending time on Moments? And I am wondering if you see if there is a lot more potential engagement time that people can spend more on WeChat Moments? Thanks so much.

<A - Chi Ping Lau>: Yeah. In terms of WeChat Moments, we obviously do look at the number of users who actually sort of use the feature and how many times they actually open it, as well as how much time they spend on it. But at the same time, we actually sort of pay a lot of attention to the quality of the content that people are seeing, because one of the thing that we actually do not want is actually sort of people get overloaded with the content, which is, sort of, of low quality. So there is a range of quantitative indicators that we look at, but at the same time we also look at lot of qualitative indicators to make sure that the quality of engagement is actually high. I think so far we believe that WeChat Moments is still very vibrant part of usage experience and the quality is actually quite good.

<A - Catherine Chan>: Thank you. Operator, we'll take the last question, please.

Operator

Certainly. Last question comes from the line of Natalie Wu from CICC. Please go ahead.

<Q - Natalie Wu>: Hi. Good evening, management. Thanks for taking my questions. So my question is regarding the game business. So given the fact that Honour of Kings resemble League of Legends in a lot of ways, and Honour of Kings is, obviously, delivering a very impressive performance during the past several months. So just wondering will Honour of Kings have some kind of cannibalization effect for League of Legends in terms of active user engagement, game revenue, et cetera? Thank you.

<A - Chi Ping Lau>: Yeah, I think the two games actually cater to different kind of positioning. If you look at League of Legends, it's actually sort of catered to core gamers. And if you look at Honour of Kings, it's actually an experience that's catered to more casual players, and so far what we have found is sort of the growth in Honour of Kings is accompanied of continued growth in League of Legends. So in some cases, users actually sort of play Honour of Kings. When they get more and more hardcore, they can actually sort of move over to League of Legends. So what we have seen is that they're not really hurting each other.

Catherine Chan

Okay. Thank you very much, operator. We are closing the call now. If you wish to check our press release and other information, please visit our company website at www.tencent.com/ir. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for your participating in Tencent Holdings Limited 2016 earnings conference call and annual results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2016-11-16
Event Description: Q3 2016 Earnings Call

Market Cap: 3.04TRI
Current PX: 320.20
YTD Change($): +130.50
YTD Change(%): +68.793

Bloomberg Estimates - EPS
Current Quarter: 1.718
Current Year: 6.605
Bloomberg Estimates - Sales
Current Quarter: 60380.571
Current Year: 229341.729

Q3 2016 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Eddie Leung
- Piyush Mubayi
- Alan Hellawell
- Alicia Yap
- Wendy Huang
- John Choi
- Alex Yao
- Chi Tsang
- Evan Zhou
- Natalie Wu

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by, and welcome to the Tencent Holdings Limited 2016 Third Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please, go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to our results conference call for the third quarter 2016. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we'd like to remind you that it includes forward-looking statements, which are underlined by a number of risk and uncertainties and may not be realized in future for various reasons. Information about general market conditions is also coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to but not as a substitute for measures of the company's financial performance, prepared in accordance with IFRS. For a detailed discussion of the risk factors and non-GAAP measures, please refer to our disclosure documents on www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview; Martin will discuss strategic highlights; James will speak to business review; and John will go through the financials before we take your questions.

I'll now turn the call over to Pony. Thank you.

Huateng Ma

Thank you, Catherine. Good evening. Thank you for joining us. In the third quarter of 2016, we delivered strong financial performance for our core businesses. In particular, our smart phone games and social performance advertising businesses reported above industry revenue growth rate and continue to generate health margin.

For key infrastructure platforms supporting our ecosystem, specifically payment and cloud services, we saw a significant progress in adoption and usage. We will continue to make investment in these strategic areas. Then I give you the headline numbers and do further discussion to the financial section.

Total revenue was RMB 40 billion, up 52% year-on-year, and 13% quarter-on-quarter. Non-GAAP operating profit was RMB 15 billion, up 43% year-on-year, and 2% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 11.7 billion, up 42% year-on-year and 4% quarter-on-quarter.

Moving to our online platforms, total MAU for 2Q increased 2% year-on-year to 877 million, with 647 million of monthly active users logging via smart devices. Combined MAU of Weixin and WeChat increased 30% year-on-year to 846 million.

For Qzone, smart devices MAU increased 1% year-on-year to 584 million. In games, we launched several successful smartphone games including role playing games, which help us expand user bases. Our PC client games sustained leadership in several genres, retaining many loyal gamers through a range of immersive in-game and less intense game-related activities.

In media, we saw healthy growth in users and traffic for our news and video platforms. Digital content subscriptions for music and video services increased. In the third quarter, we merged our online music business with China Music Corporation. We believe the combined company can help shift China digital music ecosystem to more sustainable business models.

In mobile utilities, our mobile security service continued its momentum. Our mobile browser partnered with the China Reading corporation to promote authorized content distribution. We continue to improve search, discover, and download experiences in our app store, Yingyongbao, via deep linking.

I'll now invite Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony. And good morning, good evening to everybody. Tencent's not only conduct our businesses, but also invest heavily into developing technologies that may not generate revenue directly, but are important for our ecosystems. One of these technologies is our security technology.

In the course of the past few years, we have made a significant advancement in our online security technology, which has enabled us to become a leader in the market. In mobile security, QuestMobile ranked us number one in MAUs since 18 months ago with a widening lead. In PC security, our market share exceeded 30% according to iResearch. These achievements were supported by our core security technologies. For example, we scored excellent results at the global hacking and vulnerability discovery contest this year, winning the number one title in Pwn2Own. Several months ago, engineers in our Keen Security Lab, in their efforts to enhance security for internet-enabled cars had discovered vulnerabilities that conceded direct manipulation of Tesla's control system and that was a very significant event in the entire industry. Following international standards practices, we shared our findings with Tesla who implemented the patches immediately.

We continued to be a leader in fundamental security technologies, such as scanning viruses, releasing memory, as well as boosting speed of handsets. We're also the leader in anti-fraud technology for smartphones. We own the most adopted detection system for phony base stations. We also own the largest database of fraud phone numbers and industry-leading prediction technologies based on big data analytical capabilities. As an evidence of our leading position, we became Apple's official partner in anti-spam services, supporting iOS users to identify report and block nuisance calls in China.

With best-in-class security capabilities, we are providing a superior infrastructure service with an ecosystem of our own applications as well as our partner services. With Tencent apps, we protect user ID, passwords, personal information and virtual property. Our security app at mobile manager will automatically ensure a virus-free terminal environment by scanning the mobile phone. Wi-Fi access as well as in ad links.

Our cloud-based security capability helped to detect fraudulent web pages and phone calls. For online finance, the security technology is, in particular, important because it allowed us to provide users a safe environment for payment and financial transactions.

Based on data analytics, we can identify and control dubious transactions before they are conducted. By ensuring security we can speed up the adoption of online financial transactions and make users comfortable with conducting high value financial transactions on their smart phones.

For our partners, we integrate our security capabilities into our cloud services to protect enterprise IT systems, defend against DDoS attacks and safeguard their products and services. For developers we helped them to screen applications for security and vulnerabilities before release. All in all our security capabilities has allowed us to develop a healthy ecosystem for our businesses.

So, with that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Thank you, Martin. In the third quarter of 2016, our total revenue grew 52% year-on-year. Value added services represented 69% of our revenue within which online games contributed 45% and social networks 24%. Online advertising was 19% of total revenue. The others segment, which includes payment related and cloud services accounted for 12% of total revenue.

Looking at value-added services segment revenue was RMB 28 billion in the third quarter up 36% year-on-year and up 9% quarter-on-quarter. Social network revenue is RMB 9.8 billion up 58% year-on-year and up 15% quarter-on-quarter. Strong performance of game related item sales and digital content sales drove the year-on-year and quarter-on-quarter revenue growth. In the third quarter, the consolidation of China Music Corporation contributed over RMB 800 million to sequential revenue growth, of which over RMB 700 million was booked under the social network category.

Our online game revenue was RMB 18.2 billion, up 27% year-on-year and up 6% quarter-on-quarter. New smartphone games strong performance of key PC titles contributed to the year-on-year revenue growth. Sequentially PC games benefited from positive seasonality. Some of our big smartphone games such of Honour of Kings and JX Mobile delivered strong operating performance as well.

Turning to social networks, for QQ, we added creative and fun features to enliven chat and community experiences. Specifically, we launched cmShow, mobile QQ product that provides users with animated personal avatars. With these avatars, users can interact with their friends inside the chat box or collect items from friends to unlock new features. We conducted an augmented reality torch relay campaign for the Rio Olympic Games and over 100 million mobile QQ users participated in the 22-day event.

For Weixin we're beta testing a new function called mini programs. Users would enjoy a native app-like experience conveniently without needing to leave the Weixin interface. Consequently they can reduce their phone's CPU usage and phone memory storage requirements. For Weixin Pay, we significantly increased merchant adoption. On August 8, we launched our annual Cash-Free Day in many Tier-1 and Tier-2 cities. The total number of stores participating in this promotional campaign increased by over seven times year-on-year to almost 700,000.

In September, we added Weixin Checkout, a feature that helps merchants simplify payment integration and reduce registration process time. By scanning a unique QR code assigned to each store, consumers can check out and pay quickly while store managers can manage billing activities efficiently.

Looking at PC client games, revenue grew 10% year-on-year and 9% quarter-on-quarter. Daily active user accounts were down 9% year-on-year and stable quarter-on-quarter while average concurrent user accounts for advanced casual games were down 18% year-on-year and average concurrent user accounts for multiplayer online games were down 11% year-on-year.

To put some color around these trends, increasingly fast broadband speeds are enabling more PC gamers to enjoy real-time player versus player games such as League of Legends and FIFA Online in which they alternate high engagement competitive sessions with low-intensity practice review and game-related chat sessions.

Consistent with this migration of behavior, we're shifting our engagement focus away from maximizing user time spent in game and somewhat broadening overall user engagement by game-related activity such as eSports tournaments, video streams of popular gamers and game-specific interest stripes within QQ and Weixin. This shift in focus results in users spending less time passively sitting inside the game client, which naturally translates into fewer average concurrent users, since the average concurrent user metric measures total active users multiplied by average time spent in getting client per user.

However, the shift is not necessarily reducing user engagement with our games or willingness to spend money on game items and our PC game revenue increased despite the decline in average concurrent users. Ultimately, we believe this broader engagement model should result in healthy and more sustainable gamer relationships with our key products.

Our smartphone games revenue reached RMB 9.9 billion, up 87% year-on-year, and up 3% quarter-on-quarter. We were the number one ranked publisher in the iOS App Store top-grossing chart globally, and also number one publisher in Android app stores inside China. In the third quarter, we published two new casual games and three new mid-core games.

Our player versus player competitive games and role-playing games continued to drive key metrics. Honour of Kings recently surpassed 40 million daily active users, which we believe is a usage record for mid-core games in China. Our recently launched role-playing games of JX Mobile, Yulong Mobile and Asura Mobile contributed materially to sequential revenue trends. And we're participating in eSports car trips and mobile games to high profile tournaments for titles such as CrossFire Mobile and Honour of Kings.

Moving on to online advertising, segment revenue was RMB 7.4 billion, up 51% year-on-year; and up 14% quarter-on-quarter. Brand advertisement revenue was RMB 3.1 billion, up 21% year-on-year; and up 9% quarter-on-quarter. Revenue grew year-on-year and quarter-on-quarter due to mobile news feed apps and the Rio Olympics. About 700 million unique visitors followed the Olympic games in our news and video platforms, cementing our position as the online leader in terms of sports-related traffic and revenue.

Our top five brand advertising categories were food and beverage, automobiles, online services, personal care and consumer electronics.

Performance advertising revenue was RMB 4.3 billion, up 83% year-on-year and up 18% quarter-on-quarter. Weixin advertising including Moments and Official Accounts inventories was the biggest contributor to the year-on-year and quarter-on-quarter growth. In September, we launched neighborhood apps. It enabled local merchants to promote their services and products to the most relevant users within 4,000 business hubs in major cities. The number of Weixin Moments advertisers increased by over 100% quarter-on-quarter.

In response to advertiser demand, we've been shifting some mobile news feed inventory from selling on a cost per time brand model to selling on a cost per click performance model. This has had the effect of reducing our brand advertising revenue and increasing performance advertising revenue during the period.

And now, I'll pass it to John, to talk to our financials.

Shek Hon Lo

Thanks, James. Hello, everyone, for the third quarter of 2016 our total revenue was RMB 40.4 billion, 52% year-on-year or 13% quarter-on-quarter. Gross profit was RMB 21.8 billion up 40% year-on-year or 7% quarter-on-quarter. Share of losses of associates and joint venture was RMB 619 million, an increase from RMB 292 million in the second quarter.

On a non-GAAP basis, share of losses of associates and JV reduced sequentially from RMB 206 billion to RMB 107 million. Income tax expense was RMB 2.5 billion, up 57% year-on-year or down 11% quarter-on-quarter. The effective tax rate for the quarter was 18.6%.

Net profit to shareholders was RMB 10.6 billion, up 43% year-on-year or down 1% quarter-on-quarter. After adjustment to non-GAAP operating profit was RMB 15 billion, up 43% year-on-year or 2% quarter-on-quarter. Net profit attributable to shareholders was RMB 11.7 billion, up 42% year-on-year or 4% quarter-on-quarter.

Let's turn to segment gross margin. Gross margin for VAS was 65.2%, up 1 percentage point year-on-year reflecting a revenue mix shift to in-house games. Sequentially, EBIT 1.5 percentage points reflecting increased content amortization cost relating to a premium video subscription businesses and the consolidation of China Music Corporation. Gross margin for online advertising was 36.3%, down 12.6 percentage points year-on-year and 9 percentage points quarter-on-quarter. Increased investments in video content was the primary reason behind the margin contraction.

Moving onto operating expenses. Selling and marketing expense was RMB 3.3 billion, up 60% year-on-year or 39% quarter-on-quarter. The year-to-year jump reflected our aggressive marketing efforts to promote mobile apps preloads to drive mobile payment adoption and to promote our cloud services. Sequentially, marketing expenses for games, mobile news and video services were the main drivers.

Total G&A expense was RMB 5.9 billion, up 34% year-on-year or 11% quarter-on-quarter, within which R&D expense was RMB 3.2 billion, up 29% year-on-year or 15% quarter-on-quarter. The year-to-year and sequential increase reflected the cost relating to our organic businesses.

We had just over 38,000 permanent employees at quarter-end. University recruitment, CMC consolidation and one-off recruitment of some outsourced manpower who previously engaged in our customer support work, contributed to the sequential increase in head count.

As a percentage of quarterly revenue, selling and marketing expense was 8% and G&A was 15%, R&D represented about 8% of quarterly revenue. While share based compensation was approximately 3%.

Looking at margin ratios for the third quarter, gross margin was 54% down 4.6 percentage points year-on-year and 3.3 percentage points quarter-on-quarter. The combined effect of online advertising gross margin declined and bigger contribution from others segment drove year-to-year margin decline. Sequentially, fall through from lower VAS and online advertising gross margin as well as bigger contribution from other segments were the main reasons.

Non-GAAP operating margin was 37.2%, down 2.3 percentage points year-on-year or 4 percentage points quarter-on-quarter. Non-GAAP net margin was 29.5%, down 2.3 percentage points year-on-year and 2.7 percentage points quarter-on-quarter.

Finally, let me provide a few key financial numbers for your reference. Total CapEx was RMB 3.7 billion, up 121% year-on-year or 143% quarter-on-quarter. Operating CapEx was RMB 2 billion, up 76% year-on-year and 97% quarter-on-quarter. We purchased more servers and network equipment to support business growth such as cloud based services.

Non-operating CapEx was RMB 1.6 billion, up 228% year-on-year and 245% quarter-on-quarter. We added RMB 1.2 billion for land use rights. Free cash flow was RMB 14.1 billion up 113% year-on-year or 45% quarter-on-quarter, reflecting strong cash flow generated from our operations, especially, online games during the positive season in the third quarter. Our net cash position at quarter end was RMB 8.4 billion down 61% year-on-year, and 65% quarter-on-quarter. The decline was primarily relating to the acquisition of Supercell, which we were funding investment with a combination of cash and debts.

In July, we made a cash prepayment of U.S.$3.7 billion or approximately RMB 24.7 billion, and subsequently, we recouped approximately U.S.$1.2 billion in October, which is approximately RMB 8 billion. Fair market value of our listed associates and AFS financial assets amounted to approximately RMB 94 billion as at quarter end. Thank you.

We shall now open the floor for questions.

Q&A

Operator

Thank you. We'll now begin the question and answer session. [Operator Instructions] Our first question comes from the line of Eddie Leung from Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. I have a question on some of your cost items. Just wondering, if you could share more color on the trend of sales and marketing expenses, as well as headcounts going into the future? Particularly, if you are investing more for certain opportunities, what are some of the key areas that you pay extra attention to?

And then just a housekeeping question, it'll be great if you could update us on number one, your mobile game pipeline, and number two, the ARPU of different types of games? Thank you.

<A - Chi Ping Lau>: Yeah. Thanks, Eddie. In terms of sales and marketing, I think we continue to invest pretty heavily in a number of our strategic products. Obviously, the first one is around games, right, because games is our largest business segment, and the marketing of games actually, especially sort of new games can generate a good ROI, if the game's of good quality.

The sales and marketing pattern is more around sort of the launch of new games, but in certain areas, such as new MMORPGs right, there needs to be continued marketing to attract the core users.

The other large area of sales and marketing really sort of goes into our payment business, as well as our mobile app installation, because we now own a large number of high-DAU apps, and as a result, we actually sort of continue to market these apps, especially sort of in working with handset manufacturers, as well as app stores to get these apps distributed to the users.

And the other one that I think John mentioned in his prepared remarks is on the cloud business, which we are really opening up a new market segment, which is around enterprises, and that's why we're spending in the marketing expenses.

Now in terms of head count and our human expenses, the overall approach is that, we try to control the number of our people, but we continue to enhance the quality of our overall team, as well as we continue to pay competitively in the market and reward our employees when the company is actually sort of achieving great results. So, that's the overall philosophy.

<A - Shek Hon Lo>: Yeah. And also in terms of the head count, perhaps you might view that the increase was so significant this quarter versus the last quarter that as I mentioned before, this is a special quarter, because we had a new fresh graduates. We have the consolidation of China Music as well as converting some of our outsourcing function such as customer support to be handled by our own permanent staff.

In relation to the ARPUs, for MMOG it's between RMB 310 to RMB 450, advanced casual games was between RMB 85 to RMB 370 and the smartphone games is between RMB 145 to RMB 155.

<Q - Eddie Leung>: Thank you.

<A - Catherine Chan>: Next question, please.

Operator

Thank you. Our next question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask the question.

<Q - Piyush Mubayi>: Thank you. We observed that Supercell's games have risen back to the top of the charts displacing games that were popular a quarter ago. From a Tencent perspective, when and how does Supercell impact the P&L? And also is there going to be a specific strategy you'll deploy for Supercell games as and when they get launched in China?

And second is related to the tripling in the cloud number that you've reported this quarter. Could you give us a sense of what the numbers are looking like as well as what percentage of the dip in gross margins can be attributable to potentially the cloud business or the payment side? Thank you.

<A - Chi Ping Lau>: In terms of Supercell games – well, thanks for your observation. I think, yes, we are very glad to see that the games of Supercell actually returned to the top of the chart. And I think it's actually consistent with our long term view of Supercell, which is that it creates a very exciting games that actually can be played by people – large number of people for a long time.

And I think part of it is also as we continue to exchange knowledge about how to design the commercialization of the games and how to actually sort of attract more people to pay for the games, they have actually achieved better monetization on the games.

Now with respect to the accounting, Supercell is going to be accounted for through the dividend method. So, for this year, I don't think there's going to be any dividends distributed, so that's why it's not going to make a meaningful contribution to our earnings for a while.

Now with respect to the cloud business, I think if you look at the others category, right, you can see the gross margin has improved quite significantly. It's around 18% now. But we have also talked about the fact that we are investing very heavily in some marketing of the services for both payment and cloud, and there is also a large team of people who are actually working on these products.

So, if you're counting the overhead, if you're counting the marketing expenses, I think these expenses are very significant compared to the gross profit. So, that continues our theme around these services, which is we view the payment business, the cloud business as infrastructural businesses, services for our overall ecosystem, it's beneficial for our own services, it's beneficial for our partners of services.

So that's why, we're willing to take a very long-term view, and to continue to invest in these businesses despite the fact that it may not be profitable for the time being. We felt that they are very beneficial for our ecosystem going forward, and can enhance the value of our overall business portfolio. And that's sort of the kind of philosophy that we're attaching to these businesses for the time being.

<Q - Piyush Mubayi>: Thank you, Martin.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Thank you. Our next question comes from the line of Alan Hellawell from Deutsche Bank. Please ask the question.

<Q - Alan Hellawell>: Great. Thank you very much. Just a follow-up question on payments. I was wondering if you could offer some more color on the GMV mix between non-monetizing payments and B2C payments and how that mix is likely to shift over time. And if we reference some of the publicly listed pure-play payments companies, we've seen they have operating margins in the low 20%s. I'll take on board Martin's comment that this is a strategic part of the company, but how do we think about profitability emerging, if we have those mild markets already? And then we'd love a little more detail on the quarter-on-quarter decline in advertising margin and I guess related to that any color on how the video market is evolving, particularly as if it's different to original expectations? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of payments I think it would be – we can't give you the exact GMV, but I would say we look at it from both angles. We look at it from the number of transactions. We do handle hundreds of millions of transactions a day and out of that I would say a big proportion of it is actually sort of in the category of social payments, which include [indiscernible] (32:48), which also include the transfers among consumers.

But at the same time we are seeing also sort of a significant amount of transactions that are business oriented. And these transactions include our own sort of transactions, for example, game transactions. It includes a lot of online merchant transactions that would include DD and JD and Meituan and Dianping as well as sort of people who use our platform to top up their cell phone. And then there is an increasing number of transactions which are actually sort of conducted by offline merchants. So, you have the KFCs and McDonald's and sort of the supermarkets and the convenience stores who are actually sort of now receiving payment through WeChat and QQ Wallet.

And at the same time, we are also seeing even smaller merchant, they can actually use the QR code and get paid and sort of they can use our face-to-face payments to effect transactions. So, I would say, there is a large number still sort of predominant number of person to person social payment, but in terms of growth rates, the commercial transaction is actually growing faster in terms of growth rate.

I think, James will talk about our video and advertising business.

<A - James Gordon Mitchell>: So for the advertising gross margin, there are positive factors and negative factors in this quarter that the negative factors are more obvious. On the positive side, there's the growth in social performance advertising which tends to be relatively high gross margin because it's on our own social properties and there is the rapid growth more recently of news app advertising which is also relatively higher margin.

On the negative side, there is specific kind of cost heavy events during the quarter from video, notably that The Voice of China or Sing! China competition and the Olympics and then there is a more general trend of video content costs increasing extremely rapidly due to a relatively competitive environment.

You asked whether the video environment is evolving as we would have thought of differently from what we would have thought. I think it's evolving pretty much as we would have thought, perhaps even more swiftly in terms of the shift from being a primarily advertising funded model to what customer's been willing to pay for subscriptions. And our video team recently disclosed we have about 20 million people now paying for subscriptions up from RMB 100 million a couple of years ago.

Now that shift overall we think is positive in the long-term, but it does – it's not without its costs and any one of the costs that is more and more used is paying for a premium video service. In China there's a history where once you pay for these premium video service as well as having access to premium contents such as western movies or Chinese TV series. You also don't watch ads and so the increased take-up of premium video subscriptions has a negative impact on the industry's total advertising inventory load. So that's what's happening in the online video market in terms of competition, margins and the shift from an ad funded to an ad plus subscription funded model.

<A - Chi Ping Lau>: Yeah, I think...

<Q - Alan Hellawell>: I'm sorry, James. Yeah, sorry, I know that as I recall, I think there was a quintupling in the number of either P4P or WeChat-based advertisers in the June quarter over March. Could you guys also update us on what kind of growth you've seen in the number of P4P advertisers quarter-on-quarter.

<A - James Gordon Mitchell>: I think we disclosed the total number of Weixin Moments advertisers more than doubled quarter-on-quarter and that has been driven primarily by what you refer to as the kind of the P4P advertisers.

<Q - Alan Hellawell>: Got it. Thank you.

<A - Chi Ping Lau>: Well, I actually missed answering your question about payment margins. I think, what you're seeing in the listed payment companies is actually operating in the U.S. I suppose. And the environment is actually very different. Payment is actually quite local practice. This is also the regulation-driven business in a sense that if you look at credit cards in the U.S. right, they get paid 300 basis points or thereabouts, but in China credit cards get paid a fraction of that. And I would say in China the situation for online payment is similar in the sense that it's actually a more competitive market.

If we're dealing with captive business, if for example, you have a captive e-commerce business and then the kind of margin is different. But then if the commercial transaction is actually sort of out there competing by having two large payment platforms, I think the pricing is actually very competitive, marketing is actually competitive. So, that's why I feel that we should be looking at in the medium term of our payment business as more like an infrastructure business for the entire ecosystem rather than a business that will generate profit.

<Q - Alan Hellawell>: Understood. Thank you.

<A - Catherine Chan>: Thank you, Alan. Next question, please.

Operator

Thank you. Our next question comes from the line of Alicia Yap from Citigroup. Please ask the question.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my questions. I have two questions. Number one is related to the overall mobile games industry for the third quarter. So wanted to get a sense was the revenues that you achieved meeting your internal expectation, was there any seasonal effect for the industry as a whole for the 3Q? Is there any lack of new games launch or was that other social activity that might have taken away some of the user time spend? And in related to that, for mobile games, if you could share with us some of your user analysis, for example, on average, how many games a single user usually play during the same period and if you have data for example on percentage of gamers that who play two to three games, gamers that who play maybe only one game and maybe gamers that play more than three games?

<A - James Gordon Mitchell>: So, I think in terms of the mobile game business performance versus our expectations in the industry, we discussed our mobile game revenue grew over 80% year-on-year. So like you can assume that we're fairly happy with 80-something percent year-on-year revenue growth. From a quarter-on-quarter perspective, the trends get bounced around by the timing of specific new games, the timing of monetization events within games and so forth. But we tend to look more longer time periods and a year-on-year comparisons rather than very short-term comparisons, because otherwise we'd be kind of continually chasing our tails.

In terms of the user analysis, one appealing trend about our mobile game position this year has been that, we've seen quite a nice uptick in the number of people playing our mobile games, as measured by DAU, for example. We have well over 100 million daily active users for mobile games and that number's increased quite substantially year-to-date. So we think that that puts us in a very strong position in the industry, but our leadership and revenue is balanced by actually a wider leadership in terms of usage. I think that the sort of median would be that the users would be playing two games or so on a regular basis, although there's obviously a very high degree of dispersion around that median.

<Q - Alicia Yap>: I see, very helpful. My next question is related to payment. I think you mentioned on the press release that you attracted 700,000 merchants to participate on that promotion day in August. Just could you elaborate a bit of the backgrounds of these merchants, for example, the industry vertical, the size of their business and also maybe average numbers of payment transaction that they received during the day of that promotion? And in related to that, also noticed you have gradually introducing various payment scenarios for the Honk Kong retail payment feature. So I wonder if management could share your strategies and thoughts about expanding your payment service into the overseas markets. Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the cashless pay, I think this is sort of a way for us to raise the awareness among the merchants on getting their customers to use our Weixin Payment and QQ Wallet. And the 700,000 merchants are actually sort of pretty widely distributed sort of across different industries. That include, as I said, convenience stores and sort of food and beverage outlets and supermarkets to name a few of those. And I would say the result is actually sort of quite good. Despite the fact that we did spend quite a bit of money in terms of subsidizing some of these payments, but what we actually usually look at is how many of the converted users actually sort of continue to use the mobile payment services afterwards, right. And we found that sort of there is a pretty high rate of users, ones adopting this payment solution than sort of continue to use it on a ongoing basis. So, we're very pleased with that result.

Now in relate to the Hong Kong expansion, I would say it's obviously important long-term strategy for us to serve different markets. But the first group of users that we definitely want to serve is actually the people who are travelling, China-people who are travelling outside of China, right. When they're travelling overseas, we actually want to allow them to be able to pay with Weixin Payment and QQ Wallet.

And then we will look at expansion into selected local markets, I think on the much more cautious basis. The Hong Kong is a market which serve both purposes, right, one is there are lot of Mainland Chinese who are travelling to Hong Kong on a continuous basis, and a lot of Hong Kong merchants actually sort of welcome the adoption of coverage of Weixin Payment. And at the same time, we have a pretty large user base in Hong Kong for WeChat and as a result we would like to be able to serve them with our payment services.

Now having said that, I think the regulatory environment as I said for each one of the markets, right, is actually very different, and practices of financial institutions are actually quite different. So right now, for example, in Hong Kong there are only limited number of banks who can actually allowed us to have the kind of experience in China where you can just buy a banking card to the WeChat and QQ account. And if you actually have to use credit card for the payment, right, then a lot of the social payment actually sort of is very difficult because the transaction cost is actually high. And also sort of the credit card companies do not like to move cash.

So I think, Hong Kong, will continue to cover our services, but the kind of dynamic is actually quite different from China.

<Q - Alicia Yap>: Okay, great. Thank you.

<A - Catherine Chan>: Thank you, Alicia, for your questions. Next question, operator, please.

Operator

Sure. Our next question comes from the line of Wendy Huang from Macquarie. Please, ask your question.

<Q - Wendy Huang>: Thank you. So currently, you are lumping the payment and cloud revenue together in others. So can you give us some color, which part contributed to the bigger portion of the other revenue? And also the gross margin 18% you reported for this segment, is it margin expansion more driven by payment or more driven by the cloud?

Related to that, I also noticed that there is a accounting change on your restricted cash, which I believe is related to the RMB 125 billion on your WeChat payment platform. And you mentioned in your press release, this is because some of the operating environment change in the PRC. So can you maybe share what kind of operating environment change in the payment or Internet finance space triggered you to make this change?

Yeah, that's my first question on the payment and cloud. Thank you.

<A - Shek Hon Lo>: Let me answer the question regarding the restricted cash first. From time-to-time there has been guidance being promulgated by [indiscernible] (47:20) in relation to cash hold on behalf of your customers. And I think during the third quarter, there has been some guidance and talk about that.

So as a result we make some changes to the customer agreement in terms of the payment business. And as a result, the related asset which is the restricted cash as well as the liabilities have been made off balance sheet. Anyway it hasn't got any impact on the net asset as a whole, because anyway we have the corresponding liabilities in there beforehand. I think for this, we have made clear that the restricted cash does not belong to us.

<A - Chi Ping Lau>: Yeah. So, in terms of others, right, payment is the bigger portion and in terms of the pickup in gross margins, payment is also the higher contributor and part of it is our charge on people's withdrawing cash, right, start to really come into full force. And the other one is that as you see sort of when we launch a lot of promotions in terms of Cash-Free Days and actually induce a lot of transactions on the offline merchants and sort of for those we actually generate revenue as well as some gross profit. But of course, accompanying that is actually sort of an increased amount of marketing expenses.

<Q - Wendy Huang>: Thank you. My second is I want to get...

<A - Chi Ping Lau>: Maybe we should leave this to other...

<A - Catherine Chan>: Wendy, we'll put you back on the queue for the second round of questions. Okay?

<Q - Wendy Huang>: Sure. Thank you.

<A - Chi Ping Lau>: Thank you.

<A - Catherine Chan>: Yeah. Next question, operator, please?

Operator

Sure. Our next question comes from the line of John Choi from Daiwa. Please ask the question.

<Q - John Choi>: Good evening, and thanks for taking my question. My question is on your new initiative on the mini program. Could you guys share with us the latest progress on the beta testing including the developers' feedback, and when you expect to launch and how you plan to monetize it? Is this going to be – is it fair to say this, the major purpose is to increase the user engagement within the Weixin users? And secondly a follow-on on your content side – content investment, what is the plan for next year on the investment side and how will this further impact your margins on the advertising side? Thank you.

<A - Chi Ping Lau>: Yeah, our mini programs we're still in the beta testing. There are several hundred developers who are now developing mini programs and we're doing the testing. I think in the next version of Weixin it will support the mini program.

Now in terms of the feedback, I think we have to see, right, but sort of from a technical perspective, I think the goal for us is actually for mini program to provide to some extent an upgrade experience from our Official Accounts. Official Accounts as you look at it, it's actually sort of a media and content type of a platform, whereas sort of mini programs actually provide much more flexibility for the developers to develop their services into the WeChat, the Weixin platform. And it will help the service to actually run like a native app with much faster speed and it would actually sort of allow a lot of services which we believe sort of are hard to induce people to download an app, these are sort of lot of times, infrequently used services. But if you have the mini program, the users when they want to use the program, when they need to use the service, they can actually access the service very quickly.

Some of these maybe sort of merchants offline, they can actually promote these mini programs and some of the developers maybe are sort of online operators, but their services are infrequently used, but if users want to search for their services and then use it immediately, they can actually do that.

So, that was the goal of mini program. And we'll have to see how many developers would develop the programs and how would these be received by the users, but what we want to do is actually sort of provide a platform, so that more creativity can be put into the Weixin platform.

<A - James Gordon Mitchell>: In terms of video content cost, I think, it will come as no surprise to you or anyone else that the industry is experiencing a very rapid content cost inflation, particularly for certain categories of content such as high profile TV drama series from both China and Korea. And we've accordingly been expecting modeling for a very sharp increase in our video content costs as we move from 2016 to 2017. And some of that would already be locked in because of the need to pay for content ahead of screening.

The increase in content costs naturally flows through into downward pressure on our video and our online advertising margin structure. The extent of that downward pressure naturally depends on how much would we offset via video advertising growth and video subscription revenue growth.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Thank you. Our next question comes from the line of Alex Yao from JPMorgan. Please ask the question.

<Q - Alex Yao>: Hi. Good evening, everyone. Thank you for taking the question. I have two question. One is on gaming side. Can you guys discuss where and how will you deploy augmented reality, AR technology to your gaming content and how should we think about the impact from introduction of AR on gaming engagement and the monetization?

And second is on the performance ads, can you comment on the ad load of Moments and the Qzone? We understand that you guys are prioritizing on the harder part of ad infrastructures such as technology, distribution et cetera. What will make you comfortable to release more inventory and when would that be? Thank you.

