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EA - Q3 2015 Electronic Arts Inc Earnings Call

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OVERVIEW:

Co. reported 3Q15 non-GAAP net revenue of \$1.43b non-GAAP diluted EPS of \$1.22.

Expects FY15 GAAP revenue to be \$4.485b and fully-diluted EPS to be \$2.57.

Expects 4Q15 GAAP net revenue to be \$1.16b and GAAP EPS to be \$1.07.



CORPORATE PARTICIPANTS

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Andrew Wilson *Electronic Arts Inc. - CEO*

Blake Jorgensen *Electronic Arts Inc. - CFO*

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PRESENTATION

Operator

Welcome and thank you for standing by. At this time, all participants are in a listen-only mode. (Operator Instructions) This conference is being recorded. If you have any objections, you may disconnect at this time.

Now I will turn the meeting over to Mr. Chris Evenden, Vice President of Investor Relations. You may begin.

Chris Evenden - *Electronic Arts Inc. - VP IR*

Thank you, Gabriella. Welcome to EA's fiscal 2015 third-quarter earnings call. With me on the call today are Andrew Wilson, our CEO, and Blake Jorgensen, our CFO. Frank Gibeau, our EVP of Mobile, and Peter Moore, our COO, will be joining us for the Q&A portion of the call.

Please note that our SEC filings and our earnings release are available at ir.ea.com. In addition, we have posted earnings slides to accompany our prepared remarks. Lastly, after the call, we will post our prepared remarks, an audio replay of this call, and a transcript.

A couple of quick notes on our calendar. We will be presenting at the Stifel Nicolas conference in San Francisco on Monday, February 9. And the date of our next earnings report will be Tuesday, May 5.



This presentation and our comments include forward-looking statements regarding future events and the future financial performance of the Company. Actual events and results may differ materially from our expectations. We refer you to our most recent Form 10-Q for a discussion of risks that could cause actual results to differ materially from those discussed today.

Electronic Arts makes these statements as of today, January 27, 2015, and disclaims any duty to update them.

During this call, unless otherwise stated, the financial metrics will be presented on a non-GAAP basis. Our earnings release and the earnings slides provide a reconciliation of our GAAP to non-GAAP measures. 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. All comparisons made in the course of this call are against the same period in the prior year unless otherwise stated.

Now I will return the call over to Andrew.

Andrew Wilson - *Electronic Arts Inc. - CEO*

Thanks, Chris. Q3 was an outstanding quarter for Electronic Arts. Dragon Age: Inquisition was named to more than 200 Game of the Year lists globally. More than 6 million people on average were playing FIFA games every week across the world.

Madden NFL mobile had its biggest day in franchise history on Christmas day, reaching number four on the top grossing charts in the US Apple App Store. And we finished the calendar year as the world's leading console games publisher, a testament to the strength and breadth of EA's IP.

Our excellent financial results reflect the strong player engagement and critical success of our titles. Revenue and earnings for Q3 were beyond our guidance and we delivered another quarter of strong cash flow.

At the core, we continue to focus on putting players first. As we listen, learn, and deliver for our communities with games and services that they love to play, we are experiencing new milestones in engagement. On console and PC platforms alone, more than 3.1 billion hours were spent playing EA games in Q3.

Dragon Age: Inquisition captivated fans and critics worldwide as it launched in November. And it quickly became the most successful launch in BioWare history. More than 113 million hours have already been spent exploring the depth and detail of the single player experience in Dragon Age: Inquisition and more players are joining each day.

Named Game of the Year by 32 media outlets around the world, including RGN, Game Informer, and the Associated Press, Dragon Age: Inquisition is a true masterpiece from the team at BioWare and a game that is sure to be played for a long time to come.

FIFA 2015 and Madden NFL 15 also continued to deliver for fans in our third quarter. FIFA 15 was the number one title in Europe and a top 10 title in the US in 2014, with engagement growing in Q3. There were nearly 50% more users logging in each week as compared to Q3 last year.

Meanwhile, Madden NFL 15 was the number two best-selling title in North America for 2014 across all genres. And gameplay hours were up 30% year on year in Q3.

In our Ultimate Team services, engagement is deeper than ever. The total number of players entering Ultimate Team across FIFA 15, Madden NFL 15, and NHL 15 has increased nearly 45% year over year.

Our Maxis Studio delivered three major game updates to the Sims 4 during Q3, providing fun new content and adding some of the most wanted community features. Each update has driven more players to engage with the Sims 4 and we have plans to continue delivering fresh content and gameplay to the vibrant Sims community.



EA Mobile had a breakout performance over the holiday period. Our EA sports titles are drawing more sports fans in the mobile games, averaging more than 45 million monthly active users during the quarter.

Madden NFL Mobile and FIFA 15 Ultimate Team led the way, averaging 45% more monthly players through Q3 compared to our previous iterations in the same period last year. The newly launched SimCity BuildIt was downloaded more than 22 million times in the first month, reached the top 5 iOS game downloads in more than 100 countries, and to date, players have already logged more than 1.2 billion gameplay sessions.

New games like Madden NFL 15 Mobile, FIFA 15 Ultimate Team, and SimCity BuildIt, as well as perennial fan favorites like Real Racing 3, the Sims FreePlay, and the Simpsons Tapped Out demonstrate one of our key opportunities in mobile, leveraging our IP and specifically designing experiences from the ground up for players on mobile devices.

We are listening and learning from the feedback in our mobile community, tuning the experiences based on testing and soft launch periods, then keeping players entertained with new content and challenges.

Overall, the momentum that we are seeing across different platforms today gives us great reason to be excited for the future. On consoles, the in-store base on Xbox One and PlayStation 4 continues to show strong growth, while new players joining on previous generation consoles are also tapping into our amazing IP catalog.

