

Teleconference with analysts held on May 24, 2018 - transcript

Announcer: Ladies and gentlemen, welcome to the CD PROJEKT Capital Group results conference for the first quarter of 2018. The conference will be hosted by Mr. Adam Kiciński, President of the Board of CD PROJEKT S.A., and Mr. Piotr Nielubowicz, Vice President of the Board and CFO of CD PROJEKT S.A. A Q&A session will take place following the presentations. I will now yield the floor to our speakers.

AK: Good morning and welcome, this is Adam Kiciński speaking.

PN: Piotr Nielubowicz

AK: The presentation which we're going to discuss can be found on our website at cdprojekt.com in the Q1 results section – you can find it in the top left corner. I encourage you to download it and I will now turn it over to Piotr who will discuss the figures.

PN: Good morning again. I assume all of you have been able to access our presentation. Moving to financial results, slide no. 3 – CD PROJEKT Group financial results. With regard to the presentation of results we would like to present all three Q1 periods following the release of The Witcher 3: this is due to the fact that the first quarter of 2017, which is our current reference period, was particularly good. During that period sales of The Witcher 3 and its expansion packs actually surpassed the corresponding sales in the first quarter of 2016, both in terms of units sold and sales revenues. This sets the bar high for our current report. In addition, looking back at all three quarters it is evident that despite the passage of time since the debut of The Witcher 3 the Group's sales remain strong. In the first quarter of 2018 sales revenues topped 75 million PLN. The bulk of those revenues – around two thirds – is attributable to CD PROJEKT RED, while about one third is attributable to GOG.com. With regard to GOG, its percentage share in the Group's consolidated revenues increased during Q1 2018, which translated into a somewhat greater costs/revenues ratio. Consequently, out of the 75 million in revenues our pre-tax sales profit was over 59 million PLN. Looking at all three quarterly periods, our operating costs remained essentially fixed – note that we continue to ramp up our videogame development activities and that, as a group, we also continue to recruit additional personnel – so the fact that operating costs are holding steady should be regarded as a favorable result. *Summa summarum*, the Group's post-tax result for the first quarter of the current year was nearly 23 million PLN. As already remarked, our revenues are dominated by the activities of CD PROJEKT RED – I now invite you to move on to the next slide; slide no. 4, which presents the results of the CD PROJEKT RED segment. Sales revenues were nearly 52 million PLN. The current quarter, much like both reference quarters, saw no significant new releases. The Witcher 3 again attracted a large group of customers and we also noted an increase in GWENT sales revenues compared to the final quarter of 2017 where the aggregate revenues were nearly 60 million. Nearly all of these sales were carried out without significant offsetting costs; hence 52 million in revenues translates into nearly 51 million in gross sales profit. Much like for the Group as a whole, operating costs did not change much compared to the reference period; they amounted to 22 million PLN. The bulk of this figure represents sales costs, which include, among others, promotional expenses. In Q1 2018 this refers specifically to GWENT and our esports activities. In effect, the net result of the CD PROJEKT RED segment was nearly 24 million PLN. Moving on to the next slide – GOG.com results. To begin with, it is worth noting that this period marks a major change for GOG since it directly follows the merger between GOG Ltd. and GOG Poland sp. z o.o. The merger affected recognition of revenues, particularly those related to the segment's most important product, i.e. GWENT. This resulted in a decrease in revenues posted by GOG, coupled with an increase in the corresponding CD PROJEKT RED revenues. A side effect was an overall decrease in consolidation eliminations. Altogether, these