<A - Chi Ping Lau>: In terms of AR, I think it's actually very early in technology, right. So the industry is actually testing this out, both VR and AR, I think we are quite some time away from these technology being used in sort of big user games. I think with AR and VR and particularly in VR, we felt sort of this is more like a deep immersive type of gaming experience. So it would appeal to people sort of who are now the console or PC game players, who want to have sort of a much more immersive experience. Now, then we need to have the developers who can develop these games.

So I think it's unlikely in the near future that we'll see large DAU games coming in the form of either AR or VR. Now, Pokémon Go, you may say, oh, it's an AR game, but we only think its core to the user experience. It's more like an LBS-type of game. So I think that would be some time to go.

Performance ads, maybe, James, you want to talk about it?

<A - James Gordon Mitchell>: Yeah. So, as you're aware we have I think a very moderate ad inventory load on Qzone, and an even more moderate one ad per day ad-inventory load on Weixin Moments.

I think our focus is less on increasing that ad-load and more on providing better tools, providing better performance measurements and so on, so that we can utilize the existing ad-inventory more efficiently. And if you look at the growth in our performance advertising revenue year-to-date, a great deal of it has been driven by us utilizing the existing Weixin Moments, ad inventory increasing efficiently, particularly by allowing smaller advertisers, more local advertisers to buy more targeted slices of our consumer attention in third and fourth tier cities.

So we have plenty of room to increase ad inventory at the right time. If you compare the ad inventory on in our properties with those of our peers globally or even if you compare the ad inventory on our social properties with the ad load on news apps in China, there's a very substantial gulf. But that's something we can sort of hold in reserve for the future. And for the present, we're really focused on the tools, the performance measurements, and on increasing the overall number of advertisers, who are participating in the performance bidding.

<A - Catherine Chan>: Thank you. Operator, in the interest of time, we'll take the last three questions, please.

Operator

Sure. Our next question comes from the line of Chi Tsang from HSBC. Please ask the question.

<Q - Chi Tsang>: Great. Thank you very much. I wanted to ask you a little bit about brand advertising. What do you think the current demand outlook might be for brand advertising for next year? And also, I wanted to know, if you can add a little bit more color regarding the shift in the news feed revenue from CPT to pay for performance in the terms of maybe the magnitude of that shift? Thanks so much.

<A - James Gordon Mitchell>: So, on your second question about the magnitude of the shift, we're quite conscious about what we call out in the commentary. So you can assume that it was of sufficient magnitude that we felt it ought to be called out. I think it reflects some interesting trends, one is that traditionally brand advertisers are increasingly adopting a performance mindset. A second is that the growth of news aggregator services like perhaps [indiscernible] (58:49) monetize more aggressively than we might have done in the past. It's illustrated that there is a very great performance advertiser demand to put their ads into a sort of a news-driven, news feed environment, and I think that's partly because of the nature of smartphone screen versus PC screen. That on the smartphone screen, you are trained to continually scroll, click, scroll, click, scroll click and so that lends itself very well to in performance advertising that's paid on a cost per click basis in a way that it didn't necessarily lend itself for a Yahoo home page on the PC.

So there's been a fairly substantial shift driven really by advertiser demand as opposed to our supply decisions away from brand and toward performance advertising within particularly on news app and also some of our other services. So that's part of the reason why you've seen the divergence in growth rates between very fast performance advertising revenue growth on the one hand and decelerating brand advertising revenue growth on the other.

In terms of the brand advertising outlook for next year, historically we don't have a great deal of visibility until we enter the annual commitment process in December, January. But overall it's clearly a relatively weak economic environment and there are specific pockets of additional weakness whether due to government regulatory policies such as real estate. I think for Tencent, we believe that the pattern of performance advertising growing faster than brand advertising will certainly continue in 2017, while brand advertising we'll have to grapple with these macro headwinds as well as specific factors such as advertising inventory moving from brand performance and the trend I mentioned in video of consumers paying for subscriptions and enable them to skip the brand advertising.

<Q - Chi Tsang>: Thank you.

<A - Catherine Chan>: Thank you. Next question please.

Operator

Thank you. Our next question comes from the line of Evan Zhou from Credit Suisse. Please ask a question.

<Q - Evan Zhou>: Hi, good evening. Thank you for taking my questions. My question is regarding our core products user engagement. And I noticed that there is slight decline quarter-on-quarter our QQ product and especially on the smart device MAU also came down relatively larger than the overall MAU for QQ. And also Qzone Q-on-Q MAU went down as well.

So, I was wondering is there any kind of seasonality impact or any specific part of feature changes that's making this move. Or what do you see as kind of overall outlook for our relatively speaking more legacy product lines versus Q3 and Q4? Thank you.

<A - Chi Ping Lau>: Yeah. I think on the social products, we look at it from two different angles. The first one is actually overall user base engagement across our platforms, because there are pretty significant number of people who are actually using both QQ and WeChat, and I think for us as a company we tend to look at sort of whether we are increasing the total number of users using both QQ and WeChat, and whether sort of the users are using our platform on a more frequent basis. I think the answer to both of the two questions is actually, yes.

Now the second perspective that we looked at is actually sort of are we covering the different segments of people with some kind of dedicated and specialized products. And I think if you look at the user base where people use either QQ or WeChat, I would say QQ now is actually increasingly popular among the young cohorts, the young users. And obviously QQ continues to be very strong with users who are using office workers, when they are in office, when they are sitting right next to the computer, when they need to send very large files and communicate with other users, other workers, coworkers then QQ is the preferred product.

So with these two group of users, I think QQ's engagement is still very high, particularly with respect to the young users, it's actually increasingly adopted by the young users at younger age. So I think overall we are actually pretty happy to see the overall portfolio is actually engaging with more users with higher frequency of engagement. And at the same time, each product is actually pretty successful in covering the differentiated user base as well.

<Q - Evan Zhou>: Got it. Thanks, Martin.

<A - Catherine Chan>: Thank you, operator. We shall take the last question, please.

Operator

Thank you. Our last question comes from the line Natalie Wu from CICC. Please ask the question.

<Q - Natalie Wu>: Hi. Thank you for taking my question. Just a quick question, what's the split of brand ads from a performance based ad format in terms of mobile news revenue, and what's the current revenue split among Tencent news app and Tiantian Kuaibao? Thank you.

<A - Chi Ping Lau>: Well, right now, the revenue on the news side is predominantly Tencent news. Tiantian Kuaibao is actually a relatively new product and we actually sort of want to focus on improving the user experience. So, that's why as you look into the app, the ad load is actually relatively small. I think there is a potential to have sort of meaningful ad load on Tiantian Kuaibao going forward, but sort of for the time being, I think we're much more focused on the user experience.

<A - James Gordon Mitchell>: Natalie, it's James. I didn't catch the first part of your question?

<Q - Natalie Wu>: Yeah. I think that, for your mobile news app revenue, you to split that into like brand advertising and performance based advertising, right. So, just want to get some color about the split. The every like $100 you get your like mobile news app, how many will you or how much will you be recognized into the brand advertising and how much will that be...

<A - James Gordon Mitchell>: Roughly, it's been changing very quickly. As of Q3, it was roughly two-thirds brand, one-third performance, but the mix has been, if you go back to year-and-a-half ago, it would have been 90% brand, 95% brand. So, it's in flux. For the reasons I mentioned, that the overall industry is changing, the advent of new news aggregator services that have driven performance advertising very aggressively, monetizing very high rates to sort of unlock the door to performance advertisers being willing to advertise much more news driven, news feed environment.

<Q - Natalie Wu>: Understand. Thank you.

Catherine Chan

Okay. Thank you very much for your questions, and thank you operator. We are closing the call now. If you wish to check our press release and all the financial information, please visit our company website at www.tencent.com/ir. The replay of this webcast will also be available soon. Thank you, and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2016 third quarter results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2016-08-17
Event Description: Q2 2016 Earnings Call

Market Cap: 1.83TRI
Current PX: 193.00
YTD Change($): +40.50
YTD Change(%): +26.557

Bloomberg Estimates - EPS
Current Quarter: 1.163
Current Year: 4.515
Bloomberg Estimates - Sales
Current Quarter: 36425.545
Current Year: 142275.405

Q2 2016 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Alicia Yap
- Eddie Leung
- Alan Hellawell
- Wendy Huang
- Ming Xu
- Evan Zhou
- Piyush Mubayi
- John Choi
- Jin-Kyu Yoon

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by, and welcome to the Tencent Holdings Limited 2016 Second Quarter and Interim Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by the question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please, go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to our second quarter interim results conference call. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we'd like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent. This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to but not as a substitute for measures of the Company's financial performance, prepared in accordance with IFRS. For a detailed discussion of the risk factors and non-GAAP measures, please refer to our disclosure documents downloadable on www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We've our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo. Pony will kick off with a short overview; Martin will discuss strategic highlights; James will speak to business review; and John will go through the financials before we take your questions.

I'll turn the call over to Pony now.

Huateng Ma

Thank you, Catherine. Good evening. Thank you for joining us. In the second quarter of 2016, we delivered [indiscernible] (02:00) growth in established businesses such as mobile games and social-based performance ads. We have also different user engagements for our emerging businesses such as digital content and online payments.

While we continue to invest in early-stage activities, including video content, cloud services, and Internet finance, we are generating healthy margins and profitability on branded business. Specifically, total revenue was RMB 35.7 billion, up 52% year-on-year and 12% quarter-on-quarter. Non-GAAP operating profit was RMB 14.7 billion, up 42% year-on-year and 9% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 11.3 billion, up 42% year-on-year and 13% quarter-on-quarter.

Moving to our online platforms, total MAU for Q2 increased 7% year-on-year to 899 million, with 667 million of monthly active user locking via smart devices. Combined MAU of Weixin and WeChat increased 34% year-on-year to 806 million.

For our social network, Qzone, smart devices MAU increased 4% year-on-year to 596 million. In games, we expand our user base and revenue in smartphone games through our broadening portfolio of casual, RPG, and player-versus-player titles, really [indiscernible] (03:56) industry leadership in PC games.

In media, we saw healthy growth in users and impressions for our news and video platforms. Digital content subscriptions for video and music services also increased. We recently merged our music business with the China Music Corporation and believe the combined company can help to improve the overall digital music market in China.

In mobile utilities, we maintained market leadership in mobile securities by extending our corporation model to international handset brands, such as Apple and Samsung. Our leading mobile browser recorded healthy growth in users and page views. For our app store, Ying Yong Bao, we enhanced app discovery by providing users with deep-linked app content.

I now invite Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony. And good evening, good morning to everybody. An important strategic focus area for us is our content businesses. So, in this section, I'll give you an update on our ecosystem for content businesses.

From an industry perspective, we believe that three major forces are contributing to the evolution of a healthy ecosystem over time. Firstly, regulators and industry players have been working closely to improve IP protection and strengthen anti-piracy enforcement in the past few years. Secondly, mobile Internet connectivity and smartphone adoption are making content consumption ubiquitous. Thirdly, revenue models are evolving from advertising-only to hybrid freemium models with subscriptions, transactions, as well as advertising. This in turn incentivize content creators and publishers to provide more and better content sooner to the users.

For us, Tencent, we act as a driving force for industry change, and we are also a major beneficiary of the industry change. We can satisfy the growing appetite of our large user base with diversified quality content. Secondly, we serve as a strong distribution to content creators as well as publishers, leveraging our extensive user-rich and social graph. Thirdly, we facilitate digital content purchases via Weixin payment and QQ Wallet. Fourthly, we recommend content and display ads to users based on our proprietary targeting technology. And fifthly, we own multiple media platforms and, thus, can unlock the synergistic potential of the well-known IP across literature, games, video, and music platforms.

Now, in addition to organic business execution, we also pursue strategic transactions on a selective basis. In the next two slides, I will discuss two transactions that will strengthen our alliance with ecosystem partners. The first one I would like to discuss is the merger between our QQ Music business and China Music Corp., CMC. KuGou and Kuwo under CMC and QQ Music are highly popular online music streaming platforms in China. As part of this transaction, Tencent will have a controlling stake in the merged company and will consolidate financials. We'll appoint the majority of directors to the board and key executives from Tencent and CMC will join force in managing the platforms and products. The merged company will focus on providing authorized music and superior experience to users, helping artists to reach more fans and support record labels to drive new business models. We believe digital music business is a strategically attractive vertical for our content business. According to IFPI, record labels reported declining global revenues in the past 15 years due to declining CD sales. But since 2005, global revenues began to recover, as the consumers subscribed to streaming services. So the global music business is at a turning point.

Now, particularly in China, music is among the top five Internet activities by users. But the market is very small from a revenue perspective. Leading music streaming platforms like us are serving large user base but generating small revenues due to piracy, which is not good for artists and creative people. Now, through close cooperation with regulators and like-minded industry players, we believe the merged company will create more healthy dynamics for the overall industry, which will benefit everyone as a whole.

Now, in addition to the music company, we also made a significant substantial investment in Supercell during the quarter. Supercell is the world's largest standalone mobile games company, with a proven track record in developing games that can deliver innovative gameplay and long lifecycles. We are extremely excited about Supercell joining our global network of game partners. With this transaction, we are empowering the founders of Supercell to manage the company independently. In China, we'll leverage our social graph and platform distribution capabilities to help their games further popularize among experienced and core game users. In terms of financing for the transaction, we will co-fund the investment with lenders and consortium investors under an SPV structure. This way, we can achieve optimal capital efficiency for us and also allow Supercell founders to have the autonomy to drive the company forward. We expect to adopt dividend accounting for our significant stake in Supercell.

In terms of strategic benefits, the transaction is highly strategic for Tencent's gaming business. According to Newzoo, mobile games now represent over 30% of global games revenue, and it's also growing rapidly. China is the biggest mobile games market in the world, where Supercell has already achieved good results but, in our view, has got even greater potential with the help of Tencent. As the top two players in the world by revenue, Supercell and Tencent can join force to build an even stronger presence in the market. Both of us are pioneers in real-time player-versus-player games, which is a big hit in China, and also gaining popularity globally. We're committed to delivering innovative and best-of-breed game experience to users worldwide.

With that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Thank you, Martin. In the second quarter of 2016, our total revenue grew 52% year-on-year. VAS represented 72% of our revenue, within which online games contributed 48% and social networks 24%. Online advertising was 18% of our revenue. The others segment for the first time reached 10% of our total revenue. Other revenue includes payment-related services, cloud services, some e-commerce transaction, and other activities.

Looking at value-added services, segment revenue was RMB 25.7 billion, up 39% year-on-year and up 3% quarter-on-quarter. Social network revenue was RMB 8.6 billion, up 57% year-on-year and up 9% quarter-on-quarter. The robust growth was driven by increased revenue from game-related item sales and from digital content sales. Our monthly subscription count grew 25% year-on-year to 105 million, although it decreased 3% quarter-on-quarter, as we restricted [ph] parallel (12:07) distribution of our subscription services through somewhat lower-margin distribution channels. Our online game revenue was RMB 17.1 billion, up 32% year-on-year and stable quarter-on-quarter.

For smartphone games, our player-versus-player games and new role-playing games growth, both year-on-year and sequential revenue growth. For PC games, several existing and newer mid-sized titles contribute to the year-on-year growth, but revenue dipped quarter-on-quarter during the weak period in the second quarter.

Turning to social networks, for the QQ, we added a number of new features and services, catering to young entertainment-driven users, thereby improving the overall engagement. Specifically, we enhanced chat experiences with a new video function. Users can create video GIFs of themselves, decorate the GIFs with animated stickers, and share the GIFs with friends. Within school groups, we provide third-party online educational content such as question banks, which help students and teachers enhance their efficiency and increase their engagement with our platform. Also, we launched the UGC live streaming service called NOW that enables users to record videos of interesting events and of their daily life. Users can then distribute this video to a broader audience via the standalone NOW app or share the video with selected friends via Qzone.

For Weixin, more companies are adopting enterprise accounts, which provide a built-in infrastructure supporting staff to manage more process flow, such as claiming expenses or applying for leave. About 20 million office workers are now users of these enterprise accounts.

We expanded our municipal services to third Tier cities, and we launched eLoyalty Cards within Weixin Pay that merchants can issue to their customers in lieu of physical loyalty membership rewards cards. And Weixin Pay experienced rapid growth in users, particularly in people using Weixin Pay for everyday commercial transactions.

Looking at PC client games in more detail, average concurrent users for advanced casual games were 7.4 million, down 9% year-on-year, and average concurrent users for MMOGs were 1.5 million, up 2% year-on-year. We're doing several things to engage core users with our PC game platform. For example, in April, we released a new game mode for League of Legends in China. User activity on our sports games, FIFA and NBA 2K, benefited from excitement around the UEFA Champions League and the NBA Finals during the quarter. We're using action RPG, D&F, as a test case in developing our IP strategy by releasing Dungeon & Fighter-themed comics, literature, music and, later on, mobile game. And we added a new game this quarter in the combat genre. War Thunder is set in World War II and enables gamers to fight with tanks and aircraft.

Our smartphone game revenue reached RMB 9.6 billion, up 114% year-on-year and up 17% quarter-on-quarter. We continue to lead China's iOS top-grossing game chart, publishing 6 out of the top 10 titles. In the second quarter, we published three new casual games and four new mid-core games. We believe our smartphone game portfolio benefits from publishing a range of game types. Specifically, our casual games play a key role broadening the gaming audience. The rapid success of our new casual titles such as Carrot Fantasy 3, as well as the ongoing popularity of our existing casual title, such as Timi Run Everyday and Fight the Landlord, drove our overall smartphone game daily active user count up materially this quarter.

Big player-versus-player games such as Honor of Kings and Cross Fire Mobile generate both large DAU, constant substantial revenue. For example, Honor of Kings has over 30 million daily active users, but it's also one of the top revenue games on Android in China. Our role-playing games, in common with role-playing games elsewhere in the industry, generally achieves smaller DAU basis but contribute disproportionately to revenue, especially on iOS. During the last few months, we've released several new role-playing games, including Zhengtu Mobile, JX Mobile, and Dragon Ball Z Mobile.

Moving to online advertising, segment revenue was RMB 6.5 billion, up 60% year-on-year and up 39% quarter-on-quarter. Brand advertising revenue was RMB 2.8 billion, up 41% year-on-year and up 31% quarter-on-quarter. The year-on-year growth was mostly driven by increased traffic and, thus, mobile ad impressions, particularly in our news app and our video app. The quarter-on-quarter growth reflects positive seasonality. Our video traffic sustained healthy expansion rate, especially for TV drama series, Web-native videos, and sports. For example, the number of unique viewers in China for NBA games more than doubled year-on-year to over 100 million. Our top five brand advertising categories this quarter were online services, food and beverages, automobiles, online games, and personal care.

Our performance advertising revenue was RMB 3.7 billion, up 80% year-on-year and up 46% quarter-on-quarter. The key driver of the growth was Weixin Moments. Supported by the launch of our self-service advertising platform in the first quarter, we were able to bring many more regional advertisers onboard and increased the utilization of [indiscernible] (17:25) traffic inside Weixin Moments. In addition, in Qzone, we launched carousel ads, which contributed to new ad impressions and more revenue.

I'll now pass to John to go through the financials.

Shek Hon Lo

Thanks, James. Hello, everyone. For the second quarter of 2016, our total revenue was RMB 35.7 billion, up 52% year-on-year or 12% quarter-on-quarter. Gross profit was RMB 20.5 billion, up 42% year-on-year or 10% quarter-on-quarter. Share of losses of associates and joint ventures was RMB 292 million in the quarter. On a non-GAAP basis, it was approximately RMB 206 million. Income tax expense was RMB 2.8 billion, up 51% year-on-year or 9% quarter-on-quarter. The effective tax rate for the quarter was 20.4%. Net profit attributable to shareholders was RMB 10.7 billion, up 47% year-on-year or 17% quarter-on-quarter. After adjustment to non-GAAP, operating profit for the quarter was RMB 14.7 billion, up 42% year-on-year or 9% quarter-on-quarter. Net profit attributable to shareholders was RMB 11.3 billion, up 42% year-on-year or 13% quarter-on-quarter.

Let's turn to segment gross margins for the quarter. Gross margin for value-added services was 66.7%, broadly stable year-on-year and quarter-on-quarter. Gross margin for online advertising was 45.3%, down 6.6 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year dip was mainly due to higher content costs.

Moving on to operating expenses. Selling and marketing expense was RMB 2.4 billion, up 48% year-on-year or up 16% quarter-on-quarter. The year-on-year increase was mainly driven by higher marketing spending on products and platforms. This sequential increase was mainly due to seasonal increase in advertising and promotional activities in the second quarter as well as greater marketing spend due to business expansion.

G&A expense was RMB 5.3 million, up 32% year-on-year or 21% quarter-on-quarter, within which R&D expense was RMB 2.7 billion, up 33% year-on-year or 18% quarter-on-quarter. The year-on-year and sequential increase were primarily due to higher research and development expenses and staff costs. As a percentage of quarterly revenue, selling and marketing expense was 7% and G&A was 15%. R&D represented 8% of quarterly revenue. Share-based compensation was approximately 2%.

Looking at margin ratios for the second quarter, gross margin was 57.3%, was down 4.3 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year decrease was mainly due to the increase in proportion of our other segment revenue with lower margins. Non-GAAP operating margin was 41.2%, down 2.8 percentage points year-on-year and stable quarter-on-quarter. The year-on-year decrease reflected lower gross margin, which was partially offset by lower G&A expenses as a proportion of total revenues.

Non-GAAP net margin was 32.2%, down 2.3 percentage points year-on-year and broadly stable quarter-on-quarter. For the second quarter, total CapEx was RMB 1.5 billion, down 47% year-on-year and 63% quarter-on-quarter. Operating CapEx was RMB 1 billion, up 30% year-on-year and down 23% quarter-on-quarter. As a percentage of revenue, it was at 3%. Non-operating CapEx was RMB 466 million, down 77% year-on-year or 83% quarter-on-quarter. The significant year-on-year and sequential decrease were mainly due to no addition of [indiscernible] (21:50) during the period. Free cash flow was RMB 9.7 billion, up 80% year-on-year and down 30% quarter-on-quarter. The year-on-year increase reflected the high cash generated from operations. The sequential decline was primarily due to PC game cash flow seasonality. Our net cash position at quarter-end was RMB 24 billion, up 11% year-on-year or down 12% quarter-on-quarter. This sequential decrease was mainly due to annual dividend payout. Thank you.

We'll now open the floor for questions.

Catherine Chan

Thank you. Operator, we shall take the questions, please.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Alicia Yap from Citigroup. Please, ask your question.

<Q - Alicia Yap>: Hi. Good evening, management. Thanks for taking my questions. Congrats on the good result. I have two questions. My first question is related to the advertising. So, can you share with us some colors on the latest self-service tools that enable the regional advertiser to buy those targeted traffic in the lower-tier cities. So, what type of regional advertisers specifically that – are attracted to these apps? And then, looking forward into medium term, how should we think about the revenue contribution split for Moments ads between the MNC advertiser for broad branding exposure versus the opportunity coming from the self-served regional advertiser group?

And also related to ads, for – can you give us some colors on the tractions for this new ad format, carousel on the Qzone? Will these actually help to stimulate higher social ad budget for Qzone in the coming months?

<A - James Gordon Mitchell>: Thank you, Sylvia. Congratulations on the question, Alicia. In terms of the advertising on Weixin Moments, and specifically the self-service advertising, I think we outlined some of the tools we introduced three months ago, and you know that those had a somewhat beneficial effect. The number of self-service advertisers increased over 400% quarter-on-quarter and resulted in Weixin Moments becoming our largest ad revenue-generating inventory. Specific categories that were most interested in the self-serve product in targeting some of the non-first-tier cities included, for example, the real estate category, which makes sense, given if you're developing a apartment building in Chengdu, you may not want to advertise it in Beijing. So we saw a good broadening of our advertiser mix by category as well as expansion of absolute numbers on Weixin Moments.

In terms of the long-term split of advertising revenue on Weixin Moments between self-service versus Fortune 500 advertisers, I think that the performance advertising as a whole, the mix was heavily skewed towards self-service advertisers, which is what we've seen elsewhere in the world with Facebook or with Google for that matter. Now, within our performance advertising inventory, which includes not only Weixin Moments but also Weixin official accounts, Qzone, YingYongBao, third-party ad network and so forth. But in generalization, the Weixin Moments would be particularly attractive to the bigger budget, more brand-conscious Fortune 500 advertisers. So it's possible that Weixin Moments will always be heavily influenced or heavily used by those big budget Fortune 500 advertisers. But nonetheless, we're obviously very gratified with the progress that our self-service tools have achieved and with our traction in smaller cities this quarter in Weixin Moments. And we're pleased with the diversification of revenue.

In terms of the introduction of carousel ads on Qzone, as you'd expect, we're continually seeking to introduce new technologies, new ad formats within Qzone and within our other performance advertising products. And so, that's an ongoing asset. And while Weixin Moments is the single biggest inventory opportunity within our performance ad portfolio, there are many other discrete inventories that are attractive for their own reasons as well to add to different types of advertisers.

<Q - Alicia Yap>: I see. I see. Great. Thank you. My second question is related to the digital music business. So is that fair to assume that with you consolidating China Music Corp., compared to the online video platform, music and online literature content is less competitive compared to online video? And for the content shelf life, is that also fair to assume that the music and literature content will have longer shelf life and less pressure to always acquire the latest content compared to the video so, hence, it leads to slightly better economics of return? So any comments or view on the bigger pictures on these digital content landscape will be appreciated. Thank you.

<A - Chi Ping Lau>: Well, I think it's fair to say the video business is a lot leader for us right now. And the industry structure is actually sort of very unhealthy for everyone. So I think, by default, all other digital content industry is actually in a better shape than the video industry. But I think sort of the philosophy that we take in our content business is a bit like what we have taken in the gaming business, which is we try to create a model in which every party benefits from a healthier industry condition so that on one hand, the users actually benefit from having better content. At the same time, our partners, be it a records company or the creative artists, they will benefit from having a multitude of different business models. So, I think we need to strike the right balance among all different parties. And as you can see in the way we sort of curate the music business, right now, the streaming business, by and large, is free for all users. But at the same time, we have been able to create packages, including subscription, including transaction-based albums, and as well as advertising such that we actually sort of can create enough business model for the other industry partners to benefit. So I think sort of that's how we look at the content businesses, and we hope that we can create the right model for everybody to benefit.

<Q - Alicia Yap>: Okay. Great. Thank you so much.

<A - Catherine Chan>: Next question, please.

Operator

Your next question comes from the line of Eddie Leung from Merrill Lynch. Please, ask your question.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. Could you share your thoughts with us on the trend of user-generated video? What could be the impact on social media? Any update on how Weixin can deal with this development? And then, secondly, just a couple of housekeeping questions. Wondering if you could share some color with us on the impact from the launch of Overwatch on your game portfolio? And how about the game ARPU of different types of games? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of user-generated video, I think it's actually growing very nicely within our platform and, especially, sort of, on the mobile platform. It's [indiscernible] (31:12) to say what a significant amount of official account media-related content is actually sort of from user-generated video. And so, it has actually sort of transcended from in the past, where you have to go to a video site to actually view this user-generated video to now, there are a lot of different official accounts, which are creating contents and putting their video on their push messages. And that actually sort of will be pushed to users on the official accounts system, and it will be shared widely within the Moments of different people. So that's actually sort of a very significant amount of traffic within our ecosystem. And we felt that it's good for user engagement. Right now, these videos are not generating much revenue, but it's very good for user engagement. And so far, I would say, the quality of the content is not sort of up to the professional or even semi-professional level yet. But we are starting to see some good content creators. Over time, what we hope to see is while the entire video content ecosystem will still be dominated by professional-made content, the user-generated content will become more and more professional. And so, over time, it will continue to add to our traffic, it will continue to add to our engagement and, hopefully, some time, it would start contributing to our advertising revenue.

<A - James Gordon Mitchell>: In terms of Overwatch and the impact on our PC game business and on the industry as a whole, I think it varies, to some extent, by geography. I mean, you can see, if you look at Korea [indiscernible] (33:14) on Korean Internet café behavior or you look at the results from Korean game companies that Overwatch clearly grew the market in Korea but also, to some extent, cannibalized other titles in the market. And, for us, Korea is a low single-digit percentage of our PC game revenue. If you look at, for example, Steam engagement data for the U.S. and Europe, then it's evident that while Overwatch – and it's very popular. It actually has not had a noticeable impact on the major online games in the western world such as Counter-Strike or even Team Fortress 2. [indiscernible] (33:52) probably the most superficially similar to Overwatch. And so, I think it's fair to believe that Overwatch has grown the market in the western world. And then in China, Overwatch has not so far had a very dramatic negative impact on any incumbent titles. I think that there's a couple of sort of bigger picture silver linings to be aware of. The more important one is that I think the success of Overwatch and also the success of other recent PC games like No Man's Sky shows that there is still quite a high pent-up demand for new games, including new IP among PC gamers, both in the West and in Korea and we think also in China. And then, secondly, and more narrowly, Overwatch's success is obviously good for the developer, Blizzard, and we're actually the second biggest shareholder in Activision Blizzard.

John, do you want to address...

<A - Shek Hon Lo>: Yeah. In relation to the ARPU for games, for MMOG, it ranges from RMB 310 million to RMB 450 million; for ACG, it ranges from RMB 85 million to RMB 350 million, and for [ph] platform (35:08) games, it – we view the whole portfolio as one game, it ranged between RMB 150 million to RMB 165 million for the quarter.

<Q - Eddie Leung>: Thank you very much, John.

<A - Catherine Chan>: Yes. Next question, please.

Operator

Your next question comes from Alan Hellawell from Deutsche Bank. Please, ask a question.

<Q - Alan Hellawell>: Excuse me. Thank you very much. As James mentioned, other revenues have surged to roughly 10% of consolidated revenue. And I believe that in the prepared remarks, we ascribed a majority of the year-on-year decline in growth margin to the growth in areas such as [indiscernible] (35:49) and cloud. I was wondering if you can give us [indiscernible] (35:51) revenue contributions from those two elements with the growth rates? And then, whether – what kind of impact this growth will have on margins, going forward? We've heard from your peers in the market that the margin [indiscernible] (36:12) dramatically. So, would love to get a sense of what [indiscernible] (36:17) going forward. Thank you.

<A - Chi Ping Lau>: Yeah. Well, in terms of other revenue, we actually sort of do not provide the mix. What we sort of describe this, you know, it consists of our cloud business and revenue from our payment business. But both of the businesses are sort of in relatively early stage of development. And on the cloud business, it's still a very low margin and sometimes a negative margin business. In terms of our payment business, I think the goal is actually sort of to provide an infrastructure service for our entire ecosystem. And as a result, we're not aiming to make much money from that business. And we're glad that sort of, as a whole, these series of revenues are not sort of making losses for us as we grow. But I think these are more like infrastructure businesses that we will be investing for the long run.

<Q - Alan Hellawell>: Thank you.

<A - Catherine Chan>: Thank you. Next question, please?

Operator

Your next question comes from the line of Wendy Huang from Macquarie. Please, ask your question.

<Q - Wendy Huang>: Thank you. My first question is regarding your payment business. I noticed the restricted cash on the balance sheet, actually, a record new high at RMB 125 billion again. So, how should we actually interpret this into the G&A growth on your payment platform? And, also, how are you seeing the payment transactions momentum change since there was payment policy change, either by the industry or by yourself, exactly as of March 1? My second question is, in nations that your social value actually declined sequentially due to the pressdown on the [indiscernible] (38:27) distribution, can you provide more color on this one? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of the payment business, I would say, the number of transactions as well as transaction volume has continued to grow pretty healthily. And the amount of cash in the escrow account, as you pointed out, part of it actually sort of is a reflection of the fact that user activities have been growing. The other one is, really, sort of as part of the policy that we've put in place in the – two quarters ago when we were sort of incurring a lot of losses when people sort of transferred money from one account to another where you sort of put in a charging mechanism so that we can recover part of the costs in relation to the money transfer. A byproduct of that measure is that people have more incentive – or less incentive to sort of move money immediately out of the account once they have received the money. And as we continue to increase the number of payment scenarios that they can use, they can use online; they can offline; they can use it sort for [indiscernible] (39:57) whole series of different payment scenarios and sort of I think consumers are happier to just park the money within the account. So that contributes to part of the increase.

<A - James Gordon Mitchell>: In terms of the subscriptions, I apologize, I may have – you may have misheard me a little bit. But I didn't say the subscription revenue was down quarter-on-quarter. I said the subscription accounts, so accounts were down quarter-on-quarter. And the reason for that is, in the past, we've enabled consumers of other company's products who belong to other companies in a membership reward scheme to use their membership rewards to purchase some of our privilege payments such as QQ Membership. And we actually sort of reduced some of that sort of lower-revenue, lower-margin distribution channel during the second quarter, which in turn reduced the subscription accounts for the privilege memberships. The subscription accounts for the digital content services such as premium music and premium video should help the quarter-on-quarter growth. And then, the overall subscription revenue increased quarter-on-quarter because the accounts we were sort of reducing were the lower-revenue accounts versus the digital content accounts that are growing and relatively high-ARPU accounts.

<Q - Eddie Leung>: Okay. Thanks for the clarification.

<A - Catherine Chan>: Next question, please.

Operator

Your next question comes from the line of Erica Werkun from UBS. Please, ask you question.

<Q - Ming Xu>: Good evening. This Ming Xu asking on behalf of Erica. So I have two questions. The first is regarding your subscription business. Can you share with us the latest number of subscribers and also the ARPU trend, particularly the [Question Inaudible] (41:53-42:00)?

<A - Catherine Chan>: Excuse me, I think is your line is cracking. We couldn't hear your question. Excuse me, I think your line is cracking. I think we [audio gap] (42:09) first question, and we'll come back to your second question, okay?

<Q - Ming Xu>: Okay.

<A - James Gordon Mitchell>: I apologize. I didn't hear the first question either. Beyond the subscription accounts which we disclosed in the MD&A was RMB 115 million...

<A - Chi Ping Lau>: And ARPU trend, total subscriptions. We never sort of disclose that rate, right?

<A - James Gordon Mitchell>: Yeah. But we don't disclose the ARPU. I mentioned in the previous answer that there are digital content services that have often slightly higher ARPU. You'll see if you go to our site that music ARPU – music pricing is normally RMB 15 and our video pricing is normally RMB 20. Sorry. What was the second question? [indiscernible] (42:51) clear that.