On mobile, innovative games are opening up new growth genres, like sports, with highly engaged players. On PC, our Origins service continues to grow fiscal year to date and offer exciting new ways to play.

Across all of these platforms, live services are extending the experience and bringing players deeper into the games they love. With the dynamite nature of this industry, platform preferences, player interests, play patents, and gaming experiences will constantly evolve. We are confident that throughout efforts to put players first, to continue to digitally transform our business and to operate faster and more focused team, we will be in a position of strength to make these industry changes our greatest opportunity.

I will now hand the call over to Blake for a deeper look at Q3 financial performance, then I will return with a few final thoughts.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Thanks, Andrew. EA's non-GAAP net revenue was \$1.43 billion, which was \$153 million, or 12%, above guidance. The quarter's revenue was only 9% lower than the prior year's, which included the launch of Battlefield 4.

However, our focus on live services, strong title performance, and expense control drove operating margins up significantly this quarter to 36.3% from 33.8% last year. And this resulted in excellent cash generation and earnings. This extraordinary performance was led by FIFA 15, Madden NFL 15, and Dragon Age: Inquisition.

In particular, Dragon Age: Inquisition had by far the most successful launch in BioWare's history, exceeding our expectations.

In addition, game sales for last-generation consoles were also much stronger than we had anticipated.

FX negatively impacted revenue by about \$20 million this quarter, but our hedging program offset about half of this. And combined with the natural hedging from our international operations, largely neutralized its impact on earnings.

Our non-GAAP digital net revenue for the quarter increased 34% year over year to \$693 million, 49% of this quarter's revenue and a new high. The trailing 12-month digital net revenue was also a record, up 17% to \$2.18 billion. This is the first time digital sales have generated more than half our revenue in a 12-month period.



Breaking down our digital revenue into its key components highlights the performance of each of these businesses this quarter. Extra content and freemium contributed \$314 million, up 47% over the prior year, with Ultimate Team continuing its strong performance across our FIFA, Madden NFL, and NHL franchises, up 82% year over year in total.

FIFA Online 3 in Korea continues to grow year over year. And the early indications from our partner in China, Tencent, are that it is already performing extremely well. Star Wars: The Old Republic also contributed to this segment with the expansion, Shadows of Raven, attracting many more people into the game with this epic new storyline.

Star Wars fans remain deeply engaged in the Old Republic universe and were more excited to see how that will build as we get closer to the launch of the Star Wars movie this December.

Mobile generated a record \$139 million in the quarter, up 13% over the prior year. \$125 million, or 90% of this, was from digital extra content and advertising. This was up 28% versus the prior year and continues to more than offset the decline in the premium business.

Premium full game downloads revenue was just \$14 million, down 44% compared to the prior year.

Mobile had a strong December in particular, driven by the success of SimCity BuildIt, Madden NFL Mobile, and FIFA 15 Ultimate Team Mobile, as well as the continued strength in the rest of our mobile portfolio. Leveraging proven IP like this reduces the cost of player acquisition and drives the long-term profitability of our mobile business.

SimCity BuildIt has proven to be a highly engaging title that has been a top 10 grossing one on iPhone in 85 countries and on the iPad in more than 100 countries.

Full game PC and console downloads generated \$140 million in revenue, up 22% over the prior year, driven by growth in the installed base of PS 4 and Xbox One consoles. Although the percentage varied considerably by title, platform, and geography, the trend towards full game download continues.

Subscriptions, advertising, and other digital revenue contributed \$100 million, up 52% over the same period last year. The primary growth driver was Battlefield 4 Premium revenues.

EA Access, our subscription service for Xbox One, continues to grow and we are seeing subscribers play more games, engage more broadly with EAs offerings.

Moving on to gross margin. Our non-GAAP gross margin for the quarter was 72.8%, an increase from last year's 68.1% and better than our guidance of 70.5%. The increase over the prior year was primarily due to the growth in our digital business, strength in current generation consoles, and a one-time benefit from NHL revenue deferred from the second quarter. This was partially offset by the higher proportion of sales from royalty-bearing titles in the quarter compared to last year's Q3.

Outperformance versus our outlook was driven by the record-breaking Dragon Age: Inquisition performance. In addition, sellthrough was extremely healthy across the market, enabling us to maintain margins above our expectations while keeping channel inventory clean.

Our non-GAAP operating expense for the quarter were \$521 million, down 4% year on year, \$19 million below prior year, but \$6 million above our guidance. Compared to last year, we were able to continue to reduce advertising spend by focusing on fewer frontline titles and increasing the efficiency of the way we advertise.

This was partially offset by an increase in the accruals we made from variable compensation and legal expenses, which were not in our guidance. The resulting non-GAAP diluted EPS was \$1.22 per share, \$0.32 better than guidance due to strong revenue, higher gross margin, and continued cost control.



Our cash and short-term investments at the end of the quarter were \$2 billion -- \$2.94 billion or approximately \$9.48 per share. [66] of this cash and short-term investment balance is held onshore.

Net cash provided by operating activities for the quarter was \$682 million. On a trailing 12-month basis, operating cash flow was \$1.15 billion, a record for this period.

During Q3, we repurchased 2.5 million shares at a cost of \$97 million. As a reminder, our \$750 million stock buyback program was initiated in May 2014 and has a two-year timeframe. The current rate of purchase keeps us on track to complete the full \$750 million in that time.

Turning to guidance, we are increasing our full-year guidance. For fiscal year 2015, our non-GAAP guidance for revenue will increase by \$78 million to \$4.253 billion. And our non-GAAP EPS will be increased by \$0.30 to \$2.35 per share.

This results in an expected operating margin of nearly 24%. Although this guidance passes through essentially all of the Q3 earnings outperformance to the full year, it does not pass through all the revenue. The reduction in our Q4 revenue expectation is based on uncertainty around future currency movements and the decision to move EA Sports PGA Tour and the first Sims 4 expansion pack into fiscal 2016.

