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KZ - Q2 2014 KongZhong Corp Earnings Conference Call

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## CORPORATE PARTICIPANTS

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**Leilei Wang** *KongZhong Corporation - CEO*

## CONFERENCE CALL PARTICIPANTS

**Jialong Shi** *Credit Suisse - Analyst*

**Nick Ning** *86Research - Analyst*

**Ryan Roberts** *China Stock Research - Analyst*

**Jun Zhang** *Rosenblatt Securities - Analyst*

## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by and welcome to the Q2 2014 KongZhong Corp. Earnings Conference Call. (Operator Instructions) 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.

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### **Jay Chang** - *KongZhong Corporation - 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, we 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 apply only as of the date of this conference call. Thank you for your interest in KongZhong.

I will first review our 2Q results and 3Q guidance before handing over the call to our CEO, Mr. Leilei Wang.

Total revenues were \$57.87 million, an increase of 16.7% from the first quarter of 2014 and an increase of 32.8% from the same period last year, which is in line with our guidance range of \$57.5 million to \$58.5 million.

Total gross profit was \$24.5 million, an increase of 5.1% from the first quarter and 37.2% from the same period last year. Also, in line with our guidance range of \$24 million to \$25 million.

Net income was \$0.7 million, beating our guidance loss range of a loss of \$0.5 million to \$1.5 million. Diluted net income per ADS was \$0.00.

Non-GAAP net income was \$1.45 million, exceeding our break even guidance range. Non-GAAP diluted net income per ADS was \$0.03.

At the end of the second quarter, the company had \$230.58 million in cash and cash equivalents, term deposits, held-to-maturity securities, available-for-sale securities and restricted cash or equivalent to \$5.07 per ADS. This includes the 2Q of 2014 end of -- end of mark to market value of our stake in Ourgame, which is listed on the Hong Kong Stock Exchange and the ticker 6899. The fair value of this investment was recorded under available-for-sale securities and the gain of 12.06 million was recorded on other comprehensive income.



Turning to our separate business units. In internet game revenues were \$32.02 million in the second quarter, an increase of 27.7% from the first quarter of 2014 and 35.6% from the same period last year. The increase in internet game revenues was mainly due to the launch of Guild Wars 2 and World of Warplanes.

Second quarter mainland online game operations achieved average monthly active users of 2.6 million, aggregated monthly paying accounts of 427,000, but monthly average revenue per user of RMB152. The increase in our online game metrics were due to the also from the contribution of new users from Guild Wars 2 and World of Warplanes.

Internet game revenues made up 55% of total revenues in the second quarter while Internet game goes profit was \$15.16 million, a 23.1% increase from the first quarter, while Internet game's gross margin was 48.8% compared to 50.6% from the first quarter.

Total mobile game revenues were \$10.54 million, a 30% increase from the first quarter and a 182% increase from the same period last year. Total mobile game revenues made up 18.2% of total revenues in the second quarter. While mobile game gross profit was \$4.57 million, a 13.7% increase from the first quarter, while mobile game's gross margin was 43.4% compared to the 48.6% margin in the first quarter of 2014. Despite decline in the mobile game gross margins was due to increased contribution from carrier billing channel revenues which have lower margins than our smartphone app store distribution channels.

Turning to WVAS. WVAS revenues were \$15.31 million, a 6.7% decrease from the first quarter and a 5.7% decrease for the same period last year. WVAS gross profit was \$4.81 million, a 34.8% decrease from the first quarter, while gross margin was 28.1% compared to 40.3% in the first quarter and 31.9% in the same period last year. The decrease in WVAS gross margins was mainly attributed to the increase in revenue share cost to our media and distribution partners.

Total operating expenses in the second quarter were \$25.98 million compared to \$15.04 million in the first quarter. Product development expenses in the second quarter were \$6.51 million compared to \$5.93 million in the first quarter with the slight increase in the product development expenses due to an increase in the games operations' team staff cost.

Sales and marketing expenses in the second quarter were \$16.01 million compared to \$6.74 million in the first quarter. The significant increase in 2Q marketing expenses were primarily related to promotional activities associated with the commercial release of Guild Wars 2, commercial release of World of Warplanes, as well as the marketing of the War Saga Brand.

G&A expenses in the second quarter were \$3.46 million compared to \$2.36 million in the first quarter with the increase in G&A, partly due to higher stock-based compensation expenses. And the company's total headcount remained stable in the second quarter at 1,201 staff compared to 1,116 staff at the end of the first quarter.

Now turning to our third quarter 2014 guidance. The three-month period ended September 30, 2014, the company expects total revenues for the third quarter to be within the range of \$64 million to \$65 million; total gross profit to be within the range of \$26 million to \$27 million. And we expect net income to be \$9 million to \$10 million with non-GAAP net income to be \$10 million to \$11 million as we moderate our operating expenses back towards pre-2Q 2014 levels. In addition, our 3Q guidance reflects that we have sold or activated over 1 million CD-Keys for Guild Wars 2 in China since the OBT on May 1.