<Q - Ming Xu>: Okay. Sure. My second question just on the WeChat monetization advertising. So we noticed on some third-party research report that the readership – or average leadership per article of public accounts is declining. So, could management share with us the latest public account activity and also the WeChat time spend trend? And what's the implication for the WeChat monetization? And lastly, the progress in your [indiscernible] (43:21)? Thanks.

<A - Chi Ping Lau>: Well, I think sort of there's actually a number of different ways to look at the traffic and at the same time sort of the readership, actually, distribution is somewhat changing. And what I mean by that – I think, in terms of your question, what we see as sort of the highest-quality traffic is actually when official accounts actually sort of send out those articles, how many PVs are generated there.

And second one is, we actually view the high-quality content as being those which are original content rather than sort of a retweet of other people's content. So I would say, on the number of PVs that official accounts are generating as a whole is actually sort of growing on a pretty steady and healthy basis.

Now, I think, when you talk – comment on sort of the traffic has been going down, I think there are a group of official accounts in which they try to put out some jokes and sort of retweet some other people's content, repackage some other people's content, and use a network of accounts to try to sort of cross-promote each other. Those are the kind of accounts that may see a somewhat reduced traffic because I think our systems actually sort of deliberately try to encourage the original content over those people who are repackaging content.

<A - Catherine Chan>: Okay. Thank you.

<Q - Ming Xu>: Thank you.

<A - Catherine Chan>: Questions?

Operator

The next question comes from the line of Evan Zhou from Credit Suisse. Please, ask your question.

<Q - Evan Zhou>: Hi. Good evening, ma'am, and thank you for taking my questions. My first question is regarding our brand ad growth, especially for the video ads. I think if my number is correct, I think the growth rate for video is probably like lower to roughly lower than 40% year-over-year compared to in last year this time, it's probably over 100% year-over-year. So I wondering like any sort of industry trend or budget shift trend that you have seen in the recent quarters about the willingness of a spending budget shift to the traditional online video format? Or did you see the advertisers may be shifting somebody to some short video format? And in terms of our strategy on content spending, any update on that will be helpful. Thank you.

<A - James Gordon Mitchell>: In terms of video advertising revenue growth, I think that both for the industry as a whole and for Tencent video, there has been a deceleration in growth. And I think that's for a couple of fairly structural reasons. One is the large base effect and, naturally, percentage growth rates decelerate as the base gets bigger. And the second is the growth of our subscription video. And if you take out video revenue growth, then the growth rate for advertising plus subscription revenue together is actually twice as fast as the growth rate for our advertising revenue alone. And to some extent, the two are very complementary to each other. But to some extent, if the biggest invest in U.S. content some percentage of it is going behind the subscription wall, then that may have an impact on the growth rates of the advertising-funded wall. But I think we are okay with that because it's a business historically. We've been very comfortable with consumers paying us directly for content they want. And as a generalization, the subscription-funded video content market is more tightly concentrated than the advertising-funded video content market.

But in terms of advertiser behavior, and as I mentioned, we saw a good growth in video advertising this quarter, as we've done in one year or two years ago. But this quarter, we also saw very good growth in our news app advertising and in our Weixin Moments advertising. So it seems as if the advertisers, while they continue to favor video particularly for reach that they're also increasingly allocating to news apps, both us and [indiscernible] (48:30), as well as to performance advertising within the Weixin Moments format.

With regard to video content spend, the industry continues to be extremely competitive – more competitive this year than last year. And that's especially true of a specific vertical such as the top tier kind of S-class domestic drama serials and also the sports category. And so, the video business, for us, and for the entire industry remains a loss-making business because of the rapid escalation of video content costs. But I would say that when we in the industry think about video content costs then – into the advertising growth that we can – the advertising revenue we can generate off the content, it's one component. But the subscription revenue we can generate off the content is another increasingly important component as well. So it would be wrong to compare the video at revenue growth rates, which have slowed down for the industry versus the video content costs alone because you should actually think about the video subscription revenue opportunity as well.

<Q - Evan Zhou>: Thank you, James, for the color.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Your next question comes from the line of Piyush Mubayi from Goldman Sachs. Please, ask your question.

<Q - Piyush Mubayi>: Thank you for the opportunity. Given the disclosed flattish ARPU for mobile games, what is driving the surge in the paying user number which seems to be around 125% year-on-year? Also, the strength sustainable at this higher clip? And I had a question on Supercell's revenues in China. Could you give us a sense of what percentage of revenues for Supercell are coming from China? Thank you.

<A - James Gordon Mitchell>: So in terms of the – you're correct to identify that the revenue growth has been driven less by ARPU in mobile and increasing paying users, which we think is quite a healthy phenomenon and differentiates us from many of the big mobile game companies in the West. In terms of what's behind that shift, I think there's couple of factors. One is, as you know, we have successfully released the number of role-playing games on mobile, which tend to achieve quite high conversion ratios as well as ARPU. And then, the second is, if you look at some of our big player-versus-player games, like CrossFire or like Honor of Kings, then those sort of achieved the Holy Grail in terms of both attracting big user base, as we mentioned in the opening remarks, but also over time, users are increasingly willing to purchase items within the games in order to be more competitive. So that's on the paying user trend.

In terms of Supercell's position in China, interestingly, some of Supercell's games, Clash of Clans for example, already very popular in China. Clash of Clans has many millions of daily active users. It's probably one of the – or it's certainly one of the 10 highest DAU games in the China market. But Supercell has not historically customized monetization for the China market. For example, it hasn't introduced products that are sort of at a China-friendly price point necessarily. And so, Supercell, in China, has been very popular but has not monetized that popularity in the past.

<Q - Piyush Mubayi>: And if I can add a question on Supercell, what is the rationale for the creation of the consortium in contrast, for example, to the full ownership of Supercell?

<A - Chi Ping Lau>: Well, the main reasons are two-fold right now. One is, really, sort of the structure of our partnership is actually that we empower the founders of Supercell to continue to run the company on a very independent as well as entrepreneurial basis, which we believe is really sort of the secret sauce of the success of the company. And this structure, actually, is more consistent with this sort of overarching principle. And second one is, really, sort of because we're doing this, we want to sort of preserve our capital efficiency. And by establishing SPV and taking on non-recourse debt and also inviting certain equity consortium partners, we actually sort of can put in less money, but at the same time, sort of have a significant relationship with Supercell.

<Q - Piyush Mubayi>: Thank you, Martin. Thank you, James.

<A - Catherine Chan>: Thank you very much. Operator, in the interest of time, we shall take the last three questions, please.

Operator

The last question comes from the line...

<A - Catherine Chan>: Last three, please.

Operator

Sorry. Your next question comes from the line of John Choi from Daiwa Capital Markets. Please, ask your question.

<Q - John Choi>: Thanks, and congratulations on great set of results. I have a couple of questions here on your second half mobile game pipeline. I was wondering if management could share what [indiscernible] (53:57) that you guys are still seeing opportunities, given that since your launch, Tencent has done a really good job of starting into different types of genres. I was wondering what other opportunities you guys are seeing there.

And secondly, on the Supercell investment, apart from the consortium, I was wondering that you guys mentioned about a strategic cooperation opportunity. I was wondering if the management could elaborate a bit more. I'm pretty sure James did highlight that, that Supercell didn't really monetize that efficiently in China yet. But can you give us more color there? And also any opportunities overseas with Supercell? Thank you.

<A - James Gordon Mitchell>: I think in sense of the mobile game pipeline for the second half of the year, as you'd expect, we're enthusiastic. But historically, we don't sort of spend a lot of time talking about the pipeline. We'd rather sort of demonstrate through results than demonstrate through promises. We'll continue to release mobile role-playing games, particularly role-playing games sort of associated with existing PC or comic book intellectual property. We'll continue to look for opportunities to expand in player-versus-player games. And we will continue to also look for opportunities to release board game-type experiences that can amass a large number of users if we succeed; even if they don't, immediately generate revenue. Because again, what we're really focused on, the health of the mobile game portfolio. And that health can be measured by revenue; it can be measured by engagement; it can be measured by reach. And we'd like to deliver all three of – revenue, reach, and engagement. We're also intrigued – I mean, as some of you may be aware that there's been a successful mobile game in some parts of the world called Pokémon GO that utilizes location-based services technology. And we've been intrigued for sometime by the opportunities around injecting LBS into smartphone games and whether the China audience is as receptive as the other audiences have been. Remains to be seen.

In terms of collaboration with Supercell...

<A - Chi Ping Lau>: Yeah. I would say that immediate [indiscernible] (56:25) and sort of obvious synergies actually around China, where Supercell we believe have already achieved some success, but sort of the potential is still quite high in terms of attracting more users as well as getting better with monetization. But I think sort of the even bigger picture is really the fact that both Supercell and us are leaders within the mobile gaming industry, which we believe is actually still at a relatively early stage of development, which means that there's going to be a lot of innovation that is yet to come. And so, by having the two sets of minds together, we hope to facilitate ideas exchange and create great user experience, great operational processes so that we can deliver a better experience and create and capture a bigger share of the overall market, going forward. In particular, I think sort of we have a lot of knowledge about emerging market now sort of the user behave, whereas Supercell has got a lot of knowledge about the developed markets. And by exchanging ideas, we can help each other do better.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Your next question comes from the line of Jin Yoon from Mizuho Securities. Please, ask the question.

<Q - Jin-Kyu Yoon>: Hi. Good evening, guys. Just going back to the other services revenues line on payments and on cloud, can you just kind of talk about how much – what are the kind of the revenue drivers, especially on the – both payments and cloud? Is there a – were there any one-time revenue impact this quarter that we felt whether that's promotional activities on either front? Should we expect those kind of year-over-year jumps for the following couple of quarters? And are you actually monetizing SME enterprises on payments now as well? So, any color, that'd be great. Thanks, guys.

<A - Chi Ping Lau>: Yeah. As I said early, for payment and cloud service, we're running it more like an infrastructure service for our overall ecosystem. I think sort of in the revenue lines, there's not sort of new one-time revenue per se.

But at the same time, I would sort of try to de-emphasize this a little bit to the extent that from a profit contribution perspective, both of them are more like infrastructure services, and they are still relatively early in terms of development. So it may fluctuate from time-to-time. But I would say that on the cloud business, we are growing our business and revenue on a pretty consistent basis and, actually, invest more into this business in order to expedite the growth.

<Q - Jin-Kyu Yoon>: Got it.

<A - Catherine Chan>: Okay. All right. Last question.

Operator

Your last question comes from the line of Chi Tsang from HSBC. Please, ask your question.

<Q>: Hello. Hi. Thanks for taking my question. This is [ph] Ching (01:00:02) calling on behalf of Chi. Actually, I've got a housekeeping question regarding your, like, advertising margin. The margin actually came down quite a bit like 5 percentage points, 6 percentage points. And management mentioned like it's mainly because of content cost. But actually, like, content cost as percentage of advertising revenue came down a bit from last year. So just wondering, like, can management give some color on, like, the margin difference between performance-based ad and print ad because, like, [indiscernible] (01:00:34) is also performance-based platform, and it has margin as high as like 70%. So, shall we expect the margin improvement because that increasing contribution from performance-based ads? Also, like, on the other revenue side, the business [indiscernible] (01:00:52) kind of like we're like [indiscernible] (01:00:53) pictures, and Tencent Pictures are releasing the pipelines for this year and next year. Now, we've got quite a few films and TV dramas coming out. So shall we – are we going to book that revenue in the other revenue side – others revenue line? And how shall we expect when they are going to contribute the meaningful revenue?

<A - James Gordon Mitchell>: I think in terms of the owner advertising content – because I'm not quite sure why you said that it dropped year-over-year.

<Q>: Because I think you disclosed the content and [indiscernible] (01:01:35) costs in your expense by nature. And I divided by [indiscernible] (01:01:42) advertising revenue and, actually, it's like 76% this year when compared to 88% last year, like in the second quarter last year. So I'm not quite sure like...

<A - Chi Ping Lau>: I think we can – I'm not quite sure which number you are using because for content costs, we only disclose – well, including a lot of other things, Ching, just like licensing costs for games, you throw every detail into one line.

<Q>: Okay.

<A - Chi Ping Lau>: So It's not the wrong compare.

<A - James Gordon Mitchell>: It is not incorrect comparison, yeah.

<A - Chi Ping Lau>: So it is because the content costs increased, the margin actually decreased. What was the second question?

<A>: Other revenues.

<A>: Other revenues. So...

<Q>: Other revenues. Yeah.

<A - James Gordon Mitchell>: Yeah. Actually, it includes a little bit of contribution from movies, but it's quite small at this point in time, so negligible.

<Q>: Okay. So when do you – just like quite a few Tencent pictures are released, like seven movies this year. And it's going to be like expecting 10 next year. So kind of like when it's going to be contribute or you are going...

<A - Chi Ping Lau>: We have sort of a certain percentage of the revenue. So I don't think they would be very significant to hit from a revenue perspective. And since we're still in the process of getting inducted into this industry, I don't think sort of it will be a major profit generator either. So I think it's sort of [indiscernible] (01:03:27).

<Q>: Okay.

<A - Chi Ping Lau>: For now, it's probably better to be sort of leaving it [indiscernible] (01:03:33).

<Q>: Okay. Thank you.

Catherine Chan

Okay. Thank you very much, operator. And thank you, everybody, for joining the call tonight. We are closing the call now. If you wish to check our press release and other financial information, please visit our company website at www.tencent.com/ir. The replay of this webcast will also be available soon. Thank you, and see you next quarter.

Operator

And that concludes our conference for today. Thank you for participating in Tencent Holdings Limited 2016 second quarter and interim results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2016-05-18
Event Description: Q1 2016 Earnings Call

Market Cap: 1.49TRI
Current PX: 158.50
YTD Change($): +6.00
YTD Change(%): +3.934

Bloomberg Estimates - EPS
Current Quarter: 1.080
Current Year: 4.431
Bloomberg Estimates - Sales
Current Quarter: 33035.167
Current Year: 139105.118

Q1 2016 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Dick Wei
- Eddie Leung
- Chi Tsang
- Wendy Huang
- Poon Erica Werkun
- Thomas Chong
- Natalie Wu
- John Choi
- Vivian Hao
- Richard Kramer

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to Tencent Holdings Limited 2016 First Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to our first quarter 2016 results conference call. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements, which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be especially considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and non-GAAP measures, please refer to our disclosure document on www.tencent.com/ir.

Let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo.

Pony will kick off with a shorter review, Martin will review value-added services, James will speak to you on advertising, and John will discuss the financials before we take your questions.

I'll turn the call over to Pony now.

Huateng Ma

Okay. Thank you, Catherine. Good evening, everyone. Thank you for joining us. During the first quarter of 2016, our mobile social communication platform, Weixin and QQ, further deepened in penetration in China and connected users to an expanding portfolio of online and offline services in our ecosystem. We further expanded our digital entertainment business, especially smartphone games and strengthened the foundation of our online advertising business.

Financially, we delivered a solid set of results for the first quarter. Total revenue was RMB 32 billion, up 43% year-on-year and 5% quarter-on-quarter. Non-GAAP operating profit was RMB 13.5 billion, up 43% year-on-year and 17% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 10 billion, up 39% year-on-year and 12% quarter-on-quarter. And John will provide more details in the financial section.

Moving onto online platforms. Total MAU for QQ was 877 million, up 5% year-on-year, within which smart devices MAU was 658 million, up 9% year-on-year. Combined MAU of Weixin and WeChat increased 39% year-on-year to 762 million. For our social networks, Qzone, smart devices MAU was 588 million, up 4% year-on-year.

In PC games, we maintained market leadership and continue to grow paying users via new content and items in key genres. In smartphone games, we broadened our portfolio and claimed leadership in multiple new genres. We are planning several gala eSports tournament during the year to deepen user engagement and activities.

Our media platforms, which include news and video, delivered a healthy growth in mobile usage. In particular, our exclusive partnership with NBA enabled us to significantly expand NBA viewership nationwide. In mobile utilities, we exposed our mobile security capabilities to more third-parties and widening our lead. Page views from our mobile browser increased significantly after we introduced new speed in home page. And our app store, Ying Yong Bao, gained incremental market share during the quarter.

With that, I pass to Martin speak to business review.

Chi Ping Lau

Thank you, Pony, and good morning and good evening. In the first quarter of 2016, our total revenue grew 43% year-on-year. VAS represented 78% of the total revenue, of which online games contributed 53% and social networks contributed 25%. Online advertising was 15% of total revenue. We moved cloud services revenue from social networks to others this quarter, and the others segment represented about 7% of total revenue.

Let's take a closer look at value-added services. Segment revenue was RMB 25 billion in the first quarter, up 34% year-on-year and 8% quarter-over-quarter. Social networks' revenue was RMB 7.9 billion, up 48% year-on-year and 11% quarter-on-quarter. Strong performance of monthly subscriptions as well as increased revenue from game-related item sales drove segment revenue growth. Monthly subscriptions of membership, in particular music and video content, grew, boosting total subscription accounts by 33% year-on-year to 108 million. Online games revenue was RMB 17.1 billion, up 28% year-on-year and 7% quarter-on-quarter.

For PC games, user activities benefited from positive seasonality during the Chinese New Year. Monetization increased year-on-year and quarter-on-quarter, as we further enhanced our operational capabilities. For smartphone games, new titles launched in the last six months drove both year-on-year and sequential revenue growth.

In social networks, for QQ, we further enhanced community stickiness via product upgrades and new group functions. In Interest Tribes, we launched a new timeline homepage that served a selection of content feeds based on user's interest graph. In group chats, we're increasingly using video to make group interactions more lively. We added peer-to-peer video messaging. We also enabled users to watch professional video together with each other. We also released new virtual gifts, which are popular among young users.

For Weixin, we launched the enterprise version of Weixin app to serve mobile communications needs at work. The new Enterprise Weixin app is also synergistic with existing enterprise accounts that are running in Weixin. We'll continuously enrich this new application to facilitate mobile office management, thereby increasing efficiency for enterprise users.

A point on Weixin Payment, we began in March to collect a cash withdrawal fee of 0.1% of transaction value when users move money out to their bank accounts. The cash withdrawal fee has helped us to contain losses. And, in terms of user activities, it has little impact on user activities. As a result, our payment platform continued to grow healthily since the policy change.

Now, looking at games, on PC client games, the combined average concurrent user accounts for advanced casual games was 7.9 million, down slightly by 4% year-on-year, but in the quarter, CrossFire one of our biggest title hit a new record PCU at 6 million, even after the launch of its mobile version last December. Combined ACU for MMOGs was stable at 1.5 million.

During the quarter, we released expansion packs, new items and seasonal operating activities during the Chinese New Year, driving engagement as well as paying user growth. We're also increasingly leveraging eSports to generate excitement among gamers. During the quarter, we kicked off a new tournament season for our lead titles in the mobile shooter, sports and music genres. User metrics has indicated strong enthusiasm among players and audiences both in game as well as in offline arenas.

For smartphone games, revenue reached RMB 8.2 billion, up 86% year-on-year. Sequentially, revenue grew 16% and this is mainly driven by strong performance of our mobile shooter and action games. We continue to dominate China's iOS Top Grossing chart with six out of the top 10 games. Within top 20, we operate 10 games with three serving a lifespan of more than two years. We believe our market position on Android is even stronger.

We're currently enriching our IP catalog with in-house and licensed titles from China and globally. In the first quarter, we operated 84 games in total. New casual games include a 3D running game as well as board games such as Bridge and Go chess. The success of Naruto Mobile also illustrates the power of combining a proven IP with Tencent's development as well as operational capabilities.

In order to promote mobile eSports, we're leveraging multiple Tencent properties such as QQ, Weixin, video and news app. In the final tournament of QQ game competition, nearly 2 million players participated in the matches and over 30 million users watched this event on their smartphones.

Now, I will invite James to talk about our online advertising business.

James Gordon Mitchell

Thank you, Martin. Our online advertising segment revenue was RMB 4.7 billion, up 73% year-on-year and down 18% quarter-on-quarter. Mobile contributed 80% of our total ad revenue, within which our brand advertising revenue was RMB 2.2 billion, up 56% year-on-year and down 23% quarter-on-quarter. Year-on-year, the increased mobile impressions and ad price across our media platforms delivered above-industry revenue growth rates. However, revenue declined sequentially due to weak seasonality in the first quarter and macro conditions.

Our performance advertising revenue was RMB 2.5 billion, up 90% year-on-year but down 13% quarter-on-quarter. Since we began testing Weixin Moments advertisements one year ago, we have employed user feedback data to refine our targeting capabilities and deliver more relevant adverting to users. This in turn allowed us to release more inventory in Mobile Qzone and Weixin Moments, contributing to the rapid year-on-year growth. Sequentially, our performance advertising revenue declined primarily due to the weak season for eCommerce in the first quarter.

Looking more deeply at our media and social advertising inventories, in news, mobile traffic grew as we adopted enhanced targeting based on users' interest. In the first quarter, 80% of our news advertising revenue was from mobile.

In video, we saw a rapid growth in both user visits and mobile video views due to an expanded catalog and enhanced curation capabilities. Benefiting from our exclusive partnership, NBA games attracted a large number of fans to our platform driving up unique viewers significantly. The NBA fan base is particularly [indiscernible] (12:33) big-budget advertisers such as automobile, and food and beverage companies.

In social, we're gradually building the business to scale. For Qzone, we have expanded to better serve by campaign solutions to facilitate brand storytelling. The Weixin Official Accounts were testing product listing ads that deep-link directly into advertisers' app product pages. The initial feedback from eCommerce advertisers indicates they see a lift in ad conversion as a result.

And for Weixin Moments, we're bringing long-tail advertisers on board by using traffic generated from Tier 3 and Tier 4 cities with lower de minimum ad budget and then educate them to use our self-service bidding platform. We constantly monitor user feedback and balance inventory growth with ad performance.

And I'll now invite John to walk through the financials.

Shek Hon Lo

Hello, everyone. For the first quarter of 2016, our total revenue was RMB 32 billion, up 43% year-on-year or 5% quarter-on-quarter. Gross profit was RMB 18.6 billion, up 38% year-on-year or 5% quarter-on-quarter. Share of losses of associates and joint venture was RMB 1.1 billion during the quarter. On a non-GAAP basis, share of losses of associates and joint venture was approximately RMB 340 million.

Income tax expenses were RMB 2.6 billion, up 50% year-on-year or 28% quarter-on-quarter. Effective tax rate for the quarter was 21.6%. Net profit attributable to shareholders was RMB 9.2 billion, up 33% year-on-year or 28% quarter-on-quarter.

After adjustments to non-GAAP, operating profit for the quarter was RMB 13.5 billion, up 43% year-on-year or 17% quarter-on-quarter. Net profit attributable to shareholders was RMB 10 billion, up 39% year-on-year or 12% quarter-on-quarter. Operating margin was 42%, stable year-on-year and up 4 percentage points quarter-on-quarter. Net margin was 32%, down 1 percentage point year-on-year or up 2 percentage points quarter-on-quarter.

Let's turn to segment gross margin for the quarter. Gross margin for VAS was 66%, broadly stable year-on-year or up 2 percentage points quarter-on-quarter. Sequential increase reflected the increase in revenue proportion of self-developed products including smartphone games. Gross margin for online advertising was 44%, up 5 percentage points year-on-year or down 7 percentage points quarter-on-quarter. The sequential dip was mainly due to weaker seasonality.

Moving on to operating expenses, selling and marketing expense was RMB 2 billion, up 53% year-on-year or down 33% quarter-on-quarter. The year-on-year increase primarily reflected higher marketing spending on products and platforms such as payment services and online media as well as greater staff cost. The sequential decline mainly reflected a seasonal reduction in advertising and promotional activities.

G&A expense was RMB 4.4 billion, up 19% year-on-year or down 8% quarter-on-quarter, of which R&D expense was RMB 2.3 billion, up 15% year-on-year or down 6% quarter-on-quarter. The year-on-year increase was due to greater R&D expense and staff cost whereas the sequential decline was mainly driven by lower R&D expense, consultancy fees and staff cost.

As a percentage of quarterly revenue, selling and marketing expense was 6%, and G&A was 14%. R&D represented 7% of quarterly revenue. Share-based compensation was approximately 2%. We had approximately 31,000 employees as at quarter end.

Looking at margin ratios for the first quarter, gross margin was 58.1%. It was down 1.9 percentage points year-on-year and broadly stable quarter-on-quarter. The year-on-year decrease was mainly due to the increase in proportion of others segment revenue with lower margins.

Non-GAAP operating margin was 42.1%, flat year-on-year or up 4.2 percentage points quarter-on-quarter. The sequential increase was mainly due to lower selling and marketing expense, and general and administrative expense as a proportion of total revenues.

Non-GAAP net margin was 31.7%. It was down 0.9 percentage points year-on-year and up 2.1 percentage points quarter-on-quarter. The year-on-year decline was mainly due to the increase in the share of the losses of associates and joint venture. The sequential increase was due to higher operating margin, partially offset by increased income tax expenses.

For the first quarter, total CapEx was RMB 4.1 billion, up 208% year-on-year or 118% quarter-on-quarter. Operating CapEx was RMB 1.3 billion, up 105% year-on-year and 4% quarter-on-quarter. As a percentage of revenue, it was consistent with last quarter at 4%. Non-operating CapEx was RMB 2.8 billion, up 308% year-on-year or 371% quarter-on-quarter. The significant year-on-year and sequential increase was mainly due to addition of land use rights in Guangzhou.

Free cash flow was RMB 13.9 billion, up 67% year-on-year or down 14% quarter-on-quarter. The year-on-year increase reflected to higher operating cash flow, whereas the sequential decline was reflected to lower operating cash flow, as we paid yen bonuses in the first quarter and higher capital expenditure paid, as we had more CIP and land use rights outlay during the quarter.

Our net cash position as at quarter end was RMB 27.4 billion, up 8% year-on-year or 44% quarter-on-quarter. The sequential increase in net cash was primarily driven by free cash flow generation, partially offset by payments for M&A initiatives and license contract. Fair market value of our listed associates and available-for-sale financial assets was approximately RMB 82 billion as at quarter end.

This concludes our presentation. Thank you.

Catherine Chan

Thank you, John.

Operator, shall we take the first question please? And we'd like to invite one question from each analyst at a time. Thank you.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from the line of Dick Wei from Credit Suisse. Please ask your question.

<Q - Dick Wei>: Hi. Good evening. Thanks for taking my questions. My question is on Tencent's plan on some new initiatives. For example, number one is on personalized news. I think some of the other vertical sites of news sites have more personalization on the news. I wonder any plans about for Tencent particularly beyond our [ph] Tencent Qibao (20:20). Any plans for change in terms of the WeChat Moments, the ways we present news or the newsfeed widens as purely time base will be more interest base?

And so personalized news is one area. Another second area may be the live video market. They have drawn some – a lot of attention these days. I wonder how does management see about opportunities as well as the plans for that going forward for us? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of personalized news, we feel that – it's definitely new trend that consumers actually clearly want. And at the same time, from a technology perspective, especially on mobile, it's actually easier to identify the person and then provide personalized news. We believe when people read news, there is a part of people's needs, which actually want to read the hottest news. There's another part, which there is an interest element and hence that requires a personalization. And as a result if you look at the range of initiatives that we're doing to cater to these two needs, obviously Tencent News is one that present the most authoritative and the hottest news to the users.

But on the personalized front, I think there are a number of venues we can do it. One is actually, as you said, [ph] Tencent Qibao (22:10) which is our everyday news express app, which we have launched which of primarily present news as well as additional information, news-related information to the users through a personalized timeline mechanism.

In addition to that, even within Tencent News, we are actually trying to incorporate some elements of personalization to the consumers so that in addition to the most authoritative news that everybody sees, our users can also see some personalized authoritative news for them. And thirdly, within the Official Accounts in Weixin, you can consider as another way of personalization but this is a personalization in which the consumers clearly tells us what accounts they want to follow. And then people see these news pushed to them.

Now, on Moments, I think we already captured some of the personalization through social sharing. I think that's already quite enough. We do not want to turn the Moments into primarily a news reading vehicle. So, that's why I think we're not going to do much of that within Moments. But rather focus on pushing on our [ph] Tencent Qibao (23:59) as well as personalization within Tencent News and continued pushing of our Official Accounts.

Now, in terms of the live video, we will consider live video from two elements. One is live video is actually a media format. It's a capability that a lot of our media properties would actually need to incorporate. So, that's why within a number of different of our properties, video platform, even within our music platform potentially, we could support live video functionality.

On the other hand, we saw – and in a number of our investing companies for example Douyu, they are actually a live video platform, which focuses on game-related live video streaming. So, that's also a capability that tie in with that kind of business model.

Now, the other aspect of live video is a way for people to perform, and then that's a business model. And it looks like – it's actually generating quite a bit of revenue from four different platforms. On that one, we felt this less of a network effect. It's essentially a group of content that's curated for users to pay for it. And over time, we think there is less network effect, there is less stickiness and that's a revenue stream that I don't think we'll chase with a lot of focus.

<Q - Dick Wei>: Got it. Thanks, Martin.

Operator

Thank you. Our next question comes from the line of Eddie Leung from Merrill Lynch. Please go ahead.

<Q - Eddie Leung>: Hi. Good evening. Thank you for taking my question. I wonder if you could elaborate a bit more on the macro impact on your advertising business. Could you update us on some of your top advertising industries, and any strength and weakness that you have observed in them which you came up with this conclusion of some macro impact? Thank you.

<A - Chi Ping Lau>: Eddie, I think it's really a general feeling that we see and there's some weakness in terms of the propensity to spend within – among the top advertisers and a little bit across the board and particularly stronger with sectors which would require bigger ticket item sale. So I think that's a general sense. In the past, for example, it takes two meetings to nail down a certain amount of contract. Now it takes longer time, and the average contract size is typically smaller and advertisers are keeping more of the budget for later of the year until they see clearer picture around the macroeconomics. So these are the general feeling that we are getting from the frontline salespeople.

<Q - Eddie Leung>: Martin, can I have a follow-up question? Just broadly speaking, do you feel the impact is more on the brand advertising side or on the performance advertising side? Thanks.

<A - Chi Ping Lau>: I think for us, if you look at our current business portfolio, it's more – we feel it more on the branded side. I think on the performance side, we are still in the process of ramping our business. That's one factor. The other one is generally I think the small to medium enterprises are less – the smaller ticket items are less affected by this.

<Q - Eddie Leung>: Very helpful. Thanks.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Thank you. Our next question comes from the line of Chi Tsang from HSBC. Please go ahead.

<Q - Chi Tsang>: Hi. Good evening. Thank you so much for taking my questions. I wanted to ask you a little bit about Weixin Moments. In particular, I was wondering if you can discuss sort of what your ad load is currently and how that might progress over the next year or two. And then secondly, I also wanted to ask you about Enterprise Weixin and how that business model might evolve over the next few years. Thank you so much.

<A - Chi Ping Lau>: Yeah. For Weixin Moments, I think the ad load would gradually increase. But I want to stress the point of gradually. And alongside with this gradual increase, there's a lot of work for us to do in order to accompany that, to make sure that the overall user experiences are not impacted negatively. And a lot of it is related to improving our targeted ad platform capabilities so that we can actually target our advertising to consumers with that kind of need.

We need to sign up a range of high-quality advertisers and also couple that with a lot of customer education so that the quality of the advertisement is actually high. We need to bring up a lot of intermediary so that they can act as our helper in enforcing a healthy ecosystem around advertisers, and there's a lot of work that we need to do with respect to ad format so that the ad formats are naturally embedded into the user experience so that it's effective on one hand, but doesn't affect the user experience on the other hand.

We need to put in a lot of effort in creating our self-serving – developing our self-serving ad buying system so that it can actually help more advertisers come in. So there's a lot of fundamental work to be done. And releasing more inventory is actually the easy part, but what we need to do is actually making sure that the other – all the other capabilities are increased so that when we release inventories, it's actually conducive to user experience rather than impacting negatively user experience.

In terms of Enterprise Weixin, I think it's too early to talk about business model. Right now, what we focus on is actually launching the product understanding what the enterprise users' need are and trying to keep improving our products so that we can serve the enterprise users' needs. So, that's at the moment our focus.

<A - Catherine Chan>: Okay. Thank you. Operator, next question please?

Operator

Thank you. Our next question comes from the line of Wendy Huang from Macquarie. Please go ahead.

<Q - Wendy Huang>: Thank you. On the advertising front, you also quoted the weak seasonality in the eCommerce as a reason for the advertising revenue sequential decline. I just wonder what your advertising revenue contribution from JD? Was it very significant to your advertising revenue? And also you mentioned that you already rolled out the self-bidding system in the low tier cities for the Weixin Moments ads. Just want to clarify the – in the longer term, the Weixin Moments ads platform, should it be more for the brand ads or the SME advertisement? Lastly, I want to clarify on the RMB 260 million other revenue that you reported this quarter. Is it Enterprise Weixin related or is it card related or is it payment related? Thank you.

<A - Chi Ping Lau>: Okay. Well, in the eCommerce comment, it's more related to quarter-on-quarter comparison because at the fourth quarter of every year, usually it's a big season for eCommerce industry. So it's more of that reference. Now, in terms of JD, I would say it's a meaningful contribution, but it's not quote-unquote, overly a heavy proportion of our performance ads.

Now, in terms of the second tier – third tier and fourth tier cities, we have launched that functionality as a testing. So far, I think the testing result is actually encouraging. We are cautious in doing this because we want to make sure that we continue to enforce the quality of the advertisers. And over time, we will see this platform to be sort of both serving the needs for branding as well as serving the needs for small and medium enterprises in terms of targeting their users.

The more targeting capability that we add, the more ad format that we can actually make it consistent with the user experience than it has more scalability, both from the branded perspective as well as from a performance perspective.

Now, in terms of others revenue, I would say the biggest chunk is actually related to payment and in that regards, one of them is actually related to the revenue that we receive d from third-party merchants when we actually serve as their payment gateway and then users use Weixin Payment in the merchants' consumption pathway. And second is slight revenue from – essentially one month revenue from cash withdrawal fee from the consumers. And then the other big portion is really cloud service.

<Q - Wendy Huang>: Thank you very much.

<A - Catherine Chan>: Next question, please.

Operator

Thank you. Our next question comes from the line of Erica Poon Werkun from UBS. Please go ahead.

<Q - Poon Erica Werkun>: Hi. Thank you. We note that you've launched a number of mid to high core mobile games titles across different genres. Just wondering if you can share, are there any particular genres that Tencent has found a stronger niche and where you are likely to stay more focused on? Thank you.