In addition, there is uncertainty as to when we will start to recognize revenue from FIFA Online 3 in China. However, gross margin improvements and continued expense control offset this conservatism in revenue, allowing us to substantially reaffirm our Q4 earnings expectation.

The GAAP guidance becomes \$4.485 billion in revenue and \$2.57 in fully diluted EPS. Regarding cash flow for the full fiscal year, we are increasing our operating cash flow guidance to approximately \$1.05 billion, which would be the largest fiscal year cash flow in the Company's history.

Our capital expense forecast remains approximately \$100 million, resulting in a new free cash flow forecast of approximately \$950 million. Guidance for our fourth quarter is now non-GAAP net revenue to be \$830 million, a 9% decrease compared to last year's \$914 million. The year-on-year difference is largely driven by a battle -- Battlefield 4 catalog sales, which were very strong in Q4 fiscal 2014, the quarter we -- immediately after we shipped Battlefield.

Our next major launch title, Battlefield Hardline, will start to ship the third week of March. So its impact on the quarter will be limited, even though we expect it to build into a significant title through next fiscal year.

Non-GAAP gross margin is forecasted to be 74%. We expect our Q4 operating expenses to be \$515 million on a non-GAAP basis. This results in a non-GAAP diluted EPS of \$0.22 per share as compared to \$0.48 last year.

Our Q4 guidance for GAAP net revenue is expected to be \$1.16 billion as compared to \$1.12 billion in the prior year. GAAP earnings per share is expected to be \$1.07 as compared to \$1.15 per share in the prior year.

We are pleased with our third-quarter results and most importantly with the consistent growth of cash flow and earnings. We are well ahead of where we expected to be at this stage of our transformation, largely as a result of the strength of our digital live services strategy, our ability to control cost, and the continued great commitment of our employees to drive performance.

But there is plenty more opportunities ahead of us. We expect these factors will continue to drive growth in cash flow and earnings and to be augmented by a growing mobile business as we continue to apply our core IP to this platform.

Now I will turn the call back to Andrew.

Andrew Wilson - *Electronic Arts Inc. - CEO*

Thanks, Blake. It was a great Q3 and there is more to be excited about as we look to Q4 and beyond. The launch of Battlefield Hardline will be the culmination of efforts by the team at Visceral and across EA to engage our players and deliver a rich and innovative new experience.



Battlefield Hardline is a fresh combination of speed, story, and strategy, a mix of an engaging single player campaign inspired by popular TV dramas, new speed-based multiplayer experiences, and classic Battlefield multiplayer modes. We're getting great response to the game in recent play tests and we look forward to opening up to the community with the upcoming multiplayer beta.

This is a fast, fun, and intense new experience and we think players are going to love it. We look forward to launching this new take on Battlefield beginning on March 17.

Our slate for the coming year demonstrates EA's commitment to exciting players through brand-new experiences as well as our live services. Players in our current experiences, including Dragon Age: Inquisition, The Sims 4, the EA Sports portfolio, and Battlefield 4 will continue to see updates and new content in the future.

We will now launch PGA Tour in Q1 FY 2016 in line with some of the -- golf's biggest tournaments and it will be joined by a lineup of annual EA Sports titles next year.

Our Need for Speed franchise will return in FY 2016 with a game that is already looking spectacular. And of course, the new blockbuster Star Wars: Battlefront is set to release in the holiday quarter this year. We share our full FY 2016 calendar, including a slate of new mobile games, during our next quarterly call.

I said earlier in the call that the very nature of the games industry is that it is dynamic and constantly evolving. This plays to the strength of Electronic Arts. Change is one of the constants in the history of this Company and we continue to challenge ourselves to listen, learn, and lead an exciting new future for gaming and for our players.

You will see us focus on our player relationships to engage and understand what inspires each game that they play. You will see us investing in new IP and innovation, from ground-up new experiences to cutting edge digital services.

And you will see us focus on quality at every turn, stability in our services, and delivery of long-lasting fun with games that are played for months and years, not just days or weeks.

Throughout FY 2015, EA has focused on putting our players first and strengthening the foundation of our business. We now look forward to a strong finish in Q4 and carrying momentum from FY 2015 into FY 2016.

Now Blake, Peter, Frank, and I are here for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Colin Sebastian, Robert Baird

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

Congratulations on a great quarter. First off, following up on the commentary regarding the full game downloads, console games, I wonder if you could quantify that mix of digital versus physical. And then how much of the downloads are driven by promotions and bundles.

And then secondly, regarding the market for last gen games, you mentioned this segment exceeded your expectations. I wonder if we can now say that that portion of the market has stabilized or was that specific to what you were doing over the holiday period? Thank you.



Peter Moore - *Electronic Arts Inc. - COO*

Hey, Colin. It is Peter. So 100% of full game downloads are digital from a mix perspective. As I have said on previous calls, we are seeing about 15% of our sales come from full game downloads via primarily the Sony and Microsoft platforms, of course, as well as our Origin platform.

I will say in the last couple of weeks, to your question, that we have seen an interesting and encouraging pickup in our sports titles in particular, where we are seeing the significant increase above that number for full game downloads on the console and PC platforms.

As regards current generation or Xbox 360, PS3 platforms, we saw about \$100 million in incremental revenue in Q3 on those platforms, I think driven by a number of factors.

I think it has been great value for consumers to pick those consoles up at this stage in their lifecycle. I think Sony and Microsoft continue to support them well. There is a great portfolio of titles. And in particular, what Electronic Arts brings is blockbuster IP that our gamers are very familiar with and there are relatively easy purchases.

We are also seeing strong digital pick up on those platforms as well.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Colin, it is Blake. Just to follow up on Peter's point on full game downloads. I think you had asked -- trying to get a sense of how much of that was coming through bundling.

