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KZ - Q1 2015 KongZhong Corp Earnings Call

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CONFERENCE CALL PARTICIPANTS

Nick Ning *86 Research - Analyst*

Jun Zhang *Rosenblatt Securities - Analyst*

Michael John *Private Investor*

PRESENTATION

Operator

Thank you for standing by, ladies and gentlemen. Welcome to the First Quarter 2015 KongZhong Corp. earnings conference call.

(Operator Instructions)

Please also note, today's conference call is being recorded.

I would now like to hand the call over to Mr. Jay Chang, Chief Financial Officer. Thank you. Mr. Chang, please go ahead.

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, you should not place undue reliance on them.

For additional discussions 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'll first briefly review our financial results before handing over the call to our CEO, Wang Leilei.

For the first quarter of 2015, total revenues were \$50.51 million, exceeding the prior guidance range of \$46 million to \$47 million. Total gross profit was \$19.11 million, exceeding the prior guidance range of \$17 million to \$18 million, while net income was \$4.2 million; with diluted net income per ADS at \$0.09 per share, exceeding the guidance level of \$4 million; and non-GAAP net income was \$5.17 million; with non-GAAP diluted net income per ADS of \$0.11, also exceeding the prior guidance level of \$5 million.

At the end of the first quarter, the Company had \$190.12 million in cash and cash equivalents, term deposits, held-to-maturity securities, available-for-sale securities and restricted cash are equivalent to \$4.08 per ADS, net of roughly \$50 million short-term bank loan which we'll use to fund our October 2015 one-time dividend.



The mark-to-fair value of the Company's investments in Ourgame and Forgame were priced HKD3.83 and HKD14.84 per ordinary share, respectively, equivalent to roughly \$29 million and \$17 million at the end of the first quarter. However, if using the close of the May 19th price of Ourgame and Forgame, the total value would have roughly been \$43.7 million higher.

Now, turning to our main business units. Internet games. Internet game revenues in the first quarter were \$26.36 million, an increase of 6.5% from the same period last year, but is 10.5% quarter-over-quarter decline. Although World of Tanks continue to demonstrate continued stable performance, user activity and purchases in Guild Wars 2 and World of Warplanes continued to moderate during the period. We expect player purchases in Guild Wars 2 to remain depressed until the release of the upcoming expansion pack.

Also for the first quarter of 2015, mainland China online game operation achieved average monthly active users of 1.9 million users, compared to 1.8 million in the fourth quarter, with aggregated monthly paying accounts of 333,000 and a monthly average revenue per user of RMB163.

Total mobile game revenues were \$10.56 million, a 30.8% increase from the same period last year but a 30.5% decrease from the fourth quarter, with -- while -- the decrease in mobile game revenues was due to a pause in the release of new self-developed as well as licensed games on Chinese smartphone game platforms during the period.

WVAS revenues were \$13.59 million, a 20.1% decrease from the fourth quarter and a 15.7% decrease from the same period last year.

Total operating expenses in the first quarter were \$16.19 million, compared to \$19.4 million in the fourth quarter. Sales and marketing expenses in the first quarter were \$6.23 million, compared to \$9.08 million in the fourth quarter. First quarter sales and marketing expenses decreased as we did not release any major new internet or mobile games during the period.

Now turning to our second quarter outlook. We expect total revenues to be within the range of \$51 million to \$52 million or a slight increase over the first quarter, gross profit of \$19 million to \$20 million, net profit of around \$4 million, and non-GAAP net profit of around \$5 million.

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

Leilei Wang - KongZhong Corporation - Chairman & CEO

Thanks, Jay, and thanks for your continued interest in KongZhong.

In the first quarter of 2015, we performed in line with our prior expectations. We continue to focus on the development of both our internet and mobile game business. In the past, a major part of our mobile game strategy was focused on self-developed games, but from the end of last year, we began to diversify to publish third-party licensed mobile games.

In the first half of 2015, since both our self-developed games were under development, licensed games are expected to be the key revenue growth driver. In the second half, we expect to launch more of our self-developed games.

As part of licensed game strategy, Super God Battle Squad, which is Western fantasy themed card battle game, will be released in the middle of June. Also our self-developed real-time strategy game, Rush Three Kingdoms, was successfully launched in South Korea and Taiwan market.

In PC games, World of Tanks continued to provide KongZhong War Saga game platform with stable performance, while the decline in user engagement and revenues for Guild Wars 2 and World of Warplanes has stabilized somewhat.

