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Conference Call Transcript

ERTS - Electronic Arts Inc at Robert W. Baird & Co., Inc. Technology Conference

Event Date/Time: Nov 29, 2011 / 11:05PM GMT



CORPORATE PARTICIPANTS

Eric Brown

Electronic Arts, Inc. - CFO

CONFERENCE CALL PARTICIPANTS

Colin Sebastian

Robert W. Baird & Company, Inc. - Analyst

PRESENTATION

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

All right, great. Well thanks very much, everyone. I'm Colin Sebastian, Analyst who follows Internet and interactive entertainment here at Baird. We're very pleased to have with us today Eric Brown, Chief Financial Officer at Electronic Arts, one of the leading digital entertainment companies. And, Eric, I don't think the Company needs an introduction but I do think this year has been very strong for Electronic Arts. The sports business is healthy. Battlefield came out on all cylinders, Sims Social was a success on Facebook and we have Star Wars coming in just a matter of a few weeks.

So I guess start things off, is this a perfect storm, a one year perfect storm for EA, or is this something we should expect on a recurring basis?

Eric Brown - Electronic Arts, Inc. - CFO

Yes before I dive in, Colin, I'll -- if I could just first of all, just encourage listeners to the telecast or the other replay to review the risk factors on our Form 10-Q and 10-K before making any investment decisions in EA and any statements that we make are dated as of today, November 29th, 2011 only. We disclaim any duty to update them.

In regards to your questions, Colin, I think that it's fair to say we're off to a good start. We're roughly halfway through the fiscal year and I would just remind people that through the September quarter we still have about 140% of our profitability ahead of us into the December and the March fiscal quarters, so we still have a lot of work to do. We're right in the middle of our busy season.

But in regards to, for example, the other sports businesses, they're off to a good start. The titles in aggregate were up roughly 15% year-over-year so that indicates the strength of the core sports portfolio.

Sims Social was a very successful launch for Electronic Arts. It's a product released back in August and it quickly went to number two on the charts in terms of daily active users. It's since settled into the number four or number five position and we're now in monetization mode, but what we've proven is that we can take -- marry the best of EA's intellectual property with the expertise of social game development in our acquired Playfish Division and produce a world-class social game. So we're quite pleased with that so far.

And in regards to Battlefield 3, still a big release for us. In terms of an update, I would tell you that we've now sold in about 12 million units, sold through roughly eight. So it's an update versus when we discussed several weeks ago, and Star Wars is on deck here on December 20th.

What I would like to do is provide a little bit of update on Star Wars. One of the things that we did this past holiday weekend was proceed with a very large scale beta testing and rollout for Star Wars. To be more specific, we had 731,000 unique people play the game over the weekend and we peak concurrent users just above 250,000.

So one of the things we wanted to do prior to 12/20 is really test the system at scale and make sure the people were having a great experience. The system stood up reliably. We're getting the level of concurrency that we wanted out of the server site systems and so all in all it was a pretty successful test at scale for Star Wars. And so we're feeling good as we look to the 12/20 launch date.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Great, thanks very much for that update. Maybe starting there with Star Wars, you've talked before about limiting or capping the initial usage or online usage of the game. How quickly does that scale up or how quickly does that testing phase end and then you sort of open the gates?

Eric Brown - Electronic Arts, Inc. - CFO

Well we open the gates officially on 12/20. People who have pre-ordered will get several days of early access to the servers. That's part of the pre-order incentive program. It's hard to calibrate initial demand for a product like this. There are really not that many relevant data points for an MMO of this scale.

We're in a position to scale the service as needed. Our concern has remained first and foremost our customer satisfaction, making sure that we can on-board people in an efficient manner. The queues are minimal. People who want to get on a given set of servers with their friends or people in their clan can do so and they're not put in the attached portion of the other virtual world.

So for us the focus is on quality of service and we'll on-board and manage the influx initially with an eye first and foremost in customer service as opposed to necessarily maximizing the unit throughputs. In our mind the most important thing in this game service is maximizing retention, minimizing monthly churn over the long term. So that's really the priority consideration for us.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

What would be your expectation in terms of conversion rate paid from initial unit sales, if there's either industry benchmark or what might be typical for EA in terms of online games or maybe there's not enough for a precedent?