We did have some bundles in the quarter, but not substantially more than we would normally have. So the real full game download trend is being driven primarily by full game downloads on the new generation consoles.

One phenomenon, though, we do see in the Christmas holiday is that people like to give physical gifts that fit under the tree or wherever you do your gift giving. And so oftentimes, we don't see the pickup in full game downloads until after people have played their first round of games they have gotten for Christmas presents.

And Peter's point was we have seen a just most recent pickup in the last couple of weeks of full game downloads, which would tie back to the notion that people are now starting to really understand the power of their new consoles and starting to pick that up.

Peter Moore - *Electronic Arts Inc. - COO*

Yes. And it is the convenience factor, I think, kicks in there.

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

So the 15% that is digital that you mentioned, Peter, that is specific over the holiday period and you would expect it to be higher than that.

Peter Moore - *Electronic Arts Inc. - COO*

Colin, that has been our rate for the last two or three quarters, but as I said, we are starting to see a pickup in that. To Blake's point, I think what we are seeing is consumers finding the convenience of full game digital downloads from Xbox Live and PlayStation Network as they buy their next games after they consume their games that they got -- their physical games for the holidays.

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

Great. Thank you.

Operator

Edward Williams, BMO Capital.

Edward Williams - *BMO Capital Markets - Analyst*

Congratulations on a great holiday season. A couple of questions. Can you give us a little bit more detail about how EA Access is performing? And Blake, if you can elaborate a little bit more on what sort of an FX impact we are seeing in your operating expenses?

Blake Jorgensen - *Electronic Arts Inc. - CFO*

So on EA Access, I will let Peter address that first and then I will talk about FX.

Peter Moore - *Electronic Arts Inc. - COO*

Yes, EA Access continues to perform extremely well, Edward. Not giving numbers yet, but -- and as you know, it is Xbox One exclusively.

But we are seeing significant increase. We are seeing better positioning on the Xbox Live Dashboard for the product. I think gamers are seeing great value for money and the three legs of the stool that is EA Access. Obviously, the early trial, the discounted elements of what we do in particular, and the ability to access a vault now which continues to grow with its titles.

And we are seeing significant playtime on EA Access as well as what we believe now is consumers buying games as they become available in launches [are been], in particular our iterative titles. So I think we are optimistic that that will continue to grow as we go into FY 2016 in particular. But a great start for EA Access.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

On FX, Ed, the -- we have a hedging program in place where the objective is to reduce the impact of currency moves on operating income and cash flow. And in addition, we actually get a natural hedge based on the fact that we have substantial number of employees and offices in Europe as well as in Canada.

And we tend to focus on four core currencies: the euro, the British Pound, the Canadian dollar, and the Swedish krona, which are really the four core centers of where we have employees as well as where our core revenue exists.

We are exposed to other currencies beyond that, because they are not as large in the overall mix.

The reality is is that we are able to hedge our revenue, but rarely can we hedge 100% of that. We are able to hedge partially because of actual hedges and partially because of natural hedges. More of our operating income swing. So we will tend to see a larger swing on the topline than we do on the bottom line.

This quarter, we saw virtually no impact on the bottom line. And as I said, about a \$20 million impact on the topline. The real unknown for us going forward is exactly what we think the euro is going to look like six to nine months out, where we -- our hedges are less impactful going forward. We will know more when we give guidance in May for the full year.

We see a little risk in the fourth quarter, if you see continued decline in the euro. But I think the big unknown for us is what does the euro look like all through our next fiscal year and does that present a risk. And we will give you an update and we are doing our best to try to hedge out as much of that risk as possible.

Edward Williams - *BMO Capital Markets - Analyst*

Okay, great. Thank you.

Operator

Arvind Bhatia, Sterne, Agee.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

I would like to add my congratulations as well. I wanted to see if you guys could maybe talk about how you are viewing the market for next year in light of the success you have had with the next gen. But also the stability that seems to be happening on the old generation -- just as that mix changes, how do you view the market growth?

And then you guys have been exceeding your margin goals consistently and that has been great. Just wondering if, Blake, you would take a shot at maybe a medium-term operating margin goal going forward, in light of all the cost savings you have already realized and how the gross margin benefit you have gotten from the mix. Thank you.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Let me let Andrew start and then I will come back to the operating margin question.

Andrew Wilson - *Electronic Arts Inc. - CEO*

Thanks, Arvind. Great question. As we look at the year ahead, we are very confident. We are seeing continued uptake of PlayStation 4 and Xbox One. The new boost that we had through this quarter on what was Xbox 360 and PlayStation 3 is also very good for us.

Again, we have a very, very strong portfolio of titles and we would expect that we will continue to benefit as both generations of consoles continue to show strength and growth, albeit for different markets, given the breadth and the strength of our portfolio.

In addition to that, we are seeing continued engagement with our live services and players playing longer and engaging deeper with those live services across both generations of console. And as we have talked about, we had a very strong quarter with respect to mobile. And we are starting to see the value of our IP combined with the learning experiences that we have had over the past couple of years with respect to mobile.

So all in all, when we think about two console generations of strength, we think about ongoing engagement with our live services, and we start to see the benefits of the learning and the strength of our portfolio in mobile, we feel very good about the year ahead.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

When it comes to operating margin, we are not yet ready to give next year's guidance or even longer-term guidance on operating models, but we will, in May, talk a little bit about multiple year potential here.



I will use the time, though, to remind people that we -- about 2 1/2 years ago, we were in the single-digit area and through focus of the entire organization and the full management team, we have really pushed to change how we operate, both from a consumer perspective, very focused on a gamer first mentality, and second, on a financial perspective.

And that has allowed us to move into what looks like now a roughly 24% operating margin for the year, with obviously this quarter showing operating margins well into the mid 30%. We do believe that we have got potential, continued upside on the gross margin side of the business as we push our digital business.

