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KONG - Q4 2013 KongZhong Corp. Earnings Conference Call

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CORPORATE PARTICIPANTS

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Wang Leilei *KongZhong Corp. - Chairman, CEO*

CONFERENCE CALL PARTICIPANTS

Nick Ning *86 Research - Analyst*

Vivian Mau *Woodberry Management - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q4 2013 KongZhong Corp. Earnings Conference Call.

At this time, all participants are in a listen-only mode. After management's prepared remarks there will be a question-and-answer session. Please note that today's conference call is being recorded.

I would now like to turn the call over to, Mr. Jay Chang, Chief Financial Officer of the company. Thank you, Mr. Chang. Please go ahead.

Jay Chang - KongZhong Corp. - CFO

Thank you, operator. This conference call may contain forward-looking statements. Although such statements are based on our own information and information from other sources we believe to be reliable, you should not place undue reliance on them.

For additional discussion of risks and uncertainties relating to forward-looking statements and other factors, please see the documents we file from time to time with the Securities and Exchange Commission. We assume no obligation to update any forward-looking statements, which only apply as of the date of this conference call. Thank you for your interest in KongZhong.

I will first review our 4Q results before handing the call over to our CEO, Mr. Wang Leilei.

Total revenues for the fourth quarter of 2013 decreased 0.6% from the third quarter but increased 2.8% from the same period last year to \$43.84 million exceeding our prior guidance range of \$41 million to \$42 million.

As we continue to transition our business to become a cross-platform digital entertainment company, mobile games made up 11.2% of total revenues and internet games contributed 57.2% of total revenues, as such making overall gaming revenues making up 68.4% of total revenues.

Gross profit increased 13.7% from the third quarter and 20.6% from the same period last year, to \$21.72 million exceeding the guidance range of \$20 million to \$21 million.

Net income increased from the third quarter of 2013 to \$10.03 million exceeding our prior guidance range of \$8 million to \$9 million while basic net income per ADS was \$0.22.

Non-GAAP net income was \$10.65 million exceeding the guidance range of \$9 million to \$10 million while non-GAAP diluted net income per ADS was \$0.23. At the end of 2013, the company had \$216.61 million in cash and cash equivalents, term deposits, held to maturity securities and restricted cash, or equivalent to \$4.78 per ADS.

Turning to our full year 2013 financial highlights. Total revenues for the full year of 2013 were \$179.44 million, of which WVAS revenues consistent with revenues were \$63.92 million compared to \$77.8 million in 2012.

Mobile game revenues were \$17.07 million in 2013 compared to \$21.2 million in 2012. While internet game revenues were \$98.45 million in 2013 compared to \$87.42 in 2012.

Net income in 2013 was \$20.66 million compared to \$25.74 in 2012, however net income in 2013 included a \$1.56 million impairment loss on a tangible assets and \$2 million impairment loss on long-term investments. Non-GAAP net income for the full year 2013 was \$28.87 million.

Now turning to our business units for the fourth quarter of 2013. For internet games revenues were \$25.08 million, a 17.4% increase from 3Q and 5.2% increase from the same period last year.

Domestic internet game revenues were \$24.22 million, 16.6% increase from 3Q and a 6% increase from the same period last year. Domestic internet game revenues consisted primarily of revenues from World of Tanks.

Overseas internet game revenues were \$0.86 million, 44.6% increase from the third quarter but a 13.1% decrease from the same period of last year. Overseas Internet game revenues increased sequentially due to [Kung Foo Hero] license revenues contribution from our South Korean business partners.

For the fourth quarter Mainland Chinese online game operations achieves average concurrent users of 467,000 and aggregated paying accounts of 774,000 with a quarterly average revenue per user or ARPU of RMB192.

APUs in the fourth quarter were up 11% from the same period last year and 14.2% from the third quarter. Internet games gross profit in the fourth quarter was \$13.65 million, 32.2% increase from the third quarter and a 19.3% increase from the same period last year. 4Q internet game gross margin was 54.4% compared to 48% in the same period last year and 48.3% in the third quarter.

Now turning to mobile games, total mobile game revenues in the fourth quarter were \$4.92 million, an 18% increase in the same period last year and 4.7% increase from 3Q. Feature phone mobile games in the fourth quarter were \$1.8 million compared to \$3.21 million in the third quarter. Our mobile operator partners continue to implement strict operating policies as well as continue to de-emphasize the marketing of feature phone mobile games.