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

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**Leilei Wang** - KongZhong Corporation - CEO

Thanks, Jay. Thanks for your continued interest in KongZhong. As Jay mentioned, we reported our second quarter results in line with our revenue guidance and the beat of our profit guidance. In our first half of this year, we are focused on the sales development and the licensing of a new portfolio of mobile games while we executed the commercial release of 2 new PC games, Guild Wars 2 and the World of Warplanes.



In the second half, we will focus on the continuous promotion and operation of our three existing PC games while releasing a number of new mobile games into the market. We believe in the second half this year, our new mobile games releases will be the key revenue driver for the company. But we expect continuous stable growth in our internet games business.

Now I'd like to highlight each of our major games activities in the coming second half of this year. For World of Tanks, the introduction of a number of new features and content, we will sustain stable growth. In August, we introduced the first version of new Stronghold game mode, which allows Clans to build and eventually battle for bases and the resources, similar to Clash of Clans mobile games.

We expected the continuous introduction of the new tank tech trees extensions and premium tanks in the second half of this year. And then coming back to school period in September, we expect more updates of stronghold to strengthen this game's community features.

For World of War Planes, we will introduce the new update today. It includes a new PVE mode, which should greatly improve the new player's game experience and introduce them to the unique gameplay of military warfare.

For Guild Wars 2, after the successful commercial release and after a small scale testing of the new free trial mode, we expect to increase promotion of free trials to students in September. And we will focus on the competitive PvP/eSports portion of Guild Wars 2 in the following quarter.

For our other PC games, we expect to continue technical and a small scale user testing of Blitzkrieg 3 and Auto Club Rvolution for the rest of this year and hoped to have the first alpha test for World of Warships later this year.

For mobile games, we currently have over 10 games in our pipeline. We expect four to five games to be the key drivers for our business in the second half of this year. The games are structured around three key areas; self-developed games, licensed games, and the co-developed games.

For self-developed games, we are finalizing the closed beta testing of Attack of Three Kingdoms which is themed the next generation real time strategy game. We expect to begin commercial release in September. This game takes some of the best components from our self-developed base building real time strategy game, Pocket Fort while significantly enhance it by adding popular card collecting elements and features based around the Three Kingdom generals.

Beginning around the fourth quarter period, we expect to bring our self-developed KuiBa puzzle role-play game to market to match the October release of the third KuiBa animated movie.

For licensed game, we expect to begin Open Beta testing of My Lovely Princess, a puzzle role-play game licensed from Cyber-Agent of Japan. Later in the year, we expect to license Grieta from Korea SK Network Services. It is the most anticipated mobile action role-play game in Korea this year.

We'll begin beta testing of action role-play game, mobile game, which is co-developed with Mplus of Korea. In addition to this line-up we have other games in various stages of development across our 300 staff mobile game team. We will bring more games to market depending on the market conditions. Overall I believe KongZhong will continue to development positively in the future as a leading and differentiated online game company.

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

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## QUESTIONS AND ANSWERS

### Operator

Thank you. (Operator Instruction) And your first question today comes from the line of Jialong Shi of Credit Suisse. Please ask your question.

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**Jialong Shi** - *Credit Suisse - Analyst*

Hi, good morning management. Thanks for taking my question. I have a housekeeping question. We noticed that some -- even for gaming companies, you guys have a lot of cash on the balance sheet and the business itself is a very high cash generator. So I just wonder if you guys will consider paying part of the cash back to your shareholders by dividend or share buyback going forward. This is my question. (Speaking in Chinese).

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**Jay Chang** - *KongZhong Corporation - CFO*

Thanks, Shi Jialong. We actually are actively considering all those types of different ways to enhance shareholder value including dividend and buyback. But as you just noticed, we just came through a period of where we launched a number of significant games where we did reduce our profitability in the short term. But based on our 3Q guidance obviously returning to pre-2Q levels of profitability. And obviously, if we can sustain and execute our business strategy, we do would look to enhance shareholder value through various means. And we have that done in the past through share buybacks, but we are open to dividends and share buybacks in the future as well.

But really the focus for us is to make sure that we have a very stable, diversified, and high growth portfolio of direct differentiated games in the marketplace. And that's really our current focus. And if we can deliver that over the next few quarters then we would be very, very, open to having that discussion with our board which makes that ultimate decision.

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**Jialong Shi** - *Credit Suisse - Analyst*

Thank you for the color.