We continue to work closely with ArenaNet, the producer of Guild Wars 2, to prepare for the upcoming closed-beta test of Guild Wars 2 expansion pack in the China market.

But more importantly, we have begun to conduct more meaningful tests, including a number of beta weekend tests in May for World of Warships, with the target to hopefully bring open beta of that game to market by the end of this year.



In addition, we have a number of other PC game titles which we continue to beta test in the second quarter and third quarter, including Chronicles of Dragon Wing, Blitzkrieg 3 and World of Tank Generals, with a strong focus on being the leading military game platform for Chinese gamers.

Lastly, we have begun to leverage our strategic investment in both Ourgame and Forgame to develop synergies with our business in the areas of mobile game distribution and mobile game development, among other areas, for the China mobile game market.

I remain confident in our execution ability and believe our game pipeline remains robust with significant growth potential this year.

Operator, I'd like to open the call to Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions)

Thank you. And your first question comes from the line of Nick Ning from 86Research. Go ahead please.

Nick Ning - 86 Research - Analyst

Hi. Thanks for taking my questions. So my first question is regarding your Q1 revenue. Where does the upside come from versus your own guidance? Is it PC game? And for your guidance, does that assume a decline in PC game and a stable WVAS business? Thanks.

Jay Chang - KongZhong Corporation - CFO

Hi, Nick. So for 1Q, the outperformance relative to our prior guidance was primarily in WVAS, but there were some better-than-expected results from World of Tanks. I think that's the delta in the 1Q guidance.

In the 2Q guidance, we actually are expecting PC games to decline slightly, maybe around 10% quarter-over-quarter level. I would also expect WVAS to moderate somewhat but not that significant. The main factor of the slight increase is really we kind of see roughly 50% quarter-over-quarter growth in mobile games with the release of the new game in mid-June.

Nick Ning - 86 Research - Analyst

Thanks. That's very helpful. So with the new PC games to be going online, how should we look at our PC game revenue overall for the whole year of 2015, and the trends for next? Any color would be helpful, thank you.

Jay Chang - KongZhong Corporation - CFO

Yeah. I mean we're still obviously beta-testing World of Warships. We haven't started any beta tests in China with Guild Wars 2. So in terms of specific timing, we don't have specific update.

But roughly speaking, we expect 2Q and 3Q to remain stable, relatively soft for PC games.



We expect our mobile game business to hopefully ramp up quite significantly at the end of 2Q and 3Q and 4Q period, as we talked on the prepared remarks. And then hopefully if beta testing goes well, especially for World of Warships, towards the end of this year and very early next year we expect our PC game business to exhibit significant growth again.

Nick Ning - 86 Research - Analyst

Okay, thank you. My last question is about the mobile game part. We seem to be accelerating the mobile game launch, and relative to the overall China mobile game market, do we have any estimate say for the total China mobile game market growth for this year and next year? And how should we look -- do we expect it significantly outperform the overall industry growth or just grow in line with the industry? Thank you.

Jay Chang - KongZhong Corporation - CFO

For overall industry, I think it's better to refer to third-party research firms in terms of their forecasts. But for KongZhong, we're focused on building what we feel is hopefully one of the best-quality hard-core game -- mobile game portfolios in the market.

We're just focused on getting obviously the new game which we're in the middle of testing and launching quite soon, Super God Battle Squad, to market, and do that well.

And if we can do that well, we have a slate of many other games which we believe are similar to higher quality which we're self-developing or co-licensing or co-development with Korean studios to hopefully outperform the market because we're coming from a relatively low base.

Nick Ning - 86 Research - Analyst

Okay, thank you. That's all my questions.

Jay Chang - KongZhong Corporation - CFO

Okay. Thank you.

Operator

Thank you. Your next question comes from the line of Jun Zhang from Rosenblatt. Go ahead please.

Jun Zhang - Rosenblatt Securities - Analyst

Hi, good morning. Thanks for taking my question.

So, Jay, could you give us more color on the Q2 guidance? Do you feel any impact from the China Mobile being the new party on the billing, and how should we see the trend for the mobile game in Q2? Thanks.

Jay Chang - KongZhong Corporation - CFO

We don't see that major impact on WWAS from some of the billing changes, China Mobile. Bulk of our WWAS revenues are subscription revenues to a lot of internet companies actually that use the mobile phone. So we're not seeing a big impact there, but we see some softness, but that's reflected in our guidance already. And sorry -- can you repeat your second part of your question?