Smartphone mobile games however in the fourth quarter were up 108.4% to \$3.11 million, representing 53.2% of total mobile game revenues.

For the fourth quarter, Smartphone game operations achieved average monthly active users of 1.32 million, aggregated paying accounts of 86,000, with a quarterly average ARPU RMB222.

Mobile game gross profit in the fourth quarter was \$3.45 million, a 49.2% increase from 3Q and 43.5% increase from the same period last year. The increase in mobile game gross profits was due to the increase in our higher margin Smartphone games revenues compared to feature phones game revenues.

We expect to launch a number of new Smartphone games in the first half of 2014. 4Q mobile game gross margin was 70% compared to 57.6% in the same period last year and 49% in the same third quarter.

Now turning to WVAS. WVAS revenues in the fourth quarter were \$13.83 million, a 23.2% decrease from 3Q and a 5.4% decrease from the same period last year.

As discussed previously, our WVAS business generally sees seasonal weakness at the end of each calendar year based on our mobile operator partner policies and business practices. However, we do expect WVAS operating environment to stabilize in 2014 compared to 2013.



WVAS gross profit in the fourth quarter was \$4.62 million, a 28.5% decrease from 3Q. While gross margins were 33.4% compared to 35.9% from the third quarter.

Now turning to operating expenses. Total operating expenses in the fourth quarter were \$15.7 million compared to \$21.5 million in the third quarter. Product and development expenses in the fourth quarter were \$6.82 million.

Sales and marketing expenses in the fourth quarter were \$6.52 million compared to \$10.94 in the third quarter. As previously discussed, third quarter sales and marketing activities were elevated due to increased promotion of our Smartphone games and World of Tanks. The sequential decline in sales and marketing activities in the fourth was in moderation of these activities.

G&A expenses in the fourth quarter were \$2.36 million, and the company's total headcount remained stable in the fourth quarter at 1,153 staff.

Now turning to our first quarter 2014 guidance. For the three month period ending March 31, 2014, we expect total revenues to be within the range of \$45.5 million to \$46.5 million, with business unit revenue at the midpoint expected to roughly consist of WVAS revenues of \$13.5 million, mobile game revenues of \$8.5 million and internet game revenues of \$24 million.

We further expect total gross profit to be within the range of \$22.5 million to \$23.5 million. Net profit to be within the range of \$9.5 million to \$10.5 million. And non-GAAP net profit is expected to be within the range of \$10.5 million to \$11.5 million.

Regarding internet revenue guidance, beginning in September 2013 with further implementation beginning on January 1, 2014, the company began to account for the majority part of internet game revenues under VAT tax policies.

Under VAT tax, revenues calculated excluding VAT that has been paid to the tax authorities were under business tax in the prior periods of revenues fully recorded including the business tax announced as per Chinese government tax policies. As such, although our Internet game revenue guidance for domestic Internet games implied a slight decrease quarter-over-quarter, we do expect gross profits from domestic Internet games to remain flat and stable.

Now I'd like to turn the call over to our CEO, Mr. Wang Leilei.

Wang Leilei - KongZhong Corp. - Chairman, CEO

Thanks Jay. Good morning and good evening everyone. First of all, thanks everyone for continued attention and support for KongZhong Corporation.

The fourth quarter is just like what Jay said. We outperformed again this quarter, driven by World of Tanks user and the revenue increase. And mobile games segment growth delivered a better than forecast revenue and profit.

World of Tanks supported by the new fourth quarter content updates with great marketing promotions, our user base, revenue of gross profit, all have robust increased quarter-over-quarter and year-over-year.

Regarding the four released mobile games, we continue to improve user experience and expand the domestic and the international partnership channels. User feedbacks and the marketing results have been excellent, which can be demonstrated by mobile game revenue growth exceeding over 100% quarter-on-quarter growth in the fourth quarter.

Regarding Chinese gaming market in 2014, we believe both internet game and mobile gaming market are blue oceans with mass opportunities. For internet games, no matter whether user growth has slowed down or not, many traditional digital developers are switching to mobile game market. So our competitor for PC internet games has decreased sharply.