<A - James Gordon Mitchell>: I think when we look at the mobile game industry in general, there's about a dozen genres which are large and well established today or we see as becoming very substantial in the next couple of years based on global trends and based on PC gaming behavior in China, and several of these big genres are genres that are already popular on PC in China. We see some convergence of game play mechanics, game of behavior between PC and mobile, as the mobile gamer audience becomes more sophisticated. I think that if you look at those big genres, there are some such as turn-based role playing games, where other companies are obviously very successful, and we'll seek to build market share incrementally.

But then there's other categories such as shooting games, battle arena games, running games, board and card games where not only are we very successful, but you could also argue that we have created those game genres in China or at least made those game genres five times bigger than they would otherwise be if we hadn't released the flagship games in those genres.

<Q - Poon Erica Werkun>: Thanks, James.

<A - Catherine Chan>: Thank you. Operator, next question.

Operator

Sure. Next question comes from the line of Thomas Chong from Citigroup. Please go ahead.

<Q - Thomas Chong>: Hi. Thanks for taking my questions. I have two questions. The first question is about the ARPU for MMO, advanced causal and smartphone games if management can provide some more color. And my second question is about online video. Can management comment about the online video competitive landscape for this year compared to last year? Thanks.

<A - Shek Hon Lo>: For the ARPU for MMOG, it's within RMB 310 to RMB 450 per quarter. And for advanced casual games, RMB 85 to RMB 330. And for smartphone games, if we view it as a portfolio, it's between RMB 150 to RMB 360 per quarter.

<A - James Gordon Mitchell>: I think for the online video competitive landscape, the short answer is it would be extremely competitive and likely more competitive this year than last year due to some of the mergers and acquisitions that have taken place in the emergence of newer companies like [indiscernible] (39:08) TV in the space. To get a little bit more granular, in general, those companies bid aggressively for top content during 2015 such as IT and Tencent Video platform, games, substantial user and revenue share which I think in turn is introducing everyone to bid aggressively for top tier content moving into 2016. Some of the areas where the bidding would be more intense would include drama serials, particularly drama serials that attract 15-year-old to 30-year-old female audience and also content that has the ability to drive subscription as well as advertising revenue would be areas where the competitive intensity is especially heightened.

<Q - Thomas Chong>: Thanks.

<A - Catherine Chan>: Yeah. Next question, operator, please.

Operator

Thank you. Next question comes from the line of Natalie Wu from CICC. Please go ahead.

<Q - Natalie Wu>: Hi. Good evening, management. Thanks for taking my question. I have a question regarding your advertising business. It seems to be a little bit lower in terms of sequential growth. So, just wondering is there any deferred revenue associated with that? And could the management give us some color on the contribution of eCommerce advertisers' contribution on the performance based ad in the first quarter?

<A - Shek Hon Lo>: So in terms of the second question, eCommerce would be the largest advertising category for our performance advertising business. So it will be a healthy double-digit chunk, but a minority of the total. In terms of the quarter-on-quarter trends, we've called some of them out. First of all there's the usual negative seasonality for the brand advertising business which – I think in some previous years, we've sort of grown straight through that because of the emergence of new platforms like online video whereas this year we had a more sort of industry normal impact from negative seasonality in Q1 on the brand advertising side.

Then secondly on the performance advertising side, every year, the fourth quarter is a peak season for eCommerce activity. But this year – or fourth quarter 2015, there was the 12/12 event as well as the 11/11 event and more eCommerce companies participated more aggressively than in previous years. So, to some extent, the hangover from Q4 to Q1 was more pronounced this year than in previous years.

And then thirdly, this year, again for performance advertising, during the Chinese New Year, we had a number of advertisers who bought combined packages of advertising together with red envelopes, and the accounting for those had the effect of moderately reducing our performance advertising revenue. But in general, I would say that without over-focusing on the whys and wherefores of Q4 to Q1 trends, our advertising business is becoming quite large by China Internet industry standards. And so while we still believe that it will grow faster over time and while we still aspire to outgrow the industry over time, the percentage growth rates may slow down to some of our advertising products, such as our online video business.

<A - Chi Ping Lau>: So, to be more specific, I think there needs to be some kind of reset in terms of the year-on-year growth rates that people expect for our advertising business. I would say last year was a breakout year in the sense that our mobile video business actually grew a lot. It was the first year in which we monetized our mobile news app in a significant way. And it's also the year in which we really flexed our muscle around performance ads as that was the launching of the Moments ad in the second quarter of last year. So it's a congruence of a lot of factors which fuel very fast year-on-year growth.

Now, as we look into the future, the brand ads is already approaching a pretty large size which means that it will be more closer to the industry growth and of course we strive to work to exceed that. And in terms of performance ads, we look at it as a long-term business. So we will be deliberately building it over the longer run, which means that there would not be sort of a very fast release of inventories. We want to make sure that everything is actually done right alongside with the gradual release of inventories.

<Q - Natalie Wu>: Great. Very helpful. Actually could I have a very quick up if I may? I heard that Qzone actually lifted the ad load a quarter ago. So, shall we be expecting a similar level improvement of advertising revenue related with Qzone and will there be a similar plan on Weixin Moments as well this year?

<A - Chi Ping Lau>: Well, as we said, we will gradually release more inventories. But if we're not doing well in terms of the five different initiatives that we're doing in terms of ad technology and sort of advertise education and things like that, then any release of inventory will have a marginally lower return in terms of the additional revenue. So and then it will have a bigger negative impact on the users. So, that's why we need to make sure that we continue to push forward on our own capabilities. And that should precede the release of inventories or that should be done alongside with the release of inventories.

<A - Catherine Chan>: Thank you. Operator, next question, please. And in the interest of time, we shall take last three questions, please.

Operator

Thank you. Next question comes from the line of John Choi from Daiwa. Please go ahead.

<Q - John Choi>: Hi. Thanks for taking my question. My question is on the mobile games right now. It seems like you guys have been pretty aggressively pushing the eSports culture. So if the management could give more color how this is impacting the ARPU, the game license and life cycle, and how that's impacting the monetization rate? And secondly, I just want to quickly have more detail on the subscription, the 108 million, any more details apart from music and online video? Thank you.

<A - James Gordon Mitchell>: So, in terms of the eSports events around games, you asked whether it should impact ARPU or monetization rate or game longevity. I would say that we see it primarily affecting game longevity and user retention. There may or may not be ARPU or monetization benefits over time. With League of Legends, normally when a team wins the global championships, then players like to buy similar skins to what the winning team has used. But that's a sort of happy byproduct. It's not the primary reason for us to be in the eSports business. The primary reason is that we see a huge pent-up user interest in eSports, both competing but also watching other people compete.

And we believe that by tapping into this cultural phenomenon, A, we can increase our mine share with game players, but, B, we can also deepen the engagement with the games and extend the longevity of the games. So, that's really the core reason for being involved in eSports, along with the fact that we're a gaming company and games are fun and eSports can be great fun.

Your question around the subscriptions, sorry, I didn't catch. You asked about X million subscriptions and the growth in music and video.

<Q - John Choi>: Yeah. I was just wondering you guys had 108 million. So, any churn on the ARPUs, particularly in music and online video. That will be helpful. Thank you.

<A - James Gordon Mitchell>: Yeah. So, in general, if you look at our privileged subscriptions which represents the majority of our subscriptions such as in a QQ membership and VIP and the blended ARPU is drifting higher over time because there's an increasing propensity to take the RMB 20 Super VIP package rather than the RMB 10 VIP package. But our focus is more on adding more value to the packages and maximizing the number of privileged subscribers. If the ARPU increases, it is again a happy byproduct.

If you look at the digital content subscriptions, then for video, the price point has been RMB 20 a month since we launched, which at that time was a premium to the industry but now the industry is converged around RMB 20 a month as well. For music, the initial price point was RMB 10, but now there's an increasing number of people taking RMB 12 or RMB 15 packages that enable them to download several hundred songs onto their phone as opposed to streaming. So there's also a gradual upward drift in ARPU on the music product. But the bigger focus for us is really on persuading more consumers to subscribe and then the amount they pay can flow naturally over time.

<A - Catherine Chan>: Okay. Thank you. Next question, please.

Operator

Thank you. Next question comes from the line of Vivian Hao from JPMorgan. Please go ahead.

<Q - Vivian Hao>: Hi. Thank you for taking my question. My question is still around your pay for performance ads. Apart from the seasonality in Q1, we saw that probably for JD, the second quarter guidance is still soft – relatively soft. Just wondering how should we expect the P4P revenue to trend in Q2. Also, on the new in-feed auto play video ads to be launched on Moments, can we get an update as well? Thank you.

<A - Chi Ping Lau>: Yeah. In terms of pay for performance, as I said, JD as an important partner actually contributes their ecosystem – contributes a meaningful portion of our total performance ads, but it's not overly heavy weighed. So, that should be put into perspective. Now, I think as a result, we talked about our performance ads business as a long-term business. So, that's why I would like people to sort of reset some of the expectations – overly high expectations for us to step on the pedal and keep on releasing inventories. I think we would like to do it on a gradual basis. This is the third time I talked about it. So I think that will be a much more important driving factor when you look at our performance ads in the next few quarters.

What was the next question?

<Q - Vivian Hao>: About the in-feed auto play video ads.

<A - Chi Ping Lau>: I think that one is still being tested right now. It's not fully operational. So we will see how it performs and then we may report once it's really live.

<Q - Vivian Hao>: Do we have a timeline?

<A - Chi Ping Lau>: It will be released when it's ready.

<A - Catherine Chan>: Okay. Thank you.

<Q - Vivian Hao>: Thank you.

<A - Catherine Chan>: Operator, shall we take our last question, please?

Operator

Certainly. Our last question comes from the line of Richard Kramer from Arete Research. Please go ahead.

<Q - Richard Kramer>: Thank you very much. I'm just wondering, two things, briefly. One is, can you update us on some data on the user base, attached rates, TPV, et cetera, of Weixin Pay? Will the 0.1% withdrawal fee from March grow to be something that's material to Tencent revenues by the end of 2016? And I guess the other thing that seems to be a question amongst some investors with the recent capital raising. Can you talk through your acquisition strategy and the need for raising another RMB 3 billion to RMB 4 billion of capital? And then what areas do you think we should expect Tencent to look to deploy this capital with the cash flow generation you're seeing right now? What prompted this move given that obviously the business is profitable and quite cash generative? Thanks very much.

<A - Chi Ping Lau>: Yeah, in terms of payment business, the general direction as we have provided is that the platform continues to grow healthily. And in terms of the total number of transactions, in terms of number of users, active users, it's growing healthily. I think in terms of the revenue, the revenue from both the merchants as well as the revenue from the consumers, I think a lot of this revenue is actually for us to recoup the cost that's associated with our payment platform and on the consumers because we actually pay for whatever money that comes into our system. So, as a result, when the money actually leaves our system, we actually sort of try to recoup that expense.

So, I think overall we look at payment as a business that sort of may generate more revenue, but we continue to invest in it. And the charging mechanism is actually for us to make sure that we don't sort of keep on increasing the – subsidizing that platform. So, for now, I think the more important thing for us is actually sort of continue to grow the platform rather than sort of making a lot of profit from it.

Now, in terms of acquisition, the capital raise, if you think about this, our revenue and profit is actually – cash flow is actually generated onshore. So we actually need to have cash offshore in order to pursue investments in acquisitions because most of the companies, even if these are Chinese companies, they have overseas holding structure which requires U.S. dollar investment. For example, if you look at Didi's recent financing, we actually put in U.S. dollars. If you look at Meituan, for example, we will put in $1 billion that's U.S. dollars. So, that's the reason why we actually need to raise cash outside of China in order to fund these investments.

Overall, I would say our investment strategy is that we continue to look at strategic alignment with us. We continue to look at the business momentum and positioning of the business that we invest in. We continue to look at the management quality. And as a whole, we'll use our investment strategy to enhance the overall ecosystem so that one would benefit from the growth of Internet into multiple vertical sectors within the economy, and two, we try to increase synergies between these companies and our own platform so that they will derive value from their growth.

<A - Catherine Chan>: Thank you.

Operator

Thank you. Ms. Chan, please begin your closing remarks.

Catherine Chan

Well, thank you, operator. We're now rounding the call now. If you wish to check our press release and other financial information, please visit our corporate website at www.tencent.com/ir. We'll post a replay of this webcast on the site shortly. Thank you and see you next quarter.

Operator

That does conclude our conference for today. Thank you for participating Tencent Holdings Limited 2016 first quarter results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2016-03-17
Event Description: Q4 2015 Earnings Call

Market Cap: 1.43TRI
Current PX: 152.30
YTD Change($): -.20
YTD Change(%): -.131

Bloomberg Estimates - EPS
Current Quarter: 0.999
Current Year: 4.343
Bloomberg Estimates - Sales
Current Quarter: 29392.750
Current Year: 131716.824

Q4 2015 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Wendy Huang
- Eddie Leung
- Chi Tsang
- Dick Wei
- Ming Xu
- John Choi
- Thomas Chong
- Chun Ming Zhao

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the Tencent Holdings Limited 2015 Fourth Quarter and Annual Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to turn the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you very much, operator. Good evening. Welcome to our annual results conference call for the year of 2015. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we'd like to remind you that it includes forward-looking statements which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and non-GAAP measures, please refer to our disclosure documents on www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo.

Pony will kick off with a short overview, Martin will discuss strategic highlights, James will speak to business review, and John will go through the financials before we take your questions.

I'll now turn the call over to Pony.

Huateng Ma

Okay. Thank you, Catherine. Good evening, everyone. Thank you for joining us. Since 2015, we've made a good progress in executing our connection strategy, which positions us to capture market opportunities brought by mobile Internet. As we walk through four strategic areas, they are shaping Tencent's businesses over the long run.

In Social, Weixin rapidly grew users and connected to our wide portfolio of online and offline services. QQ maintained year-on-year user growth, particularly among the youth segments. Both products served as a strong distribution platform for our games and digital content offerings. Both generate massive volume of traffic to feed our social advertising business which doubled its revenues year-on-year.

In Games, we sustained rapid revenue growth for smartphone games. We maintained leadership in key PC game genres. We are also developing eSports tournaments, which help to build friends, communities and reinforce gamers loyalty.

In Media and Content, digital consumption via smartphone, especially of news, sports and video content strengthening the traffic leadership of our platforms. We began to monetize our mobile news services via in-feed ads, and we are building our subscription businesses for premium content served on our leading video, literature and music platforms.

Looking at our broader ecosystem, we further developed our partner network via Official Account system and grew our mobile payment monthly active users seven times year-on-year. For our Internet finance business, we worked with select partners to broaden our wealth management products portfolio on Licaitong and introduced micro-loans through WeBank.

Financially, we delivered a strong set of results for the fourth quarter and full year of 2015. Let me highlight a few numbers for you. For the first quarter of 2015, total revenue was RMB 30.4 billion, up 45% year-on-year and 14% quarter-on-quarter. Non-GAAP operating profit was RMB 11.5 billion, up 43% year-on-year and 10% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 9.0 billion, up 28% year-on-year and 8% quarter-on-quarter. For the full year of 2015, total revenue was RMB 103 billion, up 30% year-on-year. Non-GAAP operating profit was RMB 42 billion, up 37% year-on-year. Non-GAAP net profit for shareholders was RMB 32 billion, up 31% year-on-year.

Operationally, our key platforms win – retained sector leadership. Total MAU for QQ increased 5% year-on-year to 853 million, within which smart devices MAU was 642 million, up 11% year-on-year. Weixin and WeChat reached combined MAU of 697 million, up 39% year-on-year. For Qzone, smart devices MAU rose 6% year-on-year to 573 million.

We maintained our leadership as the largest operator and publishing platform for PC client games and established clear leadership in several genres of smartphone games. Our Media business continue to grow supported by increasing traffic from our user base, deep user insight and our expanding catalog of exclusively licensed and in-house content.

Our new services continue to lead by daily active users and video platforms by mobile video views. In mobile utilities, we expand marketing leadership in mobile security, mobile browser and Android-based app store in China.

I'll now invite Martin to discuss strategic highlights.

Chi Ping Lau

Thank you, Pony. Good evening and good morning. Our connection strategy has really extended Weixin and Mobile QQ from being social communication tools to becoming platforms for games, publishing, social advertising, premium content distribution and provisioning of other online services. I'll discuss in my section our strategies to build out each one of these businesses.

In games publishing, we're leveraging our PC game expertise and mobile traffic to deliver high-performing mobile games across different genres. In Shooter and MOBA genres, we extended our leadership from PC to mobile with new releases including CrossFire Mobile and WeMOBA.

In RPG, we achieved initial success with The Legend of MIR 2 as developed by our partner developer. We're able to attract new gamers to our mobile platform. And we observed limited average impact on users and revenue due to cannibalization on our PC similar titles.

We're fostering partnerships with game developers globally to bring best-in-class mobile games to our users. Game developers typically prefer to work with us because we can leverage our large user base and social graph to distribute games to a broad audience and run user-targeted marketing campaigns.

Many leading PC game developers reviewed Tencent as the partner of choice for publishing their next mobile title in China. These partnerships will enrich our existing pipeline, which include games we developed based on popular game titles as well as comic IPs. Running a well-diversified portfolio of game titles is important in our view because the lifecycles of mobile games tend to be shorter than PC games.

As it relates to social advertising opportunities during 2015, we made progress in building our social advertising business, which is becoming a mainstream sizeable market opportunity globally. Compared with traditional online advertising, social advertising is less intrusive and, if done properly, can trigger viral sharing in our social platforms.

We're growing this business in four ways. Firstly, we're developing advanced data mining, look-alike and retargeting technologies that support enhanced audience profiling and targeting capabilities to drive ad engagement and conversion. Secondly, to attract a bigger share of top advertisers online ad spend, we're creating new ad formats to support brand storytelling. We've also formed dedicated sales teams to serve key accounts with customized solutions.

Thirdly, to serve a growing base of long-tail advertisers, we're developing new audience targeting solutions for specific industries and increasing the types of ads sold through our self-service platform. Last but not least, we're gradually releasing inventories while balancing user experience with ad load performance. We view social advertising as a long-term opportunity and we'll built it with patience to make sure that we get things right.

Moving on to digital content services, the increasing user demand for quality content and on-demand content access as well as improving copyright protection in the digital environment are creating a market for paid premium content in China. As pirate activities diminish, content suppliers are making new content available online sooner. App stores and standalone apps offer better mechanism for copyright protection as opposed to the previous web page architecture.

We're also cultivating this market environment via paid services for premium content served on our video, music, and literature platforms. While all of these businesses are still in investment mode financially for us, we believe premium content paid services will help us cope with the increasing content costs over the longer run.

For premium movies and video programs, we charge either a monthly subscription or a pay-per-view fee. During 2015, we made heavy investments that expended our library of exclusive premium videos, which led to a six-fold increase in our video subscriptions year-on-year. In music, we're in the early stage of moving the industry toward a free basic plus subscription premium model. We're the leading master licensor of music copyrights in China in terms of number of songs. In the second half of 2015, we started sub-licensing the content to key online music providers to support an industry-wide transition toward paid package.

For online literature, we're currently the largest digital publisher by user and by revenue, and we publish over 80% of the most popular online literature in China. We're also cultivating the commercial value of our vast IP library through participating in game, drama, movie and animation productions.

I'm going to round up my section with an update on our Internet Plus strategy. Connecting more digital content and broader types of offline to online services is helping our social apps to make users' life more convenient.

Users are gaining broader access to e-commerce and O2O services as we support our strategic partners to grow their product offering and service level. We're making local public services such as healthcare, transportation, utilities and municipal government services more accessible to users. We're also adding functionalities that facilitate online bookings, purchases, order tracking and other transactional services through Official Accounts and our mobile payment solutions.

We believe creating a vibrant ecosystem will help us drive payment adoption and transaction volume. This, in turn, will position our payment platform as a launch pad for online financial transactions such as wealth management and consumer lending over the longer run.

So with that, I'll pass to James to talk about business review.

James Gordon Mitchell

Thank you, Martin. In the fourth quarter of 2015, our revenue grew 45% year-on-year. Value-added services represented 76% of our revenue, within which online games contributed 53% and social networks 23%. Online advertising was 19% of our revenue, up from 12% last year.

For the full year, our revenue grew 30% year-on-year or 38% excluding eCommerce transactions. Value-added service revenue was RMB 23.1 billion, up 35% year-on-year and up 12% quarter-on-quarter. Our social networks revenue was RMB 7.1 billion, up 37% year-on-year and up 14% quarter-on-quarter.

Monthly subscriptions increased notably for our digital content offerings. Paid music downloads boosted growth in our premium music subscriptions and the drama series [ph] country romance (14:30) season eight drove premium videos subscriptions.

Online game revenue was RMB 16 billion, up 33% year-on-year and up 11% quarter-on-quarter. Mobile and PC game revenue each increased both year-on-year and sequentially. For the full year 2015, VAS revenue was up 27% on a reported basis and up 24% on a gross-to-gross basis.

Looking at social networks, we took several initiatives to deepen engagement within the QQ community during the quarter. For example, our revenue sharing scheme to incentivize QQ group activity. Under this scheme, group organizers receive a share of in-group spending and gifting, also facilitating third-parties to share video content within the Qzone newsfeed more effectively.

For Weixin, we continue to develop our Official Account ecosystem and expand use cases. The number of Official Accounts doubled year-on-year to approximately 20 million, and enterprise accounts allowed us to penetrate new verticals such as logistics, real estate and store management.

On social payment, red envelope gifting of our Mobile QQ and Weixin has become a widespread component of holiday greetings in China. Leveraging user activity on our social platforms, we ran a successful Chinese New Year campaign in February. The total number of red envelopes exchanged by our Mobile QQ was 6 billion and via Weixin was 32 billion.

Moving to PC client games, average concurrent users for our advanced casual games grew 7% year-on-year to 7.8 million, primarily due to existing games while average concurrent users for massively multiplayer games grew 3% year-on-year to 1.7 million, primarily due to new titles. In battle-arena games, League of Legends ran several highly popular eSports events, deepened user engagement and we increased paying user activity through in-game promotions.

In shooter games, we released new items in Assault Fire which drove up ARPU and a new content to Call of Duty Online which boosted usage. In role-playing games, our recently launched titles such as Moonlight Blade and ArcheAge contributed to growth in paying users and revenue.

We believe we possess a rich PC game pipeline including titles such as Master x Master, a battle-arena game, MapleStory 2, a side-scrolling RPG; Orcs Must Die!, a tower defense game; and War Thunder, a combat game.

For smartphone games, in the fourth quarter our smartphone game portfolio generated RMB 7.1 billion revenue, up 72% year-on-year and up 33% quarter-on-quarter. We're the market leader in many popular genres including shooter games, mobile games, ARPG, card RPG and puzzle games.

We're seeking to enrich our smartphone gamer experience. First, by lining up a diversified portfolio of strong IPs based on PC games and comics that provide inspiration for new mobile games. For example, we published mobile games based on the CrossFire PC game and on the Naruto animated series, see good consumer response. Secondly, by expanding to new game genres. And, thirdly, by developing community and eSports cultures around mobile games. In our recent Game Center upgrade, we bundled video replays into the game apps themselves and enhanced the community management tools for the in-game tribes and guilds.

Given our operating strengths and proven ability to grow communities and revenue, we believe we're the China publishing partner of choice for game developers locally and globally. For example, we have mobile game publishing relationships with Shanda, Kingsoft, Giant, and a range of international game developers.

Moving on to online advertising, segment revenue was RMB 5.7 billion, up 118% year-on-year and up 16% sequentially. Brand advertising revenue was RMB 2.8 billion, up 89% year-on-year and 10% sequentially. We increased sell-through of mobile news inventory via paid feeds, driving the sequential revenue growth during what's historically a seasonally weak quarter for our brand ad business.

Our video ad revenues more than doubled year-on-year, they were down slightly Q-on-Q due to the high base from the Voice of China 4 program last quarter. Our performance advertising revenue was RMB 2.9 billion, up 157% year-on-year and up 22% quarter-on-quarter.

New ad formats and increased mobile impressions volume delivered year-on-year revenue growth. Also, we selectively increased ad loads in Qzone and Moments to coincide with the e-commerce peak season during the fourth quarter. For the full year 2015, our advertising revenue was RMB 17.5 billion, up 110% year-on-year.

Looking into 2016, we assume a tougher macro environment may have some negative impact on the overall advertising industry, including our business within it. Reviewing some of our leading ad properties, in news, we shifted mobile inventory from banner into paid feeds, which boosted average CPM and improved sell-through rate.

In video, our mobile daily video views nearly doubled year-on-year, thanks to our expanding catalog of popular content. As the NBA exclusive partner in China, we have launched the season in October with several high profile events, and we estimate the average online viewership per NBA game. Aggregating all platforms across the industry has doubled year-on-year since we became exclusive partner.

In social, we enhanced our audience profiling capability by look-alike for Qzone and LBS targeting technology for Weixin. We've added new ad formats such as auto play video and eCoupons. And our Official Accounts grew impression volume and gained wallet share from top advertisers.

And with that, I'll pass on to John to discuss the financials.

Shek Hon Lo

Thanks, James. Hello, everyone. For the fourth quarter of 2015, our total revenue was RMB 30.4 billion, up 45% year-on-year and 14% quarter-on-quarter. Gross profit was RMB 17.8 billion, up 41% year-on-year or 14% sequentially. Net other gains was RMB 249 million in the quarter.

Operating profit was RMB 10.9 billion, up 47% year-on-year or 5% quarter-on-quarter. Shared losses of associates and joint ventures was RMB 1.3 billion for the quarter. The year-on-year increase mainly reflected high losses from associates. On a non-GAAP basis, share of losses of associates and joint ventures was RMB 164 million.

Income tax expenses were RMB 2 billion, up 124% year-on-year or 28% quarter-on-quarter. Effective tax rate was 21.7% for the fourth quarter and 19.6% for the full year 2015. Net profit attributable to shareholders was RMB 7.2 billion, up 22% year-on-year or down 4% quarter-on-quarter. GAAP diluted EPS was RMB 0.759. Non-GAAP diluted EPS was RMB 0.949.

For the full year 2015, total revenue was RMB 102.9 billion, up 30% from 2014. Gross profit was RMB 61.2 billion, up 27% from 2014. Operating profit was RMB 40.6 billion, up 33% from 2014. Net profit attributable to shareholders was RMB 28.8 billion, up 21% from 2014.

After adjustments to non-GAAP, operating profit for the fourth quarter was RMB 11.5 billion, up 43% year-on-year or 10% quarter-on-quarter. Net profit attributable to shareholders was RMB 9 billion, up 28% year-on-year or up 8% quarter-on-quarter. Operating margin was 38% stable year-on-year or down 2 percentage points quarter-on-quarter. Net margin was 30%, down 4 percentage points year-on-year or 2 percentage points quarter-on-quarter.

For the full year 2015, non-GAAP operating profit was RMB 41.8 billion, up 37% from 2014. Non-GAAP operating margin was 41%, up 2 percentage points. Non-GAAP net profit attributable to shareholders was RMB 32.4 billion, up 31%. Non-GAAP net margin was 32% and stable compared to last year.

Let's turn to segment gross margin. For the fourth quarter, gross margin for value-added services was 64% stable year-on-year and quarter-on-quarter. Gross margin for online advertising was 51%, up 11 percentage points year-on-year and 2 percentage points quarter-on-quarter. Social advertising revenue, especially from mobile contributed to best margins. For the full year 2015, gross margin for VAS was 65%, on a gross-to-gross basis, it was down 1 percentage point from last year. Gross margin for online advertising increased 5 percentage points to 49%.

Moving onto operating expenses. In the fourth quarter, selling and marketing expenses was RMB 3 billion, up 47% year-on-year and up 48% quarter-on-quarter. Higher marketing and promotion spending on smartphone games, literature and mobile news services contributed to both year-on-year and quarter-on-quarter increase. In addition, the quarter-on-quarter increase was primarily affected by seasonality. Selling and marketing expense was 10% of quarterly revenue.

Included under G&A, R&D expense was RMB 2.5 billion, up 15% year-on-year and 1% quarter-on-quarter. Total G&A expense was RMB 4.8 billion, up 20% year-on-year and up 9% quarter-on-quarter. R&D represent 8% of quarterly revenue and total G&A was up 16%. Share-based compensation is around 3% of quarterly revenue.

On a full year basis, selling and marketing expense was RMB 8 billion, up 3% from 2014 and represents 8% of revenue. R&D expense was RMB 9 billion, up 19% from 2014 and represented 9% of revenue. Total G&A was RMB 16.8 billion, up 19% over 2014 and represented 16% of revenue. As at quarter-end, we had about 30,600 employees, up 11% year-on-year or 2% quarter-on-quarter.

Let's go through our marginal ratios for the fourth quarter. Gross margin dipped 1.9 percentage points year-on-year to 58.4%, mainly due to increasing bank handling fees incurred from C2C money transfer in our mobile payment platforms. Gross margin was stable sequentially.

Non-GAAP operating margin was 37.9%, which was broadly stable year-on-year. Sequentially, it dipped to 1.6 percentage points, primarily due to higher selling and marketing expenses, partially offset by lower G&A expenses.

Non-GAAP net margin was 29.6%, which decreased 4.2 percentage points year-on-year and 2.2 percentage points quarter-on-quarter. The year-to-year decrease was due to higher income tax expenses and higher share of loss from associates. The sequential dip was mainly due to higher selling and marketing expenses.

Turning to earnings per share and proposed dividend for 2015, GAAP basic EPS was RMB 3.097 and diluted was RMB 3.055. Non-GAAP basic EPS was RMB 3.485 and diluted was RMB 3.437. Subject to the approval of shareholders at the AGM to be held on 18th of May, 2016, we are proposing an annual dividend of HKD 0.47 per share.

Finally, let me share a few key financial metrics with you. Total CapEx was RMB 1.9 billion for the fourth quarter, up 17% year-on-year or 14% quarter-on-quarter. Operating CapEx was RMB 1.3 billion and non-operating CapEx was RMB 586 million.

Free cash flow for the fourth quarter reached RMB 16.2 billion, up 76% year-on-year or 144% quarter-on-quarter, which was mainly attributable to the increase of operating cash flow from our games and advertising businesses.

At year-end, our net cash position was RMB 19.1 billion, down 16% year-over-year or 10% quarter-on-quarter. The negative year-to-year comparison was mainly due to payments for licensed content, dividend and M&A, partially offset by free cash flow generated during the year. Devaluation of our U.S. dollar-denominated debt also contributed to the decrease. The fair market value of our listed associates and available-for-sale financial assets were approximately RMB 98 billion.

That concludes our presentation. Thank you.

Catherine Chan

Thank you. We shall open the floor for questions now. Operator, we'll take one main question and one follow-up question each time. Shall we invite the first question now? Operator?

Q&A

Operator

Thank you. [Operator Instructions] Our first question comes from the line of Wendy Huang from Macquarie. Please ask your questions.

<Q - Wendy Huang>: Thank you for taking my question. My first question is about your broad Internet finance business, you mentioned the mobile payment MAU increased significantly. So what's the absolute number for that mobile payment MAU and also what kind of revenue model that you will try to build around your Internet finance business?

<A - Chi Ping Lau>: Okay. Well, in terms of MAU, we have never disclosed it and sort of we are not providing the exact number. I think we try to provide the relative amount to give you some color on sort of the growth of the activity. In the past, we have announced that our total number of cards binded was more than 200 million. Now, the number is safely more than 300 million. So I think this should give you a sense of the continued growth of both the number of users as well as the level of activity.

In terms of mobile payment, it's interesting that you asked the question because it was actually generating losses and the loss has been accelerating at a very fast clip as the level of activity increased, because as a payment platform we actually have to pay the bank certain handling fee when user move their money into the payment system. And when – it's actually used for merchant payments and we get some revenue from the merchants. But if it's actually a user-to-user transfer, then we don't receive any fees. So that's why it was actually generating loss.

And recently, I think, we actually have told the public that in the month of January, the amount of bank handling fee that we pay minus the amount of money that we get from the users actually exceed RMB 300 million a month. So it's actually a pretty significant number. And as a result, we announced on March 1 that we have to put on a fee when people extract money out from the payment platform onto their bank card. So this measure actually help us to contain the cost.

Now, in terms of what we see as the revenue model for payment platform, I think number one, when the payment is actually to merchant, then we actually charge merchants a certain fee, and that's actually more than able to cover our bank handling charge. Now, because of competition, sometimes we actually have to reduce the fee and even sort of subsidize some of the merchants. So, as a result, we actually believe that the payment platform itself is not going to be a profitable business.

But what's the value actually to us? The value of the payment platform is that there's a lot of activities that can happen. It will benefit our overall ecosystem. And when we actually try to make our ecosystem a diverse one, and when we start to put advertising into our ecosystem, then having the ability to pay actually helps to make the advertising more valuable to merchants.

And, also, we believe in the longer-term, having the payment pathway actually help us to secure a very important launch pad of online financial transactions, for example, our wealth management platform, Licaitong, and our consumer lending business in our affiliate WeBank actually rely on the fact that we have a lot of people active on our payment platform, a lot of people who have binded their bank cards to the Weixin and to the QQ account. And when we have that then being able to identify these as potential customers and directing them to the online financial applications will be much easier.

<Q - Wendy Huang>: Thanks, Marty. My second question is about your advertising business. So on the revenue front, you mentioned that mobile advertising already accounted for 65% of the total revenue, total advertising revenue in 2015. I just wonder what kind of pricing that mobile is at the moment, whether if CPM is still at a discount to PC CPM or it has already exceeded the PC CPM due to its more talking nature.

And, also, how do you see your advertising model to develop differently from Facebook down the road? So on the cost side, I think, in the past two quarters, you especially mentioned about the Voice of China and also NBA costs in the Q4. Given the uncertain competition in the video market, how should we look at 2016's content costs? Thank you.

<A - Chi Ping Lau>: Yeah. On mobile advertising, well, PC advertising has got a very, I would say, bipolar type of inventory composition, right, there is the homepage and then there's everything else. The homepage typically sells very well and commands a high CPM. But then sort of very quickly, when you go to the deeper pages, then the CPM drops significantly.

Now, on mobile, what we're seeing is that, because we can do it on the feed and because we can actually sort of get the advertising in a more targeted way, as you said, the CPM that we get on the different type of pages is actually sort of not that different. So that's why, on an aggregate basis, actually we will say the mobile platform is a better place to put advertising. And what you may not be able to command exactly the same CPM as front page, but there's actually much more inventories that you can sell that can command a respectable CPM.