And as we add more and more revenue via either digital live services or mobile, we think that will continue to benefit us through some operating leverage and give us more operating upside.

We kind of view the first stage of this change is the turnaround. We feel that that has been done and now it is really time to focus on the transition and transformation that we believe has the potential here of driving much higher operating margins and cash flows over time.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Great job, guys. Thank you.

Operator

Chris Merwin, Barclays.

Chris Merwin - *Barclays Capital - Analyst*

Congratulations. First question is just as it relates to your cash flow guidance, it looks like that came up by about \$200 million for the full year. I think it was about \$100 million more than net income.

So maybe, Blake, if you could just talk about what is improving free cash flow conversion and if that is something we should expect to continue going forward.

And then just secondly, I was hoping if you could just please provide some more color around how FIFA Online 3 is doing in China, how is that compared to the launch in South Korea, just in terms of the user growth and monetization. Thanks.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

So I will start on the cash flow and then Andrew or Peter can weigh in on FIFA in China. The cash flow was a couple of benefits.

One is just obviously the strength in the business across the board and the strength in our physical retail partners, I think, helps. People pay faster when they are in a stronger position.

And then second, our digital business obviously fuels a much faster cash collection cycle. There is relatively little inventory in the channel. That is a very good positive for us. And all that comes together to try to drive significantly upside on our cash flow.

We have been continuing to manage our CapEx aggressively and that is helping on the free cash flow side of the business. But I would say the bulk of it is really just a flow through from the real strength in the operating earnings that are coming out of the business as we are really hitting on all cylinders.

Peter Moore - *Electronic Arts Inc. - COO*

And Chris, this is Peter. On FIFA Online 3 in China, as you know, we are being published by our partner Tencent there. We are still yet to get to the official launch, but we are in a very strong soft launch period right now. Tencent themselves announced in December that they had reached 500,000 peak concurrent users, which was a new record for a sports title in that marketplace.

So all of the key indicators are very, very positive. We expect at some point in this quarter to go fully live. And as we mentioned in our prepared remarks, we are yet to determine when to recognize revenue against this title. But all key indications are that this is a record-breaking start and we are very optimistic. But more primarily an impact on FY 2016 at this point.

Chris Merwin - *Barclays Capital - Analyst*

Okay, thank you.

Operator

Mike Olson, Piper Jaffray.

Mike Olson - *Piper Jaffray & Co. - Analyst*

You are talking about higher engagement in live services and moving from a transition phase to kind of a transformation phase. Can you give us a sense for how you envision EA's business model will evolve maybe over the next three to five years?

I realize that is light years away from now, but how should we think about EA's mix of revenue from newer business models, like subscription or free to play or other digital models, and maybe kind of compared to traditional retail physical disc sales, et cetera?

Andrew Wilson - *Electronic Arts Inc. - CEO*

Michael, this is Andrew. As Blake has talked about and as Peter has talked about, we are definitely seeing a greater trend towards digital revenue and over this quarter, certainly, that trend continued.

As we look to the future and we think about the various opportunities inside of digital revenue, we look a lot at our adjacent media companies that provide music and television and movies and recognize that an opportunity for us is to capture the greatest possible share through the offering of multiple consumption models.

So as we have talked about on calls in the past, we have been investing for some years now in a digital platform that will facilitate transactions in any number of ways, either through a free-to-play micro transactions-driven model, a premium download model, or a subscription model, or some combination of those things.

So as we think about our digital future, we are really looking at various platforms, various markets, and various business models in that digital realm and looking to offer that in a way that any particular player might want to consume the great games that we make.

Mike Olson - *Piper Jaffray & Co. - Analyst*

All right, thanks very much.



Operator

Justin Post, Bank of America.

Ryan Gee - *BofA Merrill Lynch - Analyst*

This is Ryan Gee calling in for Justin Post. Just two quick questions on the digital business. First, it has encouraging to see the growth of Ultimate Team, both players and sales.

I was wondering if you could talk about some of the drivers last quarter. Was there anything in particular about this year or last year we need to keep in mind? And whether this growth trend that you are seeing there is sustainable.

And then second, the growth in Ultimate Team compares to the mobile business, which around 13% is tracking below the digital average. Can you talk about your plan to either reaccelerate that business or as feature phones? Are those still a headwind that we should be looking at going forward? Thanks.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

This is Blake. Why don't I start and then I can toss it to Frank. The one reminder is underlying growth in mobile is really 28% if you pull that premium business out, which it is a legacy for us. It is down to about \$14 million a year and declining year over year.

We can't force it out any faster than we are already doing because it is embedded in a lot of way that people can play games still. But Frank can talk about the exciting growth ideas as well as growth that we are seeing in the mobile business.

First, on just on the Ultimate Team side of the equation. The key for us in Ultimate Team right now has been discovery, making sure people understand what it is and how exciting and fun it is. Still a smaller portion than -- of all the people that buy the game, less than half the people actually enter into Ultimate Team and a small fraction of those people actually get heavily involved in Ultimate Team and ultimately monetize.

And so part of our goal is increasing visibility of Ultimate Team and making sure that people understand how to play it and how fun it is. So you see, when you load up the Madden disc for the first time, you see Ultimate Team come up on your screen. We're trying to make sure people understand -- get into the funnel, essentially, and understand how passionate and powerful it is as you start to play it.

And we are trying to encourage people to play with their friends. And so you will see more and more of that drive Ultimate Team. Clearly, it is of a scale today that you question how much larger can it get, but we are surprised every quarter about the continued growth in it.

And we do know particularly how much people love it, particularly how much the opportunity there could still be going forward. So exciting times ahead and we are looking at ways that we can leverage an Ultimate Team mechanic in more games than we currently have, even nonsport-style games.