We also believe user demand for Triple A games have grown. This has given us great space to expand, seems everyone already understands the mobile game market growth potential. I'm not going to mention it here.



In 2014, we will continue to excel in our three segments, WVAS, internet games and the mobile games. I believe WVAS, will continue to provide the company with healthy cash flow, mobile game user base will scale with continuous release of new games. And building on the strong foundation of World of Tanks, we expect two new internet games to be released recently, Guild Wars 2 and World of Warplanes and have higher expectations that we will launch them successfully.

In the first quarter of 2014, we have tons to do. We will host large scale World of Tanks third anniversary celebrations, announce KongZhong's number one military internet game brand and establish our provision in this important agenda. This means, we have the most Triple A military internet games and the largest military internet game user base and they are still growing.

In the first quarter, we will officially begin to release Guild Wars 2 commercialization strategy and the large scale marketing of Guild Wars 2. Even though new high quality titles have emerged in 2014, judging from various data, Guild Wars 2 is currently the most popular anticipated internet game in China market.

Before Chinese New Year, we started Guild Wars 2 pioneer server test, user feedback was great, especially regarding the localized user tutorial. Last week, World of Warplanes also started a small-scale closed beta testing. Judging from players' feedback, the control scheme is easier to learn while the control complexity of flight simulation games, have disappeared in World of Warplanes.

We believe these two games will have the potential to officially launch in the market in the first half of 2014.

KongZhong sales developed action fighting games Legend of Meteor Blades, also launched its third close beta testing in March this year. Since 2013, World of Warplanes and the Legend of Meteor Blades have been in the top 20 of new anticipated game rankings in China market.

Also Auto Club Revolution and Blitzkrieg 3, will undergo alpha testing in March and June respectively. These two games have almost no competitors in the China market in terms of game play. Their core game play comes from successful single-player games namely Nascar Racing and Blitzkrieg 1 & 2 respectively.

Also they have innovative game modes for the online game genre. We hope gamers will love these two games. In the first quarter, four Smartphone games will be distributed overseas even more. For example, Smartphone game Kooky Three Kingdoms will soon land on a famous Korea platform and its traditional Chinese version will soon launch in Taiwan and Hong Kong markets.

Moreover in March, we will begin testing domestically two mobile games developed by our Tianjin and Shanghai studios. One is action role-play game while the other is chess type strategy game. In the first quarter, we will continue to strengthen our Smartphone game development team and marketing channel expansion.

In January, we announced a strategic investment in Ourgame International, which is known as Lian Zhong. KongZhong's focus will continue to be on the hard-core mobile game market segment this year, but we also have an optimistic view of the casual PC and mobile game market. Through this investment we expect to realize complimentary marketing channel resources and the synergies.

In conclusion, we will have many licensed games and in-house games, which have been prepared with partners or self-developed over the past one or two years. We will find the right opportunities to launch them in the Chinese market this year. We believe in 2014, KongZhong will have great opportunities and amazing performance to uplift its value and industry position.

Operator, I'd like to open the call to questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Your first question comes from the line of Nick Ning from 86Research. Please ask your question.

Nick Ning - 86 Research - Analyst

Hi, thanks for taking my questions. So, my first question is, is there any other PC games you're trying to launch on a commercial basis for the year of 2014 besides Guild Wars 2 and World of Warplanes?

Wang Leilei - KongZhong Corp. - Chairman, CEO

Well, we believe we will focus on make official launch for the Guild Wars 2 and World of Warplanes. And the backup, the other two games is Auto Club Revolution, our car racing game and Blitzkrieg 3. But this is relay on the results for the alpha testing for these two new games in this year. And as I said that we will focus on the Guild Wars 2 and World of Warplanes official launching this year.

Nick Ning - 86 Research - Analyst

Thanks. That's very helpful. So for your older games, World of Tanks, what do you see the trend in its revenue and is it fair for us to assume this sense of growth for this game to continue in this year?

Wang Leilei - KongZhong Corp. - Chairman, CEO

In the fourth quarter, we have restructuring our World of Tanks operation centre, and we got more resources and more human resources focused on the operation and the localization and the marketing promotion for the World of Tanks. And we believe for this year, and World of Tanks we'll have healthy cash flow and healthy growth in terms of PCU and in terms of the revenue.