events had a negative impact on the reported sales volume in the GOG.com segment. GOG.com also suffered from the significant weakening of the US dollar – in the first quarter of the current year the dollar stood much lower than during Q1 2017. Considering that the vast majority of GOG sales – approximately 90% – are exports, most of which are paid for in US dollars, this means that for each dollar in Q1 2018 revenues we obtained 0.60 PLN less than during Q1 2017. This strongly affected the reported sales revenues. With regard to operating costs, they amounted to nearly 10 million PLN, a bit more than during the past year, despite a modest decrease in sales revenues. This outcome is primarily due to the participation of the GOG segment in the consortium which develops and maintains GWENT, and on promotional costs incurred by the consortium during this period. Another factor which affected the segment's financial result comprises financial costs – 443 thousand PLN in surplus negative exchange rate differences, which represents a significant part of the reported result, and, as noted, the result achieved in this rather peculiar quarter is a loss of over 800 thousand PLN. Moving on to slide no. 6, the Group's asset/liability balance, in the scope of fixed assets the greatest change concerns development expenditures, naturally a consequence of our ongoing videogame development activities – our most important current projects are Cyberpunk, GWENT and Thronebreaker. We spent nearly 23 million PLN on these activities during the reporting period. Another major change involves current assets – our trade receivables decreased by nearly 25 million PLN, a natural consequence of collection of receivables following strong sales in the final quarter of 2017. Regarding the change in working assets related to a slight increase in prepaid expenses – on the level of the Capital Group this is mostly due to minimum guarantees in the GOG segment, i.e. licensing royalties for games sold on GOG. The increase in royalties payable by GOG resulted in an increase in prepaid expenses during Q1 2018. The most significant component of our asset balance – cash and bank deposits – increased by 14.5 million PLN, reaching 662 million PLN at the end of March. With regard to liabilities – slide no. 7 – equity increased to 908 million PLN, naturally due to current-period results. The second major change is the decrease in trade liabilities; a natural consequence of strong Q4 sales, much like in the case of trade receivables. Another important component of liabilities are provisions, which increased by approximately 4 million PLN, chiefly due to creation of new provisions for result-dependent compensation. As you can see, we reported over 43 million PLN in other provisions at the end of the previous year; like most other entities, we decide upon annual bonuses following the approval of our annual financial statement. As of 31 March 2018 the statement had not been approved – but we're now past the end of this reporting cycle and, consequently, the provisions will begin to be consumed during Q2 2018 – a similar situation occurred in 2017 and 2016. Regarding cash flows – slide no. 8 – we generated over 37 million PLN in positive cash flows from operating activities, primarily as a result of two major factors: current-period results (almost 23 million) and collection of Q4 receivables. Both factors had a favorable effect on operating cash flows. Negative factors included the reduction in liabilities and, of course, taxation, which includes our annual income tax return. With regard to investment activities, the most important component is ongoing R&D work – development of new videogames: including Cyberpunk, GWENT and Thronebreaker, as well as new technologies developed in the GOG.com segment. Concerning bank deposits, newly created deposits were similar in value to those which matured during the reporting period, with a slight surplus of the latter. This translated into over 17 million PLN in cash inflows with a 2.6 million PLN decrease in the value bank deposits, for an aggregate increase in the balance of cash and bank deposits of 14.5 million. The total value of monetary assets exceeded 660 million PLN. That's all from me; I will not turn it over to Adam.

AK: I would like to present three of the most important events occurring during the past quarter – in fact, these events continue up until the present time. The first is the launch of another GWENT gameplay mode – the Arena. This was very warmly received by players; the Arena is very popular and enables players to get to know new cards not currently in their decks. We will, of course, continue to

develop this mode in future version of the game. The second major event is the establishment of a branch in Wrocław following our purchase of an enterprise from the Strange New Things studio. In effect, the Strange New Things team has joined us and will collaborate with us on Cyberpunk's development. This should not be regarded as a change in our strategy – we do not intend to grow by acquiring other entities; the Wrocław team was simply viewed as an excellent match for our vision and enabled us to inject significant new experience into our own development process. We will continue to manage this team – last week we signed the corresponding final agreement and just today we announced a small-scale share buyback program; slightly over 20,000 shares needed to settle this transaction with the seller, i.e. with Strange New Things. The final highlight I wish to mention is Homecoming, a major initiative internal to GWENT. We have decided to implement another round of significant changes to GWENT before the game's full release, which is scheduled for this year. Homecoming implies a return to the roots of GWENT – of course I do not mean reverting to old releases; rather, I'm referring to the underlying concept. We want GWENT to represent a battle between two armies; we want the game to become even more tactical and more skill-based, as was originally the case. Of course, this also implies major updates to the game; the project is moving forward at a rapid pace and I expect to be able to share further information regarding Homecoming soon – specifically, we intend to get back to you with more details after E3, so please bear with us. We're confident that this is a good idea and that Homecoming will be well received. We intend to couple Homecoming with the simultaneous release of Thronebreaker, which we also expect to occur by the end of the year. Thank you very much – we will now take your questions.

