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Electronic Arts, Inc. *(EA)*

Q4 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome, and thank you for standing by. At this time, all participants are in a listen-only mode. [Operator Instructions] Today's conference is being recorded. If you have any objections, you may disconnect at this time. Now I'll turn the meeting over to Mr. Rob Sison, Vice President of Investor Relations. Thank you, you may begin.

Rob Sison

Vice President-Investor Relations, Electronic Arts, Inc.

Thank you, and welcome to EA's fiscal 2013 fourth quarter earnings call. With me on the call today are Larry Probst, our Executive Chairman; Blake Jorgensen, our CFO; and Frank Gibeau, our President of Labels. 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 and audio replay of this call and a transcript.

This presentation and our comments include forward-looking statements regarding future events and the future financial performance of the company. Actual events 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 May 7, 2013, and disclaims any duty to update them.

Throughout this call, we will discuss both GAAP and non-GAAP financial measures. The comparable GAAP measures for certain non-GAAP measures to be discussed are, for Q4, net revenue of $1.209 billion, digital revenue of $453 million, gross margin of 74.4%, operating expenses of $591 million, and a resulting EPS of $1.05 per diluted share. For the full fiscal year 2013, net revenue of $3.797 billion, digital revenue of $1.44 billion, gross margin of 63.4%, operating expenses of $2.288 billion, and a resulting EPS of $0.31 per diluted share.

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'll turn the call over to Larry.

Lawrence F. Probst

Executive Chairman, Electronic Arts, Inc.

Thanks, Rob. As most of you know, I have agreed to serve as EA's Executive Chairman while the board of directors searches for a new CEO. In this role, I am focused on three key priorities.

First, completing a fiscal 2014 operating plan with a disciplined approach to cost control, along with growth on both the top and bottom line. Blake and Frank will take you through the details shortly, but I'm pleased to say we have locked a plan that delivers higher revenue while keeping our operating costs essentially flat. Doing that in the middle of a hardware transition will be a challenge, something we've never done in the 31-year history of this company, but we are committed to making it work.

Priority number two is to help drive the process in the board of directors' search for a new CEO. We don't have any specific news to share today on the timeline or candidates. However, I can tell you that both internal and external candidates are being considered.

Third and most important is to ensure EA is well positioned to deliver the best games and services on the next-generation consoles. Over the years, we've learned how great games delivered early in the cycle of a new platform can build strong and enduring relationships with our audience. This transition will determine market leadership for the rest of the decade, and we intend to win over customers with world-class entertainment experiences.

We have a saying at EA, transition is our friend. This is a time when we tighten our belts and position the company for future growth and success. We've cut operating costs, sharpened our product focus, and made strategic investments in next-generation consoles, mobile, and PCs. The world is changing, and technology is about to take another big leap forward. Our goal is to capitalize on this opportunity by delivering high-quality games and services to our consumers on their platform of choice.

With that, I'll hand it off to our CFO, Blake Jorgensen.

Blake J. Jorgensen

Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

Thanks, Larry. First I'd like to begin with Q4 results. During the March quarter, the packaged goods market in the West continued to be soft, characteristic of what happens during a console transition. EA's total Q4 non-GAAP net revenue was $1.04 billion, which was within our guidance. In the quarter, we saw solid sales for SimCity, most notably from direct downloads. However, Crysis 3 and Dead Space 3 came in below our forecast. Compared to the same period last year, net revenue was up 6%, driven mainly by our digital revenue. EA's Q4 non-GAAP digital net revenue increased 45% year over year to $618 million. Trailing-12-month digital net revenue was $1.66 billion, representing growth of 36%.

Our digital business continues to be a diversified mix of high-growth, profitable segments. Breaking the digital revenue down by type shows the following. First, full-game downloads contributed nearly $100 million, up 65% compared to the same period last year. Full-game downloads have typically been driven by PC products, and this quarter, SimCity was a key driver of that growth.

Second, extra content and free-to-play contributed $224 million, up 45%, led by sustained growth in FIFA Ultimate Team and solid results from Star Wars: The Old Republic and Bejeweled Blitz. This revenue relates to business on PCs or consoles where consumers can enhance or extend their gaming experience by buying additional digital content, including virtual characters, virtual goods, and map packs associated with console browser-based games or MMOs. Our Star Wars: The Old Republic game is a combination of free-to-play and subscription business models. Both models are performing well. The game has attracted new free-to-play members, and total active users are up. We continue to deliver new game updates for the community every six weeks, helping drive subscribers and free-to-play consumers to the game.

Third, our mobile business generated $104 million for the quarter and was up 21% over the prior year. Smartphones and tablets were a major portion of the revenue, accounting for $79 million of the $104 million total, growing 27% year over year. Real Racing 3 successfully launched simultaneously on iOS and Android, while The Simpsons: Tapped Out continued to be a key contributor. We remain focused on this segment due to the significant global growth in the smartphone and tablet markets.

And fourth, subscriptions, advertising, and other digital revenue contributed $191 million, growing 54% over the same period last year. The significant increase is primarily due to the recognition of $121 million of the full-year's Battlefield 3 premium subscriptions. We recognized this revenue in Q4 when we delivered the fifth and final expansion pack, entitled End Game. As a reminder, the majority of the development and delivery costs were recognized in previous quarters.