Jun Zhang - *Rosenblatt Securities - Analyst*

Yeah, sure. So what's the trend for the mobile game, what's the pipeline for the mobile game in Q2? And how should we think about the gross margin trend? Because now you have your own developed games and also publishing some other games. So, how we should model the gross margin for the mobile game part?

Jay Chang - *KongZhong Corporation - CFO*

So the 2Q guidance reflects the mid-June release of Super God Battle Squad, and that's really the bulk of the incremental delta from our Q2 kind of imply 50% quarter-over-quarter growth from 1Q is going to be roughly a month of revenues from that game, which we expect to be hopefully quite successful. But obviously we're still not to the mid-June yet.

We have a lot of testing and distribution and marketing to do. But the early signs are quite good relative to our small-scale tests and our discussion with all the major Android platforms in China.

Going past the end of 2Q, we have three or four other high-profile mobile games which were still under development but could come to market based on -- I think we'd like to see Super God Battle Squad hopefully become one of the flagship games.

And with that, then we have probably a little more flexibility to launch some of these other games like Castle of Heroes, which we're in development from Korea, Three Heroes which is another Korean action RPG game. And then we have another Chinese mobile game -- mobile game, as well as another action RPG Three Kingdoms theme, as well as many others actually.

But those all potentially could come in the 3Q period, but I think really we want to make sure that Super God Battle Squad does hopefully outperform our expectations and that becomes a flagship growth driver by itself, and then we have a lot more flexibility with making sure the other games do well. As you know, the mobile game business is not about just quantity, it's about quality. And we hope to achieve that with the mid-June launch of Battle Squad.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay. Sure. And also, I do see you have some investment in the Ourgame and Forgame, especially Forgame, in Q1 this year. So, how should we look at those investments? Do you have any plans to monetize those investments sometime because the stock looks like [Hong Kong] performed very well?

Jay Chang - *KongZhong Corporation - CFO*

No. Those are strategic investments. We would look to maybe trim our stake as the market reflect the valuations.

But our view of Forgame is we just only recently invested, we believe that company has also robust mobile game portfolio. We're working with them quite closely on some of their investee studios to either publish or do co-developments, or even talk about distribution with them. Similarly, with Ourgame, with their kind of more casual user base.

So we look at both of those as strategic plus financial investments. And we think there's still potential upside in those investments. So we're happy holding them now and working closely with them on strategic business to leverage more value out of those relationships.



Jun Zhang - *Rosenblatt Securities - Analyst*

Okay. And my last question is about, I guess a lot of Chinese [ADR] right now are talking about alternative strategic -- alternative choice. You know, CMGE, they start privatized, and some other gaming company looking at other choices. So as a few mobile game or PC game companies invest in this Chinese ADR, so what's your plan, and what's your thoughts over there? Thanks.

Jay Chang - *KongZhong Corporation - CFO*

Yeah, we're keeping abreast of market activity, but our focus is really on making sure our mobile game business and PC business continues to perform well, and build out our pipeline.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay. Great. Thanks a lot.

Jay Chang - *KongZhong Corporation - CFO*

Okay. Thank you.

Operator

(Operator Instructions)

Your next question is from the line of [Michael John] who's a private investor. Go ahead, thank you.

Michael John - *Private Investor*

Yes, hi, Jay. Good morning. Thank you for taking my call. I have a couple of quick questions.

I didn't notice any of the games you mentioned in the recent release, so I'm just curious how Racing League, Peerless, [Valkyrie], Kung Fu Hero and Hunting Spirit, I know you mentioned some of the games you have in the pipeline, and I'm wondering if you referenced any of those games inadvertently just in generalities?

Jay Chang - *KongZhong Corporation - CFO*

So, for Blitzkrieg 3, we actually still have quite high expectations for that game, but it's still, I would say, alpha testing phase right now. I think there's an alpha test quite soon for that game in China.

And that really is -- that game, because it's like asymmetric real-time strategy game, it really, with World War 2 background, really sets our strategy to dominate the military game space in China. So that's a very core game for us. But it's still quite early, so, it's just kind of alpha testing right now. But we're working very closely with Nival, the Russian developer, there.

Kung Fu Hero, actually it's called Master of Meteor Blades, is a game we continue to work on very diligently, I believe close to over three years now. And the game's progressing. And hopefully over the next few months we'll have some interesting news about that game for the China market.

The other games, I would say, that we're still beta testing. And I think the focus is what we talked about at our prepared remarks and kind of additional comments on those two other games.