Frank Gibeau - *Electronic Arts Inc. - EVP EA Mobile*

Thanks, Blake. This is Frank. The question on mobile, really what I would draw your attention to is the new releases that we put out with Madden, FIFA, and SimCity BuildIt, which were built from the ground up as freemium services.

We have spent the first part of this year taking the best and brightest from inside Electronic Arts as well as from outside, bringing in from the industry, to build a world-class mobile team. And those three products really represent what we believe the future potential of big brands with natural organic acquisition advantages, coupled with great quality, great technology, and a focus on engagement and live services represents.



So in the quarter, if you strip away the headwind from the premium download business, we are growing around 28%. But that growth actually accelerated as we stepped into December and we picked up share there with the release of SimCity BuildIt.

And as we look into 2016 and beyond, our next product up is Need for Speed BuildIt, another huge brand that will acquire very well. We have built from the ground up freemium service layer. We're really bullish on how this slate will unfold going forward and really drive that growth rate that is currently in the high 20%s to something that we are pretty proud of.

Ryan Gee - *BofA Merrill Lynch - Analyst*

Okay. Great. Then one follow-up quick question, if I may. We saw in the NPD, the retail data in December, that there was some weakness in the average selling prices, particularly on the new gen consoles.

Is that something that you guys have seen in early January continue? And is that something we should be concerned about, maybe in 2015, just faster price-cutting by retailers?

Peter Moore - *Electronic Arts Inc. - COO*

No, I don't believe so. I think, Ryan, what you were seeing was maybe some promotional -- short-term promotional, as retailers, particularly here in North America, were trying to gain market share over the holiday period. I think things then revert to normal.

I haven't seen that. My team in the field haven't seen it. I think what you saw was a short-term blip.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

You guys have heard me say this before, but I will say it again, and that is, be really careful using NPD data. It is becoming less and less valuable as more and more of the business is going digital.

And there is obviously not a digital comparison to it, but both in volume and in pricing, it can be sometimes very -- a very large distraction. And then when you add in that there is no international piece to it, it really underestimates the strength of our business, I think as you can see in this quarter.

Ryan Gee - *BofA Merrill Lynch - Analyst*

Great. Thanks, you guys.

Operator

Drew Crum, Stifel

Drew Crum - *Stifel Nicolaus - Analyst*

I wonder if you could comment further around Battlefield Hardline. I think you suggested that it would not be material to fiscal fourth-quarter numbers. Is that from a revenue perspective or is that apply to profit as well? And should we expect most of it to shift to the first quarter of fiscal 2016?

And then on gross margin, I have two questions. Can you pull out the NHL benefit you saw in the quarter? And then Blake, just thinking kind of longer term, your gross margin guidance for fiscal 2015 is now above 70%, but digital is a little more than 50% of total non-GAAP revenue. Any thoughts on longer-term gross margin upside for the business?

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes. Thanks, Drew. Don't take my comment on Hardline to be in any way negative. It was simply to say that we don't ship it until the third week of March. And so it is primarily a sell-in only and we will see a very large impact as we roll into next year with that title.

As an example, right now, the levels of people playing Battlefield 4 are some of the highest we have seen in the last year. And so people play and buy Battlefield products for a long time into the future. And so we think the sell in be very strong for Hardline. It will be important for the quarter, but I think it is a strong indicator going forward.

Andrew Wilson - *Electronic Arts Inc. - CEO*

Yes, Drew, just one add to Blake's comments there. It is a great window for us and our retailers around the world see this late March window. To Blake's point, not hugely material for the quarter because it will be what we call an initial purchase quantity or a one-day load in and then a little bit of replenishment.

Huge opportunity, I think, for FY 2016. But retailers like Game Stop here in North America, in particular, who see this as a go big title, are really getting behind it. We are seeing the same across the rest of the world.

I think it is a huge opportunity for us to be able to reestablish a new offshoot to the franchise that is Battlefield. As Blake said, it is one shot on the quarter, but FY 2016 looks very strong when we look at our forecast for this title.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

As Andrew mentioned, the speed and the excitement of the game exceeds almost anything we have done in a Battlefield franchise. And I think that is going to really catch people by surprise. And you are going to see a lot of people -- the momentum is going to build on it as more and more people start to play it and want their friends to be able to come in and play it.

The things you are able to do with vehicles, with weapons in the urban centers, it is just almost unbelievable. And you will start to see more and more screen -- more and more live gameplay of that over the next few weeks as we start to crank up the marketing activities. And then obviously the beta that Andrew mentioned. So more to come there. It is pretty exciting, though.

On the gross margin side, NHL was -- it was under \$50 million in terms of revenue that was deferred into the quarter. And so that really, probably, took gross margins up by about a point relative to the overall overdelivery of gross margin.

And it obviously helped. That is why we wanted to call it out. We did that because we had more to deliver on NHL than we did during the quarter and that is why we deferred some of the NHL revenue.

I think, longer term, gross margin -- more to come when we give guidance next year, but we do believe that we could operate in the 30 -- or, excuse me, 72% to 74% gross margins longer term. This year, we are in that 70% to 71% and a couple of quarters bouncing higher than that.

But we do believe there is potential, particularly as we continue to shift that digital business and the live services moving forward. So more to come on that.



Drew Crum - *Stifel Nicolaus - Analyst*

Thanks, guys.

Operator

Mike Hickey, Benchmark Company

Mike Hickey - *The Benchmark Company - Analyst*

Great quarter. Congratulations. Two questions. The first one is -- relates to your fiscal 2016. And I realize, Blake, that you are not providing guidance, but perhaps as a broad strokes how you guys are thinking about your title count growth for frontline console releases in the year? And your headcount assumption, what sort of headcount growth you are thinking about in fiscal 2016. Then I have a follow-up.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes, so first on the titles. You should assume all the sports titles obviously will be in their regular rotation. I would assume that we are going to continue to try to double down, as we mentioned, on Ultimate Team and try to expand that business. We have Need for Speed back in the rotation next year, which is a positive.