Moving on to gross margin. Our non-GAAP gross margin was 74%, in line with our guidance and up almost 10 percentage points over the prior year. Battlefield 3 premium subscription revenue accounted for approximately 30% of this improvement, while the remaining gross margin expansion was due to a focused effort to reduce online support costs and solid results from the rest of our digital revenue offerings.

Operating expenses for the quarter were $540 million, $15 million higher than our guidance. We were above guidance due to charges associated with operating expense reduction actions and costs associated with the resignation of our CEO. Our cost reduction plans will reduce our overall head count by approximately 10%. In total, $16 million of expenses were recognized in the quarter related to these actions. The resulting non-GAAP diluted EPS was $0.55 for the quarter, slightly below our guidance, driven in part by the $16 million in severance costs.

Our cash, short-term investments and marketable securities at the end of the quarter were $1.68 billion, or roughly $5.60 per share. Approximately 60% of this cash and short-term investment balance is held outside of the U.S. Net cash provided by operating activities for the quarter was $233 million. For our full year 2013, operating cash flow was $324 million. Fiscal year 2013 capital expenditures were $106 million, resulting in free cash flow of $218 million, more than double from last year's total.

During Q4, we repurchased nearly 1 million shares at a cost of approximately $13 million, bringing the total shares repurchased under the current program to 22 million shares at a total cost of $278 million. As a reminder, the current $500 million share repurchase program was initiated in August 2012.

Before we discuss guidance, we want to address a few housekeeping items. First, as we finalize our financial plan for fiscal year 2014, we re-evaluated the classification of certain operating expenses, based on our current management operating structure. As a result, the company reclassified certain operating expenses, primarily head count and facilitates costs, during the fourth quarter of fiscal 2013. These reclassifications are reflected in our financial disclosures and do not impact the company's consolidated operating results for our cash flows.

Second, we have stated in previous calls we are developing our games-as-a-service models to create a deeper relationships with our customers. We've clearly seen success in this initiative, as consumers are playing our games online over longer periods of time. However, this longer period affects the length of time over which we are required to recognize GAAP revenues. In fiscal 2014, we will be lengthening this period, resulting in approximately $500 million of net revenue being deferred into fiscal 2015. This longer service period has no impact on our non-GAAP revenue or cash flows.

And third, the continued growth in our digital business is having a long-term benefit to our corporate tax rate, such that now we view our long-term non-GAAP tax rate to be 25% instead of 28%. This change in our long-term non-GAAP tax rate favorably impacts our fiscal 2014 guidance by $0.05 per share.

Turning to guidance, I'll start with a brief overview of the gaming sector for this current calendar year. We estimate that the worldwide gaming market will continue in the mid to high single digit percentage for the calendar year 2013. This is driven by continued digital market growth, offset by packaged goods declines as we reach the end of the current console cycle. In Western markets, the growth will be flat because the console transition has a more significant impact than it does in the rest of the world.

For fiscal year 2014, we plan to release 11 major titles, including the highly anticipated Battlefield 4 and The Sims 4, compared to 13 titles in fiscal year 2013. Along with these major titles, we will release approximately 15 mobile titles on the iOS and Android platforms. Frank will provide you with more detail on our title plan for the coming year.

Starting in fiscal year 2014, we are changing our guidance approach, providing investors with a single point estimate for each of our key metrics. GAAP revenue for the fiscal year is expected to be $3.5 billion, and we expect GAAP loss per share of $0.97 per share, as a result of recognizing GAAP revenue over a longer period of time. And as a reminder, we do not defer any cost of sales. Non-GAAP revenue for the fiscal year is expected to be $4 billion.

And we expect non-GAAP diluted EPS of $1.20 per share, which reflects the change in our long-term corporate tax rate. Without this change, non-GAAP diluted EPS is expected to be $1.15 per share. This guidance forecasts over 5% of total non-GAAP revenue growth. We believe this reflects the current softness in the packaged goods market and the challenges associated with the anticipated console transition.

Segmenting the sales provides further insights to the key drivers of our full-year revenue. Packaged goods and distribution revenue is estimated to be approximately $2.3 billion, up 7%, driven by Battlefield 4 this year versus Medal of Honor in the prior year. The growth will be partially offset by the decrease in the number of announced launches and a tempered view of our current-generation launches as we are in the late stages of the console cycle. Digital revenue is forecast to generate over $1.7 billion, up 4%. Growth of our digital revenue is masked by the decline of our subscription business, due to the $121 million of Battlefield Premium that was recognized in fiscal year 2013. Our digital business would show a much higher growth if we had recognized Battlefield 3 Premium ratably.

Breaking down our digital revenue into its four primary categories, we see sustained growth in the key areas. Our mobile revenue is expected to grow over 30% as the smartphone and tablet market continues to expand at a significant pace. In addition, we plan on launching more titles and content. Frank will provide more insights into our mobile offerings. Full-game downloads are anticipated to grow over 25%, due to the Battlefield and Sims launches, both historically strong PC franchises with a high level of direct download attach rates. Extra content and free-to-play will be flat year over year, due to the reduction in the number of social game titles and given the console transition. We are now placing greater emphasis on mobile and less on social games. And, lastly, subscription revenue is expected to decline approximately 20% as we recognize the full year of Battlefield 3 Premium in fiscal year 2013.