In terms of content costs?

<A - James Gordon Mitchell>: In terms of the content costs, you mentioned video advertising revenue grew more than 100% year-on-year and video subscriptions grew a little more than 600% year-on-year. So, of course, when we see an industry that's exhibiting those transformational rates of growth, then it's very natural you should expect us to continue reinvesting in content, both exclusive and non-exclusive.

As a reminder, some of the exclusive content we already possess includes NBA rights, HBO, Star Wars, James Bond 007, [indiscernible] (36:38) rights. But we'll continue to look for rights just to somewhat be competitive as well because the video industry is a very fast-growing dynamic industry. And if you look at the video subscriptions opportunity, I think we and a couple of competitors are all growing very quickly as a better regulatory environment and consumers more willing to pay for premium content really creates a business model that didn't exist in the recent past.

<A - Catherine Chan>: Thank you. Operator, next question please.

Operator

Thank you. [Operator Instructions] Your next question comes from the line of Eddie Leung from Merrill Lynch. Please ask your questions.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. Regarding your performance fee based advertising, as we have seen more inventory from different types of applications, just curious how does it affect two things: number one is the average eCPM you get from across the board? And then, secondly, how that would affect the gross margins of your performance fee based advertising basis? And then, finally, perhaps, just a housekeeping question, any update on the ARPU trend of your different types of games? That will be great. Thank you.

<A - James Gordon Mitchell>: So on the advertising eCPM and gross margin, as you'd expect, we have placed some performance advertising across a wide range of inventories and different inventories have different trends, different formats, have different trends. For example, when we put advertising into third-party ad network, which we're building out, initially the eCPM might be a little bit lower whereas when we put advertising into Weixin Moments newsfeed, then the eCPM would be materially higher. And if we put advertising into a video format, then that would be materially higher CPM versus a text format.

In terms of the gross margin, the pricing is the less important determinant than to gross margin. The bigger determinant of our performance advertising gross margin is whether the inventories are owned inventory such as the Weixin Moments, or kind of shared inventory where we're the exclusive distributor such as the Weixin Official Accounts or third-party inventory such as our ad network and it's really the nature of the owner of the inventory that determines the gross margin. But in general, the incremental gross margin on our performance advertising business is quite high, because much of the inventory is owned inventory given our substantial unutilized traffic.

<A - Shek Hon Lo>: In relation to the ARPUs, for MMOG, it ranges from RMB 265 to RMB 410 in quarter four; of unscheduled games, RMB 85 to RMB 310; and for smartphone games, it ranges within RMB 185 to RMB 190 flat when we see it as the portfolio.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

The next question comes from the line of Alan Hellawell from Deutsche Bank. Please ask your question.

<A - Catherine Chan>: Hello, Alan? So if he's not on the line, we'll move to the next question, please.

Operator

Thank you. Your next question comes from the line of Chi Tsang from HSBC. Please ask your question.

<Q - Chi Tsang>: Good evening. Thank you so much for taking my questions. I had two quick questions. Firstly, I was wondering if you can give us an update and maybe an outlook on WeChat Moments advertising. You mentioned the potential to increase your ad load. So I'm wondering what do you think about Moments for this year?

And then, secondly, if you can give us an update on WeBank. Any sort of data on sort of micro loans or user behavior would be very helpful. Thank you.

<A - Chi Ping Lau>: Okay. In terms of Moments ads, I would say it is ad format, an ad platform, which carries significant long-term opportunity, but it's a very important engagement for our users. So we want to do it slowly and do it right. So if you look at our performance ads revenue, a big chunk is still actually on our Qzone feeds. And then there is a significant portion which is on the Official Accounts or the content page in the Official Accounts and then it's the Moments.

So I think, over time, as we continue to improve the targeting technology as well as always continue to educate more and more advertisers about how to create the right type of Moments ads in a stylish and in a social way, then we'll continue to release more inventories. But that's not the highest priority for us. The highest priority for us is actually to make sure that our technology is done right and we continue to expand the universe of advertisers who are capable and who are proficient in developing performance ads especially on Moments.

Now, as it relates to WeBank, I think WeBank is performing according to plan. They have their flagship product, which is a consumer loan product, which has been signing up a pretty good number of users and it leverages our WeChat and our QQ channel to reach users in a targeted way. It has a white list which allows it to target the creditworthy users and it's gradually expanding the white list to include more and more users as it continues to refine its credit model.

On the funding end, it's actually using a capital-light model so that it actually partner with a lot of banks to provide loans in a joint basis. So, basically, it's not a traditional bank. Essentially, it's a bank cooperation or partnership platform with banking license. And I think that model is actually working out pretty nicely and we continue to gradually increase the number of users that we feed into that system.

<A - Catherine Chan>: Thank you, Martin. Next question, please.

Operator

Your next question comes from the line of Dick Wei from Credit Suisse. Please ask your question.

<Q - Dick Wei>: Hi. Thanks for taking my question. So I wonder if management can share some observations on the user behavior for paid premium content? I wonder other users are mainly from existing QQ users or they may not be existing kind of paying members on Tencent. And how do we expect paid subscription growth, is it mainly from kind of cross-sell into different categories as we have more diverse subscription content, or is it going to be more spread out into more new users going to subscription of our premium content? And I wonder if you can also comment on is there any kind of synergy that brings into maybe from paid subscription to some of these services within our [indiscernible] (45:07) service and content ecosystem? Thanks.

<A - James Gordon Mitchell>: So in terms of the nature of the consumers who are subscribing to our digital content services, it's relatively nationwide and it's relatively balanced across different demographics, although, like most things, Internet is skewed a little bit to men and a little bit to younger users. We do, do some limited upselling of our traditional privileged subscriptions into the content subscriptions, but historically that's been a small minority of the subscriber growth. The large majority has been activating people calls who previously weren't paying us and persuading them to pay us because they love music or they love movies or they love literature.

When we look at the growth opportunity going forward, I think that as Martin alluded to in the opening remarks, we feel that's an increasingly supported macro environment in terms of government regulations, in terms of the app stores, leasing content, and in terms of consumers becoming more sophisticated moving to pay per content and then finally in terms of the content suppliers willing to make their content available more widely, but behind a premium service.

So while there's many individual sort of tactics, that's the broad backdrop. Another factor that I think has been particularly impact within the last 12 months or 18 months has been the growth of mobile payment platforms such as our Weixin Pay, because when we have surveyed consumers in the past or when movie studios or record labels have surveyed consumers in the past and talked to them about why they're not paying for premium content, then typically the answer was not that they felt RMB 10 or RMB 20 per month, which is the rate we charge is too expensive, the answer was that it was inconvenient to pay. If they wanted to watch a movie now, if they wanted to listen to a Taylor Swift record now that they didn't want to have to go to a 7-Eleven and buy a prepaid card in order to activate that experience. But now that they have a smartphone in their hand and that smartphone is bound to their bank accounts, and they can pay instantaneously through Weixin Pay, then it makes what was previously inconvenient inaccessible service much more convenient and accessible.

So we think those are all the factors supporting the growth and those should also continue to support the growth going forward. Of course, we'll continue to work with content suppliers. And to some extent, we're also – our growth is also a function of how our competitors behave a little bit, if our competitors adopt a forward-looking mentality and try to nurture the premium content assumption as well, then that's good for them, but it's also good for us and for the overall industry.

<A - Catherine Chan>: Thank you. Operator, next question please.

Operator

Your next question comes from the line of Natalie Wu from CICC. Please ask your question.

<A - Catherine Chan>: Hello, Natalie? Okay, operator, we will do the next question, please.

Operator

All right. Your next question will come from the line of Erica Poon from UBS. Please ask your question.

<Q - Ming Xu>: Good evening, management. This is Ming Xu asking on behalf of Erica. So I have two questions. The first question is regarding WeChat. So, firstly, could you share with us maybe the split between – in terms of Moments ads, could you share with us the split between the big advertisers and the long-tail advertisers in terms of number and also in terms of revenue? We also noticed recently that you have lowered the minimum placing requirement for each ad. So I'm wondering what's the update in the past one month and, also, what's your outlook for the rest of 2016? Secondly, could you share with us some color on the application account and, also, corporate WeChat? And then, I have a follow-up on games.

<A - Catherine Chan>: I think, Ming, that will be the two questions that we're going to take from you. Thank you.

<A - James Gordon Mitchell>: In terms of the Moments advertising, at this point, it's really the bigger advertisers, that's where we had focused it because we think it's initially most appealing for the bigger advertisers. As far as the outlook is concerned, I'd refer you back to Martin's earlier comments that we think this has a great long-term potential as evidenced by the success of global peers, as evidenced by the advertising reaction to our initial batch of ads, but we'll manage the growth carefully. In terms of...

<A - Chi Ping Lau>: Yeah. In terms of app, well, you actually asked two questions which are not really launched yet, and they're forward-looking questions. I think the idea of application account is really helping the Official Account owners to provide more functionality and more custom-made functionality for their Official Account. So for the traditional Official Account, it's menu-based and it's conversation-based, and we saw that with a lot of different types of merchants and organizations using the Official Account. Some of them actually said, want to upgrade the experience and provide a light app for the users through our platform. So that's why we are now designing the Official Accounts to cater to these kind of needs.

In terms of corporate IM or enterprise IM, we clearly see that more and more people are using WeChat for business purpose and there's a lot of mixing between personal usage and enterprise usage. And we also saw that enterprises now want to have a more unified experience for their employees. So that's the idea behind our enterprise IM and both of the products are actually in the making right now. So I think we can provide you with more update when we actually launch the product.

<A - Catherine Chan>: Okay. Thank you. Next question, please.

Operator

Your next question comes from the line of John Choi from Daiwa Securities. Please ask your question.

<Q - John Choi>: Thank you for taking my question. I have actually a question on mobile games. Could management give more color particularly in the user behavior given that you guys have been always – already been doing games for three years? And now we've started to see more IP from your PC largely on the mobile side. And particularly if you look at the developed markets, seems like the mobile game market has been maturing. So I think for this year we should continue to see strong growth, but how long do you think mobile game will continue to deliver strong growth momentum? Thank you.

<A - James Gordon Mitchell>: Well, I think that's mobile games individually and mobile games in aggregate. So mobile games individually, titles move in and out of favor and that can cause volatility by individual products and individual companies. The mobile game industry in aggregate, we think, is on a strong secular growth trend. And if we look at how user behavior has evolved in the U.S. and Europe and Japan, there was relatively rapid move from casual games into mid-hardcore games with long life and greater monetization.

In China, it's been a more winding path. I think that three years ago, most of the games in the market were very casual games with correspondingly very low ARPU. Then we started to see a handful of mid-core games enter the market with much higher ARPU, but typically shorter life.

Early 2015, we began to see some role-playing games come into the market, which appeared to exhibit a decent ARPU and a decent longevity, but relatively small absolute number of users. And then, I think, as the years moved on, we have tried to bring games to the market that are mid-core in nature, have respectable ARPU, have – we hope some degree of longevity, but also have actually fairly sizable user base.

So as the game markets move through those, then it's expanded with each new generation iteration. And looking forward, while we've already pioneered some genres such as mobile shooting games, mobile battle-arena games, there's many, many more genres that are popular on the PC, but not yet popular on mobile and many genres that are popular in the West are in Japan or Korea, but not yet popular in China, that we think will become popular in time. And we hope to support the growth of the overall mobile game industry.

<A - Catherine Chan>: Thank you. Operator, in the interest of time, we'll take the last three questions please.

Operator

Your next question comes from the line of Thomas Chong from Citigroup. Please ask your question.

<Q - Thomas Chong>: Hi. Thanks, management, for taking my questions. I have two questions. The first question is that in the press release you talk about the cloud computing business delivered over 100% year-on-year revenue growth. I think this is one of the few times that you talk about the monetization for the cloud computing business. Now, can management talk about your view on that front and the trend for the next couple of years?

And, secondly, the question is about payment. Can management comment about how Apple Pay will affect the competitive landscape in China? Thanks.

<A - Chi Ping Lau>: Yeah. In terms of cloud business, right, we believe the cloud business is a very strategic business for us to grow over the long run. The reason is because it's part of our overall connection and ecosystem strategy. As we continue to build our platform, our social ad platform, we get into a lot of – relationship with a lot of companies, entrepreneur companies, large and small companies providing services.

Our app store, for example, also host a lot of these companies. So, as a result, we actually see a lot of these companies are sources for our cloud business. And our cloud business is a gateway for us to leverage our very large in-house cloud computing infrastructure. So we have the economies of scale just based on our existing in-house business.

And at the same time, we have developed over the years many, many technologies such as acceleration technologies such as security, such as bandwidth saving, such as caching technologies, which we can actually share with a lot of companies in our ecosystem.

So, as a result, we have been building our cloud business. We started off from the game vertical. And in the course of last year, we have expanded it to cover many other industries. And we've seen strong growth traction in this business and we'll continue to invest in this business as part of our overall ecosystem strategy.

Now, in terms of the payment, I think we do not want to be too much focused on what other companies are doing. What we are focused on is actually sort of building our own payment platform because it is actually very tied with our own ecosystem. And so far, we have been seeing strong traction in terms of both number of users adopting our payment solution, in terms of merchant adopting our payment solution as well as in terms of user activity.

<A - Catherine Chan>: Thank you. Operator, we'll take the last question please.

Operator

Thank you. The last question comes from the line of Ming Zhao from 86Research. Please ask your question.

<Q - Chun Ming Zhao>: Thank you. Two questions. First question, on mobile gaming. So can you talk about the mobile games in your pipeline? Will you slot those games evenly for the balance of this year and next year? Or do you expect a sharp increase in the supply of such games, especially the mobile MMO games, and then you want to launch them quickly to gain market share? That's question number one.

Question number two is on margin. So correct me if I'm wrong, from Q4 performance and the fact that you are charging users fees for withdrawing money from the wallet, management seems emphasizing profit margins a bit more than the past. If not, what are the areas of heavy expenses this year? Thank you.

<A - James Gordon Mitchell>: I think on the mobile games, it's never been Tencent's policy to rush a lot of product to market in order to grab market share. We don't think that that's how the mobile game industry works at this point in time. So we have what we hope is a very good pipeline of mobile game titles and we'll release them at a measured pace through the year-end, we hope give each of the new mobile games time to find its speed and grow its audience. And if we do that, then our market share will take care of itself. And more importantly, the overall market will take care of itself.

I think when we have launched successful battle-arena games or shooter games, we haven't been pulling users or revenue away from competitors. We've been creating a demand, creating an audience and creating revenue that wouldn't exist were it not for what we're doing. So we're not particularly focused on market share grab and we're certainly not frontloading or tank crushing a huge quantity of mobile games to market in a short period of time.

<A - Chi Ping Lau>: Yeah. In terms of margin, I think sort of in your – I will repeat what James said, right, we're not really focused on margin. The reason is because our margin is actually a collection of different businesses with very different natures, right? So it's very difficult to sort of just draw an implication from a particular number which sort of is a composite of many, many different elements. So addressing a little bit to your question, the bank handling fee was actually accelerating throughout the past, I would say, six months. And the highest number of which was actually sort of January, so that was that number and it becomes very significant and hence we have to put in some measures to contain it.

Now, in terms of the margin itself, I would say, the margin – the bigger impact on the margin, frankly, in the course of last year and fourth quarter was mainly because of the cost that we incurred in sharing – in acquiring content from our partners, right? For example, games, we actually have a lot of partners in which we operate their games and publish their games and then we have a revenue share.

And, for example, in terms of video and music content, we actually share – we pay licensing fee to our content partners and, as a result, incur these costs. And this sharing to the partners, actually, reduce the margin on our business. But I think it's actually a healthy increase, right, because it means we are actually becoming the gateway of revenue for a lot of our partners, and that's a healthy relationship. And, over time, we can actually leverage this – the creativity and value created off these partners and to create more tied-in and more attraction for our own users. So I think that's actually a healthy decrease over time. So I think it's hard to just look at that number. I think we actually have to look at different business lines and look at how the margin trends, then it would be a much more informative insight.

Catherine Chan

Okay. Thank you very much for joining us this evening. We're closing the call now. If you wish to check our press release and other financial information, please visit our company website at www.tencent.com/ir. The replay of this webcast will also be available soon. Thank you and see you next quarter.

Operator

Thank you. That does conclude our conference for today. Thank you for participating Tencent Holdings Limited 2015 Fourth Quarter and Annual Results Announcement Conference Call. You may disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2015-11-10
Event Description: Q3 2015 Earnings Call

Q3 2015 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Eddie Leung
- Wendy Huang
- Chi Tsang
- Erica Poon Werkun
- Alan Hellawell
- Dick Wei
- Jin-Kyu Yoon
- Cynthia Meng
- Alicia Yap
- Thomas Chong

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Tencent Holdings Limited 2015 Third Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session.

[Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to the third quarter 2015 results conference call. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and our non-GAAP measures, please refer to our disclosure documents downloadable at www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Mr. Martin Lau; Chief Strategy Officer, Mr. James Mitchell; and Chief Financial Officer, Mr. John Lo.

Pony will kick off with a short overview, Martin will speak to strategy, James will review our business, and John will go through the financials before we take your questions.

I'll turn the call over to Pony now.

Huateng Ma

Thank you, Catherine. Good evening. Thank you for joining us. During the third quarter of 2015, we delivered a solid growth in our core platforms for social, games, news, video and payments. Financially, our mobile games business [indiscernible] (2:09) following the implementation of the new strategy that extend our products range. Our online advertising revenue doubled year-on-year, benefiting from growing mobile contributions in our popular media platforms and our unique social performance advertising.

We also saw a sharp increase in mobile payment usage. In addition to commercial success, we also seek to leverage our platform to create positive social impact. On September 9, we launched a one of its kind Internet+ donation campaign. The 9.9 Charity Day creates widespread resonance among our partners and the community at large.

Let me highlight a few numbers for you. John will provide you the details in the financial section. Total revenue, excluding eComm transactions, grew 37% year-on-year to RMB 26.5 billion. Sequentially, it rose 14%. Non-GAAP operating profit was RMB 10.5 billion, up 27% year-on-year and 2% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB 8.3 billion, up 26% year-on-year and 4% quarter-on-quarter.

Moving on to platform update, our social communication product, QQ and Weixin, further deepen its engagement with a wide spectrum of Internet users in China. QQ is the most popular social platform for young entertainment-driven users. Total MAU reached 860 million in the third quarter, within which smart device's MAU increased 18% year-on-year to 639 million.

Weixin is a fast-growing, mobile-only social platform that was able to convert users, who had not used instant messaging before. Combined MAU of Weixin and WeChat rose 39% year-on-year to 650 million. Qzone, our social sharing platform integrated to QQ, grew total MAU to 653 million, within which smart device's MAU rose 14% year-on-year to 577 million.

For online games, we've deepened its penetration in multiple genres in PC and mobile, reinforcing our leadership as the largest operator and publishing platform in China. And now, our online media platforms, our mobile news service continued to grow due to better content curation and improved customization. Total video views increased robustly, both within the mobile apps and within Weixin Official Accounts. In mobile utilities, YingYongBao app store became the most popular third-party app store in China. And our mobile security and mobile browser are also a market leader in their respective categories.

With that, I will pass to Martin.

Chi Ping Lau

Thank you, Pony. Good evening and good morning to everybody. Since there has been many news flows in the online-to-offline, O2O space, and we have also made quite a number of significant investment in best-of-breed O2O companies, we feel that it's important to provide you with more information around our O2O strategy.

First of all, we do believe that the O2O space is very important to Tencent. Why? Firstly, it's a way for us to capture business opportunities when various industries move part of their business processes from offline to online as part of the bigger Internet+ movement in China.

Our highly engaging social apps, Weixin and QQ, can connect users to a broadening spectrum of vertical services. This unlocks business opportunities for partners in that O2O ecosystem, and at the same time provide our users with better user experience. Secondly, O2O activities can grow Weixin Pay and QQ Wallet user base, as well as develop payment habit among our users. Thirdly, we can also source new advertisers for our performance-based advertising platform via our O2O partners as we look into the future.

Now, why do we choose to partner with best-of-breed companies as opposed to doing it ourselves? The most important reason is that O2O businesses require significant domain expertise, as well as significant offline execution capabilities. These are not particularly the strongest suite of a technology and product-focused company like us. By partnering, we can actually leverage the skills owned by the best-in-class management in the entire market.

In addition, we can also increase our capital efficiency by investing in multiple companies and multiple category leaders and achieve best overall consumer experience.

Now, as to the future of O2O companies, we believe that while many of them are still in investment mode in the near-term, but over time, we believe that our investment in these leading O2O companies would generate significant value as these companies gain better efficiency in business processes as well as achieve economies of scale when their businesses continue to grow rapidly.

In addition to that, we believe the O2O activities also help you deepen a mobile payment habit among our users. Our mobile payment solutions, Weixin Pay and QQ Wallet, have grown rapidly to produce a synergistic relationship with our O2O ecosystem. They're now more than 200 million users with bank cards bound to Weixin Pay and QQ Wallet. This impressive growth was initially driven by C2C transactions among users such as red envelope gifting and money transfer. And now, it is increasingly expanding to commercial payment, such as O2O activities, utilities payments, as well as eCommerce.

Weixin Pay and QQ Wallet are very important building blocks in our overall ecosystem. We're doing a number of things to grow user adoption and deepen payment habit among our users. Firstly, we invest in technologies to upgrade our product, as well as to enhance the security protection for our users. Secondly, our key O2O partners, such as Didi-Kuaidi, Meituan-Dianping and 58.com generate millions of transactions per day. By integrating Weixin Pay and QQ Wallet to their platforms will leverage these high-frequency payments scenarios to deepen user's habit of using our mobile payment solutions and at the same time will also drive traffic through our important O2O partners.

Thirdly, we encourage repeated usage of the users by subsidizing the bulk of the bank handling charges to the users. Although, we are now incurring significant costs as a result, we believe that these subsidies are worthy investments for the future.

As our mobile payment solutions continue to gain traction, our ecosystem can be more useful to our partners, where consumers can find what they need, interact with merchants and complete transactions in a seamless manner.

And with that, I'll pass to James to talk about the business review.

James Gordon Mitchell

Thank you, Martin. In the third quarter of 2015, our total revenue increased 34% year-on-year and, excluding eCommerce transactions, grew 37% year-on-year. VAS represented 77% of our revenue, within which games contributed 54% and social networks 23%. Online advertising represented 19% of our revenue, up seven percentage points year-on-year.

For value added services, segment revenue was RMB 20.5 billion, up 28% year-on-year and up 12% quarter-on-quarter. Social networks revenue was RMB 6.2 billion, up 32% year-on-year and up 14% quarter-on-quarter. Our Super VIP privileged subscription service, premium content subscriptions and item sales drove the growth.

Online games revenue was RMB 14.3 billion, up 27% year-on-year and up 11% quarter-on-quarter. New smartphone games and the strong performance of advanced casual games delivered the year-on-year growth, while new smartphone games and positive seasonality contributed to the quarter-on-quarter increase.

Looking at social networks and starting with Mobile QQ, enriched functionalities with specific types of QQ groups, such as project assignments for students and friend-finding for nearby groups. We introduced celebrity-themed fonts, stickers and chat bubbles to make messaging friends more fun and more engaging. With our QQ Wallet product, we are leveraging red envelope gifting to drive greater QQ Wallet adoption.

For Weixin, we upgraded voice and video technologies to support nine-party video conferencing. We added group chat management features, such as a publishing tool for group announcements. And for Weixin Pay, we've seen very rapid growth in consumer-to-consumer transactions over the last two years. More recently, Weixin Pay has started to experience a surge in money transfer, eCommerce and O2O transactions.

Looking at our PC client games, average concurrent users for our advanced casual games grew 14% year-on-year to 8.7 million, reflecting deeper engagement within our key genres. Average concurrent users for massively multiplayer games were flat year-on-year, stabilizing after several quarters of declines.

Within the major game genres, for our battle arena games, League of Legends sustained healthy total user growth and expanded its paying user base with new limited edition skins. Within our shooting games, we organized several eSports events, such as the national finals for CrossFire and city matches for Assault Fire.

For our sports games, we're looking for new users with co-marketing activities such as cross-promoting FIFA Online 3 with a new reality TV show and cross-promoting our NBA 2K Online basketball game with specialized programming on our video platform.

And for massively multiplayer games, we put two new games, Moonlight Blade and ArcheAge, into large scale open beta testing in the third quarter and these contributed to the sequential uptick in average concurrent users.

For smartphone games during the third quarter, we began implementing new developments and publishing strategies for specific types of gaming experiences. For example, for content-driven games such role-playing games, which generate most of the mobile game industry's revenue today, we're launching titles based on proven IPs and targeting them at existing fan communities. For example, our new RPG and battle card games, Legend of MIR 2 and King of Fighters '98, ranked within the top five revenue grossing games in China in September.

For gameplay-driven titles such as shooting and action games, which we expect to become increasingly important in the future, we're building on our PC experiences to launch innovative titles that should define and popularize their genres. For example, our shooting and battle arena games, WeFire and MOBA, are leaders in their emerging categories.

And for platform-driven titles, such as board and playing card games, which generate low ARPU but high daily active usage, we're leveraging Weixin and QQ to drive activity into our titles and maximize their social impact. For example, our playing card puzzle and Mahjong games each have millions or tens of millions of daily active users.

While it's still early days for these new strategies, the initial results are quite encouraging. We generated RMB 5.3 billion in smartphone game revenue in the third quarter, up 60% year-on-year on a gross-to-gross basis, and up 18% quarter-on-quarter. Out of the 12 new titles we launched in the quarter, eight were mid-core. And according to App Annie data, we operated 5 of the top 10 grossing titles in China during the third quarter of the year.

Moving on to online advertising, segment revenue doubled year-on-year to RMB 4.9 billion and rose 21% quarter-on-quarter. Our brand advertising revenue was RMB 2.5 billion, up 67% year-on-year and 27% quarter-on-quarter. More traffic in our video and news apps drove the year-on-year growth. The Voice of China 4 program and monetization of our news app contributed to the sequential growth.

Performance advertising revenue was RMB 2.4 billion, up 160% year-on-year and up 16% quarter-on-quarter. Mobile inventory, fill rates and pricing all contributed to the year-on-year growth. Revenue grew sequentially due to higher click-through rates and CPCs on our Weixin Official Account ads and more impressions in our mobile ad network.

Taking a closer look at our media brand advertising, we gained market share across our top five advertiser categories, namely food and beverage, automobile, personal care, online services and consumer electronics. In video, if we add together the video views within our Tencent Video app and the video views inside Weixin Official Accounts, we enjoy increasingly clear mobile traffic leadership. Compared with the same quarter a year ago, our average daily video views within our video app almost doubled and our average daily video views within Weixin Official Accounts quadrupled.

Consequently, our mobile advertising inventory more than doubled year-on-year, resulting in our video advertising revenue in total almost doubling year-on-year. We continue investing in high-quality content, licensing live sports broadcasts and movies as well as online drama series. In news, we improved mobile sell-through rates and revenue by shifting to selling more paid feed ads on a CPM basis.

For social performance advertising, we continued to carefully control ad loads but grew revenue rapidly nonetheless by enhancing our targeting capabilities and broadening our advertiser client base. Looking at some of our major social ad inventories, Qzone CPC increased year-on-year due to more bidders and better targeting. Weixin Official Accounts ad impressions more than tripled year-on-year. Weixin Moments ad campaigns increased quarter-on-quarter as we lowered the minimum ad spend threshold to RMB 200,000 per city and added new verticals such as travel and real estate advertisers.

And finally our mobile ad network traffic partners impression volumes grew significantly year-on-year from a low base.

And I'll now pass on to John to walk through the financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the third quarter of 2015, our total revenue was RMB 26.6 billion, up 34% year-on-year or 14% quarter-on-quarter. Gross profit was RMB 15.6 billion, up 23% year-on-year or 8% quarter-on-quarter. Other gains of RMB 614 million in the third quarter primarily reflected disposal and deemed disposal gains arising from 58.com and other investee companies, which was partly offset by impairment provisions for certain investee companies.

Operating profit was RMB 10.3 billion, up 37% year-on-year or 3% quarter-on-quarter. Net finance costs of RMB 481 million in the third quarter mainly reflected interest expense on debt balance in the third quarter as well as foreign exchange losses of about RMB 108 million, mainly arising from renminbi depreciation.

The increase in share of losses associated in joint ventures mainly reflected additional loss related to one-off non-GAAP expenses incurred by associates. Income tax expenses were RMB 1.6 billion, up 13% year-on-year or down 15% quarter-on-quarter. Effective tax rate for the quarter was 17%. Net profit attributable to shareholders was RMB 7.4 billion, up 32% year-on-year or 2% quarter-on-quarter.

Looking at non-GAAP, operating profit for the quarter was RMB 10.5 billion, up 27% year-on-year or 2% quarter-on-quarter. Net profit attributable to shareholders was RMB 8.3 billion, up 26% year-on-year, or 4% quarter-on-quarter. Diluted EPS was RMB 0.881 for the quarter.

Turning to segment gross margin, gross margin for value added services was 64%, roughly flat year-on-year on a gross-to-gross basis and down two percentage points quarter-on-quarter. Sequential dip in gross margins primarily resulted from a mix shift towards lower margin third-party smartphone games revenue and higher channel costs in the third quarter. Gross margin for online advertising was 49%, down three percentage points year-on-year and quarter-on-quarter. The lower gross margin mainly flowed from higher video content costs.

Moving to operating expenses, selling and marketing expense was RMB 2 billion, up 7% year-on-year or 28% quarter-on-quarter. The year-on-year increase was a result of greater staff costs and advertising spending which was partly offset by reduced marketing expenses for WeChat. The sequential jump was mainly driven by greater advertising spending to promote key products such as online games, online media and mobile utilities; some of which are seasonal in nature.

G&A expense was RMB 4.4 billion, up 16% year-on-year or 9% quarter-on-quarter, of which R&D expense was RMB 2.5 billion, up 21% year-on-year or 19% quarter-on-quarter. G&A expense increased due to increased R&D expenses. As a percentage of quarterly revenue, selling and marketing expense was 8% and G&A was 16%. R&D represented 9% of quarterly revenue and share-based compensation was approximately 3% of quarterly revenue. As at quarter end, we had just over 30,000 employees, representing a 15% increase year-on-year or 7% quarter-on-quarter. Campus recruitment was the driver behind head count growth sequentially.

Looking at margin ratios for the third quarter, gross margin was 58.6%. It was down 3.5 percentage points year-on-year on a gross-to-gross basis and down three percentage points quarter-on-quarter. Increased video content costs and bank handling fees on money transfers using our mobile payment solutions drove margins lower year-on-year. Sequentially, the mix shift due to lower margin third-party smartphone games and increased channel costs from smartphone games were additional factors that compressed margins.

Non-GAAP operating margin was 39.5%. It was down 1.1 percentage points year-on-year on a gross-to-gross basis or down 4.5 percentage points quarter-on-quarter. Lower operating margins year-on-year reflected lower gross margins, partly offset by reduced operating expense as a proportion of total revenues. The sequential drop mainly flowed from lower gross margins and higher selling and marketing expense as a proportion of total revenues.

Non-GAAP net margin was 31.8%. It was down 0.8 percentage point year-on-year on a gross-to-gross basis or down 2.7 percentage points quarter-on-quarter. The sequential decrease was due to lower operating margin, partly offset by reduced income tax expense as a proportion of total revenues.

For the third quarter, total CapEx was RMB 1.7 billion, up 56% year-on-year or down 42% quarter-on-quarter.

Operating CapEx was RMB 1.2 billion, up 94% year-on-year or 45% quarter-on-quarter. The increase was primarily for the purchase of service to support business operations. Non-operating CapEx was RMB 498 million, up 7% year-on-year or down 76% quarter-on-quarter. Non-operating CapEx was significantly lower quarter-on-quarter because we had CapEx for land use rights in the second quarter.

Free cash flow was RMB 6.6 billion, down 5% year-on-year and up 22% quarter-on-quarter. Free cash flow in the third quarter reflected higher operating cash flow, partly offset by payment for land use rights and service.

Our net cash position at quarter end was RMB 21.2 billion, flat year-on-year and down 2% quarter-on-quarter. Slight sequential decline in net cash mainly reflect the exchange losses on bank borrowings and notes payable denominated in U.S. dollars. Fair market value of our listed associates and available-for-sale financial assets was approximately RMB 73 billion as at quarter end.

This concludes our presentation. Thank you.

Catherine Chan

Thank you, operator. We'll open the floor for questions now. And we will take one question and one follow-up in every turn. And we'd actually prefer the others to go back on the queue and do a second time if they have any more questions. Please, operator, let's take the first question.

Q&A

Operator

Thank you. [Operator Instructions] Your first question comes from the line of Eddie Leung from Merrill Lynch. Please ask your questions.

<Q - Eddie Leung>: Hi. Good evening. Thank you for taking my questions. Just wanted to understand how your O2O ecosystem benefits your advertising business? Could you share more color on that front? Any metrics will be helpful. And then just a housekeeping question, I wonder if you mind to share the ARPU of various types of your games? Thank you.

<A - Chi Ping Lau>: Yes. In terms of the O2O ecosystem, I think right now, we are still in the process of building the ecosystem. So, there's not a lot of meaningful revenue contributed on that advertising side. But sort of if you take the eCommerce ecosystem as an example or precedent, what we see is as we work with each one of the eCommerce network, and the biggest being JD, for example, because JD itself has got an open platform which hosts a large number of merchants.

When we work with JD, we're able to convert a lot of those merchants into advertising clients on our platform. And effectively, JD's advertising platform would take in the advertising dollars from its own merchants. And then, in order to get additional traffic, it would actually put some of the money in our own performance-based advertising system. And as a result, a lot of the merchants on the JD network become our own advertisers.

As we look into the O2O space, the O2O space is a big movement in which there will be platform companies, which helps the merchants within particular verticals to become online, right? So, in the case of, for example, in the future, right, we look at Dianping and we look at Meituan, when they host a lot of restaurants and when they host a lot of offline services companies, they can actually convert some of the merchants into our advertisers.

Likewise, for 58, for example, when they host a number of different advertisers on their platform, be it companies which are trying to hire people, be it agencies which are trying to sort of promote their services, in the future, when we have these connections to their advertisers, our entire network of performance-based advertising inventories can actually serve them. So, right now, we're still in the process of building these links. But over time, we can actually sort of leverage them to get access to advertisers in different industries that they serve.