As Frank mentioned, there is a Need for Speed coming on mobile, but also we are going to have another couple of unannounced, very exciting mobile titles as well in the quarter -- or in the year.

And then, last, but far from least, we have got the Battlefront Star Wars title coming in before Christmas next year, aligned with the Star Wars movie rollout. We are extremely excited about that. We think there is huge potential for that title.

More to come in the next couple of months on that as more about the movie comes out as well as more about our title comes out. But you should consider that a very large activity for us next year and a very large focus, similar to how we thought about Battlefields in the past.

Mike Hickey - *The Benchmark Company - Analyst*

And then you talked on headcount, Blake.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Oh, sorry, yes. In terms of headcounting, I think our focus on margins and on cost discipline will not stop. We are very focused on that. We are focused on what that means for headcount around the world as well as marketing spend around the world. And that focus is going to stay.

So you shouldn't see a dramatic change in headcount. Probably think about it roughly as flat. And really our challenge is how do we offset some of the natural increases in compensation costs during the year. And we have got everybody trying to drive efficiencies through their business to try to offset some of that.

We are remaking some of the headcount, so we are moving towards more live services. That means more customer service, more live service management, and that will have to be offset by reductions in other places where we can balance that headcount mix or remix the headcount amongst what people do in their day-to-day jobs.

Mike Hickey - *The Benchmark Company - Analyst*

Okay. Thanks. That is very helpful. And the last question for me is I'm sort of curious how you think about free to play becoming a more viable business model for consoles over the medium term, particularly for sort of multiplayer-only experiences that are starting to pop up a little bit more than prior cycle.

Andrew Wilson - *Electronic Arts Inc. - CEO*

This is Andrew. On free to play with consoles, we think about this much the way we think about free to play overall. And there is a couple of different vectors to this.

The first is as we look to the future, we believe a very big part of our player base will expect a free to start experience. When we look at film, television, music, books, very often there is this free trial notion that actually onboards new players, new listeners, new readers, or new viewers into a service.

We are actively looking at how we could offer that type of experience to our players, console and across other platforms. From there, it really comes down to do they make their next step in terms of a premium download, a micro-transaction in a free to play type environment, or a broader relationship through a subscription.

And our expectation is that we will be offering all three of those options to players, both on console and across other platforms.

Mike Hickey - *The Benchmark Company - Analyst*

Thank you.

Operator

Sean McGowan, Needham.

Sean McGowan - *Needham & Company - Analyst*

I have a couple of follow-up questions from earlier ones. Blake, on the hedging, I just want to be clear. Are you actively engaged in trying to hedge more than just the transactions that you have and extend that into translation?

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes, so we hedge both balance sheet cash flow as well as earnings. And we are hedging, essentially, the core currency that where we operate around the world.

So think about it as effectively trying to minimize the swings in exchange rate. The impact of the exchange and swing rates on our P&L and on our balance sheet. We don't try to place bets to try to make money on hedges. We simply are trying to offset swings that could occur.

So ideally for us, it would be -- we are constantly neutral to any currency moves. Now obviously, that is hard to do and it gets expensive. And so when you see rapid changes in FX like we have seen in the last six weeks, it is harder to be able to protect against that over a long-term period of time because it just gets very expensive to do.

So we are constantly -- we have rolling hedges that we add over time to smooth our hedging. And we try to make sure that we are protecting both the revenue line, but most importantly, the cash flow in the earnings line.

Sean McGowan - *Needham & Company - Analyst*

But is it safe to say that the driving assumption is as you enter those hedged transactions is that the current rate persists or you're making some bet about the direction?

Blake Jorgensen - *Electronic Arts Inc. - CFO*

We will make some bet about the direction, but we are not trying to make a bet about the direction to make money, per se. It is just simply to protect where our cash flows are coming from.

Sean McGowan - *Needham & Company - Analyst*

Okay. Thank you. That's helpful. And I not sure who should take the next questions. It refers back to the stability that we are now seeing in the old gen -- previous generation sales. We've seen some zigging and zagging in recent quarters about that.

So is the stability more a function of your expectations getting better honed or is there really a change in the marketplace going on?

Peter Moore - *Electronic Arts Inc. - COO*

Sean, this is Peter. I don't think there is a change. We are entering the ninth year of the cycle here. So we are -- I think we are seeing a strong tail. I think both Sony and Microsoft, to their credit, are providing support behind their current gen, between both Xbox 360 and PlayStation 3.

Having been that side of the business, as you well remember, it is a strong opportunity for both of these to continue leverage the power of that very large install base. There is a great portfolio of titles that stretches back nine years. The hardware is great value for money, for consumers that haven't jumped in yet for a console hardware.

We were concerned -- you may recall probably two or three quarters ago that all of the action was in Xbox Ones and PS 4s, but I think what has happened is that that consumer has moved on and there's plenty of consumers are still looking to get involved in games.

Great deals for retailers around the world in Q3 and the holiday period. And our job is obviously to be able to take full advantage of that. And nobody in the industry has more recognizable blockbusters than Electronic Arts. And I think it is a simple as that.

Our teams are well positioned with our content, with both our retail partners as well as full game downloads of those titles. And this is where great brands and great IP shines. With consumers that may be coming in a little late and looking for recognizable content.

So I think you can characterize it as a stable situation. I think as we look at our FY 2016 numbers, we expect that to continue and to take full advantage of it.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

You know, there were, during the year, there were roughly 3 million old generation consoles sold here in the US. And half of that came in the last two months of the year. So obviously Christmas, discounting, probably drove a lot of that sales.

And if you are buying a console for the first time, as Peter said, there is a high probability you are going to go buy FIFA or Madden or Need for Speed or one of the titles -- Battlefield -- titles that people really know of as a great title to play.