Eric Brown - Electronic Arts, Inc. - CFO

Again I don't think there's enough of a precedent here to point back and say this is a number or even a range of numbers. So we have, obviously, a lot of demand. We're up to 2.4 million people double opted in. So people have registered and actually volunteered to test the game for free so that's -- the number has been rising in the weeks leading up to the launch of the game itself. But in terms of the conversion rates, from initial sell in to say first month's subscriptions, we don't have an estimate for that.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Okay, I guess one follow-up would be more to your original comments. The new game publishers that wear multiple hats in terms of platforms, their console, PCs, social, mobile, how does that -- how is he able to sort of achieve success across those platforms or does each platform require a different skill set?

Eric Brown - Electronic Arts, Inc. - CFO

I think it's fair to say that each platform requires a slightly different skill set. In some case we build and develop capabilities and expertise organically. In other cases in the social game space we acquired that expertise with Playfish. What we tried to do, though, is stitch together game experiences across platform in such a way that a fan of the FIFA master franchise has an opportunity to experience the high quality FIFA experience high definition on the console, also as a mobile variant, an IOS variant, a Facebook variant, a play-for-free variant. And what we're trying to do is ensure that people get a -- we develop the best game for the platform because each platform is a different window, a different interface, different set of technical specs. The game is -- experience is different but we're trying to provide linkages from one set of experiences to the next.

For example, you could set up a match on one platform, have it queued up ready to go when you activate the game session on your 360 on your big-screen TV. And so that's really central to our strategy to take our brands across platform. Cross platform used to be three consoles. Now cross platform is across half a dozen very distinct environments, Facebook being one, IOS being another one, free-to-play, micro transaction base being another.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

And it sounds like from what the developments with Origin and all the millions of registered users that you have across these platforms that there's a bit of a pull towards maybe a central technology foundation at EA using and of course leveraging the data you have. Can you talk about sort of where you are on that time frame and hopefully perhaps the vision that you have for the Company from a platform perspective?

Eric Brown - Electronic Arts, Inc. - CFO

As of today we have roughly 140 million unique registered users in our central user database and that really serves as the kind of the nexus for all the cross-platform experiences and opportunities that I described. So people log on and register to play an EA game. We know who they are. They're registered in nucleus. We know which game they purchase, which game they played in many cases, what levels they've played through, what achievements they've unlocked.

We know exactly what they're entitled to. They can take a game, the PC download purchased on one PC, activate an account and play that game on a completely different PC, not concurrently but in a cross platform sense. And so that master user registration system allows all these types of things to occur. Think of it as a single user ID system analogous to what's at the back end of Amazon or iTunes.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

And does that extend also to mobile platforms?

Eric Brown - Electronic Arts, Inc. - CFO

We are extending it to mobile. We actually purchased a small mobile developer that had a mobile version of that user registration system that allowed assets, entitlements and achievements to be linked to a user account and to be taken across different games. So there is a mobile variant to the strategy.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Okay, thinking mobile is one more of the themes at the conference here and also more generally in terms of content free-to-play models are certainly becoming more prevalent. How do you see that changing the economics of this business in moving from games on the client to apps and from \$60 games to free-to-play apps or free apps?

Eric Brown - Electronic Arts, Inc. - CFO

Well, it's a combination of opportunities and risks presented by mobile gaming. On the opportunity side, you have tens of millions of new gaming capable devices. We're all carrying in our pocket today a smart phone, which is capable of providing a great gaming experience. What's the risk I guess is not so much displacement of gaming other form factors like a 360 console or a PS3 because the two gaming experiences are clearly very, very different, not a substitute one versus the other but some of the pricing model has changed.

Three years ago there really wasn't an IOS gaming market. It started with paid downloads and now roughly two-thirds of that marketplace is no longer paid downloads but it's free-to-play. That is to say you purchase a game via the app store. You play it for free and then you combine new levels or micro-content items so you monetize at the back end.

So that market is -- it's emerged in the last three years and in the midst of the three-year period it's completely transformed at least two-thirds of the way towards free-to-play. So that's I guess the risk in the mobile market, but all in we just look at the tens if not hundreds of millions of new people that are playing games for the first time on mobile devices. It's an opportunity for publishers with a good intellectual property portfolio.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

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And, as all of these emerging platforms become a bigger part of the mix for the Company, I believe you've talked about it before it's scale, margins and these platforms are in the 20% range. I guess, does that still sound like the right scenario and also how far are they from reaching that type of scale?

Eric Brown - Electronic Arts, Inc. - CFO

Yes certain sub-segments of our digital business, an example would be we have a number of older MMOs in operation and all in they're at north of 20%, closer to 30% operating margins, and so that speaks to what an MMO can generate at modest scale over time. The mobile business or areas of the mobile business can operate at 20% margins.