<A - Shek Hon Lo>: In relation to ARPUs, for MMOG, quarterly ARPU ranges from RMB 145 to RMB 455. For advanced casual games, it ranges from RMB 80 to RMB 270. And for smartphone mobile games, we look at this as a performance as a whole, it'd be within RMB 170 to RMB 180 on a quarterly basis.

Operator

Thank you. Your next question comes from the line of Wendy Huang from Macquarie. Please ask your questions.

<Q - Wendy Huang>: Thank you. My first question is regarding the bank handling fee you mentioned for the C2C money transfers. Was it actually mainly related to the red envelope issued in the WeChat platform? And I noticed that cost of revenues for others almost doubled to RMB 1.1 billion. So, is this amount actually mostly related to this, the bank handling fee?

And second question is regarding your ambition in the travel space. So, currently, you're holding 15% in Tongcheng and 37% in eLong. What's your plan to integrate those travel assets you already invested? Or do you have other plans for the travel space? Thank you.

<A - Chi Ping Lau>: Okay. In terms of the bank handling fees, what happens is when users transfer money from either bank cards, either debit card or credit card, to our accounts or use Weixin Pay and QQ Wallet to pay merchants, we incur a bank handling charge. And for the part which I related to merchant payments, right, we actually charge the payments and we generate sort of corresponding revenue. But for the consumer-related payments, then we actually sort of incur a cost. And the cost actually is proportional to the amount.

And as you look at the two different big components, one is actually our red envelope payment scenario. And the other one is money transfers. It turns out that the red envelope is actually a small amount, but large volume type of payment scenario, whereas transfers among consumers can have much fewer transactions, but much higher amount per transaction. So a lot of that bank handling charge is actually sort of related to the second part, which is the money transfer rather than the red envelope.

So at this point in time, we're still subsidizing a lot of these bank charges. But over time, we'll think about ways to contain the bank charges, especially with respect to the higher amount per transaction type of transactions, so that we don't lose the high frequency transactions. We continue to sort of provide a lot of incentive for users to use the high frequency transactions which, by the way, constitute a small part of the overall expense. So that's our plan going forward.

<A - Shek Hon Lo>: Yes, in relation to the increase of cost in the others, you're right that a big chunk of this is attributable to the bank charges, but there are three parts of it as Martin has mentioned before. The first part is in relation to red envelope and the second part is in relation to money transfer, and the third part is in relation to our normal online payment businesses.

<A - Chi Ping Lau>: Now, in relation to the travel industry, as you have pointed out, we have investments in Tongcheng, and we have the investments in eLong. And we think each one of the two companies is actually a competent player in the overall market. And each one of them actually plays a slightly different role in the overall ecosystem which is actually very big.

So, Tongcheng is a player which focuses on scenery spots, and they are also moving into package tours, whereas eLong is actually a dedicated hotel player. And we feel that since the overall travel market is actually growing in a pretty rapid manner and the entire industry is actually moving online, we believe with the distinctive positioning of the two companies, each one of them will have pretty healthy growth going forward.

Operator

Thank you. Your next question comes from the line of Chi Tsang from HSBC. Please ask your questions.

<Q - Chi Tsang>: Hi. Thank you very much for taking my question. I had just a kind of a question. My first question relates to the Wallet. I mean, your seeing the 200 million users is a very, very impressive number. I was wondering if you can give us a little bit more color in terms of the transaction volume. How much is coming from C2C versus eCommerce, O2O? Maybe you can comment on what kind of market share you might have in mobile payment today.

And secondly, I was wondering if you can just kind of comment on how you view the current video landscape, especially after Alibaba acquiring Youku. Thank you very much.

<A - Chi Ping Lau>: What I can say in terms of Weixin Pay and QQ Wallet is that, first of all, we have seen rapid growth in terms of the number of people who have binded their bank cards, that's the first step. Last time, we have provided the number of more than 100 million, and this time around, we have exceeded 200 million.

And a pretty high proportion of these people are actually active users of the payment solution. And in terms of the payment scenarios, by far the largest is still C2C which includes by far the largest being the red envelope gifting which is very unique to the Weixin and QQ ecosystem. In addition to that, the transfers has got a pretty important volume, and the amount is actually quite big because the transfer per transaction, it's much higher than the red envelope.

Followed by that is actually O2O transactions, which is that our partners actually generate millions of O2O transactions on a daily basis. And then it's followed by utility payments, including people charging up their mobile phone cards, including people paying for different types of utilities. And then eCommerce, which constitute a smaller number of transactions but usually higher amount per transaction. So, the overall volume on eCommerce is actually quite large as well.

<A - James Gordon Mitchell>: In terms of the video industry, as you know, we were not the first mover in video. And so for us, the video industry has always been extremely competitive and it always will be somewhat competitive.

That said, we think that we've done several things that improve our competitive position and that insulate us to some extent from some of the shorter-term disruptions in the market. For example, we've purchased a large volume of very high-quality content on long-term multi-year contracts such as our NBA Basketball rights, our HBO rights, our Paramount rights, our Star Wars rights and our James Bond rights which we just announced yesterday. So, again, those are long-term multi-year contracts that don't come up for re-bid every few months.

And then, more importantly, I think that our position in video is a little bit dissimilar to the rest of the industry in that we have some unique advantages that flow from our platform. One set of advantages is our ability to drive IP across different formats, such as from our online literature business or our online game business into online video.

Another set of advantages that's becoming increasingly apparent is the growing consumption of video content within social networks. And this is something that's happening globally, if you look at the big social networks in the U.S. And we mentioned in the introductory remarks that it's also happening in China, where the video views within Weixin Official Accounts quadrupled this quarter versus the year-ago period.

<A - Catherine Chan>: Okay. Next question, please.

Operator

Thank you. Your next question comes from the line of Erica Werkun from UBS. Please ask your questions.

<Q - Erica Poon Werkun>: Thank you. If I may, just first follow up on James' comment on video. For your overall video business or movie business, how should we think about the roles of Penguin Pictures and also Tencent Pictures? And also, how do you allocate capital among these two divisions and, also, online video?

And then, a quick question on Moments advertising; could you just share, I think last quarter, you shared that you ran about 60 ads. How many ads did you run in the third quarter? And what is the split between the Fortune 500 brands and the SME? Thank you.

<A - James Gordon Mitchell>: Certainly. So, on the video front, we allocate capital based on expected return but also on the broader sort of halo impact around the platform both in the eyes of users and advertisers, which means that we often focus disproportionately on very highly-branded, high-value content in the eyes of both users and advertisers.

With regard to the two vehicles you specifically mentioned, Tencent Pictures is primarily focused on managing Tencent-sourced IP, particularly game and literature IP, and then managing that through different windows such as movie, TV series, game and so forth. You may know that as well as having the leading online game platform in China, we also have the leading online literature platform in China. And so, you're probably aware that there's been a recent trend, which we think is a persistent trend, of popular online novels becoming popular TV series, popular movies, popular games and so forth. And so, Tencent Pictures is our attempt to leverage on and accelerate that trend.

Penguin Pictures is a different vehicle, which focuses on taking stakes, usually minority stakes, in drama series that are being created, and, therefore, participating in the distribution of IP that's often sourced from outside Tencent. So, although the two are superficially similar, one of them is more focused on the IP and then, managing the IP through multiple windows, whereas the other is more focused on tapping into the single video window. So, that's on the video question.

With regards to Weixin Moments, we're progressively ramping that product up. We served over 100 advertisements in the third quarter and we continue to expand the number of advertisers, although right now, we are still primarily focused on large-sized advertisers. So, I think in the first half of the year, it's primarily Fortune 500 advertisers. During the second half of the year, we're enabling more targeting by city. And so, that's opening up some of the more kind of regional or provincial advertisers. But we're still primarily focused on bigger advertisers and we'll kind of democratize that as we move forward.

<A - Catherine Chan>: Okay. Next question, please.

Operator

Your next question comes from the line of Alan Hellawell from Deutsche Bank. Please ask your questions.

<Q - Alan Hellawell>: Yes. Hi. Thank you. Taking in turn Erica's questions a bit further; with regards to Weixin, can you give us just a rough sense of what might've been the revenue contribution from Moments in the quarter? And I'm not sure, maybe you mentioned this, how many P4P advertisers do we have currently? And how would we envision that growing maybe over the next year? And then one small other question; what is the current revenue share with Official Account owners? And is that likely to change? Thank you very much.

<A - James Gordon Mitchell>: Sure. So, a number of questions. I think that with regards to Weixin Moments, we don't disclose the exact breakdown, but within our performance advertising business, some of the bigger contributors include advertising on Mobile Qzone, advertising on the Weixin Official Accounts, advertising on our mobile ad network, advertising on Weixin Moments, also advertising within our app store and our mobile browser. So there's a range of different contributors, and Weixin Moments is a meaningful, but certainly not the biggest line of those numerous advertisers.

In terms of the number of advertisers, I think you're asking about the number of advertisers on our performance advertising platform in total. So that would be in the ten thousands. That number is up over 50% year-on-year. And we have some initiatives that we think may accelerate the growth in number of advertisers going forward, that we're seeking to develop.

In terms of the revenue share with the Official Account owners, so these are situations where an advertiser buys an ad at the bottom of an Official Account within Weixin, and then we'll share that advertising revenue with the owner of the Official Account. We have a sort of sliding scale based on the nature of the content. But the owner of that content might capture roughly half of the advertising revenue, depending on where he falls in that scale.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Your next question comes from the line of Dick Wei from Credit Suisse. Please ask your questions.

<Q - Dick Wei>: Hi. Yes. I got two questions. First question is on how should we look at the IVAS gross margin trend going forward? I think there are a couple of dynamics about in-house games, third-party games, as well as Android, iOS. I wonder how should we think about those trends going forward? And then secondly, as the shareholder of Meituan-Dianping, what is currently Tencent thinking about the right strategy for the company growth, in terms of the strategy, technology and subsidies? Thank you.

<A - Chi Ping Lau>: Okay. Well, in terms of IVAS, so that's a pretty big basket, right. I think there are two components, right? One is obviously the games. And in terms of the games, as you can see, we have actually delivered a pretty consistent growth or those that are slower than before but consistent growth on our PC games and that's actually sort of mainly driven by our main games, including most prominently League of Legends.

In terms of mobile games, which is sort of the segment that's really gaining traction as overall gaming sector, we have put in a new strategy as we mentioned in our last conference call in that if you think about in the past, right, the key component of our strategy was actually putting our mobile games on our two important social platforms. One is Weixin. The other one is QQ.

But over time, we started to leverage the two platforms as well as leverage our YingYongBao as well as our browser to push for, to find more channels and traffic as well as more context to promote games to our users. And then in terms of the content itself, we have actually moved from the casual games into mid-core games, now into more hardcore games. And as you move from these game genres, typically, you will see fewer players, but higher ARPU. So, the ability to do a more target advertising is actually important.

So, our strategy actually also involve us identifying pockets of users which may be interested in certain harder core genres and promoting those genres to these users. And as you can see in our latest MMOG on mobile, it's actually quite successful. We still believe that the mobile game segment has got good growth opportunity. We'll continue to execute our new strategy to tap into that opportunity.

Now with respect to Meituan and Dianping, I think we are a relatively small shareholder in the company right now. And we feel that the two companies, by merging has established a very strong presence within the O2O space, both in terms of the restaurants, as well as other lifestyle services, as well as the food delivery part.

So, over time, we believe that they would be able to establish stronger economies of scale. They will also be able to not only just do the transactions right, but also, get deeper into the entire value chain so that they can create more value for their merchants, as well as for their consumers. And as mentioned in our O2O strategy section, right, we believe that our ecosystem can help not only them, but other O2O partners in terms of directing user traffic to them, in terms of helping them with the payment scenarios, as well as, going forward, if their network actually connects with our advertising network, we can actually help them to generate revenue and also direct even more traffic to them.

<A - Catherine Chan>: Thank you. Operator, next question, please.

Operator

Your next question comes from the line of Jin Yoon from Mizuho Securities. Please ask your question.

<Q - Jin-Kyu Yoon>: Hey, good evening, guys. Just a couple of more questions on Moments; can you just talk about what are the current ad loads on Moments looking like right now? And what are the impending – or what are the remaining impediments to kind of pushing forward with more Moments ads?

And the follow-up question is to your prior statement that you said that on WeChat Moments or on SMS advertising, you're targeting more localized advertisers. Is that advertiser acquisition going to be direct or indirect coming from agencies? And if so, what are the economics behind that? Thanks, guys.

<A - Chi Ping Lau>: In terms of the ad load right now, Moments, sort of when we first launched Moments, it was in a pilot launch mode. And then over time, we continued to scale it. But in terms of the ad load, right now, we still put in a very stringent control. Right now, a user would not see more than one ad within 48 hours, right? So, when you compare it to a lot of the other apps, this is actually very low ad load.

The reason we are doing this is this is a very important user engagement scenario for us. We want to make sure that we can get the content right. We can get the technology right. We can sort of understand the user behavior in relation to advertising. And we want to invent certain mechanisms so that we can add the fun component and add the social component around advertising.

So, there are a lot of basic things as well as innovative things that we are testing on the Moments ads. And we want to make sure their quality is high so that users would like these ads actually before we start to increase our ad load. So, that would take a process. We know that this is something that can be done over time, but we want to ensure the quality of execution along the way along the different dimensions I talked about.

Now, in terms of the localized advertisers, for now, in terms of the big advertisers, we are leveraging our own sales force to do it, and we're working with the four advertising agencies which is the typical channel. We also have a self-serve channel, which allows advertisers to upload their advertising. But that's sort of in our general inventory. But in terms of Moments right now, we are still in a pretty stringent mode which is there needs to be a pretty heavily-engaged process in which the advertiser will work with agencies and then come up with a high-quality advertising and then we put it on to the Moment. Over time, we'll continue to find other agencies, who can actually help us to source advertisers and also create campaigns that are of high quality and that will proliferate.

<A - Catherine Chan>: Thank you. Operator, in the interest of time, we shall take the last three questions, please.

Operator

Thank you. Your next question comes from the line of Cynthia Meng from Jefferies. Please ask your questions.

<Q - Cynthia Meng>: Thank you, management. I have two questions. First of all, eCommerce, the newly announced Jingdong plan, can management give us more color on the progress of your cooperation in terms of traffic directed to JD and conversion ratio that you can see from your statistics? And also, the payment from Tencent; does that also benefit JD? And then I have a follow-up question.

<A - Chi Ping Lau>: Okay. Well, the cooperation with JD has been progressing quite nicely, I would say overall. And that includes generating transactions for JD within our ecosystem, within our Weixin and Mobile QQ apps, in terms of transactions on a daily basis that has been growing on a consistent basis.

At the same time, we also find that our apps are great sources for JD to reach new consumers. So, as you know, in JD's brand and access is actually very strong in a lot of first-tier cities, but as it gets into the second-tier, third-tier, fourth-tier cities, there are still users who have not really get exposed to the service.

But through our app, a lot of these new users would put in their first order and once they discover that the user experience is great, the product is actually authentic and quality is high, fulfillment is great, then they may repeat purchase within Weixin or Mobile QQ. And at the same time, they may just download an app and start buying through the JD app.

So, from a new user acquisition perspective, we actually contribute quite a large proportion of the new users to JD, especially on the mobile side. Now the new – well, in addition to that, we also talked about the cooperation around ad networks, right? A lot of our traffic is actually directed to JD's advertising system for them to present these inventories to their merchants and that actually is a good way for them to bring more traffic to their merchants.

The recent Jingdong plan is really for us to create more CRM and more marketing opportunities for high-quality brands that sell on JD and that would include advertising inventories, that would include a better promotion of the Official Accounts, and that would also include some specific entry points for some of these good brands.

So, overall, I think the relationship as well as the performance of our cooperation is actually progressing well as well as going from strength to strength.

<Q - Cynthia Meng>: Thank you, Martin. My follow-up question is in the area of mobile game. Mobile game has shown very strong growth this quarter compared to last quarter. I know some of that is related to product launch delay in the second quarter. Is there something else that has driven the rebound? Is it related to the overall industry or an uptake in the more sophisticated hardcore games? Thank you.

<A - James Gordon Mitchell>: I think the major change is a change in strategy. We had a mobile game strategy that we were executing from late 2013 until early 2015. We recognized that as the mobile game industry matured and segmented, it was time to adjust our strategy. We came up with the new strategy during the second quarter, during which time we actually delayed several key new title launches while we were preparing a new strategy. And then we began to implement the new strategy in the third quarter. And I think that internal change was the primary dynamic.

<A - Catherine Chan>: Thank you. Next question, please.

Operator

Thank you. Your next question comes from the line of Alicia Yap from Barclays. Please ask your questions.

<Q - Alicia Yap>: Hi. Good evening, everyone. Thanks for taking my questions. I have couple of questions. Number one is that could you actually give us a little bit more detail how this Official Account advertising is progressing? And how is that, for example, now, this quarter versus three months ago or six months ago. And then second, I have a broader question on the video industry landscape. So will video to be a winner takes all or the landscape will remain to have multiple players?

Related to that, it seems like all the major online video platforms are trying to own or secure as many differentiated content as possible to attract user. And with the takeoff of the video subscription service, what is the management view regarding the consumer behavior over time on the subscription side? Will one platform stand out to win more user or do you think that user could potentially subscribe to multiple video sites? And then the attractive content will still be a swing factor?

And then lastly, just related to that is that when should we expect Tencent Video to turn profitable? Thank you.

<A - James Gordon Mitchell>: So in terms of the Official Accounts, I believe we launched advertising in the Official Accounts in the third quarter last year. It's actually a very powerful advertising medium. I think more powerful than many people in the financial community recognize. And that's first because there's a gigantic volume of page views in the Official Accounts each day. We're talking in the billions of impressions.

And secondly because advertising within the Official Accounts can use dual targeting technologies, one based on the social profile of the Weixin or now the QQ user which we know is very powerful from the ads we have in Qzone and Moments and so forth. And then secondly, based on the content of the Official Accounts itself. So, we're actually seeing very good growth in Official Accounts. We mentioned the inventory tripled year-on-year, good growth in CPC, very high click-through rates, and we're quite optimistic about the future.

One change we have made is that in the past, we had a flat fee or a flat rate revenue share with the Official Account content creators. Now, we actually channel a bigger proportion of the revenue to those Official Account owners, who create original content into their Official Account first and then a lesser share to those who simply repurpose Web-based content into the Official Account. And that's having the desired impact of driving more original content creation both text, image and now video within the Official Accounts. So, that's the Official Accounts.

On the online video side of the business, I think you touched on an interesting issue, which is that, all else equal, an advertising-funded video world is more likely to be fragmented between multiple channels, whereas a subscription-funded video world tends to consolidate a little bit more because it's easier for the consumer to change channels than it is for them to cancel one subscription account and subscribe to a new subscription account.

So, all else equal, while I think that both formats, ad-funded and subscription-funded, are super competitive today, will remain super competitive in the future, at the margin, the subscription-funded business will probably be a little bit more consolidated and the ad-funded business will probably remain more fragmented.

In terms of user behavior, I think that – I mean, I can give you a mix of quantifiables and qualitative factors. On the quantitative side, what's interesting is that the habit of watching subscription video is something that's truly nationwide. It's still relatively concentrated in terms of age group and the type of content people pay for which is top tier local drama serials, Western drama serials, Western movies and Western sports. But it's a habit that's evolved nationwide.

In terms of qualitative, if you look at the comments people put on to the subscription-funded comment, a year ago, it was all about how can I watch this for free, which other sites have this for free? Now people have largely kind of grown through that and they're much more inclined to actually discuss the merits or drawbacks of the content itself, which is an encouraging signal. I think it reflects the fact that the willingness to subscribe or the willingness to pay in order to watch high-quality video content has increasingly embedded. And that's something that's benefited the whole industry.

So, our own subscription revenue, video revenue is up about 800% year-on-year. But I think that's off the low base than many of our peers are seeing similarly rapid year-on-year revenue growth rates for the subscription video service.

In terms of bringing the video business in aggregate to profitability, that's not a near-term target for us. Right now, what we're seeing is that as we spend more money on content, we attract more users which generates more revenue and enhances our platform quality. And so, we continue to reinvest in content rather than focusing on near-term profitability.

<A - Chi Ping Lau>: I just want to add, we don't look at the video platform in isolation. We believe that the video platform is actually a very important part of our overall traffic ecosystem. And as we look at – as an engagement tool, it actually just generates a very engaging time – amount of time with the users. And at the same time, when you look at our overall IP strategy which is get us into the literature which help us to monetize through the content as well as games.

We believe a lot of these different platforms actually will work together, and the overall profitability, right, of the entire ecosystem will be bigger than the individual platforms on an aggregate basis. So, I think that's the strategic importance of our overall video platform.

<A - Catherine Chan>: Thank you, Martin. We will take the last questions, please.

<Q - Alicia Yap>: Great. Thanks.

Operator

Thank you. Your last question comes from the line of Thomas Chong from Citigroup. Please ask your questions.

<Q - Thomas Chong>: Hi. Thanks, management, for taking my questions. I have two questions. The first question is about how we should think about the competitive landscape of the mobile games market next year because we see Tencent and that you're already consolidating the market. And for the CrossFire and D&F for the mobile games, should we expect these two to be a blockbuster? Is there any color on that front?

And my second question is about the margin trend. The management talks about how we should think about the margin trend going forward. Should we expect it to be year-on-year increase, stable? Any color would be great. Thank you.

<A - James Gordon Mitchell>: I think that in terms of the mobile game market, you're correct to observe that NetEase and Tencent have taken some share of the mobile game market this year and more importantly have enjoyed some sort of stability in terms of both of us having multiple games within the top 10 games by revenue month in, month out. I think that's the sort of trend that we're seeing globally in terms of the – some of the bigger, more established mobile game developers in the United States and Europe and Japan and Korea enjoying enhanced market share and more importantly greater revenue stability from their mobile games.

And I think it reflects structural changes in how easily consumers can discover new mobile games, the ability to update and enhance the player experience within the big existing mobile games and so forth. So, that's something that's generally worked to the benefit of the stronger mobile game developers and publishers in the industry.

With regards to specific new mobile games, we're obviously optimistic, otherwise, we wouldn't be publishing the titles. But time will tell how successful they become. I think in terms of margins, as you know, we generally don't give margin guidance. You should be aware that in the third quarter, we're still lapping the change in our accounting from net to gross. And that effect will drop out of the year-on-year comparisons going forward.

And looking forward, we'll continue to bear some costs related to the growth of our payment business. We'll continue to bear some costs related to the growth of our video business. In the third quarter, you saw some impact on our Internet VAS gross margins, because some of our newer mobile games, A, have a revenue share to the third-party developer; and, B, for various reasons skew more toward iOS than Android.

And to the extent that our future mobile games are also third-party and also skewing more toward iOS than Android, that would have some impact on margins. But it's not something that particularly bothers us given the incremental margin on those third-party iOS skew in mobile games. It's still a very healthy incremental margin relative to our overall corporate operating margin, even if it's not as good as first-party game that's largely on Android. So, anyway, those are just some of the things to think about when you're thinking about our margins.

<Q - Thomas Chong>: Thanks.

Catherine Chan

Okay. Okay. Thank you very much, operator. We are rounding up the call now. If you wish to check our press release and other financial information, please visit our corporate website at www.tencent.com/ir. We'll post a replay of this webcast on the site shortly. Thank you and see you next quarter.

Operator

Thank you. That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2015 third quarter results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2015-08-12
Event Description: Q2 2015 Earnings Call

Market Cap: 1.27TRI
Current PX: 134.90
YTD Change($): +22.40
YTD Change(%): +19.911

Bloomberg Estimates - EPS
Current Quarter: 0.867
Current Year: 3.344
Bloomberg Estimates - Sales
Current Quarter: 25841.200
Current Year: 100028.800

Q2 2015 Earnings Call

Company Participants

- Catherine Chan
- Huateng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Alicia Yap
- Wendy Huang
- Cynthia Meng
- Natalie Wu
- Dick Wei
- Erica Poon Werkun
- Eddie Leung
- George Alan Hellawell
- Thomas Chong
- Piyush Mubayi

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Tencent Holdings Limited 2015 Second Quarter and Interim Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you, operator. Good evening. Welcome to the second quarter of 2015 results conference call. I'm Catherine Chan from the IR team of Tencent. Before we start the presentation, we would like to remind you that it includes forward-looking statements which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions that's coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for measures of the Company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and our non-GAAP measures, please refer to our disclosure documents downloadable on www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We have our Chairman and CEO, Mr. Pony Ma; President, Mr. Martin Lau; Chief Strategy Officer, Mr. James Mitchell; and Chief Financial Officer, Mr. John Lo.

Pony will kick off with a short overview; Martin will speak to strategy; James will review our business, and John will go through the financials before we take your questions.

I'll now turn the call over to Pony.

Huateng Ma

Thank you, Catherine. Good evening. Thank you for joining us. During the second quarter of 2015, we maintained our leadership across our social, games, and media platforms. Operationally, we made notable progress across our portfolio of mobile utilities with our Mobile Manager security service, and Mobile QQ browser and YingYongBao app store moving into industry leadership positions.

Strategically, we achieved rapid growth of our mobile payment solutions and expand the subscriber base for our premium literature, music and video services. Financially, we delivered a solid set of results benefiting from the growth of our online advertising.

Let me highlight a few numbers for you and leave the details to John's financial section. Total revenue, excluding eCommerce transactions, grew 27% year-on-year to RMB23.3 billion. Sequentially, it rose 5%. Non-GAAP operating profit was RMB10.3 billion, up 34% year-on-year and 10% quarter-on-quarter. Non-GAAP operating margin crept up 2 percentage points to 44% for the quarter. Non-GAAP net profit to shareholders was RMB8.0 billion, up 32% year-on-year and 11% quarter-on-quarter.

For our key platforms, total MAU for QQ was 843 million, within which smart devices' MAU grew 20% year-on-year to 627 million. Total MAU for Qzone was 659 million, within which smart devices' MAU rose 15% year-on-year to 574 million. Weixin and WeChat reached combined MAU of 600 million, up 37% year-on-year.

For online games platform, we retained leadership across PC client, web and mobile games in terms of users and revenues. We are adapting our strategies for mobile games to the changing market conditions, and James will discuss this in the business review section.

And now our media platforms. Our mobile news is the most popular among Internet users in China. Our mobile video service more than doubled its video traffic year-on-year, anchoring our leadership across PC and mobile. For our mobile utilities portfolio, we recently achieved significant milestones in product performance and market share. Martin will share more with you in the strategic highlight section.

With that, I will pass to Martin.

Chi Ping Lau

Thank you, Pony, and good evening and good morning to everybody. For this quarter's strategic highlight, I'd like to highlight the breakthrough that we have achieved in our mobile utilities. Our mobile utilities include security, browser, and app store, and they're fundamental in providing the infrastructural support to our expanding mobile ecosystem. This portfolio of mobile utility service is very valuable to us where they technically support each other to deliver a seamless product experience to our users and also across channel traffic to our partners in the ecosystem. Each one of these apps rank within the top 20 mobile apps in China in terms of MAU.

On its own, our Mobile Manager ensures a secure environment for digital consumption and transactions online. Mobile QQ browser and YingYongBao respectively provide our users quick access to a broad mix of web-based and app-based content and services. Together, the trio allowed us to establish constructive relationship with a very large number of industry partners.

Benefiting from our overall mobile social franchise, as well as our continuous efforts on product innovation and performance enhancement, we're able to leap from a late entrant to a market leader in each one of these areas. Recently, we are beginning to see the financial benefits materialize through advertising in Mobile QQ browser and in app user spending in YingYongBao app store. I'll discuss each one of these mobile utilities in turn.

Starting with our security service Mobile Manager, according to QuestMobile our mobile security app gained market share continuously in terms of monthly active users in the past years and in the most recent month, overtook the incumbent industry leader. How do we achieve this? We provide best-in-class performance across core protection features such as virus scanning, cleaning and speed boosting. We innovate and differentiate our product offering by investing to enhance our capabilities especially in payment security and antifraud phone database. This enabled us to earn trust and credibility from users.

In addition to our standalone security app, we are also building a network of partners including handset manufacturers, RAM developers and O2O partners offering them our mobile security solution through software development kit, as well as open API. Our standalone app and security solution together now protect over 60% of Android smartphones, and support leading Android app stores in China. We believe a neutral and secure online environment is crucial to the development of our mobile ecosystem in China, and our mobile security service ensured this is the case.

Turning to Mobile QQ browser, our standalone app has evolved into a platform that supports HTML5 websites and provides quick access to digital content such as video and literature to our users. According to QuestMobile data for June, our mobile browser had achieved the number position by monthly active users.

We are gradually monetizing browser traffic through advertising. In addition to our standalone app, we also use our browser kernel to support Tencent browser service, which enables viewing of web-based content within non-browser apps such as Weixin, Mobile QQ and many of our partners' apps. As these apps continue to attract users and serve content via out browsing solution, we saw very heavy volume of page views traffic and monthly active users on Tencent Browser Service exceeding any standalone mobile browsers in China.

Moving on to YingYongBao App Store, our market share by monthly active users doubled in the last 12 months to make YingYongBao the second most popular Android app store in China according to iResearch. We believe we lead the industry in terms of the total number of apps available and in terms of the speed of bringing updates from the majority of top app store users.

Leveraging our mobile social franchise, we have refined our targeted recommendation based on social and interest graphs, and we're working with partners to deep link in-app content. These efforts enhanced the overall user experience, the download conversion, as well as the revisits to our app store, thereby enabling us to increase our market share on a consistent basis.

On a monetization front, we have implemented revenue-sharing arrangements with game developers and are also testing our cost per download advertising. So, with that, I'll pass to James to talk about our business review.

James Gordon Mitchell

Thank you, Martin. In the second quarter of 2015, our total revenue grew 19% year-on-year. Excluding eCommerce transactions, total revenue increased 27% year-on-year. VAS represented 79% of our revenue within which online games contributed 56% and social networks 23%. Online advertising represented 17% of total revenue, up 7 percentage points year-on-year.

For our Value Added Services, segment revenue was RMB18.4 billion, up 17% year-on-year and down 1% quarter-on-quarter. Social networks revenue was RMB5.4 billion, up 18% year-on-year and up 3% quarter-on-quarter. Premium subscription packages and item-based content drove the year-on-year revenue growth, while subscriptions from mobile privileges into premium literature, music and video services led the sequential revenue increase.

Online games revenue was RMB13 billion, up 17% year-on-year and down 3% quarter-on-quarter. Revenue grew year-on-year due to higher monetization of core PC gamers and to contributions from new smartphone games. Adverse seasonality for PC games in the second quarter resulted in the sequential revenue decline.

Looking at social networks, the Mobile QQ, we enabled direct streaming of music, books, comics and videos to deepen user engagements and promote digital content purchases.

We integrated access to over 200,000 Interest Tribes into Mobile QQ to facilitate discovery of popular chat topics such as celebrities, sports and movies.

For Mobile Qzone, we introduced the smartphone storyline and new photo-editing features that boosted photo-sharing activity. Average daily photo uploads increased 70% year-on-year in June.

For Weixin, broader use of digital red envelopes in everyday social interactions and corporate marketing events led to a dramatic increase in payment transaction volume year-on-year. We're encouraging concept producers to enhance the quality of their content through sharing our advertising revenue with them and through incentive schemes such as enabling users to send cash rewards to creators of especially interesting content. We have connected users in 47 cities to local health, transport, utilities, and municipal services as part of our Internet Plus strategy.

Looking at PC client games, total average concurrent users increased year-on-year, although the mix shift from massively multiplayer online games to advanced casual games continued. Within advanced casual games, League of Legends grew users and increased monetization through new skins and gifts packs.

We're enhancing our sports games, FIFA Online 3 and NBA 2K Online, by tying them more closely into high-profile sports events such as the new NBA Season where we hold exclusive China Online distribution rights.

We are investing time and energy into e-sports activities, which we believe enhance community activity around our games and so contribute to a game's longevity. We organized some of the most watched e-sports events in China.

For massively multiplayer online games we saw lower average concurrent users and higher spending per user year-on-year. In early July, we had begun large-scale beta testing of Moonlight Blade, a new self-developed martial arts RPG. Initial user feedback is positive and we're internally testing several high-profile new titles, including Monster Hunter Online.

For smartphone games, we generated revenue of RMB4.5 billion in the second quarter, up 11 % year-on-year on a gross-to-gross basis and up 1% quarter-on-quarter. We remain the largest platform for smartphone games in China, operating the top titles in the playing card, shooting, running and fighter plane genres.

We are implementing several strategies to extend our leadership and to benefit from the increase in user propensity to spend money on mid-core mobile games. Specifically, over the coming months you'll see us exporting some of our most popular PC game IPs on to mobile. We are also bringing some of our PC game best practices in the areas of testing, marketing and operations to mobile so as to encourage user engagement, enhanced user spending and extend game's life cycle. We're developing new internal marketing resources to promote games more broadly.

In the Red Sea categories that are well developed and intensely competitive, such as battle card and role-playing games, we're focusing our key marketing resources more tightly on our most promising titles to cut through the industry clutter. And we are developing high-quality games in blue ocean genres such as action, role-playing and tower defense to cultivate new user behaviors, as we have already done with our WeFire shooting game.

Moving to online advertising, segment revenue was RMB4.1 billion, up 97% year-on-year and up 50% quarter-on-quarter. Mobile contributed over 60% of our total advertising revenue. Our brand advertising revenue was RMB2 billion, up 47% year-on-year and up 45% quarter-on-quarter. Year-on-year revenue growth flowed from increased video traffic and higher sell-through of mobile ad inventories to both portal and video. Quarter-on-quarter revenue growth positive, benefited from positive seasonality.

Our performance advertising revenue was RMB2.1 billion, up over 100% year-on-year and up 54% quarter-on-quarter. Revenue jumped year-on-year due to new ad inventories, especially in Qzone and Weixin Official Accounts and due to higher cost per click. Sequentially, increased ad impressions and positive seasonality drove the performance advertising revenue growth.

For brand advertising, we believe we again outgrew the overall market based on internal tracking. Over the past 12 months, we've gained substantial market share in three of our top five advertising categories: personal care, online services and consumer electronics. And we've sustained our market share in food and beverage and automobiles.

For our video platform, traffic increased substantially and revenue more than doubled year-on-year. Our mobile video views more than doubled year-on-year and mobile now contributes most to our video ad revenue. During the second half of 2015, we're adding more exclusive content, including Voice of China Season 4 and NBA coverage.