Based on this segmentation, digital revenue will be approximately 43% of our total revenue. The anticipated heavier mix of packaged goods revenue does impact the gross margin growth, and therefore we are forecasting gross margins to be approximately 66%. GAAP operating expense for the fiscal year is expected to be around $2.32 billion, flat over the prior year. Non-GAAP operating expense for the fiscal year is expected to be approximately $2.15 billion, essentially flat to the prior year. This includes our investment in next-generation consoles, as well as the development costs for the newly announced Star Wars titles. And it is the first time during a console transition that our operating expenses are being held flat.

It should be noted that included in guidance is approximately $25 million of severance payments. The majority of this expense will be recognized in the first quarter. These payments relate to our Q1 efforts to reduce operating expenses as part of our goal to expand our operating margins.

Focusing on Q1, GAAP revenue is expected to be $875 million as compared to $955 million in the prior year. GAAP diluted EPS is expected to be $0.33 a share, as compared to $0.63 per share in the prior year. Non-GAAP revenue for the quarter is expected to be $450 million, an 8% decrease over last year's $491 million. In the first quarter of fiscal 2013, we benefited from continued strong demand for Mass Effect 3, compared to this quarter's only new title, Fuse. Despite the decrease in revenue, gross margin is forecasted to be approximately 62%. Operating expenses will be impacted by the severance payments, and we expect our total non-GAAP operating expense to be $530 million. For the quarter, we expect non-GAAP loss per share of $0.62 as compared to the loss of $0.41 per share last year. $0.02 of this quarter's loss is due to the change in tax rate.

Looking at the phasing for the year on a non-GAAP basis, we expect a heavier concentration of revenue in our fiscal third quarter compared to previous years. We will have fewer console launches, and with Battlefield 4 launching in the holiday period, Q3 will be a larger revenue quarter than in prior years.

Finally, cash flow will continue to be a key metric for us going forward. In fiscal year 2014, we are forecasting operating cash flows of approximately $400 million and capital expense of approximately $100 million. We expect free cash flow of $300 million versus $218 million in fiscal 2013.

Now I'll turn the call over to Frank.

Frank D. Gibeau

President-EA Labels, Electronic Arts, Inc.

Thanks. As Blake noted, it was a challenging year, with both hits and misses on the product front. However, we're proud of our overall product quality, our progress in digital, and our record for creating blockbusters across multiple genres and on multiple platforms. Additionally, the investments we made last year in next-gen technology will deliver great games this year.

Now I wanted to offer some color on Q4 and a look ahead to the games we're developing in the new fiscal year for consoles, mobile, and PC. I'll start with Q4 and SimCity, a great game that has recovered from a challenging launch. The short explanation for the launch is that the initial rush of consumers overwhelmed our game service, disrupting the consumer experience. As we stabilized the game and improved service in the first week, fans continued to pour in.

So far, we are ahead of forecast, with more than 1.6 million units sold through to customers. The digital story is particularly strong. Nearly 50% of those sales were high-margin digital downloads. The key takeaway here: SimCity is a highly resilient global franchise with a long service life in front of it. But we learned our lesson and are now building better processes to anticipate and service demand. This will not happen again.

Also in Q4, we had some success that affirms our belief in the ongoing growth of the mobile and PC platforms. On mobile, The Simpsons: Tapped Out, developed by our Bight Studio, continued to perform at the top of the Apple app charts and the Google Play store, with more than 13 million installs. With the recent Android release of The Simpsons, it had 5.4 million DAUs at its peak, across both leading mobile platforms. And our latest content update, Whacking Day, has been well received, suggesting another great year ahead for The Simpsons: Tapped Out.

Another breakthrough mobile title is Real Racing 3, a visually stunning game from our Firemonkeys Studio. This one has registered more than 30 million installs to date and was the number one racing title on iOS last month. In April, we received and released an update to address fans' request for more cars and a cloud save feature, which allows players to transfer data between mobile devices.

Another title developed by our Firemonkeys Studio is Sims FreePlay, an EA-owned IP. And despite having launched nearly a year and a half ago, it is stronger than ever. The game has more than 55 million install, and after 18 months, the audience and revenue is still growing. The trend line on mobile is hard to miss. With thousands of new titles added every month, consumers accept nothing short of top-quality games. Our strategy is to give them exactly that.

We are also seeing traction in Asia with FIFA Online 3 and a powerful new publishing partnership with Nexon. FIFA Online 3 is the number one online sports game in Korea, based on both traffic and revenue. This one went into open beta in December and is still ramping, with more than 3.1 million registered players already.

In the year ahead, we have focused our creative teams to deliver high-quality games on HD consoles, mobile, and PC, while further tightening our cost structure. This improved focus allows us to do this while keeping our operating expenses essentially flat. This will be the first time in the history of EA that we've executed against a console transition without a significant increase in R&D.

In fiscal 2014, we will release 11 major titles across consoles and on the PC. This includes our core sports titles, Madden, FIFA, FIFA Manager, NBA Live, NHL, and NCAA Football, as well as Need for Speed, Battlefield, Command & Conquer, and from our partners at Insomniac, Fuse. And as we announced yesterday on EA's blog, we will publish The Sims 4 on PC in early 2014.

Regarding next-generation consoles, we are under a non-disclosure agreement with our platform partners. However, we're planning a full reveal at E3, including more next-generation titles in development for fiscal 2014. This will include breakthroughs in graphics and gameplay for some of our biggest franchises, including Battlefield, FIFA, Madden, NBA Live, and Need for Speed. We plan to unveil new titles from EA SPORTS, BioWare, and DICE and a first look at some brand new games.