A very -- probably the highest margin digital opportunity that we have is using our Origin digital distribution service and so when we can transact and sell a PC game direct to the end user to capture the entire margin stack and can transact on an ongoing basis with that registered customer and so that's probably the greatest percent net margin opportunity that we have in digital. Blend these together and scale them up with good cross management we think that the digital portfolio over time is what allowed EA to drive its non-GAAP op margin to where it is today, midpoint kind of 9 percentage points in terms of non-GAAP op margin revenue to -- and we would like to push that into the teens over time.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

I guess turning back to Star Wars and some of these do you have expectations there and for various margin thresholds can you -- you talked about this before I think. Can you remind us sort of where the game needs to be in terms of reaching profitability and then where you'd like it to be over time?

Eric Brown - Electronic Arts, Inc. - CFO

Yes in terms of profitability, because we expense all of our R&D you're just launching Star Wars and eliminating dilutive R&D spending is accretive to EA's P&L and so it's from December 20th onward it's going to be accretive.

In terms of kind of the scale of profitability or how to measure the investment, which I think is one of the points you're getting to, Colin, we've talked before about if you were to do a standalone just kind of a cash flow analysis of the Star Wars investment, go back roughly four years from when we started development, make all the [sunk] and expense to R&D dollars and then look at all the profitability expected over the life of the product, 0.5 million subs using our cost of capital and discount to all this, it's negative NPV. At 1.0 million subs it's slightly positive NPV. At 1.5 million subs or better we start to produce a pretty good premium to our cost of capital and so that's the framework that we've talked about in terms of how to think about Star Wars subs versus the investment case.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

What is your perception in the competitive landscape as in the market with World of Warcraft entering the declining cycle or phase? Is that an opportunity for Star Wars to come out of the gate here and absorb some of those users or do you view them as somewhat extinct?

Eric Brown - Electronic Arts, Inc. - CFO

Yes I don't think that recent declines in a specific MMO is indicative of a change in kind of the category overall. The MMO has been and is expected to remain a pretty robust category for digital. It's in growth mode in all the major geographies. I think it's a function of a specific franchise that is six plus years old and there may be people looking for alternatives. We think that Star Wars is very different in a lot of ways. It's story driven. It's the first fully voiced over MMO. You can play eight different character classes over the life of the game and completely alter the flow of the game so it represents I think a very different experience compared to World of Warcraft and most other MMOs for that matter.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Is there any reason that we should be concerned about this monthly subscription model that maybe, given these alternatives you're exploring other parts of your business, for example free-to-play etcetera, that that business model may be a bit outmoded?

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Eric Brown - Electronic Arts, Inc. - CFO

Yes I don't think the business model is outmoded and just I think that declines in one business over the last quarter is I think indicative of specific issues around an older franchise. We still believe that the monthly paid subscription model for an MMO with a great ongoing content screen and a great experience in this great story driven kind of RPG core will be very attractive and again we think about the fact that we have dates, participation rates in the large scale beta of 731,000 uniques over the past weekend, 2.4 million double opted in, registered Star Wars MMO fans, we think that demand indicators are reasonably robust.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Great. In terms of acquisitions and use of capital and you've made some acquisitions already this year but how should we think about the plans, Company's plans, for the next 12 months on that front?

Eric Brown - Electronic Arts, Inc. - CFO

Yes the thing about acquisitions we tend to think of smaller scale tuck-in acquisitions on the digital side either digital content. We talked a little bit about some of the smaller scale free-to-play mobile development deals that we've done. Other areas that interest us are the social game space and so either a content in or capabilities at a reasonable price there is something that's attractive to us and so that is how we think about M&A.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Okay any other uses of capital, the planned use of the cash that we should be aware of?

Eric Brown - Electronic Arts, Inc. - CFO

Yes the Company, we've been engaged in a share repurchase program. We've executed roughly half the program to date so that's also been a means of deploying capital and providing returns for our stockholders.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Turning back to Facebook as a platform, I guess from a pipeline perspective post some social what are some of -- or can you talk about any of the games that have that type of potential for repeat success from Electronic Arts? And then beyond Facebook but also for the social perspective whether that's Google plus or somewhere else, what is the strategy there?