For our mobile news service, average daily page views and the number of advertisers both increased substantially such that our mobile news ad revenue more than doubled year-on-year and exceeded our PC portal ad revenue.

For central performance advertising, we have integrated Weixin Official Account ads into the Guangdiantong engines, simplifying the advertiser experience and increasing liquidity. The advertising base or number of advertisers on Qzone tripled year-on-year, supporting higher cost per click and overall revenue. Advertising on Weixin Official Accounts benefited from more traffic and more ad impressions.

Advertising on Weixin Moments offers significant potential, especially among brand advertisers. We're currently adding new categories of brand advertisers to the mix, including luxury products and financial services. And we ran over 60 advertisements on Weixin Moments in the second quarter. In the second half of the year, we'll continue to refine our ad formats, our ad approval processes and our ad targeting within Weixin Moments.

And with that, I'll pass you over to John to talk through the financials.

Shek Hon Lo

Thank you, James. Hello, everyone. For the second quarter of 2015, our total revenue was RMB23.4 billion, up 19% year-on-year, or 5% quarter-on-quarter. Gross profit was RMB14.4 billion, up 19% year-on-year, or 7% quarter-on-quarter. Operating profit was RMB10 billion, up 28% year-on-year, or 7% quarter-on-quarter.

Income tax expense was RMB1.8 billion, up 10% year-on-year, or 9% quarter-on-quarter. The effective tax rate for the quarter was 20%. Net profit attributable to shareholders was RMB7.3 billion, up 25% year-on-year, or 6% quarter-on-quarter.

In the second quarter, we included non-GAAP adjustments for material associated in the definition of our non-GAAP measures. We believe this will reflect a more accurate picture of our core businesses and renders us more easily comparable with peers.

Non-GAAP operating profit for the quarter was RMB10.3 billion, up 34% year-on-year, or 10% quarter-on-quarter. Non-GAAP net profit attributable to shareholders was RMB8 billion, up 32% year-on-year, or 11% quarter-on-quarter. Non-GAAP diluted EPS was RMB0.849 for the quarter.

Turning on to segment gross margin. Gross margin for Value Added Services was 66%, down 1 percentage point year-on-year on gross-to-gross basis, and up 1 percentage point quarter-on-quarter. The year-to-year dip was primarily due to increased revenue sharing cost from a larger mix of third-party smartphone games and increased channel costs. The sequential change reflected a mix shift towards higher margin first-party games in the second quarter.

Gross margin for online advertising was 52%, up 7 percentage points year-on-year, or 13 percentage points quarter-on-quarter. The higher gross margin resulted from rapid advertising revenue growth, partially offset by high sharing and content cost.

Moving to operating expenses. Selling and marketing expense was RMB1.6 billion, down 19% year-on-year, or up 21% quarter-on-quarter. The year-on-year decrease mainly reflected reduced subsidies relating to taxi booking services, while the sequential jump was a result of increased advertising spend to promote key products and mobile payment solutions.

G&A expense was RMB4 billion, up 16% year-on-year or 9% quarter-on-quarter, of which R&D expense was RMB2.1 billion, up 10% year-on-year, or 2% quarter-on-quarter. G&A expense increased mainly due to annual salary review and higher R&D expenses.

As a percentage of quarterly revenue, selling and marketing expense was 7% and G&A, 17%. R&D represented 9% of quarterly revenue. Share-based compensation was approximately 3% of quarterly revenue. As at quarter end, we had 28,072 employees, up 12% year-on-year and broadly stable quarter-on-quarter.

Looking at margin ratios for the second quarter, gross margin was 61.6%. It increased 2.1 percentage points year-on-year on a gross-to-gross basis, and increased 1.6 percentage points quarter-on-quarter.

The year-on-year increase primarily reflected a mix shift away from low margin revenues following the divesting of our eCommerce business. This sequential increase mainly reflected higher online advertising gross margin as well as mix shift to higher-margin games within our game portfolio. Non-GAAP operating margin was 44%. It was up 6.4 percentage points year-on-year on a gross-to-gross basis, and up 2 percentage points quarter-on-quarter.

Higher operating margin year-on-year benefited from higher gross margins and reduced selling and marketing expenses as a proportion of total revenues. The sequential uptick mainly fueled from higher gross margins. Non-GAAP net margin was 34.5%. It was up 4.8 percentage points year-on-year on a gross-to-gross basis and up 1.9 percentage points quarter-on-quarter.

The higher net margin year-on-year was mainly due to high operating margin, partly offset by recognized share of loss of associates as a proportion of total revenues. The sequential increase in net margin was due to a higher operating margin.

For the second quarter, total CapEx was RMB2.8 billion, up 210% year-on-year and 113% quarter-on-quarter. Operating CapEx was RMB801 million, up 38% year-on-year and 22% quarter-on-quarter. The increase in operating CapEx is primarily for the purchase of network equipment and replacement of office computers.

Non-operating CapEx was RMB2 billion, up 507% year-on-year and 202% quarter-on-quarter. Non-operating CapEx in the second quarter mainly relates to land use rights prepend construction of a new office building to support business growth.

Free cash flow was RMB5.4 billion, down 14% year-on-year and 35% quarter-on-quarter. Free cash flow decreased on higher capital expenditure paid during the quarter for the land use right mentioned above.

Our net cash position at quarter-end was RMB21.7 billion, down 4% year-on-year and 14% quarter-on-quarter. Year-on-year decline in net cash was mainly due to dividend payments of approximately RMB2.8 billion, or about $450 million in the second quarter.

Fair market value of our listed associates and available-for-sale financial assets rose to approximately RMB90 billion as of quarter-end.

This concludes our presentation. Thank you.

Catherine Chan

Thank you, operator. We shall open the floor for questions, please.

Q&A

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Alicia Yap from Barclays. Please ask your questions.

<Q - Alicia Yap>: Hi. Good morning. Can you hear me? So good evening, everyone. Thanks for taking my questions. I have a first question that can you elaborate a bit more details on your plans and strategy how to potentially increase the payment fees revenue that you could generate via your partners that integrated into the Weixin and Mobile QQ?

And related to that, can you share with us currently what are the rankings of the payment transaction volume that come through the retail payment currently? For example, after the gaming payment, the Red Packet Friends Circle transfer, what are some of the higher frequency transaction that you could monetize and your plans for increasing the fee-based income in the future?

<A - Chi Ping Lau>: Yeah. In terms of payment, I think the strategy for us is really to increase the number of users that use our payment solution; thereby, increasing the attractiveness of the payment solution to merchants, and thereby increasing the number of transactions that actually go to our payment system. At this point in time, we actually do not really look at the revenue as much. I think broadly speaking, our payment business is actually at breakeven from a fee generation versus banking charge perspective. And then we do spend quite a bit of money actually in terms of subsidies in order to drive the adoption of the payment solution among users and among merchants.

So, the most important thing for us is really to increase the usage. We believe this is actually important for our overall value, not in the sense of generating revenue, but more importantly we can increase the efficiency of our advertising business in the future. When you actually have merchants and service providers who actually can get their users to respond to an ad and pay for the services in a very seamless way, then the advertising rates will go up.

In addition to that, payment also generates a very good entry point for our online finance applications going forward. And it also provides us a lot of data, which we believe the consumption pattern of users and that would also help our targeted performance advertising performance. So, I think that's where we stand on the strategic plan for our payment solution.

In terms of the key categories of payments, right, so you have sort of the first, the Red Packet, the person-to-person. And then, from that point onwards, we have a number of virtual items, let's say, sort of mobile charge-ups, people who pay for games and Tencent, as well as a partner's virtual services. In addition to that, we have a whole range of O2O services as well as eCommerce services, which sort of follow that in terms of ranking.

<Q - Alicia Yap>: I see. My second question is – thank you, Martin. My second is on mobile games. So excluding your strength in the YingYongBao app store, it seems like the tractions on Mobile QQ and WeChat Game Center has experienced some slowdown. Is that mainly due to the saturations of the mobile gamers, which is more an industry issue? Or is it just because during second quarter for Tencent, there was lack of the big hit titles released in the WeChat Game Center? How should we think about the growth outlook for the overall mobile games revenue in the coming quarters? Thank you.

<A - James Gordon Mitchell>: So, Alicia, perhaps I'll speak to address that question. We believe there's ample room for revenue growth for the mobile game industry in China. So, today, there's more than twice as many people playing mobile games, PC games each day, but both for the industry as a whole and for Tencent specifically within the industry.

Recently, there has been some examples including a very popular game from NetEase including our own shooting game of titles that can both monetize relatively healthy levels and enjoy relatively long use lives.

So, we believe that the China mobile game industry is becoming more like the U.S., European, Japanese or Korean mobile game industries where not only do you have very casual games with long life and more mid-core games with short life, but also you have mid-core games that can really redefine their genres and generate substantial revenue over extended periods of time.

In recent months, we've been following the evolution of the industry with great interest. We've seen some challenges, but we also think therein lie opportunities, and that's really behind the strategic shift that I outlined earlier that within the Red Sea categories, we're focusing more resources on fewer titles that we believe can not only participate in a genre, but also potentially redefine the genre. And then in the Blue Ocean categories, we're focused on developing new game experiences that currently don't exist in China and training people to play mobile games in a way that they haven't before.

And we'll see what happens going forward. But if you look at the app store rankings, today, for example, you can see that some of our new titles, for example, King of Fighters or Legend of Mir 2 fit squarely within that criteria of being mid-core games with a great user experience where we're cautiously optimistic that they'll enjoy a healthy longevity.

<A - Catherine Chan>: Next question, please.

Operator

Thank you. Your next question comes from the line of Wendy Huang from Macquarie. Please ask your questions.

<Q - Wendy Huang>: Thank you. And congratulations on the solid results and also the breakthrough you made on the different mobile products. My first question is about mobile games. So, are you seeing any new technologies such as MTML05 (sic) [HTML5] to actually revolutionize the mobile game industry in the near future and also to bring the monetization opportunity for Tencent? And second, your margin record very high level in the past three years. So, is this kind of high margin sustainable for the rest of the year? Thank you.

<A - Chi Ping Lau>: Okay. So, on the game question, I'll answer that. I think at this point in time, we look at sort of native apps as sort of the best technology for mobile games. I think sort of there are a lot of industry participants and we ourselves are actually sort of testing out HTML5 as a platform for games and try to see sort of whether there are more casual games that could actually fit into that category.

If sort of this technology becomes an important technology for games, I think we are very, very well-positioned in that segment. In fact, we wish there is a big market for that segment because as we went through in our strategic highlight, we have a very strong browser app, right, on a standalone basis, which is leading in terms of the market. And at the same time, we actually sort of have even bigger traffic on our HTML5 Tencent browsing service in terms of page views, in terms of active users. So if there are games which actually fit into this technology platform, which we believe there will be, but whether how big it is, it's a question mark. If it becomes very big, right, then we will be a major beneficiary of that technology shift.

<A - James Gordon Mitchell>: Just on the margin outlook, first, as you know, we generally don't comment on margin outlook going forward. So my answer to the question will be consciously vague.

Second, in terms of specific cost items, our cost of revenue is experiencing some weight – will experience some weight going forward from items such as exclusive content payments, for example, for NBA rights, and also to the support for our online payment business where we have to incur the interbank handling fees.

Thirdly, I would say that by global standards, our margins are fairly comparable to those of global peers and it's important to bear in mind that our margins are not – they don't bear the cost of margin disruptive O2O experience, as O2O activities because we've adopted a strategy where, generally speaking, those O2O activities and the financing around them takes place at our partner company level rather at the consolidated Tencent level.

Operator

Thank you.

<A - Catherine Chan>: Next question, please.

Operator

Your next question comes from the line of Eddie Leung from Merrill Lynch. Please ask your questions.

<A - James Gordon Mitchell>: Eddie, can you hear us? Perhaps we'd go to the next question.

<A - Catherine Chan>: Yeah. Next one, please, operator.

Operator

Thank you. Your next question comes from the line of Cynthia Meng from Jefferies. Please ask your questions.

<Q - Cynthia Meng>: Hi, everyone. Thank you for giving me the opportunity. I have two questions. First one is on the advertising. Currently, Tencent doesn't participate in the revenue-sharing on mobile Guangdiantong. Is this the revenue shared to advertisers reported on the cost of goods sold line? And does Tencent have any near-term or a mid-term plan of participating in doing so?

I have a second question on online travel. We noticed that you submitted a going-private proposal to Elong recently. Just wonder if management can share some of your overarching strategy behind online travel and how does that fit into Tencent's overall O2O footprint. And given that Baidu and Alibaba are both quite aggressive in O2O, if you can talk about your O2O strategy as well, that will be great. Thank you.

<A - Shek Hon Lo>: Actually for the Guangdiantong on the official account, we share revenue with the content providers and the sharing would be included under COGS.

<A - Chi Ping Lau>: Right. In terms of online travel, right, we look at it as an important – well, as an attractive vertical, right. But sort of – it's not sort of the biggest contribution into the frequency of payment, but it's an attractive business in itself, right. So we have some participation in the sector. As you can see, we have invested in a number of different companies, including eLong, including 17u. Now, a number of these companies actually sort of coincidentally also sort of have investments from Ctrip.

So I think overall we are – we look at sort of eLong as an attractive business going forward because it does have a pretty good exposure to the hotel segment. And we feel that in the public arena, right, it has to make continuous investment, and so that's why the share price are very suppressed. If we can actually take it private, we can actually invest in the company and really make it a more viable business. And over time, we may actually sort of list it in the Asia market in the future. But sort of that's undecided at this point of time. Overall, we feel that sort of our various investments in the travel segment as well as our partnership with Ctrip at the different levels give us pretty good exposure to a good vertical business.

In terms of our O2O initiative, right, we do focus a lot on the high frequency O2O services. So we have a number of different investments, including investment in Didi Kuaidi, and including our investment in Dianping, including our investment in Ele.me and a number of other investments too. As James talked about, right, we feel that this – O2O also this is, on one hand, requires some traffic, right, but on the other hand, requires actually a lot of offline exposure and the ability to manage a very large sales force in particular. So these are not the kind of expertise that we, as a technology company and user experience company, is very good at managing.

So what we had decided on a strategic basis is really sort of working with a number of best-of-breed partners and help them to sort of generate the online exposure while they actually sort of focus on building out on their offline expertise.

And at the same time, as James has said, this not only give us exposure to the best team in the industry with a lot of focus, it also allows us to leverage our capital in a more efficient basis, because we don't necessarily need to spend all the money that these companies are going to lose in the process of building up market leadership. As you know sort all these companies are actually generating pretty heavy subsidies and losses at this point in time.

Operator

Thank you. Your next question comes from the line of Natalie Wu from CICC. Please ask your questions.

<Q - Natalie Wu>: Hi. Good evening, management. Thank you for taking my question.

<A - Huateng Ma>: Can you speak up a little bit, please?

<Q - Natalie Wu>: Okay. Can you hear me?

<A - Huateng Ma>: Thank you. Yeah.

<Q - Natalie Wu>: Okay. I have two questions, actually. The first is congratulations on the strong performance in your online advertising business. But can you elaborate a little bit more about your advertising revenue? You mentioned that RMB2 billion was generated from brand ad. I'm just wondering how much is contributed from online video? Also, for performance-based ad, what is the mobile revenue contribution?

And the second question is actually on your deferred revenue. If we look at your deferred revenue in current identity line, there is actually RMB1 billion decline some of the quarter's level. So, just wondering, can you share with us what is the major cause for this sequential change? I would appreciate it if you could just break down these effects from maybe game and advertising business. Thank you.

<A - James Gordon Mitchell>: Why don't I handle the advertising question, and then John will look after the deferred revenue question. So, we can follow up with a detailed analysis offline, but given that the rapid growth in our video business, video will be the largest portion now, the largest contributor to our brand display, which I think was your first advertising question. And then for your second advertising question, on the performance advertising, mobile would be the large, the very large majority at this point. It's primarily a mobile business, so essentially a mobile business.

<A - Shek Hon Lo>: In respect of deferred revenue, actually, this quarter it increased by about 6.3%. There are two reasons for that because number one is in terms of the business cooperation agreement of Jingdong every quarter, there will be a natural decrease of more than RMB200 million. And secondly, you can see that this quarter is lowest season for online games, which in 2014, it was the same case. And at that time, it decreased by about 3% quarter-on-quarter. Next question.

Operator

Thank you. Your next question comes from the line of Dick Wei from Credit Suisse. Please ask your questions.

<Q - Dick Wei>: Good evening. Thanks for taking my questions. I have two questions. First question is on the premium content subscriptions. I wonder if you can give some updates on how Tencent is progressing across different videos and also some of the music reading content subscription. And wonder if the number is also included in the fee-based VAS registered subscription line as well. Thanks.

<A - James Gordon Mitchell>: Sure. So, yes, it's included inside our fee-based VAS. I think that the big picture here is that the Chinese consumer behavior is changing and that's very positive for everyone in this business including us, but also our competitors. If you look at the U.S. today then, the top 10 highest revenue apps in Apple app store in the U.S., seven of them are games, but then three of them are HBO NOW, Spotify and Pandora. So, in developed markets, there's a very well-established trend now toward people spending substantial time and money on premium digital content especially on smart devices.

We're just starting to see that happen in China. If you look at some of our own products, recently, we've run a promotion for a Korean singer called Big Bang, and that's generated millions of digital album sales in the last few weeks. We just put online the Universal movie, Fast & Furious 7 and that'll generate millions of transactions in a few days. So, it seems like there's a great deal of demands now emerging amongst consumers to pay to premium content.

We're tapping into that with our literature, digital literature business which is a very clear industry leader. We're tapping into that with our digital music business, which is a very clear industry leader. Our digital video business which has added millions of subscribers year-to-date. But I don't want to give you the impression that this is all Tencent alone. I mean, we feel that both we and our competitors together are enjoying a buoyant, an increasingly substantial market for consumers paying for premium digital content.

<Q - Dick Wei>: Great. Thanks for the color, James. And next question is on Internet finance. I think companies started some of the small lending program, maybe back in May, June timeframe. I wonder how is that progressing along and any kind of color you can share with us? Thank you.

<A - Huateng Ma>: Yeah. WeBank launched a product called WeLoan, which is a consumer loan on the very convenient basis. So, we have actually launched it on the basis of a white list. So, we go through the list of users within Mobile QQ at this point of time and basically sort of leveraging on our credit model, identify a certain number of users and then sort of we are going to offer them sort of new entry point to these credit product and see what the response is.

At this point in time, it's still on trial. We have put in a small number of users into this program. So far, I think the result is encouraging, I would say both in terms of – for the people that we has shown the entry point, the adoption of these loans as well as when we look at the credit model, right? So far, with limited data, of course, but we feel pretty good about the credit model that we have at this point in time. Obviously, in the next few months, we'll gradually load out to a larger number of users within Mobile QQ. Over time, we'll also sort of launch this product on Weixin as well.

So, by that time, we will sort of maybe able to give you much more color on how this product is faring but so far, I think, so good.

<A - Catherine Chan>: Okay. Thank you. Next question, please.

Operator

Thank you. Your next question comes from the line of Erica Werkun from UBS. Please ask your questions.

<Q - Erica Poon Werkun>: Thank you. My first question is on Moments advertising. I think James mentioned that you ran about 60 advertisements in second quarter. Can you share just how significant was the revenue contribution for second quarter? And if we kind of look at that run rate on a 12-month basis, how significant can Moments advertising be? And my second question is on selling expenses. That amount was down 19% year-on-year, and one of the reasons cited was WeChat marketing, were you being more selective in your global expansion of WeChat? Thank you.

<A - James Gordon Mitchell>: So, on the first question about advertising inside Weixin Moments, I'd say it was a contributor to our performance advertising business in the second quarter. But given it's still very early stage, a substantially smaller contributor than advertising on Mobile Qzone or advertising on Weixin Official Accounts as just comparison points.

Over the long-term, we think that it has the potential to be one of the largest products within our mobile performance advertising portfolio, because it enjoys enormous traffic. It enjoys relatively affluent users who are disproportionately appealing to advertisers. And, therefore, we believe it can tap into not only the kind of hardcore performance advertisers such as eCommerce companies and app developers, but also the brand performance advertisers. And we're already seeing that with – in a very good response from luxury goods advertisers or ultimately our advertisers to participate in Weixin Moments. So, it's a long path ahead, but we're very optimistic about the destination for Weixin Moments advertising.

<A - Shek Hon Lo>: In respect of the selling and marketing expenses growth year-on-year, it was mainly due to the significant reduction in subsidies for taxi-hailing apps, Didi Dache, as well as a little bit of reduction in the WeChat overseas market expenses.

<A - Catherine Chan>: Okay. Thank you very much. Next question, please.

Operator

The next question comes from the line of Eddie Leung from Merrill Lynch. Please ask your questions.

<Q - Eddie Leung>: Apologize. Bad connection. Two questions. The first one is about mobile games. I'm wondering if James could talk a little bit about your guys view on the future of overseas mobile games in China. It seems like they haven't seen too many successful overseas games in China. And traditionally, we all know Tencent has an advantage in licensing overseas games in China. So, just wondering what's your thought on that?

And then secondly, perhaps something more long term, could you guys give us any update on the so-called social commerce within your ecosystem? We have heard certain anecdotal data points that the growth has been pretty good. So, just wondering if any more color on this business? Thanks.

<A - James Gordon Mitchell>: Yeah. So, with regard to the success or lack thereof of overseas mobile games inside the China mobile game market, I think that's a fair observation. If you look at Southeast Asia or India, then the correlation between the top mobile games in those markets and the top mobile games in the U.S. and Europe, it's about 75%. If you look at China, the correlation is about 20%.

So, for a number of reasons including local taste, localization, publishing and so forth, so far, the Chinese mobile game market has evolved relatively independently from the rest of the world with a couple of high-profile exceptions such as Clash of Clans. Our belief is that over time as the Chinese mobile game audience becomes more sophisticated and as foreign games are better localized to suit Chinese tastes then there will be an increase in the success of overseas games in China. We've certainly tried to position ourselves for that trend. So, we've partnered with and made investments in some of the biggest and best mobile game companies in Korea.

We have a relationship with CJ Games, for example; in Europe with Miniclip; in the U.S. with Glu; and Japan and so forth. And we have a number of international games both from third parties and from our partners which we're looking forward to releasing in China. But as of today, the Chinese mobile gaming market is still 75% a local game market. And that hasn't hurt us so far. I mean, I'd emphasize that most all of our biggest and most successful mobile games historically have been mobile games developed by our in-house studios such as Tian Tian Ku Pao or such as [indiscernible].

<A - Chi Ping Lau>: In terms of social commerce, right now, I think at this point in time, it's still at a very primitive stage of growth. We do see quite a bit of action that's happening within our social network, and we do see one of our investing companies like Koudai has seen pretty good traction in terms of their growth.

But I feel that overall, we're still in a trial mode in terms of how can we really capitalize more growth of social commerce. I think there are certain elements that's needed. One is actually payment. The other one is advertising. For example, other ways for people to discover about these shops, these sellers, also the supply chain of good products is actually important, right?

So, I think at this point in time, it's more like a grass root effort. But over time, as we continue to build up our own payment system as advertising continue to grow within our ecosystem and then we provide different ways to capitalize the discovery of these products and as more and more good sellers actually start to use this channel, I think there could be more growth right, but we need to sort of keep trying. And I think if you look across the ocean, right, Facebook has been trying quite a bit in terms of figuring out what would be a good way to capitalize commerce on their platform as well. So, I think we're in experiment and learning mode in terms of doing this and we are also building a lot of the infrastructural core elements to support this.

<A - Catherine Chan>: Okay. Thank you. And operator, in the interest of time, we'll take the last three questions, please.

Operator

Thank you. Your next question comes from the line of Alan Hellawell from Deutsche Bank. Please ask your questions.

<Q - George Alan Hellawell>: Thank you very much. Forgive me if you mentioned this already, but what is the current number of Official Accounts on Weixin? And how many do we now have on Mobile QQ? I'm also curious as to what the time line might be for launching Official Accounts-based ads on Mobile QQ?

My second question relates to the appreciable sequential improvement in advertising gross margin in the second quarter. I assume it's largely the interplay of p-for-p margins which are very high, but also content spend on video, which is consequential of the base of margins. The question is, is content spend growth likely to continue to stay significantly relative to overall ad revenue growth given your current marketing conditions? Thank you.

<A - Chi Ping Lau>: Well, in terms of Official Accounts, right, I would say so we have continued to see a healthy growth in terms of the total number of Official Accounts on WeChat, on Weixin, as well as sort of the number of active Official Accounts and the number of page views and the number of articles that sort of these Official Accounts send out. So, all in all, sort of the trend has been sort of quite nice. In terms of ball park figures, we have sort of more than 10 million Official Accounts registered and, on active basis, a couple of million active. So, in term of Mobile QQ, we are creating a whole infrastructure for supporting Official Accounts, too, and that will be launched in the next couple of months. And we expect that could also sort of generate additional traffic on our Official Accounts.

<A - James Gordon Mitchell>: With regards to advertising gross margin, so you're correct that the increase reflects the combination of positive seasonality in the mix shift towards the performance advertising which tends to be higher gross margin, all else equal.

With regard to content costs, our experience historically is that when we buy excellent content exclusively such as the Voice of China program or the Game of Thrones series, then that content combined with our platform strengths, combined with our distribution through Weixin and so forth can deliver a jolt surge to our video traffic, to our video advertising and more likely also to our video subscription revenues.

So, given those very positive experiences, we continue to reinvest very aggressively in video content. We've mentioned numerous times that our video advertising revenue more than doubling year-on-year, and you should assume that as our revenue grows, our content will grow at not exactly the same rate but at a relatively rapid rate as well because we find that buying the best content delivers the biggest and most successful results for us.

<Q - George Alan Hellawell>: Thank you.

<A - Catherine Chan>: Thank. Next question, please.

Operator

Your next question comes from the line of Thomas Chong from Citigroup. Please ask your questions.

<Q - Thomas Chong>: Hi. Thanks for taking my questions. I have two questions. The first question is about the macro headwinds. Can management comment about how it impacts the brand advertising business? And my second question is about the M&A strategy. What other verticals would Tencent be interested to invest in the future? Thanks.

<A - James Gordon Mitchell>: Well, in terms of macro headwind, I think we don't really view it that much. I think you had identified sort of among our entire business, probably sort of the only thing that's exposed to it is actually our branded advertising, which actually is relatively small compared to our total revenue. And at the same time, within the branded advertising, a big part of it is actually video advertising, which is on secular or structural growth mode. So, I think the macro headwind is not felt that much at Tencent at this point in time.

In terms of M&A, as we said, right, in the past, we focused on acquiring stakes in companies that would enhance our overall ecosystem and at the same time these are management who have proven track record and have a similar culture with us. So, I think these are the criteria for our investment.

And with the rollout of Internet Plus strategy, with Internet actually sort of approaching different verticals within the economy, I think there are actually more opportunities for us to find ourselves being at the crossroad with a partner. And if our technology, if our ecosystem, if our user base is actually helpful to help companies to make use of Internet to capture opportunities, I think we will be happy to do that. So, I think that's sort of in broad general terms what we are looking for.

<Q - Thomas Chong>: Thanks.

<A - Catherine Chan>: Yeah. Thank you. The last question, please?

Operator

Thank you. Your next question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask your questions.

<Q - Piyush Mubayi>: Thank you. Could you talk about the net revenues that you earned in mobiles games in the quarter as well as the new genres of games that you'll be launching in the coming months? How soon can we see that price improve? That's the first question.

And second on WeBank and the strategy, will you remain focused on microloans or should we expect WeBank to evolve into a platform potentially supporting all but the top five banks? Thank you.

<A - James Gordon Mitchell>: Piyush, on the first question, we can go into net revenue versus gross revenue offline because it's a fairly technical discussion.

I think with regards to the new genres of games, it's a combination of a new approach of putting more resources behind key titles within the existing Red Sea genres and then developing and publishing what we hope will be big transformative games in Blue Ocean genres, which have not yet formed in China, but which we hope to form. And you should expect that to be a kind of gradual but continual process. If you look in recent weeks, we've already released two mobile games that are more Red Sea in nature, that seems to be successful, one being King of Fighters, another being Legend of Mir that are based on our proven IP.

And one trend that's become very apparent in the first half of this year, whether you look at net users Fantasy Westward Journey game in China or the Fallout Shelter game in the U.S. that PC gamers who in the past treated mobile games the way that someone who reads novels might treat a comic book adoption and now taking mobile games much more seriously and much more willing to play mobile games that are tied into PC games.

So, we've already released a couple of titles on mobile that are linked to PC and we have several more in the pipeline. And then going forward, we'll seek to attack both these Red Sea and Blue Ocean categories progressively.

<A - Shek Hon Lo>: Yeah. I would just add one more point to James' discussion about our strategy. I think if you look at PC platform, we actually have spent many years in terms of developing the best traffic paths for bringing traffic into games. I think the same exercise needs to be done for our mobile platforms, and if you look at the first inning of that effort was really creating these game centers. But I think that's just the first part of the story.

We arguably have a much bigger franchise on mobile Internet than we had on PC Internet and as a result, they are actually sort of a lot of venues to which we could actually generate traffic for our games. I think some of the things that James talked about, for example, sort of cross promoting our content with the games, so video platform can be brought to bear. For example we can actually leverage music to, bring traffic to music games. So, there are a lot of our existing new platforms which have not really participated in our game initiative yet. So, it would take time for us to build that. But over time, they will be built.

In terms of our Internet finance and WeBank initiative, WeBank as we constantly said, WeBank wants to be a provider of products that actually sort of you can bring value to consumers as well as to its partner banks. So, WeBank is not sort of just a bank, but really it's sort of an open platform for banks to access users and provide better services to users.

So, I think WeLoan is one of these products, but we'll continue to develop good products along these lines. But – so, for example, making loans to stay on the enterprises, a large corporate is not really something that's along the lines, so we probably refrain from doing that for some time.

Catherine Chan

Yeah. Thank you very much for joining the call and thank you, operator. We are rounding up the call now. If you wish to check our press release and other financial information, please visit our corporate website at www.tencent.com/ir. We'll post a replay of this webcast on the site shortly. Thank you and see you next quarter.

Operator

Thank you. That does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2015 second quarter and interim results announcement conference call. You may all disconnect now.

Company Name: Tencent
Company Ticker: 700 HK
Date: 2015-05-13
Event Description: Q1 2015 Earnings Call

Market Cap: 1.47TRI
Current PX: 156.80
YTD Change($): +44.30
YTD Change(%): +39.378

Bloomberg Estimates - EPS
Current Quarter: 0.839
Current Year: 3.353
Bloomberg Estimates - Sales
Current Quarter: 23918.600
Current Year: 99753.068

Q1 2015 Earnings Call

Company Participants

- Catherine Chan
- Hua Teng Ma
- Chi Ping Lau
- James Gordon Mitchell
- Shek Hon Lo

Other Participants

- Dick Wei
- Eddie Leung
- Alicia Yap
- Alex Yao
- Cynthia Meng
- Erica Poon Werkun
- Chi Tsang
- Vivian Hao
- Wendy Huang
- Chun Ming Zhao
- Piyush Mubayi

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by, and welcome to Tencent Holdings 2015 First Quarter Results Announcement Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today.

I would now like to hand the conference over to your host today, Ms. Catherine Chan from Tencent. Please go ahead, Ms. Chan.

Catherine Chan

Thank you very much, operator. Good evening. Welcome to the first quarter of 2015 results conference call. I'm Catherine Chan from the IR team of Tencent. Before we begin the presentation, we would like to remind you that it includes forward-looking statements which are underlined by a number of risks and uncertainties and may not be realized in future for various reasons. Information about general market conditions is coming from a variety of sources outside of Tencent.

This presentation also contains some unaudited non-GAAP financial measures that should be considered in addition to, but not as a substitute for, measures of the company's financial performance prepared in accordance with IFRS. For a detailed discussion of the risk factors and our non-GAAP measures, please refer to our disclosure documents downloadable on www.tencent.com/ir.

Now, let me introduce the management team on the call tonight. We have our Chairman and CEO, Pony Ma; President, Martin Lau; Chief Strategy Officer, James Mitchell; and Chief Financial Officer, John Lo.

Pony will kick off with a short overview. Martin will review value-added services segment performance. James will speak [indiscernible] (1:45) advertising, and John will go through the financials before we take your questions.

I'll now turn the call over to Pony.

Hua Teng Ma

Thank you, Catherine, and good evening. Thank you for joining us. In the first quarter of 2015, we achieved a solid financial growth in our core platforms. We then expanded mobile user base in rich entertainment media content and enhanced ad solutions.

A few numbers to highlight; total revenue, excluding eCommerce transactions was RMB22.2 billion, up 40% year-on-year and 8% quarter-on-quarter. Non-GAAP operating profit was RMB9.4 billion, up 45% year-on-year and 16% quarter-on-quarter. Non-GAAP net profit to shareholders was RMB7.1 billion, up 36% year-on-year and 5% quarter-on-quarter.

Turning to our key platforms; total MAU for QQ was 832 million, within which smart devices' MAU grew 23% year-on-year, to 603 million. Weixin and WeChat reached a combined MAU of 549 million, up 39% year-on-year. Total MAU for Qzone was 668 million, within which smart devices' MAU rose 22% year-on-year, to 568 million. Our online games platform sustained its leadership on PC and mobile with a broader and more diversified games portfolio.

And now our media platforms, our mobile news is the most widely viewed news service in China. Our video platform solidified its leadership, leading position in China with traffic more than doubling year-on-year.

And now our utility services, we drove higher adoption of our mobile security solution and mobile browser services and app store.

With that, I will pass to Martin to speak through business review.

Chi Ping Lau

Thank you, Pony, and good evening, everybody. In the first quarter of 2015, our total revenue grew 22% year-on-year. Excluding eCommerce transactions, our total revenue increased 40% year-on-year. VAS revenue represented 83% of total revenue, of which online games contributed 59% and social networks, 24%. Online advertising represented 12% of total revenue, up from 6% a year ago

For value-added services, segment revenue was RMB18.6 billion, up 29% year-on-year and 9% quarter-on-quarter. Social networks revenue was RMB5.3 billion, up 32% year-on-year and 3% quarter-on-quarter. The growth flowed from higher sales of in-game items and monthly subscriptions for mobile privileges and premium entertainment content.

Online games revenue was RMB13.3 billion, up 28% year-on-year and 11% quarter-on-quarter. Contributions from new games on smartphones and PC, and increased monetization of popular events, casual game titles led to year-on-year revenue growth. Sequential performance benefited from positive seasonality in PC games and also broader mix of smartphone game genres.