Sean McGowan - *Needham & Company - Analyst*

All right, thanks for that detail. Thank you.

Operator

Tim O'Shea, Jefferies.

Tim O'Shea - *Jefferies & Company - Analyst*

Hi, Blake. Another question on the balance sheet. You guys ended the calendar year with over \$2.9 billion in cash and equivalents. And by my math, I think that is up from about \$2.1 billion last year.

Just given the elevated levels, I thought it made sense to revisit your current thinking with respect to things like how much cash you need on the balance sheet, about share repurchases, and maybe even those 0.75% convertible notes that are due 2016. Just wondering if your thinking has evolved as the balances continue to rise. And then I have a quick follow-up.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes. So clearly, we have flexibility that as we get more and more cash on the balance sheet, we are very focused on making sure that that cash goes back to shareholders in the most efficient way.

We do, as we are thinking about our cash needs, obviously, first we think about just the general operating needs. And we are always weighing on the notion that now 60% of that cash is sitting onshore, but that is a benefit from the repatriation that we did a year and a half ago. Or a year ago.

There is a natural cash build that occurs internationally and so that will start to deplete over time and we'll go back to probably a greater cash balance internationally than domestically.

Also weighing on our thinking is the current converts that are due in August of next year -- August calendar year 2016. And we are thinking through ways in which we either can refinance those or pay those off. But that clearly weighs on how much cash we hold, at least in the interim.

And then last but not least, we are very committed to continuing to buy back stock. We are on track to be able to complete the \$750 million two-year buyback. And as we generate more cash, we will consider greater buybacks over time. It is not complicated. I think we just have a simple model, which is saying how do we get that back to shareholders.

Tim O'Shea - *Jefferies & Company - Analyst*

Great. Thanks. And then just looking at guidance, it does appear you only drew a portion of the [beat] to full year. Just curious, is there anything out there in the March quarter that maybe you are a bit more cautious -- perhaps around FX? Or does this just reflect some general conservatism on your behalf? Thanks.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes. Well, unfortunately, I guess I am just -- we're starting to think that we are conservative all the time, which I guess we are, which is a good thing. I do remind people, we started the year with guidance of \$4.1 billion and \$1.85 in EPS. And some of the original conversations I had with people thought we were crazy to guide that high. And obviously now, we are at \$4.253 billion and \$2.35 EPS.

As I said on the call, I think the major driver of not flowing through all \$150 million of the revenue feed was first, we decided to move two titles out of the quarter. Small titles, but titles nonetheless. PGA Golf and the first Sims expansion pack will both fall into Q1 now. Those were originally in our thinking for Q4.

Second, we don't know where FX is going to go. I don't think it is going to go down a lot more, but I said that when the euro was at \$1.30. So there is some uncertainty there.

And then third, we are waiting to see when we will be able to recognize our revenue on the FIFA Online 3 in China with our partner, Tencent. There are some contractual obligations that need to be met and we don't know if those will get met in the fourth quarter or in the first quarter.

And so those uncertainties stopped us from flowing all \$150 million through. But what we did is flow through essentially the operating income benefits to really flow through the entire EPS in the quarter.

Tim O'Shea - *Jefferies & Company - Analyst*

Great. Thanks. And congrats on the quarter.

Operator

Neil Doshi, CRT Capital.

Rob - *CRT Capital Group - Analyst*

This is Rob on the call for Neil. I just wanted to quickly ask on the nice marketing efficiency that you showed in the quarter. I think if you could just maybe give us a little bit of color on how much of that is due to -- or how are you thinking about how much of that is due to improvements in game quality versus structural shift to live services versus changes in marketing tactics. Thank you.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

I will let Peter answer that, but one just simple thing to remember is we didn't have Battlefield this year in the quarter. We had it last year in the quarter and Battlefield was scale of a product going to spend a little bit more money. So that is really just a simple fact. But there are a lot of efficiencies and we are also focused on --

Peter Moore - *Electronic Arts Inc. - COO*

Yes. I think, Rob, to answer your question -- all of the above. I think it is obviously great job a title with the quality of Dragon Age: Inquisition. That not only had great marketing, but then organically grew with the quality of the title and the ability for it to be able to get picked up virally by gamers, who then passed on their recommendations to fellow gamers is something that we see.

Secondarily, yes, we have been talking for two, three years now about increased systems and efficiencies that we are applying as a Company towards the way that we communicate with our gamers. And you are seeing that and you seeing that in every single quarter. [I wish] it would continue to ratchet down our expenses without revenues dropping and without our efficiency actually increasing in the way that we communicate directly with our gamers.

We track metrics that are based on demand and tend to purchase aided awareness. Those continue to grow across all of our franchises. And our ability to track our consumers on a day-to-day basis rather than simply launch with big TV campaigns, which may have been what we have done many years ago, you are seeing the resulting efficiencies as a result in our marketing spend as a percentage in that revenue. And that will continue.



Andrew Wilson - *Electronic Arts Inc. - CEO*

There is one more dynamic I will just add to that and Peter is right on all fronts. The other dynamic, of course, that is happening is by virtue of our live services and the ongoing engagement with our players, we are now more connected with our player base for much, much longer.

And so the need to go out and kind of re-recruit players who we may have had a disconnect with or a disengagement with is something that we are not having to encounter at the same rate that we maybe did two, three years ago.

So there is ongoing shift to a live services philosophy. It is not just helping us in terms of the ability to deliver amazing experiences to our players, but also is keeping us connected with them so that we can ensure that they know about the latest, greatest experiences that we have.

Rob - *CRT Capital Group - Analyst*

Thank you.

Blake Jorgensen - *Electronic Arts Inc. - CFO*

Thanks, everyone. Appreciate the time today. We will talk to you next quarter.

Operator

And with that, we conclude today's conference. Thank you for participating. You may disconnect your lines at this time.

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