In March, our DICE Studio debuted Battlefield 4 with a stunning 17-minute demo entitled "Fishing in Baku." Critics were blown away by the advanced physics and graphics, and fans demonstrated their support. Preorders are going extremely well. Join us at E3 for a deeper look at the title that will define the next generation of gaming: Battlefield 4.

I also wanted to call out a big accomplishment by the teams that built the development engines for our next generation of games: Frostbite 3, engineered at DICE, and a brand new engine from EA SPORTS. These world-class tech stacks are powering all of our development on the new systems. They provide an enduring common technology that saves cost, fosters efficiency, and provides spectacular physics and graphics for our games.

This isn't a vision. These engines are fully functional right now and powering the games you'll see at E3 in June. You'll hear more about Frostbite 3 and our new sports engine at our E3 Investors Breakfast in June.

One more positive milestone is the recent licensing agreements we've reached with partners in our sports businesses, including FIFA, the PGA Tour, the NHL, and NHL Players Association. Together with our long-term agreements with the NFL, NFLPA, NBA, CLC, and the UFC, this bodes well for fans who will continue to get games with all the teams and players they love. Next, this year is a big year for our PopCap Studio in Seattle, beginning with the highly anticipated Plants vs. Zombies 2 and an all-new title from the Bejeweled team.

We'll also see new mobile titles from EA SPORTS and the continued release of new content and features for our two existing blockbusters: Real Racing 3 and The Simpsons: Tapped Out. On PC, we are developing an incredible new version of our classic Command & Conquer: Generals, powered by the Frostbite 3 engine, featuring an amazing array of units, armies, generals, deep PVP modes, and maps with physics-based destructible environments.

Moving on to The Sims 4, The Sims is one of EA's most enduring franchises, with more than 150 million games sold since it debuted in 2001. We listened closely and designed a game that incorporates the incredible feedback from our players. First and foremost, The Sims 4 will be designed as a single-player offline experience with integrated community features that allow players to connect and share their creativity in compelling new ways. However, it will not require that players always be online to play the game.

Finally, big news yesterday from Disney and EA. We have an agreement to develop and publish several new games on the epic Star Wars franchise. Millions of Star Wars fans all over the world are waiting to hear more about these games. We are not releasing details about the games today, but some of our most renowned and innovative creative teams are working on ideas in the Star Wars universe. DICE and Visceral will produce new games, joining BioWare, which is already developing games for the Star Wars franchise. The new games may borrow from films but will be entirely new stories and new gameplay. Powering it all will be our Frostbite 3 game engine.

With that, I'll hand it back to Larry.

Lawrence F. Probst

Executive Chairman, Electronic Arts, Inc.

Thanks, Frank. To summarize, EA is in very good shape. At the core is a great team delivering innovative games and services. We have invested in product quality, digital delivery, and sustainable leadership on console, PCs, and mobile. In recent weeks, we underwent a reorganization to focus our product portfolio and reduce our operating costs. And we have constructed an ambitious but achievable business plan for our employees and shareholders. Best of all, we have an incredible lineup of games and services for our consumers.

With that, Blake, Frank, Peter, and I will take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Colin Sebastian from Robert Baird, your line is open. Go ahead with your question.

Colin A. Sebastian
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Great, thanks for taking my question. And, Larry, good to hear your voice again. I guess, first off, curious now that you're talking more about the next gen. How should we expect EA's consumer online service and Origin to fit together with some of the other platforms that have similar online services and platforms, like Sony and Microsoft? And then, secondly, it sounds like you're seeing some better traction in The Old Republic since the switch to free-to-play and was hoping you could provide a little more color on some of the stats from the game, perhaps what the breakout is between free-to-play and the subscription side. Thank you.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.

A

Sure. This is Frank. I'll start with the second question first. As you know, last year we took a new approach in Austin by introducing some new pricing models to Star Wars: The Old Republic, including a free-to-play model for our fans. Since it was induced in November, we've added more than 1.7 million new players on the free model to the service. And the number of subscriptions has stabilized at just under half a million.

The really interesting thing that's happening inside the service right now is monthly average revenue for the game has more than doubled since we introduced the free-to-play option. And as we look forward, we're going to continually invest in new content for the service and for players every six weeks or so. We just recently released Rise of the Hutt Cartel as our first major digital expansion, and it's reviewed extremely well and it's selling very well. So it's early days, but we're very cautiously optimistic about how the conversion to free-to-play has gone for Star Wars: The Old Republic.

As it relates to online services and next-generation platforms in your first question, there's not a lot of details I can give you on the call right now. We want to wait until E3 happens and we start to get more public about what's possible with these next-generation platforms. But just know this, Electronic Arts is a content company that's also a platform company. It's a company that is investing in building out capabilities, that is allowing us to connect consumers across multiple platforms. And so that part of our mission still remains true, but we'll have to wait until E3 to give you more details on how that manifests itself inside the next-gen platforms.

Colin A. Sebastian
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Thanks.

Peter Moore
Chief Operating Officer, Electronic Arts, Inc.

A

Yeah and, Colin, it's Peter. Let me address the Origin question. Just to update you on the installs, we're now at 47 million, of which 27 million are on the PC and then 20 million on mobile. And as you might imagine with Battlefield 4 coming this year, we're expecting a very strong comp year-on-year on Origin. We love the fact that we can interact directly to our consumers through the Origin platform, and you can expect to see a ton of new consumer-friendly, gamer-friendly upgrades in the feature set this year.