Moving to social networks; for Mobile QQ, during the quarter, we further reinforced the young and active differentiation of Mobile QQ via new personalization and entertainment options and we deepened penetration among young Internet users. We promoted user engagement on a daily basis via nearby groups, and on special occasions through red envelope gifting. Our nearby groups, which was launched a year ago, scaled to around 1.7 million, and we also have 1 billion red envelopes shared among QQ users over the six-day Chinese New Year period.

For Weixin, we organized [ph] shake (6:34) for red envelope's promotions, which spread widely among Weixin users. This led to a record 3 billion red envelopes shared over Chinese New Year as well as a meaningful increase in Weixin Payment adoption and Payment transactions. As part of the connection strategy, we enabled offline merchants to offer user coupons to promote their products and services. We also connected users in five major cities to local health, transport, utilities and municipal services.

Now, moving on to games, looking at PC client games, the average concurrent users trend showed an ongoing shift of users' playing time from MMOG to advanced casual games. For advanced casual games, in the battle arena category, League of Legends' robust performance benefited from enhanced sales of holiday items as well as player-to-player gifting over Chinese New Year. We're closed beta testing new 3D battle arena titles including SMITE and Master X Master to expand the genre.

In the sports category, holiday gift pack sales boosted revenue of FIFA Online 3.

In April, in order to enhance local content and player engagement, we introduced China's soccer teams and also enabled Global Tournament play mode. In the shooting category, we deepened our leadership, offering the broader selection of shooting games in China.

For MMOG, we're working to bring more compelling and innovative titles to attract users. Moonlight Blade, our in-house martial arts role-playing game is now one of the top three most highly anticipated PC games in China, will enter closed beta testing in late May. We also started to close beta test some ground-breaking hybrid genre games, including Monster Hunter Online, the first action role-playing MMO in China with hunting gameplay. The game is the first free-to-play online game from Capcom's popular console game franchise. And also MX, the first action role-playing MMO in China with third-person shooting gameplay, will leverage this creative IP to develop not only PC games but also mobile game, anime series as well as books.

For smartphone games, we widened our mid-core audience adding seven new mid-core titles for Mobile QQ and Weixin game centers. To diversify player base, we're introducing new genres like shooting, quiz show and dress-up. We extended our success in shooting genre from PC to mobile with the game WeFire, which reached the number one in China's iOS app store revenue ranking during the quarter.

We're licensing titles based on popular game and anime IPs. We operate the game, I am MT2, which is sequel to 2013's most popular card battle game. In the pipeline, we also have Infinity Blade Saga, Carrot Fantasy 3, and mobile versions of DnF as well as Naruto.

Besides Mobile QQ and Weixin game center, we've also extended our game platform to include app store YingYongBao, and mobile browser, and they're emerging as important game distribution hubs in China.

First quarter smartphone games revenue for Mobile QQ and Weixin game center, YingYongBao and browser, as well as other platforms, altogether reached RMB4.4 billion and that's up 82% year-on-year and 8% quarter-on-quarter on a gross basis.

With a multi-platform distribution platform and with continued genre diversification, we retained our position as the leading mobile game publisher in China by both daily active users and revenues.

With that, I will pass to James to review our online advertising segment.

James Gordon Mitchell

Thank you, Martin, and good evening, everyone. Our online advertising segment revenue was RMB2.7 billion, up 131% year-on-year and up 4% quarter-on-quarter, within which, our brand advertising revenue was RMB1.4 billion, up 90% year-on-year and down 7% quarter-on-quarter.

Revenue jumped year-on-year due to strong video traffic growth, particularly on mobile. Sequentially, increased video viewership partially offset the usual weak seasonality in the first quarter. Mobile contributed approximately 40% to our brand advertising revenue.

Our performance advertising revenue was RMB1.3 billion, tripling year-on-year and up 18% quarter-on-quarter. New mobile ad inventories, more effective targeting driving higher click-through rates, and higher cost per click drove the year-on-year revenue growth.

New mobile ad inventories particularly from Mobile Qzone, Weixin Official Accounts, and YingYongBao app store was the primary driver to the sequential performance advertising revenue growth and mobile contributed about 75% to our performance advertising revenue during the quarter.

For brand advertising, our top five advertiser industries were food and beverage, automobiles, online services, personal care and consumer electronics. Benefiting from more TV drama series and movie rights, our video platform attached to wider viewer base and increased engagement in terms of video views per user. This resulted in a more than doubling of video views and video app revenue year-on-year. For our mobile news service, daily page views increased 75% year-on-year and ad revenue more than doubled year-on-year.

For performance advertising, Mobile Qzone app revenue increased quarter-on-quarter as click-through rate and cost per click both improved. Weixin Official Account ad revenue increased modestly quarter-on-quarter as traffic growth offset seasonally lower demand from eCommerce advertisers in the first quarter versus the fourth quarter.

We began generating meaningful revenue from YingYongBao listing ads and in Weixin Moments, a limited number of brand advertisers ran ads to help us establish advertising case studies and best practices for the future. We monitor consumer engagement with the ads across a number of metrics such as click-through rates, viral ad shares and for automobile advertisers, test drives are actually taken on the car that are advertised. The results so far are encouraging and we will therefore progressively expand a number of advertisers, range of ad formats and ad targeting mechanisms for Weixin Moments advertising in the months to come.

In April, we combined the products and ad sales team of our Weixin Group and our Social Network Group into a single operation. We believe this unification enables us to better serve advertisers across our different properties and better target ads to consumers across our different properties using the [ph] Guang Dian Tong targeting engine (13:48).

And with that, I'll pass to John.

Shek Hon Lo

Thank you, James. Hello, everyone. For the first quarter of 2015, our total revenue was RMB22.4 billion, up 22% year-on-year, or 7% quarter-on-quarter. Gross profit was RMB13.4 billion, up 27% year-on-year or 6% quarter-on-quarter. Operating profit was RMB9.4 billion, up 20% year-on-year or 27% quarter-on-quarter. Finance costs were RMB433 million, up 82% year-on-year, or 59% quarter-on-quarter. Interest expense incurred on new $2 billion bonds issued in February as well as forex loss contributed to the quarter-on-quarter increase.

Income tax expense was RMB1.7 billion, up 46% year-on-year, or 91% quarter-on-quarter. The increase mainly reflected higher pre-tax profits, and a higher corporate income tax applied for certain subsidiaries in China. Effective tax rate for the quarter was 19.7%. Net profit to shareholders was RMB6.9 billion, up 7% year-on-year or 17% quarter-on-quarter.

On a non-GAAP basis, operating profit for the quarter was RMB9.4 billion, up 45% year-on-year or 16% quarter-on-quarter. Net profit attributable to shareholders was RMB7.1 billion, up 36% year-on-year or 5% quarter-on-quarter. Diluted EPS was RMB0.752 for the quarter.

Turning to segment gross margin; gross margin for value-added services was 65%. On a gross-to-gross basis, it was down two percentage points year-on-year and up one percentage point quarter-on-quarter. The lower gross margin year-on-year was primarily due to increased revenue sharing costs from a larger mix of third-party smartphone games and increased channel costs.

Gross margin for online advertising was 39%, up four percentage points year-on-year and was down one percentage point quarter-on-quarter. The higher gross margin year-on-year resulted from rapid advertising revenue growth, partially offset by retail investment in video content.

Moving on to operating expenses; selling and marketing expense was RMB1.3 billion, down 29% year-on-year or 36% quarter-on-quarter. The year-on-year decline mainly reflected reduced subsidies to user who booked [indiscernible] (16:35) choosing Weixin Payments. Sequential decrease primarily resulted from a seasonal reduction in advertising and promotional activities.

G&A expense was RMB3.7 billion, up 25% year-on-year or down 8% quarter-on-quarter, of which R&D expense was RMB2 billion, up 34% year-on-year and down 6% quarter-on-quarter. The year-on-year growth in G&A expense was mainly driven by increased R&D expense in [indiscernible] (17:09). Sequentially, G&A expenses decreased mainly due to lower consultancy fees, outsourcing costs for [indiscernible] (17:18) research and development project and other related costs.

As a percentage of quarterly revenue, selling and marketing expense was 6% and G&A, 16%. R&D represented 9% of quarterly revenue, and share-based compensation was about 3% of quarterly revenue. As at quarter end, we had just under 28,000 employees, up 4% year-on-year or 1% quarter-on-quarter.

Looking at margin ratios for the first quarter, gross margin was 60%. On a gross-to-gross basis, it increased 3.7 percentage points year-on-year and was broadly stable quarter-on-quarter. The year-over-year increase in gross margin was mainly driven by a mix shift away from low margin eCommerce business.

Non-GAAP operating margin was 42%. On a gross-to-gross basis, it was up 7.6 percentage points year-on-year and 3.5 percentage points quarter-on-quarter. Higher margin year-on-year was mainly due to higher gross margins and the decline in selling and marketing expenses as a proportion of total revenues. The sequential uptick was primarily due to a decline in operating expenses as a proportion of total revenues.

Non-GAAP net margin was 31.9%. On a gross-to-gross basis, it is up 4.2 percentage points year-on-year and down 0.7 percentage points quarter-on-quarter. The higher net margin year-on-year was mainly due to higher operating margin, partially offset by a higher effective tax rate. This sequential dip in net margin resulted from a higher effective tax rate.

For the first quarter, total CapEx was RMB1.3 billion, up 17% year-on-year or down 17% quarter-on-quarter. Operating CapEx was RMB656 million, down 27% year-on-year and up 11% quarter-on-quarter. Non-operating CapEx was RMB676 million, up 187% year-on-year and down 33% quarter-on-quarter.

Free cash flow was RMB8.4 billion, up 52% year-on-year and down 9% quarter-on-quarter. Our net cash position at quarter end was RMB25.3 billion, down 26% year-on-year or up 11% quarter-on-quarter. Year-on-year decline in net cash was mainly due to strategic investments, partly offset by an increase in free cash flows generated during the year.

The fair market value of our listed associates and available for sale investments were RMB74 billion as at quarter end. This concludes our presentation. Thank you.

Catherine Chan

Thank you. Operator, we shall open the floor for questions, please.

Q&A

Operator

Certainly. [Operator Instructions] Your first question comes from the line of Dick Wei from Credit Suisse. Please ask your question.

<Q - Dick Wei>: Hi. Thank you for taking my questions, and congrats on solid earnings. My first question is on the – maybe on the expense front. Looks like the sales volume expenses for the quarter is a bit lower, maybe the sequential decline is high more than the normal seasonality. I wonder, should we see that trend to continue or are we moving some of the expenses essentially go to the COGS line, cost of goods sold, on the [indiscernible] (21:10) line because they are more like maybe payment-related spending on that. Just want to see what's the general thoughts on sales and marketing or the COGS of value services going forward. Thanks.

<A - Chi Ping Lau>: Yes, on the sales and marketing expense, the decline is mainly due to the fact that in the first quarter of last year, there was a very big campaign for [ph] taxi (21:40) subsidy in relation to our mobile payment solution. And with this year, the first quarter, we don't have that expense.

Now, having said that, I think, one, mobile payment is actually a very important strategic initiative for us; and second, as you can see in the O2O space, there's actually a very competitive landscape with a lot of companies offering services and subsidies to the consumers.

And for some of those services, there is actually a pretty good ability to promote our mobile payment solution. So, I think while we have scaled down that promotion on [ph] taxi-hauling (22:31), if there are other ways through which we can actually promote our mobile payment solution, we will actually, we will invest that money in order for us to continue to build our mobile payment franchise.

<Q - Dick Wei>: And would that be booked under sales and marketing or would it be more under other COGS line?

<A - Chi Ping Lau>: Sales and marketing.

<Q - Dick Wei>: Sales and marketing. Okay, got it. Maybe, Martin, if you can give us, I guess, maybe [indiscernible] (23:03) ago, I asked the same questions about any updates on maybe the performance-based advertising on the Moments area? I mean, with the restructuring, I don't know any – and more testing what kind of visibility do you have for that area, as well as maybe some of the kind of the performance from the Official Accounts, if you can share some of the parts, that would be great. Thanks.

<A - James Gordon Mitchell>: I think, as we mentioned in the prepared remarks, we're very happy, and more importantly, the advertisers are very happy with the results of the first sequence of that participants that occurred in the first quarter. And because its performance advertising, we can kind of quantify their happiness through looking at engagement metrics, viral shares, actual actions undertaken and so forth. So, given the advertiser happiness, we're going to be progressively expanding the number of advertisements, range of advertising formats and so on, as we move through the year.

With regards to the restructuring, internally, we thought it was important to create the advertising platform with the most simplicity, and therefore the greatest liquidity. And in order to facilitate that consolidation, we actually took two teams and products that were previously separated and unified them into a single team with a single product that would serve ads across all of our performance advertising inventory.

Operator

Thank you. Your next question comes from the line of Eddie Leung from Merrill Lynch. Please ask your question.

<Q - Eddie Leung>: Good evening. Thank you for taking my questions. I have a follow-up question on your performance-based advertising solution. Could you give us a little bit more color on the advertisers you expect to have going into the future? Do you expect the advertiser base to continue to be very different than your brand advertising solutions? Is there any opportunity to bring some of those large brand advertisers on your performance-based advertising system? So that's my first question.

And the second is just a housekeeping question on your game data. Any update on the revenue contribution of your mobile game portfolio, as well as the ARPU of different types of your games? Thank you.

<A - James Gordon Mitchell>: I think with regard to whether our big brand advertisers will buy performance advertising, I mean, it's a global trend that we have seen in the United States and Europe that brand advertisers are increasingly beginning to allocate some percentage of their ad budget towards performance formats. And if we look at our own results, then we only had about a dozen advertisers on Weixin Moments during the first quarter of 2015, but the majority of those were kind of classic brand advertisers flow through that advertising in a performance format.

So, going forward, we feel that there will be some of our ad inventory, example, the YingYongBao app store, where the preponderance of the advertising may come from classic performance are into the advertisers such as eCommerce companies, and then there'll be other ad inventories, perhaps including Weixin Moments where we'll have performance advertising coming from what advertisers should more traditionally be brand advertisers.

So, we believe that our performance advertising solution is increasingly suitable for increasingly broader range of advertisers, and maybe I'll pass the ARPU question on to John.

<A - Shek Hon Lo>: Yes, for the MMOG, the quarterly ARPU, it's between RMB295 million to RMB395 million, for advanced casual game, it would fall within the range of RMB100 million to RMB245 million. And in relation to smartphone games, it will be within RMB155 million to RMB165 million.

Operator

Thank you. Your next question comes from the line of Alicia Yap from Barclays. Please ask your question.

<Q - Alicia Yap>: Hi. Good morning and good evening, everyone. Thanks for taking my questions. I do have quick questions on the smartphone games revenue. So, it looks like YingYongBao and mobile browser contribute about RMB400 million revenue this quarter. I assume this mainly come from the games revenue sharing. So, how should we think about the app store revenue line and how meaningful will this grow into?

<A - James Gordon Mitchell>: I think on the app store revenue line, we have a model that's somewhat similar to those of couple of our listed competitors. And as of today, we'd have traffic activity that's similar to or greater than our competitors but revenue that's materially lower than our competitors. Over time, if we execute on monetization and our market share remains where it is, then we should expect our app store mobile game revenue to increase.

<Q - Alicia Yap>: I see. Then, is there any update on the Weixin Payment account in terms of tractions and also the numbers of accounts? I think, last quarter, you guys mentioned it's about 100 million paying user that linked through the bank account. Any update for this quarter especially after the Chinese New Year?

<A - Chi Ping Lau>: Yes, after Chinese New Year, well, number one, during Chinese New Year, we actually had a pretty big campaign around red envelopes and that actually sort of add meaningfully to both the number of people who buy-in their accounts as well as the activity within the accounts.

And then, sort of after Chinese New Year, there is a consistent growth in terms of the number of people who buy-in their cards because not only we have person-to-person transactions, we also have an increasing number of merchants who are using the payment solution. And for mobile payment solution, it's actually sort of a two-ended platform. You need to have more merchants than you can actually attract more users using it. And then sort of by having more users, you can actually attract more merchants. So, I think we have seen a virtuous cycle in terms of increasing number of people, who can pay and increasing number of merchants. So, the overall growth cycle is actually quite healthy.

Operator

Thank you. Your next question comes from the line of Alex Yao from JPMorgan. Please ask your question.

<Q - Alex Yao>: Hi. Good morning and good evening, everyone. Thank you for taking the question. The first question is to follow up with the previous question on Moments monetization. James, you discussed the feedback from advertiser encouraging and they are happy. And now that you guys have already accomplished the restructure of internal ad system, what's the strategy to release more inventory to a larger number of advertisers into the next few quarters?

And then the second question is can you share with us the development of affiliate ads network on mobile. Do you book that on gross revenue basis and the development there? Thank you.

<A - Chi Ping Lau>: Yes. On mobile – Moments, I think we'll continue to sort of develop it in a paced manner, I would say, because I think, very clearly, we know that there's a lot of traffic in the Moments timeline. There are a lot of people who are paying a lot of attention both in terms of number of visits as well as the amount of time they spend on Moments [indiscernible] (31:36) quite high.

But what we want to do is actually to make sure that we have the right advertising format, that, one, would sort of present a good user experience to users. Two, we want to make sure that we can actually sort of target the advertisements, so that the efficiency actually increase. And thirdly, we actually want the advertisements to be interesting enough that users would actually [indiscernible] (32:13) so you get sort of an additional benefit.

So I think the first round of testing, right, have confirmed that we were able to create these elements. But we also have continued room to improve. In particular, sort of, how exactly we can actually make the creation of these advertisements more efficient and sort of coming on standardized format so that advertisers can actually come up with these ads in a faster manner, I think, is an important aspect. So, I think that's sort of one thing that we're doing.

The other thing is actually sort of testing on other formats of advertising, so that we can provide the same elements, right? Good response from the users, good exposure for the advertisers, and also sort of having the viral effect. So we'll also work on that.

So over time, what you can see is there'll be an increasing number of advertisers. There will also be an increasing number of ad formats that will be added. And then sort of the performance metrics is built in terms of targeting, in terms of viral effect, hopefully, will continue to increase as well.

<A>: Okay, so the [indiscernible] (33:41).

<A - Shek Hon Lo>: So, I think in relation to the ad network, we book on net basis. Sorry, it's gross [indiscernible] (33:57).

<A - James Gordon Mitchell>: Yes, consistent with industry practice, we book ad network advertising on a gross basis which both our domestic and our global peers do.

<A - Catherine Chan>: Yes, thank you. Next question please.

Operator

Thank you. Your next question comes from the line of Cynthia Meng from Jefferies. Please ask your question.

<Q - Cynthia Meng>: Thank you management and congratulations for a solid quarter. I have two questions. Number one is, what contributed to the sequential jump in the other revenue category? And how much of this was contributed by eCommerce and how much was from online payment? And gross margin of this segment declined to 19%; how should we think about this going into the rest of the quarter? Can management give us some more color, please? I have a second question after this one.

<A - Shek Hon Lo>: In relation to the other revenue there, a few big components, one of which was, obviously, the eCommerce transaction which had been moved from the eCommerce segments to others. And other than that, there are also revenue generated from [indiscernible] (35:23) payment services, as well as some [ph] will show (35:29) eCommerce transactions, as well as some enterprise software revenue.

And in terms of margin because there's a mixture of a lot of things, so at this point in time, it will fluctuate quarter-over-quarters.

<Q - Cynthia Meng>: Great, I understand, thank you. And in terms of advertising gross margin trajectory, given the launch of performance-based advertising, which typically is higher margin, can you – can management give us some more color on how we should look at this? And particularly, we have seen after Facebook launch, performance-based advertising, the gross margins started to trend up. Will this also apply to Tencent? Thank you.

<A - James Gordon Mitchell>: I think, if you look at our advertising business, we have a traditional portal business, which is now becoming a news app business, where margins have been relatively stable over time. Then, we have layered on a video business, where margins have been very negative and now improving, but still remains a drag on profitability.

And then, within the performance advertising business, the substantial components is on our own inventory, where the incremental margins should be rather high because we're already bearing the content costs. And then some portion is the affiliate ad network, where the margins would be lower because we would share the revenue with our affiliate ad network partners.

Operator

Great. Thank you. Your next question comes from the line of Erica Poon Werkun from UBS. Please ask your question.

<Q - Erica Poon Werkun>: Yes. Hi. Thank you. Just want to have a quick follow-up on the Moments advertising, whether you can just share with us in the first quarter how much is contributed to revenue? Second question is on just the breakdown on your advertising revenue. How much of that was coming from video? Thank you.

<A - James Gordon Mitchell>: I think that if you look at the brand advertising revenue, then a substantial portion of the base and very much of the growth comes from video. On the performance side, we won't disclose advertising product by product because there's a lot of products, but we did say that the sequential growth was driven notably by Mobile Qzone, Weixin Official Accounts and YingYongBao. So, while we're excited about Weixin Moments advertising, we only had a dozen advertisers in the first quarter and we're still at a very early stage of deploying that. Whereas we also have lots of room to grow inventory and grow click-through rates and to grow revenue on some of our other properties, including Qzone, Weixin Official Accounts and YingYongBao app store.

<Q - Erica Poon Werkun>: Thank you.

<A - Catherine Chan>: Next question, please.

Operator

Thank you. Your next question comes from the line of Chi Tsang from HSBC. Please ask your question.

<Q - Chi Tsang>: Great. Thank you so much for taking my question. My first question is, I was wondering if you guys can give us an update on your initiatives on WeBank. And secondly, I was wondering if you can give us sort of an update on your expectations for your smartphone gaming portfolio for the balance of the year, in particular, the mix between licensed and in-house and casual and mid-core. Thank you so much.

<A - Chi Ping Lau>: In terms of WeBank, I think there's not that much to update. I think we have talked about many times it's going to be sort of a bank cooperation platform with banking license. It will be focused on picking up the credit needs of our vast number of users as well as the smaller enterprises. And it would be based on sort of our understanding of the users. If the users so required where we can actually sort of leverage that understanding to do dynamic pricing of their credit. And we'll certainly deliver those credits through our cooperation banks for money to be lent to these users.

So, this setup requires actually a lot of work in terms of coming up with the product, coming up with the right way to reach the users, coming up with the right way to sort of determine credit for these users. So, we are in the process of actually we're designing these products and also sort of on a very limited basis, testing some of these products among the users.

So, I think, I [ph] can't (40:21) give an update on that. Building a bank actually requires a pretty long time and especially sort of building a bank with sort of such a distinctive positioning, actually requires a lot of patience. So, I think we will give quite a bit of time for it to come up with the right product and right technology.

So, that's on WeBank. In terms of games why don't James talk about it.

<A - James Gordon Mitchell>: Okay, I mean, I'll start with history and finish with future. But historically, when we started launching smartphone games integrated with Weixin and Mobile QQ. Our primary objective was to train consumers who previously weren't playing smartphone games or indeed playing any games to begin doing so. And in order to do that, we initially focused on developing relatively casual, mass appeal games ourselves.

And we are pretty happy with our trajectory. We have disclosed that over 100 million people play our mobile games every day which is more than double the number of people playing PC games every day. Through last year, we felt that market was beginning to evolve and that it was important that we provide an attractive venue for third-party game developers, and also, we provide our users with reasonably more mid-core games.

So, at the second half of last year, moving into early this year, we put a great deal of energy into securing third-party game licenses and publishing some successful mid-core games such as I am MT2 or [indiscernible] (41:58) and so forth. Sitting here today, we believe the market will continue to evolve in multiple directions, and therefore, we want all of the above. We continue to develop many games internally in increasing number. We continue to license many games where we have some reasonably casual games in the portfolio, which intended to educate our users on the joys of gaming and also serve those of our users who want a casual game experience.

And then we have some more mid-core games in the portfolio. Today, we're in a position where we have somewhere in the region of half of the mobile game market. But if you look at it on a category-by-category basis, then there are certain genres which we have essentially pioneered and created ourselves like mobile shooting games, and there's other genres where we actually have very low market share, and we're looking forward to releasing good games that can increase our market share.

Operator

Thank you. Your next question comes from the line of Vivian Hao from Deutsche Bank. Please ask your question.

<Q - Vivian Hao>: Hi. Thank you for taking my question. I have two quick questions. First of all, regarding the all transition of streamlining for our advertising – retail advertising business, can management please provide some more color on the incoming execution plans for this streamlining more specifically? What are the key differences before and after this integration for advertisers? I have another question after this one. Thank you.

<A - Chi Ping Lau>: Well, the organization basically just combined two teams into one. It's essentially sort of combined our platforms into one performance-based platform. And so, both from the advertisers' perspective, there will be one platform for them to put money into. Internally, all the different media platforms or traffic platforms will be facing one platform. And also, sort of the data that we own will be sort of unified so that it would actually achieve the best result in terms of targeting users. So, those are the key differences.

<Q - Vivian Hao>: Right. So, we meant to make it more user-friendly. That would be the key purpose for this one.

<A - Chi Ping Lau>: Yes. I think we talked about the three elements, right? The user-friendly from an advertiser perspective; it will be sort of more unified from the internal communication perspective and also sort of from a product and technology development perspective. It will be one platform rather than two platforms.

<Q - Vivian Hao>: Okay, understood. There's a second question actually related to this. Is it possible if management can also give us some rough idea in terms of the CPC level and also the revenue sharing scheme for the WeChat public account owners we're offering right now?

<A - Chi Ping Lau>: I think generally the CPC trend – the CPC level is still relatively low when compared to sort of other performance-based ads. And the CPC level in terms of trend has been trending up as we continue to improve our targeting technology.

In terms of revenue share with OA accounts, it's an evolving situation. We have initially sort of tried to provide more advertising [indiscernible] (45:58) to the OA accounts, right, so that we can actually incentivize more and more third parties to put up advertising. Over time, we start to discover so that the traffic are not sort of created completely because there are certain accounts that are sort of original content. There are certain accounts which are sort of less original in terms of content, right?

So, over time, I think they will refine the revenue sharing mechanism, so that we will ascribe more revenue share through the OA accounts that actually will provide the most original content as well as the most incremental value, whereas we may actually sort of reduce some of the revenue share to the guys who are just sort of picking other people's content and putting on to their official accounts. So, it will become a much more sophisticated system in order to try to sort of grow this ecosystem.

Operator

Thank you. Your next question comes from the line of [indiscernible] (47:04) from Mizuho Securities. Please ask your question.

<Q>: Hi. Good evening. When you say that advertisers seem happy with the results from performance-based ads, how are you comping performance-based ads in China with? Is it performance relative to ROI to other social media companies globally or is it comping it to Search? Can you kind of provide some color on that? And I have a follow-up as well.

<A - Chi Ping Lau>: Well, I think, one, it has to be sort of compared to China, right? I think, the advertisers are operating in China, so they have certain expectations of a campaign. And these are sort of new advertisers who have a very experienced marketing team, and they have essentially run campaigns across all different platforms.

And usually, what happens, they have certain expectation on a certain amount of money to be spent and how much result will be achieved. And what happens is, I think, the Moments advertising is flowing through all of these metrics and exceeding their expectation.

<Q>: Got it. And just to follow up on your previous comment, you talked about the importance of the ad engagement, providing ads that are more engaging for the consumer. So, are all the ads on WeChat now native or unique ads? And how much is Tencent involved in the creative process or is that all from the advertisers themselves?

<A - Chi Ping Lau>: Well, number one is sort of all the Moments ads are original. And number two, in the very initial stage, where we're actually very involved in the creation of these ads because we want to make sure that the ad formats are something that's sort of in line with what a consumer's expectation of what Moments represent.

Over time, we said, in order for this to scale, we actually have to somewhat standardize it, right? So we're in the process of helping the advertisers as well as a lot of ad agencies now like to standardize these ads. So that's sort of where we can actually come up with different formats. We can come up with sort of certain elements. We can come up with a quality standard. And the good thing is that we can also sort of test on some of the ads, right, so that if it's actually effective, then we can sort of broaden the exposure. So, there are a lot of things that we're doing in order to standardize the ads so that the production of these ads can be done on a scale basis.

<Q>: Right. Well, thanks for the feedback. Thank you.

<A - Catherine Chan>: Thank you. Operator, in interest of time, we shall take the last three questions, please.

Operator

Certainly. Your next question comes from the line of Wendy Huang from Macquarie. Please ask your question.

<Q - Wendy Huang>: Thank you. My first question is on the recently announced TOS. So, what's the rationale behind started developing the operating system this year and how will the structure change Tencent to mobile ecosystem in the long-term?

My second question is on the mobile game. In April, I think, China Mobile actually closed down its payment channel in several provinces. So, according to some media report, this actually result in the 30% decline in the whole mobile game industry revenue. So, if Tencent being affected, if that's the case, and how should we actually read your Q2's mobile game revenue as well as the seasonality on the mobile games? Thank you.

<A - Chi Ping Lau>: Yes. On TOS, it's really I think an extension of a [indiscernible] (51:03) initiative. Our TOS was really sort of leveraging Android, then we're providing a layer that has sort of a deep integration with Android on one end and then here on the other end with a range of services that we provide. And we'll also create a framework such that it can be used for different hardwares, right, so it can be done for mobile phones, but it can also be used for watch, for virtual reality glasses, and over time, for other devices that people they come up.

So that's what we have done. I think we leverage quite a bit on the technology knowhow that we have developed both from sort of very system and technology, such as [indiscernible] (52:03) such as our browsers, such as our security technology. And then on the other end, we have a broad range of applications which are widely used by consumers. So we can actually sort of provide the APIs to make much better connection with these applications.

So far, I think we've received quite an enthusiastic response from the industry. A lot of hardware manufacturers are interested in exploring cooperation with us [indiscernible] (52:33) It is still an early initiative, but I think it's a good aggregation of many technologies that we have developed over the years and now sort of bring it into one framework that we can bring to the hardware industry in a very systematic way.

On mobile games, I don't think we've seen much impact from that – actually, we have not really paid attention. This is the first time I heard about it.

<Q - Wendy Huang>: Thank you.

Operator

Thank you. Your next question comes from the line of Ming Zhao from 86Research. Please ask your question.

<Q - Chun Ming Zhao>: Oh, thank you. I've got two questions. First question is on your mobile gaming. So, if we look at last two quarters, the performance on QQ games and the Weixin game, I mean, they're pretty healthy, but they're kind of lukewarm. Why is that? Is it because the mobile gaming industry is still very short history; so, this kind of trajectory seems a little bit less steep than expected. Do you see it because of the overall market is maturing or maybe give us your thoughts; do you think this mobile gaming market is a bigger or smaller market than the PC gaming? That's the first question.

The second question is your video ads are doing great. My question is on your digital content strategy. Can you give us more color about users paying for movies, your initiatives in literature, music and so on and so forth? Thank you.

<A - James Gordon Mitchell>: Okay. On the mobile games, I think we reported 8% sequential revenue growth for our overall mobile game business. So, while that's certainly cooler than the double digit sequential growth rates that we were generating a year ago, I think it's still relatively comfortably warm for us. And we do not feel that the industry is at a late-maturation stage yet given it's only a couple of years old and very early in terms of moving game genres from PC to mobile.

In terms of the long-term size of the market, I think again it depends heavily on how successfully different game genres move from PC to mobile, particularly some of the higher ARPU game genres. And what we know for sure today as I mentioned earlier is the number of people playing mobile games is much greater than the number of people playing PC games. And so if the right gaming experiences can be brought to them, then the monetization in revenue will follow. But that may take many years to fully transpire. So I guess that's our view on mobile games.

On the digital content strategy, and that was something we outlined as one of our focal points for 2015 and we have been investing against it. I think the products you mentioned, video, music, literature, growing varying degrees of growth depending partly on the timing with which we add new content. So for example in the first quarter we started to see the benefit of our HBO relationship which has brought very popular shows like Game of Thrones for the first time to Internet users in China and that's been very well received by our subscribers and by our free users.

And then as we move through the year, we'll have other exclusive content such as the NBA Basketball games joining our platform as well.

Operator

Thank you. Our last question comes from the line of Piyush Mubayi from Goldman Sachs. Please ask your question.

<Q - Piyush Mubayi>: Thank you. On the mobile gaming revenues itself, should I be taking out the revenues that you're earning from the app store, which is about RMB400 million? If I do that, then the sequential growth rates become narrow. Is that the right way to be thinking about it?

And also on the relationship with JD, the first – the previous quarter, the relationship looked like it was very strong. Could you share with us your thoughts on the partnership with JD? Thank you.

<A - James Gordon Mitchell>: I think on the mobile games side, if you exclude the portion related to YingYongBao and also our browser and other distribution channels, and also, those games that we publish on to in iOS that have not been to Mobile QQ or Weixin, then the mobile game revenue still increased by a single digit, mid-single digit percentage quarter-on-quarter. So again, that's not the pace which our mobile game revenue is increasing a year ago but we think it's a reasonable rate of increase and we'll be happy with it.

For the JD question...

<A - Chi Ping Lau>: Yes, for JD, I think we're still in the process of sort of continuing to create more synergies out of the relationship. So, whatever level of value that sort of you had seen in the previous quarter, I think our trend is actually sort of to magnify that over time.

I think, so far, what we have seen is through an entry point, we're doing our platform, we have been able to bring a lot of users particularly the users who are on mobile platform and who are in cities that have not been active users of a JD yet because there, the delivery network has not been covering those. But sort of over time, it's expanding to cover these cities.

Our platform have been able to bring these users to be first time user of JD's services. And over time, they may actually continue to visit JD and buy products on our platform. But they also sort of install a JD app, they get sort of loyal enough and start buying from the JD app. But I think to the extent that we can actually convert users and help them to grow their overall user coverage, I think that's one thing that's already adding a lot of value.

And over time, our app network can also sort of bring new users to JD because JD is actually a pretty big advertiser on our platform, and they serve as an aggregate of a lot of their merchants. And altogether, they're putting ads on our network. They're bringing users to their merchants, but also, sort of in the process build more fidelity with JD's eCommerce platform.

And we're also testing on new ways to bring social traffic into eCommerce. So, I think that continues to progress pretty well.

Catherine Chan

Thank you, Martin. Thank you, operator. We'll round up the call now. If you wish to check our press release and our financial information, please visit our corporate website at www.tencent.com/ir. We'll post a replay of this webcast on the site shortly. Thank you and see you next quarter.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating in Tencent Holdings Limited 2015 first quarter results announcement conference call. You may all disconnect now.