Eric Brown - Electronic Arts, Inc. - CFO

Well, next on deck in the social game portfolio, not necessarily a game that we'd expect to hit the levels and the (inaudible) of some social risk factions and game developed in partnership with Hasbro to play specifically across Facebook, again a casual game. Most of us are familiar with Risk, the board game, and so that's a game that is out or about to be out in the marketplace. I think that we've also talked about other properties we have in the social genre within the EA and PopCap portfolio. 80%, 85% of the games, top games, top 250 games on Facebook today, fall into the social genre and so if you think about the types of influential property we might bring to market without again naming specific franchises, think casual first since that's what gets the greatest play and distribution across the Facebook gaming community.

Beyond that about social gaming or social gaming alternatives, we've taken FIFA, on of our big name franchises, into partnership with Korea and Japan, recently launched that game. It's become the number one third party game across the Korean network today so this is out in the market just as of several weeks ago, generating well in excess of \$100,000 per day gross so that's again another social extension of the core IP and I think that pretty much all games have become social at one level or another.

Even if we take a look at the traditional first person shooter category in high definition console, people playing multiplayer, we look at the ratio of units sold through to on-line multiplayer activations and the tie ratios are incredibly high. People play on line because they want to social either

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cooperative or head-to-head experience and I think that high definition gaming in general has become inherently quite social and we see single player detached experiences in decline by comparison and consoles being high def or for standard definition consoles so almost all gaming has become more social in nature.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Good point. I don't know if you saw Microsoft announce today that this past week the Xbox has sold more units than in its entire history any other week so that leads me to wonder has the traditional console market now that Nintendo has sort of reached the tough comps or past those tough comps, do you think that the overall console market has stabilized or is this just a really strong weekend for gift giving and perhaps an anomaly?

Eric Brown - Electronic Arts, Inc. - CFO

Well, I think the Thanksgiving holiday weekend with Black Friday was actually pretty good. The NRS staff would indicate it was the best since 2007 versus last year the data I saw across all categories, not necessarily video games but across all retail categories, is a 16% increase year-over-year, 8% based on increased traffic flow and 8% or so based on increased purchase rate so it was a good weekend overall so I guess we can take some comfort in that collectively.

Within video games the trends that we've been seeing, you know video game software sales were flattish versus down as is highly been comping the last several quarters so a slight improvement there but, even within kind of a flattish overall category performance, we saw a sharp decrease in standard definition video games and we've talked about that for the last five to six quarters, no surprise there. And about a 20% or so increase on high definition software sales, so to your point on the 360, the high definition platform, great online capabilities, great innovation with Kinect, the fact that they had a good weekend in terms of hardware sales is not a surprise because it's just a reflection of the trend we've been seeing on high definition platforms and platform trends versus standard definition.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

With that, I think I've used my time. Let me turn it over to the audience now for questions.

QUESTION AND ANSWER

Unidentified Audience Member

(Inaudible - microphone inaccessible).

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

Sure. For the webcast so I think two questions, one on outsourcing the talent and what you're seeing with trends there and then secondly on Origin.

Eric Brown - Electronic Arts, Inc. - CFO

Sure I'll start with the Origin question first if I may, so Origin is EA's PC client digital distribution service. It's backed up by our sophisticated user registration database of 140 million plus registered users that I talked about but it's a piece [acquired property] that's downloaded. We have about 6.5 million installed to date. We have now started to sign up more third parties like Warner and THQ, who will be distributing their titles on Origin with EA taking the digital retailer margin. So Origin is doing well and this is an effort for us that is less than a year old. We unveiled it at e3 roughly five or six months ago and so the team has really delivered nicely. It was key to supporting the rollout of Battlefield 3, which tends to have pretty good PC mix.

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What we're seeing in terms of the purchase take right on the Origin to date though is average revenue per paying users in the \$45 to \$50 range so on average people are going to Origin and buying a front line PC title for less than for \$45 to \$50 would suggest and so we think that Origin is something that allows us to digitally interact direct with our consumers, deliver our content and leading third-party content and we think it's quite margin accretive there.

Regards to your first question, the cost structure to EA's global company roughly 8,000 employees worldwide, what we're finding is that we've been quite successful outsourcing different aspects of development, QA, monitoring operations etcetera to places like Hyderabad, India, Romania and Shanghai and this is part of our stated strategy of trying to improve our mix of resources in high cost versus low cost locations so that's our footprint to date. We continue obviously to do even better there for the benefit of our stockholders.

Colin Sebastian - Robert W. Baird & Company, Inc. - Analyst

We have time for one last question. Okay great. Eric, thanks so much.

Eric Brown - Electronic Arts, Inc. - CFO

Thanks, Colin.

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