Colin A. Sebastian
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Very helpful. Thank you.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.

A

Next question?

Operator: Thank you. Edward Williams from BMO Capital Markets, your line is open.

Edward S. Williams
Analyst, BMO Capital Markets (United States)

Q

Good afternoon. Just a couple quick questions. Larry, I was wondering if you and Blake can kind of follow up on your comments with regards to kind of your confidence level in the cost structure as we enter this console transition given, as you pointed out, Larry, that it's been in 31 years, you haven't been able to keep costs flat on a year-to-year basis. And then, secondly, Frank, if you can tell me a little bit more or just clarify for me a little bit more about Star Wars in terms of which platforms the games actually can be playable on.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

Well, let me start – it's Blake. I'll start with the operating margin and question around the console transition. I think as everyone knows, we've given guidance over the last year that we were spending roughly $100 million a year on next-gen development. We've continued to include that in our expenses. What we've done is we've gone through a very detailed process to eliminate expenses associated with products that either aren't growing or aren't large enough or aren't on platforms that we feel are long-term viable in the industry. And then we've also focused on how to minimize costs around the support structures inside the organization to make sure that the studios are getting the core funding for developing games.

And so we've tried to consolidate our marketing organizations. We've tried to consolidate our G&A support to make sure that we have a very lean structure. And we've taken those actions during the last two quarters to try to tee us up in a position where we'd be able to announce to you that we're going to hold our costs flat for the coming year. We're very confident of that. And for those who know Larry, he's a very tough manager, and so he's holding the executive team to that goal, and we're very focused on continuing to look for ways to bring our operating costs down to continue on the journey of expanding our margins.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.

A

This is Frank. On the second question about the agreement with Disney, we are not offering any additional details on which titles we're doing right now. But I do want to clarify and call out one thing, that we have rights to make the games on all platforms: console, PC, mobile and tablet. So for the products that we're building, you can expect that you'll see them across all of those major platforms. And we're very excited about the studios at DICE and Visceral and BioWare are really fired up and we're excited about this opportunity and how it fits into our overall portfolio.

Edward S. Williams
Analyst, BMO Capital Markets (United States)
Q

Okay, great. Thank you.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.
A

Next question?

Operator: Thank you. Justin Post from Merrill Lynch, your line is open.

Justin Post
Analyst, Bank of America Merrill Lynch
Q

Great, thank you. Blake, maybe you could reconcile the $0.85 this year to the $1.15 next year, ex the tax change. What are the big, big drivers? And how confident are you in that $1.15? Is there an upside case to that number that you guys are thinking about and maybe what are the potential risks? Thank you.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.
A

Thanks, Justin. So I think – let's start with the top, at the revenue line. The $4 billion in revenue we believe is a realistic revenue number within the confines of a console transition. As I said, we've tempered our views on the gen 3 titles, particularly our sports titles, which will be out in the early fall. We also are very optimistic about Battlefield 4. The preorders look very strong, and we've had great reaction to the demos, as Frank has mentioned. So we're confident about the revenue line, and that represents some serious growth across all of our different components, digital and packaged goods.

On the OpEx side, we're also confident, primarily because some of the cost actions we've taken and the fact that we've fully baked in estimates for marketing expenses associated with both gen 3 and gen 4 titles, the costs associated with developing the new Disney Star Wars titles, and the continued expansion of the mobile titles that Frank mentioned in his topic. So, all in, I think we're in very good shape. The CapEx line is pretty consistent with what it has been in the past. And so we're fairly confident that we can deliver those, subject to a massive change in the market in the next couple of quarters. But based on what our expectations are for a smooth transition and primarily gen 3 revenues for us for the year, we're fairly confident of that.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.
A

To answer your question about risk, I think the primary issue relates to the next-generation consoles, and the questions are when, in what kind of quantities and what sort of price point. But we think we have planned conservatively around that issue and around those questions and we have a high level of confidence in the guidance we've provided.

Justin Post
Analyst, Bank of America Merrill Lynch
Q

Okay, great. And one maybe follow-up. How are you thinking about The Sims 4? Is that a really important earnings driver in the year?

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc. A

Well, it's clearly 100% owned IP. As SimCity was in Q4, it's an important earnings driver in the fourth quarter. But I would take our announcement now, a full almost year ahead of schedule, that we're very focused on making sure it's delivered in the quarter and will be delivered in a way in which we think consumers will gravitate to the title, and we'll see both strong packaged goods as well as digital business in that title.

Justin Post
Analyst, Bank of America Merrill Lynch Q

Great, thank you. Appreciate it.

Operator: Thank you. Arvind Bhatia from Sterne, Agee, your line is open.

Arvind Bhatia
Analyst, Sterne, Agee & Leach, Inc. Q

Thank you. I had a couple questions. First one, I was wondering if you guys can talk about Battlefield Premium, what you're assuming for fiscal 2014 relative to fiscal 2013. And then a couple product questions. On the NBA Live product, it's coming back, it's in your lineup now. Maybe a quick update on where that is in development. Thank you.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc. A

Sure. Hey, this is Frank. I'll take both questions. On NBA, we're very focused on getting into the NBA business in a significant way this year. It's a very competitive category with a clear market leader there. So you'll learn more about our plans on NBA at E3. And we're very excited about that. As it relates to Battlefield Premium, we have no announcements at this time as it relates to a potential premium program for Battlefield 4. We can tell you that premium on Battlefield 3 was accounted for in fiscal 2013. It was a very well received platform and subscription that the customers really like and enjoy, and it was a great value. So that'd be the texture and color I'd give you on premium.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc. A

What I would add was – and this has nothing to do with a Battlefield 4 Premium announcement. This is just a pure accounting statement. The accounting team here has been very focused on how do we recognize subscription revenue over time, or on a ratable basis, associated with the life of the subscription, to try to avoid the lumpiness of the Battlefield 3 Premium. We know that frustrated people, that they didn't see it until the end quarter, and so we're working to try to smooth that, if we have future products like that.