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**Operator**

(Operator Instructions) And our next question comes from the line of Nick Ning of 86Research. Please ask your question

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**Nick Ning** - *86Research - Analyst*

Hi, thanks for taking my question. Sounds like to me that there's delay in the new PC game launch for the rest of this year, so I'm curious why is that. Could you update us on the last schedule to 2015? And related to that I'm wondering if there's any change in the way that we allocate the internal resources between PC and mobile going forward. Will we continue to focus more on PC in the coming years? Thank you.

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**Jay Chang** - *KongZhong Corporation - CFO*

Hi, Nick. Thanks for your question. Regarding the PC portfolio, so the new games that we still have under development Blitzkrieg 3, World of Warships and Auto Club Revolution and there are others that we have under development which are not anywhere near to talk to be discussed about. But I would say our focus right now is to kind of the three game portfolio that we have, World of Tanks, Guild Wars 2, World of Warplanes. We just launched those and we believe we have a multi-year development schedule for those games that we want to focus on.

On top of that, in the second half, we do have a number of mobile games which we believe will be a key driver for our business going forward. We haven't had release any kind of large scale mobile games in the past or the past six months, so I think we're -- in terms of marketing to the marketplace, we want to make sure that we're not flooding the market with only KongZhong games.

But I would say that in terms of commercial release of the other PC games are probably more towards end of 2014 to 2015. But a lot of it is dependent on development schedules of our development partners whether Eutu chnyx for Auto Club Revolution, Nival for Blitzkrieg 3 or War Gaming for World of Warships. At the same time, we will continue to develop our existing PC games. We believe we have multiyear growth opportunity for all three of those games which were recently launched.



In terms of resources -- I mean the only thing that's reallocated is marketing in terms of games that are what we feel are -- have the good commercial potential to be successful. We will put them to the marketplace in the second half of the year. In the first half of the year, the focus was Guild Wars 2, World of Warplanes; in the second half of the year, I would say it is the four to five mobile games that we've been working on for quite some time. So, I would say the allocation resources could not, in terms of development or publishing, have changed at all but it's really the marketing timing relative to development cycles and games being commercially ready to come to the market.

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**Nick Ning** - *86Research - Analyst*

Okay, that's very helpful. And can you also give us some color on Guild Wars 2 and our expectation for this game going forward?

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**Jay Chang** - *KongZhong Corporation - CFO*

The game is doing well. As I mentioned, we sold or activated over 1 million CD-Keys since the OBT. The community is actually is very strong and very passionate. But I think the key focus for us going forward is we've just started small scale free trials with the CD-Key model still intact and during the September period, which is still coming, we plan to do a more large scale promotion of that free trial system to the back-to-school period. And from ArenaNet standpoint, they are now marketing their feature pack in the US and as well as in China and the key focus of that is the World Versus World PvP competitive part. And we also did announce a global tournament with North America, Chinese, as well as European players.

So, the focus there is really around the development schedule for Guild Wars 2 and in the near term is really around the PvP part of the game which is we believe is quite differentiated in the China market place.

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**Nick Ning** - *86Research - Analyst*

Okay. That's all my question. Thank you.

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**Operator**

(Operator Instructions) And our next question today comes from the line of Ryan Roberts of China Stock Research. Please ask your question.

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**Ryan Roberts** - *China Stock Research - Analyst*

Good morning, Jay and Leilei. Thank you for taking my question. I just want to ask about the distribution strategy for the mobile games for the four to five we're going to try and release for the second half. I noticed that some of the margin impacts this quarter was due to the different distribution channels. And can you give us an idea what it's going to look like in the second half?

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**Jay Chang** - *KongZhong Corporation - CFO*

So the margin impact for the mobile games in the first half of the year was really due to relying more on the China Mobile channels. The new four to five games that we planned to release in the second half would be primary focused on the newer channels or the channels that people mostly prefer for smartphone games which are the IOS Apple Store or the Android Stores.

Based on our strategy for those four to five games is really to likely go on IOS first which has higher margins than the current business today. And then based on the performance there, hopefully it's strong. Then we have some negotiating power or we can show many of the larger platforms in China the key metrics and retention and monetization of the games to have potentially better bargaining power in discussions with them, which would obviously impact margins in terms of cooperation, revenue, share deals.



But case-by-case, each of those games, it's still a case-by-case discussion with these different platforms. And some of them we may consider to go exclusive, some of them we may not that, and depending on how those deals are structured, there is gross net revenue discussion there in terms of who is the ultimate provider of the services. But we're not at that point yet.

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**Ryan Roberts** - *China Stock Research - Analyst*

Okay. Got you. And if I can just switch just quickly to the PC games. I think earlier you've mentioned that you expected some synergies, some gamer synergy of World of Tanks and some of the other related -- the World of Warplanes. And I just wondering if you're actually seeing that so far that's developing as you expected?