And also, we believe we can get more help from our producing partners from Wargaming. They will give us more new content patch especially for new timesheets and new game plays.

Nick Ning - 86 Research - Analyst

Okay. Thanks. And then for your mobile games, could you give us some color on the -- how many games we plan to launch for this year, and with the mobile game gross margin kinds of levels or you could also be affected by this issue?

Wang Leilei - KongZhong Corp. - Chairman, CEO

As we mentioned from Q3 and this quarter, we will launch one or two titles each quarter, same as the last quarter. And we will launch about 8 to 10 new titles for 2014. And also this is our in-house developed mobile games. And also we have strategy and opportunities to licensee some of the Triple A mobile games from overseas studios to expand their China market.

Nick Ning - 86 Research - Analyst

And along the margins?



Jay Chang - KongZhong Corp. - CFO

Yes. Today the majority of our Smartphone game revenues are through self-published platforms so the marketing tends to be higher. In the future we could go to other platforms where the revenue share is higher so the margin would have trends to be lower than the 70% level but probably not a whole lot.

And if there was that we would get the uplift in terms of less marketing costs as well as the assets to that user base. The VAT tax, I wouldn't worry that too much on the Smartphone side given as the coming off a small base. And as I mentioned, I think the key thing there is growth that we're seeing in that business especially in the first quarter. And we also expect for the rest of 2014.

Nick Ning - 86 Research - Analyst

Also on the overall basis, how should we look at your overall margin trend for the rest of this year with several new games to be launching? Thank you.

Jay Chang - KongZhong Corp. - CFO

Well, I think the focus for us is getting the launch of both Guild Wars 2 and World of Warplanes brand. That's going to be based on a lot of the data we get back from the upcoming data sets that we intend to put out to the market. Based on that, we're determining our marketing plans and from there.

So I think right now to give a kind of a long-term operating margin target, we still believe if our game portfolio is successful over the long-term, 25% target kind of operating margin is where we would like to get. But as we launch games obviously there are going to be some upfront marketing expenses which would change that. But over the long-term we do believe that these games are successful, we would target roughly that kind of level.

Nick Ning - 86 Research - Analyst

25% GAAP operating margin, right?

Jay Chang - KongZhong Corp. - CFO

Correct.

Nick Ning - 86 Research - Analyst

Yes. Thank you. And then it seems that over the fourth quarter, your mobile game revenue is a little bit lower than your previous guidance. So where does that shortfall come from, any details?

Jay Chang - KongZhong Corp. - CFO

Primarily internet, yes. Primary is our feature phone business, at the end of the year, because the feature phone business is really the WVAS business for mobile games that was impacted a lot by the year-end policies. And as we've guided in the first quarter of 2014, we do see feature phone stabilizing and slightly rebounding. But majority of the growth in our mobile game business is coming from Smartphone games.



Nick Ning - 86 Research - Analyst

Well, thank you. And then, could you give us some color on what are your top mobile games right now and roughly speaking, how much is generated under monthly grossing basis? Thank you.

Jay Chang - KongZhong Corp. - CFO

The top two games right now we have that of the four main games that we've released to the market are Kooky Three Kingdoms and Pocket Fort. In terms of monthly grossing I would rather cite, go to our overall guidance and you can kind of calculate that. But those two games make up majority currently of Smartphone game revenues. And then, Pocket Lord as well as the Three Kingdom Generals make up a smaller amount but they are actually still strong contributors.

Nick Ning - 86 Research - Analyst

Okay. So what do you see the revenue share for platforms like Qihoo UC Web for the rest of the year, are they -- do you think from picking a smaller portion versus would be the last year's December? Have you talked to other platforms like Alibaba to place your games on their platform? Thank you.

Wang Leilei - KongZhong Corp. - Chairman, CEO

I think our major mobile game revenue is coming from our direct marketing promotions revenue generated. And now we have talked with some big platform operators. We believe the revenue sharing with some big platform operators just like 50% to 50% revenue sharing.

And also we try to focus more on expand our overseas to find some partners to expand our mobile game overseas market especially for Korea, Japan, and the Taiwan market. And we believe the margin whatever for revenue sharing with big platform operators or our direct promotion marketing is the same.