Arvind Bhatia
Analyst, Sterne, Agee & Leach, Inc. Q

Yeah, so one quick one for Larry. Larry, you've gone through several transitions in this business. The technology leap we're about to see that you mentioned, how does that compare to what we've seen in the past? And just give us your comfort and confidence level in what we're about to see in the coming generation.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc. A

So you're basically calling me old I take it.

Peter Moore
Chief Operating Officer, Electronic Arts, Inc.
A

Larry saw the transition to electricity.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.
A

In many respects, I think this is similar to what we have seen before. I mean, obviously these next-generation consoles are going to be more powerful and deliver more exciting and more fulfilling entertainment experiences. And obviously these are companies that we have worked with historically and have good relationships with. So I think a lot of similarities to previous transitions. We're excited about it. As I said in my earlier comments, we think it's really important to get out of the blocks quickly with a portfolio of products that will drive market share for us and hopefully delight our consumers. So we're looking forward to it, and we think we're going to have a great reveal at E3. Frank, do you want to...

Arvind Bhatia
Analyst, Sterne, Agee & Leach, Inc.
Q

Great. Thank you, and good luck.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.
A

Yeah, the only thing I would add is that in comparison to last transition, we're in a much better state as a company in terms of our development. As I mentioned in my remarks, our investments in Frostbite and EA SPORTS over the last year has really put us in a position where the technology side or the engine side of this transition has largely been de-risked. And so we feel very good about how we're heading into this console. We're in much better shape this time than we were last time.

Arvind Bhatia
Analyst, Sterne, Agee & Leach, Inc.
Q

That's great. Thank you.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.
A

Next question?

Operator: Doug Creutz from Cowen, your line is open.

Doug L. Creutz
Analyst, Cowen & Co. LLC
Q

Thanks. Yeah, maybe if you could comment on you had a pretty big divergence between some significant revenue growth in Europe in the quarter versus a decline in North America. And what was driving that? Were there specific titles or industry conditions and so forth? Thank you.

Peter Moore
Chief Operating Officer, Electronic Arts, Inc.
A

Hey, Doug. It's Peter. I think a lot of it was the strength of our catalog in the quarter. Particularly, FIFA in Europe continued to do extremely well. You saw our numbers on FIFA digital, particularly FIFA Ultimate Team. And that has a stronger bias towards the European market than it does towards the North American market, although North America is growing rapidly with the FIFA franchise, and we have great expectations that that will continue in fiscal 2014.

But I think you can point to strong catalog, growing digital, particularly in the European market, that we're seeing now, as those individual markets start to really come up to speed with their broadband distribution, not only through our own platform, Origin, but our third-party e-tailers in Europe and, again, as I say, through FIFA. I think that those were the core drivers that you saw the discrepancy between North America and Europe.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

Yeah, I think you're seeing the continued growth of FIFA as a product and, as we mentioned, the continued playing of that product all during the sports calendar. The old days of people playing for a quarter or maybe even two have gone away, and the combination of FIFA with FIFA Ultimate Team has created an amazing consumer experience that continues through the entire sports year, and in the case of soccer, that's almost 12 months. And it's just a fantastic business for us. And we're very excited about the coming sports calendar.

Doug L. Creutz
Analyst, Cowen & Co. LLC

Q

Great, thanks.

Operator: Brian Pitz from Jefferies, your line is open.

Timothy O'Shea
Analyst, Jefferies & Company

Q

Yes, hi. It's Tim O'Shea for Brian Pitz. Just wondering if the Star Wars deal reflects a strategy shift away from internally developed IP? Or was that decision to acquire the license more opportunistic, given Disney's decision to shut LucasArts? And I have a quick follow-up. Thanks.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.

A

This is Frank. As it relates to overall portfolio, this is very complementary to our wholly-owned IP plans. Wholly-owned IP is the centerpiece of our portfolio. We're going to continue to invest and grow that. The Star Wars products and ideas that we have for that business line are very complementary to what we are currently planning over the next couple years. And it gives us a real opportunity to reach new markets and new audiences that potentially will be very accretive over the long term.

Timothy O'Shea
Analyst, Jefferies & Company

Q

Thanks. And then, quickly, I know you mentioned the 11 announced titles for fiscal 2014. Just wanted to clarify, are these the only titles that are included in guidance, or maybe is there something like a new Star Wars title or you mentioned some new games that might be announced at E3. Are those baked into guidance at all? Thanks.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.
A

Yeah, the 11 titles are what we're basing our guidance on, plus the 15 mobile titles that Frank mentioned. So obviously mobile's a large portion. But that is what we're basing guidance around, and if you feel like there's a title that's missing, that's because we probably don't have it in our title plan for the year. We're trying to be fairly focused this year and make sure that we get the gen 4 titles off the ground when those boxes are available.