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**Jay Chang** - *KongZhong Corporation - CFO*

Yes. I mean, at the start of the Open Beta period roughly 20 -- a quarter to a third of the World of Warplanes players that came in were overlaps of World of Tanks players. Maybe 25% to a third were existing World of Tanks players. And the rest were brand new players because the game play is very different than the World of Warplanes.

And we continue to grow the overall World of Tanks registry user base, which is now I believe approaching over 40 million. So as we go to market with -- and we've been expanding that with World of Warplanes. And with the unified account system, having World of Warships, which I believe is going to be very highly anticipated by the market as we go to alpha testing, we have a lot of synergies.

In addition, of that we are evaluating other type military genre games both in the PC and the mobile side which can take advantage of some of the learning we have from the War Saga platform that we've built. And the first one of that is obviously Blitzkrieg 3, which we actually did demo a little bit at ChinaJoy. And we have number of other mobile games that we're looking at in terms of -- that have a military genre which could get leverage upon those synergies as well.

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**Ryan Roberts** - *China Stock Research - Analyst*

Okay. Great. Thank you.

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**Operator**

(Operator instruction) And our next question comes from the line of Jun Zhang of Rosenblatt Securities. Please ask your question.

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**Jun Zhang** - *Rosenblatt Securities - Analyst*

Thanks for taking my question. I have two questions. Jay, could you refresh us, what's your PC game pipeline and mobile game pipeline for the second half and the first half next year? Thanks.

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**Jay Chang** - *KongZhong Corporation - CFO*

So PC is really, I would say, still a little bit flexible based on beta test results, but for the second half, I wouldn't expect any large scale commercial release of any of our PC games. Those are probably be more towards either very late of 2014 or 2015. Those would relate to Auto Club Revolution, Blitzkrieg 3 as well as World of Warships that would get on PC side.

So the focus for us to the second half of 2014 for PC games would be our existing portfolio -- the Guild Wars 2, World of Warplanes, and World of Tanks. Just to reiterate again what Leilei mentioned on our mobile games, at the end of this quarter, September, we plan to release Rush and Attack



of Three Kingdoms, hopefully quite soon. And then in October, November, December period, depending on beta testing, we plan to release the KuiBa IP-based game, the My Princess game from Cyber-Agent, which actually is a top 50, top 10 grossing game in that marketplace. And then depending on beta testing and development of Grieta, Mplus, and a number of other games which we haven't actually -- didn't talk about in the call, which we're looking at internal beta testing numbers to see if we want to release this year or continue to improve them for next year.

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**Jun Zhang** - *Rosenblatt Securities - Analyst*

Okay, thanks. So my second question, you gave the guidance for the next quarter, it looks to have a better margin than I expected. So should we expect the marketing cost coming down quarter to quarter in the next few quarters? And also, should we expect the mobile game to have a better margin than the PC? Thanks.

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**Jay Chang** - *KongZhong Corporation - CFO*

Well, I would say that in terms of the PC game margin, our target, we've mentioned before is really about 50%. Mobile games has all these opportunity to exceed that depending on the different deals in the different channels that we go through and the success of the various different mobile games.

In terms of marketing, yes, the 3Q number reflects lowered marketing compared to 2Q. But that said, if the testing obviously goes well and the results go well for these four or five plus mobile games, we would look to market, I wouldn't say aggressively, but not likely back to 2Q levels. But that said, they're not going to go back probably to all the way to 1Q level as of 2014. But that's going to be dependent on each different mobile game testing and so on and so forth.

But so far, the Rush and Attack Three Kingdoms, the current number looks quite good. But we hope to go on IOS in the short term. And then based on that result, then we'll look to go through different Android stores in the marketplace quite soon after that.

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**Jun Zhang** - *Rosenblatt Securities - Analyst*

Okay. So my last question is that, do you see any results from the free trial of the PC game you launched in the late July or early August.

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**Jay Chang** - *KongZhong Corporation - CFO*

It was still very small-scale free trials. I think there's a lot of optimization that we're looking to do, and that's really the focus now for, obviously, the rest of August and moving into September before we kind of go more large scale. So I would categorize, that we're looking to do a lot more optimization with ArenaNet but I would say the free trials have gone okay. And then I think for September, based on optimization and more promotion, you know we hope that there could be definitely improvement there.

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**Jun Zhang** - *Rosenblatt Securities - Analyst*

Okay. Thanks a lot, that's all my questions.

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**Operator**

(Operator Instructions) It appears there are no further questions. I'd now like to hand it back to today's presenters for closing remarks.

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**Jay Chang** - *KongZhong Corporation - CFO*

Okay. Thank you for continued interest in KongZhong. We look forward to talking to you in the near future. Take care. Thank you.



**Operator**

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

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