Nick Ning - 86 Research - Analyst

Okay. Thanks. And then -- hello? Yes, so could you elaborate a little bit on the rationale behind investment in R&D, how does that correlate to your mobile strategy and what kind of cooperation can we expect? And finally, what's the impact on your P&L from this deal?

Wang Leilei - KongZhong Corp. - Chairman, CEO

As our strategic investments in Ourgame International we believe KongZhong has more -- have more synergies and complimentary with Ourgame (Lian Zhong) in terms of their user base and their marketing channels. Because KongZhong, we focus on develop and operate the hard-core mobile games. And we also have optimistic will of the casual mobile games market.

So as a strategic investment in Ourgame (Lian Zhong), we believe this is a good complimentary for KongZhong, from the promotion and from the user base.

Jay Chang - KongZhong Corp. - CFO

And as minority investments we would only expect to account this on our balance sheet not as an income statement in time.



Nick Ning - 86 Research - Analyst

Okay. So my last question is regarding your deferred revenue, that point is declined to a low level. Could you provide some color on this revenue stream? Thank you.

Jay Chang - KongZhong Corp. - CFO

I will take the key things to remember, when we recognize revenue for World of Tanks, we have very, very limited permanent or long-term items. The majority of our revenues from World of Tanks are generally recognized within the quarter. So some of the volatility like deferred revenue is really related to consumption patterns and what type of items people buying World of Tanks whether premium accounts or premium tanks and when they did it in the period.

So I wouldn't read too much into that that line. And then I think the focus says as we demonstrated in the past we've been pretty fairly consistent in matching or exceeding our revenue guidance for internet games and I would look at that as the kind of the key area of how we're managing our business.

Nick Ning - 86 Research - Analyst

Okay. That's all my questions. Thank you Leilei and Jay, thank you very much.

Jay Chang - KongZhong Corp. - CFO

Thank you.

Operator

Your next question comes from the line of Vivian Mau from Woodberry Management. Please ask your question.

Vivian Mau - Woodberry Management - Analyst

Hi. Good morning management. Congratulations for the good results. I have two questions on the gross profits; number one is that in fourth quarter we see the gross margin of your internet game business actually improved significantly. So I wonder if there were any reasons behind that. So that's the first question.

Jay Chang - KongZhong Corp. - CFO

Hi, Vivian. The key reason was the shift, the gradual shift from business tax to VAT tax. If you look at our business segment analysis and our earnings release, business tax for internet games was relatively low not because internet games started to portion as they started to shift over to the VAT tax revenue recognition that will amend. Because of that the gross margin improved.

Vivian Mau - Woodberry Management - Analyst

Okay. So just a follow-up to that, so if that already started to happen in the fourth quarter, whereas your reported internet games revenue also slightly impacted by this changing accounting?

Jay Chang - KongZhong Corp. - CFO

Yes, if you compare 3Q to 4Q. And then as well as 1Q 2014 compared to 4Q. But we're not going to provide any specific apples-to-apples break down, the differences are relatively small and as we believe, over the long term as we launch all these new games, mostly under VAT tax in 2014.

Vivian Mau - Woodberry Management - Analyst

I see. Okay. And also in the earnings call, you mentioned that going into first quarter, I think you said that you expect on the gross profit level the gross profit for the internet game business will be stable. I just would like to clarify when you say stable, do you mean that kind of the reported gross profit in this first quarter will be roughly kind of the same as last year's first quarter level? So if that's the case, does that mean that like the World of Tanks is relatively flattish?

Wang Leilei - KongZhong Corp. - Chairman, CEO

I think the World of Tanks revenue growth was stable is dependent on the new content updates, like fourth quarter we have three times content updates, our producer Wargaming provide a lot of new content patch in fourth quarter. But in the fourth quarter, but for this year, the fourth quarter they only have one important content update in March. So that means the content update frequency is lower than the fourth quarter. So our expectation for the first quarter is flat compared with Q4.

Vivian Mau - Woodberry Management - Analyst

Okay. That's clear. Thanks a lot.

Wang Leilei - KongZhong Corp. - Chairman, CEO

Thank you.

Operator

(Operator Instructions). There are no further questions at this time. I would now like to hand the conference back to today's presenters. Please continue.

Jay Chang - KongZhong Corp. - CFO

Thank you for your continued interest in KongZhong. And we look forward to speaking to you in the near future. Thank you.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.



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