Timothy O'Shea
Analyst, Jefferies & Company
Q

Got it.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.
A

And the question on Star Wars, it is part of the guidance as well.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.
A

Yeah, the Star Wars expenses are in there, but obviously we're not planning on shipping a title in FY 2014.

Timothy O'Shea
Analyst, Jefferies & Company
Q

Got it. Thanks for the color. Appreciate it.

Operator: Mike Olson from Piper Jaffray, your line is open.

Andrew D. Connor
Analyst, Piper Jaffray, Inc.
Q

Hi there. This is Andrew Connor on for Mike. I would ask about the console cycle and just understanding how most estimates suggest the new consoles are going to ramp slowly. So would just be curious how important to you, really, the current-gen installed base is going to be, really, this fall, this holiday, and next year. And then you alluded to E3, in talking about being able to talk about more next-gen titles. I'm just curious what your expectations are in terms of the total number of sort of console titles after the next-gen consoles are out. And then lastly, obviously FIFA is doing very well globally, and we're approaching a World Cup year. So just wanted to hear your sort of preliminary plans on calendar 2014 as it relates to FIFA. Thanks.

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.
A

This is Frank. I'll step through – I think there's about four questions there. In terms of the ramp on next-gen consoles, it's way too early to tell or forecast whether it's slow or fast. We're big believers in next-gen consoles being a key growth driver for what we're looking at in terms of the overall market. So I don't think you can characterize that next-gen consoles will grow slowly or fast. We'll learn more as we get further into the year, E3 and beyond.

As it relates to current-gen platforms, I think we launched a PlayStation 2 version of FIFA about two years ago, very profitably, and it was a good product for what customers are looking for. The current-gen platform's going to stick around for a while. It'll be a viable platform, much like PS2 was a very viable platform for an extended period of time. So it will not dry up and go away immediately. It'll be there as an existing platform for us to continue to publish games against over the next couple years.

As it relates to FIFA in an upcoming World Cup year, as you know, in the past, we have done World Cup editions of the FIFA franchise. We have nothing to announce at this time on this call. But it's clearly going to be a soccer-mad year next year with the World Cup coming and with the continued expansion in popularity of the Premier League and the other leagues around the world. So we don't see any slowdown happening in the soccer business for a while.

Peter Moore
Chief Operating Officer, Electronic Arts, Inc. A

Yeah, Andrew, this is Peter as well. Let me just add in from a sales perspective on consoles. And I've been through a couple of hardware – not as many as Larry – but a couple of hardware transitions myself. And typically what we see here, you're seeing a little bit of a polarization of the marketplace right now. The top 10 titles taking more and more of the unit revenue. In calendar year 2012, we saw 49% of our total revenue occupied by the top 10 titles. And from that perspective, that will probably continued on a polarization basis, until – to Frank and Larry's point – we learn more about next-gen announcements at E3.

You typically see a little bit of a slowing down of the current gen, and then once next gen is out, you actually see an increase again. And we saw an actual – when we look at the numbers for the last transition, we saw an increase of 10% in the post year launch of the current generation. So from that perspective, we're pretty bullish that current gen continues. It's in its eighth year. Pricing seems to be holding up well. So from the perspective of continuing to drive against Xbox 360 and PS3, we're extremely bullish.

Andrew D. Connor
Analyst, Piper Jaffray, Inc. Q

Okay, thanks. And if I could just ask the question on the total console title count. With the additions of maybe some Star Wars games moving forward, and NBA Live, do you expect the total console title count to increase during the next gen, or is it going to kind of continue to be at this reduced level?

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc. A

My expectation – this is Frank. My expectations is that as the console transition gets through this year and expands, you'll see our title count go up.

Andrew D. Connor
Analyst, Piper Jaffray, Inc. Q

Thanks a lot.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc. A

Next question.

Operator: Thank you. James Hardiman from Longbow Research, your line is open.

James L. Hardiman
Analyst, Longbow Research LLC

Q

Hi, thanks for taking my call. Two questions. First, on the guidance – maybe, Blake, take this one. From a cash flow perspective, talk a little bit about the uses there. Share count was down, I think, 20 million shares fiscal 2013 versus 2012. In your guidance, it's actually turning up a little bit. Much better cash flow, it sounds like you guys are guiding to. How should I think about that? What are the other potential uses for that cash? If not free cash – share buybacks, I should say, or is that just conservative guidance at this point?

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

Yeah, so we're not building into the guidance any share buyback forecast. We've tended to do our guidance without that. You can assume that since we're only about halfway through our buyback program, we'll continue to look for ways to return cash to shareholders. The CapEx, as I said, is pretty consistent with what it was last year, around $100 million. And so assume that everything is free cash flow below that until you see future buybacks. And as we do those, we'll report in to you each quarter what those buybacks were and how much we spent on them.

James L. Hardiman
Analyst, Longbow Research LLC

Q

Great. And then – question for Frank on Star Wars. Obviously you're extremely limited in terms of what you can say with regards to licensing arrangements, but can you tell us just a little bit, directionally, how the royalties may compare with the new Star Wars agreement with regards to maybe some of your other license-based games? Is this going to be a margin-enhancing relationship, or could it dilute margins a little bit? Obviously Lucas has historically been known to charge a little bit of a premium in terms of royalties. But how does this fit in with the rest of your portfolio?

Frank D. Gibeau
President-EA Labels, Electronic Arts, Inc.