Michael John - - *Private Investor*

Do you guys feel any increased pressure to maybe put out more cost of revenue to be -- to gain better-quality, higher-quality IPs? I know that's kind of -- there's so many games and it's certainly expanding globally, and that's kind of what -- the quality of the IP sometimes make a big difference on how much access and how much the game is a success. Do you guys anticipate any increase in revenue just to try to gain more the market share there?

Jay Chang - *KongZhong Corporation - CFO*

I think one of the things we want to do is be relatively diligent in type of IP we pay for relative to our user base, relative to our team's knowledge of the China market, and, you know, try to, within that parameter, have a portfolio of really good games. And I think you'll hopefully start seeing that with the launch of Super God Battle Squad coming in the next week -- few weeks or so.

Beyond that, you know, we're not going to go crazy and spending hundreds of millions of dollars on IP, which may not have that much relevance for the China market. And so I think we have a pretty robust portfolio which we hope to execute over the next couple of quarters. And it's our job to execute and show that. And then from there, those -- we are looking -- we are -- that's how we are looking at reasonably priced IP which fits our strategy and user base.

Michael John - - *Private Investor*

My final two questions are this. There's been a lot of -- we've seen a lot of private companies -- I'm sorry, we've seen a lot of public companies go private and also be bought out, or some stake of their company being taken over by another company. Are you guys considering sometime in the near future or at least weighing your options to sometime go private or form some type of synergy with another company?

Jay Chang - *KongZhong Corporation - CFO*

It's difficult for us to obviously to talk about kind of corporate development, things which are not finalized or imminent. But I think for us, we're obviously actively following the market activity. And I think I'll put it at that.

Michael John - - *Private Investor*

Okay. My last question is, reflection of kind of the stock price. I know we've had kind of a volatile range here since the last couple of quarters here, on the US exchange, at least we went down to about \$4.80, now we're -- it looks like we're trading at about \$6 a share after the release here. I think one of the things that a lot of the shareholders here is, you know, perception is everything. Some of the headlines today are saying 50% reduction in profit and stuff like that.

Well, I know that you guys are more focused on quality games versus quantity. What can you say to the shareholders who believe in the long-term strategy and your commitment to developing quality games, where the actual share price hasn't quite caught up to that mentality, if you will? Because I mean, I think many of us would agree that the price per share is really not reflecting the real intrinsic value of what you have to offer comparably to many of the other companies you compete against for the similar pipelines, similar revenue.

Jay Chang - *KongZhong Corporation - CFO*

Thanks for those comments. I guess I would say, there's nothing that's going to deviate so much from what we've just talked about on our prepared remarks and how we're building out our smartphone game portfolio and you know unless -- diversifying our PC game business. And we believe



through that execution, we hope the market will continue to realize that we're undervalued, our intrinsic value of KongZhong is higher than current levels.

On top of that, through some of our investments, our, at least based on kind of roughly current today mark-to-market value, we have roughly about \$5 per ADS of cash and marketable securities on our balance sheet also, which provides some downside protection for any investor who's looking at almost a call option, our ability to execute as we've expanded over the last 12 months from three or four self-developed games to now 10 to 15 licensed plus self-developed games, if not more.

And now we're getting closer hopefully to closed beta testing and eventually open beta of World of Warships, as well as -- and then on top of that, we also have later, hopefully later this year, the expansion for Guild Wars 2.

So we actually have a lot of things that we're working on. It's just we now need to start executing and show the financial performance metrics hopefully over the next few quarters.

Michael John - - *Private Investor*

While I have you on the phone, and I won't take up any more of your time, and I appreciate, thank you for answering some of the tough questions I know it's hard to answer these questions.

But I would say that, certainly for the shareholders in the US, we're not really focused on all the little, small, minute details, but you talked about a lot of the exciting things that you're doing with beta testing.

Most of the time we hear about it during the conference calls. Just as a consideration point, it will be wonderful to be able to hear some announcements how things are going and any trends that you're noticing, certainly, as you progress in trying out and hopefully launching some very successful games.

Thank you, Jay, for your time.

Jay Chang - *KongZhong Corporation - CFO*

Okay. Thank you.

Operator

Thank you. We have no further questions at this time, so I'll hand back for closing remarks.

Jay Chang - *KongZhong Corporation - CFO*

Okay. Thank you for your continued interest in KongZhong, and we look forward to speaking to you in the near future. Take care.

Operator

Thank you. Ladies and gentlemen, that does conclude our conference for today. Thank you for your attendance.



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