A

Yeah, I can't get into too much details on how it compares and contrasts, other than to say that the business plan that we looked at over the long term in this agreement was very good for Electronic Arts. It'll contribute both top and bottom line growth. And as it relates to margins, we were very comfortable with making this investment and making this commitment.

James L. Hardiman
Analyst, Longbow Research LLC

Q

Got it. Thanks, guys.

Operator: Thank you.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.

A

Next question?

Operator: Ben Schachter from Macquarie, your line is open.

Ben Schachter
Analyst, Macquarie Capital (USA), Inc.

Q

Just a couple of questions for Larry and one for Blake. Larry, within the context of the financial history of EA over the past few years, versus when you were last CEO, just wondering, at a high level, if you could help us understand your philosophy around guidance and around sort of leading the company internally and externally. And then long-term margins, there was no discussion about that on the call. In the past, you've achieved 20% plus. Is that something that you're targeting again? And what are the key factors that could make that happen? And then, Blake, just help me understand that the – the guiding to flat OpEx, even though you just had pretty significant head count reductions, just how does the math work there? Why don't we see OpEx going down? Thanks.

Lawrence F. Probst
Executive Chairman, Electronic Arts, Inc.

A

With regard to philosophy about planning and guidance, I would say my philosophy is to be conservative and exceed expectations. As we mentioned as we went through the script, we've taken a hard look at the organization. We have really focused the product portfolio. We've made some adjustments in terms of head count and operating expenses. My job is to make sure that we're growing the top line and the bottom line and rationalizing head count and cost in conjunction with revenue. I think we've done a really good job of that in nailing down our fiscal 2014 plan. I said earlier, we have a high level of confidence in the guidance that we've provided. And we're excited about the product portfolio this year and in future years going forward.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

Yeah, and both on the margin and the guidance question. On the margin question, clearly we've been very public about our goal to continue the march towards 20% operating margins, if not higher. And that's a combination of continued expansion on the gross profit line. Digital is a major driver there, as well as our investment in the back-office abilities to deliver our digital platform. And all of those are on track. The gross margin for the forecast is dampened slightly by the fact that Battlefield is such a large product for us in number of units that we'll skew towards more packaged goods just because of its size, and that counters the gross margin growth in some way. But we'll continue to be on that path.

I think the key to remember on the operating expense forecast is gen 4 investments that we're making, plus investments in a couple of key products during the year. So you should assume that we'll spend more money marketing Battlefield than we did Medal of Honor, for example, and continuing to build out the digital platform and the mobile platform, as Frank said, investing in 15 mobile titles. All of those are what I would call increases in operating expenses. We've counterbalanced all those by decreases in expenses associated with the organization and with some products that we're stopping. That's allowed us to hold OpEx flat. But those would be the reasons you're not seeing an OpEx coming down during the year.

Ben Schachter
Analyst, Macquarie Capital (USA), Inc.

Q

Great. Thanks, and good luck.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

Thanks.

Rob Sison
Vice President-Investor Relations, Electronic Arts, Inc.

A

Operator, we'll take one more question.

Operator: Thank you. Eric Handler from MKM Partners, your line is open.

Eric O. Handler
Analyst, MKM Partners LLC

Q

Thanks for taking my question. Just wondered how we should be thinking about the catalog business this year and how it sort of plays out as you get closer to the transition of a next-gen cycle. And also, when you look at your cash, I mean, you ended the year nearly $1.7 billion in cash. Let's say you generate another $300 million or so in free cash flow. How much cash do you really think you need on hand, and – as you – this is a follow-up to a prior question talking about allocating the cash. Is acquisitions – are those really viable at this point going forward? Or some of the other uses you might have for your cash?

Peter Moore
Chief Operating Officer, Electronic Arts, Inc.

A

Eric, this is Peter. I'll talk about catalog. It's always a strong pillar for us to lean on as we head through a transitional period. And this year will be no different. As I mentioned earlier to a previous question, catalog was very strong for us in Q4. We expect it to be strong again in Q1, primarily because we have but one major release in Fuse. And then as we head into the transition and hopefully into next-gen consoles by the holiday, depending what's announced in the next few months, it will still continue to be a large part of our business. But then our focus, obviously, moves to the front-line titles. Our back end of the fiscal year is heavy laden, as it typically is with our new releases. So we'll transition our publishing teams on the ground to focus on front-line.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

A

And on the cash question, we're very comfortable with the current cash balance. As a reminder, about 60% of that's offshore. We do have a convert outstanding that we think about all the time as a bill coming due at some point in the future. But also, I think most important, we're very focused on the internal opportunities that we see today. We have purchased businesses over the last few years, and we've been spending our time trying to figure out how best to integrate those and leverage those.

PopCap, for example, is a huge opportunity with the Plants vs. Zombies and Bejeweled franchises. And we're really focused on how we get our best value out of those existing franchises versus worrying about going out and buying something new. Our goal is to return cash to shareholders, and we'll do that in whatever is the most efficient way to do it at the right time. But you should continue to see buyback programs and very much a focus on generating cash flow over time.

Eric O. Handler
Analyst, MKM Partners LLC

Q

Great. Thank you very much.

Rob Sison
Vice President-Investor Relations, Electronic Arts, Inc.

All right, guys. Well, thank you much for joining our call, and we'll catch up with you next quarter.

Blake J. Jorgensen
Chief Financial Officer & Executive Vice President, Electronic Arts, Inc.

Thank you, everyone.

Operator: Thank you. That does conclude today's conference. Thank you for your participation. You may now disconnect from the audio portion.