PN: I would like to begin with some questions submitted to us electronically – perhaps some of those will pre-empt questions which you intend to ask. The first question refers to our future profit margins in light of expenditures related to Cyberpunk, and whether we anticipate further increases in development expenses. The answer – Cyberpunk-related expenditures do not directly affect current-period results; they accumulate over time as expenditures on development projects and will be progressively reassigned to costs following the game's release. Expenses related to development of Cyberpunk will be pegged at the moment of release and will not change from that point onwards. Accordingly, future profit margins will depend on the sales volume. Referring to the latter part of the question – development costs tend to increase as the game nears completion. While this is only a rule of thumb, it nevertheless reflects actual conditions quite well. The next question – “What fraction of the total development expenses in the amount of 21.2 million PLN was devoted to GWENT?” While we do not provide a breakdown of development expenses into specific projects, our three most important ongoing projects are Cyberpunk, GWENT and Thronebreaker. The Cyberpunk development team is approximately three times larger than the GWENT and Thronebreaker development teams put together, and this is reflected in our ongoing development expenditures. “Is Thronebreaker still scheduled for release in the final quarter of the current year?” Yes, as Adam already said, we confirm that this release is scheduled for the final quarter of the year. The final question submitted by e-mail – “How many people are currently working on Cyberpunk?” The Cyberpunk development team is slightly over 300 strong. Thank you, and we will now take questions from the audience.

Announcer: Ladies and gentlemen, we will now open the Q&A session. To ask a question, please dial 01 on your phone keypad. Thank you.

Announcer: Ladies and gentlemen, the first question will be asked by Mr. Tomasz Rodak, BOŚ Brokerage House. Mr. Tomasz, the line is open.

TR: Hello, Tomasz Rodak speaking. I would like to ask – the CEO said that Homecoming communication will begin after E3 – does this mean that you will make Homecoming-related announcements at E3? That’s my first question. The second question relates to GOG results, and I’m not sure if you are able to answer, but if we were to disregard the effect of the USD exchange rate and the change in GWENT revenue accounting for the first quarter of the year, would these results represent an increase or a decrease compared to the Q1 2017 results, I mean – has GOG grown organically during the first quarter, year over year?

AK: As regards Homecoming communications, allow me to be more precise – we will begin sometime in early July and Homecoming has nothing to do with E3.

PN: Referring to the question which concerns GOG revenues – I’m not sure I can answer the question as stated; however, I believe I can share some information which may be of use to you: the aggregate sales revenues of the GOG.com segment in the first quarter of 2018, when denominated in US dollars, were higher than the corresponding Q1 2017 figures. In addition, if we were to look solely at revenues generated by the distribution platform – excluding GWENT revenues – they also increased year over year compared to the first quarter of 2017. I hope this answers the question.

TR: Yes, thank you.

Announcer: Ladies and gentlemen, to ask a question, please dial 01 on your phone keypad.

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Announcer: As we have no further questions – I apologize, we do have a question from Mr. Albert Rokicki.

AR: Greetings, this is Albert Rokicki. As we know, you have decided to not pay out a dividend for the past year. I would like to ask if you expect to pay out dividends in future years.

AK: Hello. As already noted, we do not have a dividends policy – so we cannot make any commitments in this regard. We will make decisions on a case-by-case basis and inform the market accordingly. While I’m at it, I would ask myself a question – or, more specifically address a question which continues to recur with great frequency: will the Cyberpunk marketing campaign be a short one? It seems there’s a misconception going around that we have announced this – which is untrue, by the way; we did muse about the length of the campaign at a similar results conference some time ago, and noted that campaigns may be either long or short; however, we’re past these discussions now and we understand that we will need to, or rather want to tell players a great deal about Cyberpunk. It’s a new release, a new world, and we want to share our vision for Cyberpunk. Thus, the Cyberpunk campaign will not be a short one. I hope that settles this issue.

AR: Hello, thank you very much. Can you still hear me?

AK: Yes, you’re still on.

AR: If that’s so, I would like to ask about the campaign specifically. Are there any preferences regarding the amount of resources committed to this campaign in relation to the cost of the game itself? I mean, have you settled on an amount – for example, 10% or 20% of the development budget?

AK: No, we have no such arrangements in place, and I will explain why. With The Witcher 3 the costs of the promotional campaign were comparable to the game's development costs; however, this was a coincidence. The costs of promoting and marketing the game are tied to projected sales and represent a percentage thereof. They do not relate to development costs. Our projections regarding future sales will become more and more detailed as we approach the moment of release – of course, we already have certain projections in hand. It's a very important project for us and our ambitions are great. We understand that developing and promoting the game will cost more than in the case of The Witcher 3, but it's too early to speculate about the details. The closer we get to release the more accurate our sales forecasts will be, giving us a better idea of how much to allocate for marketing. That's how we have always operated, and it can even be called an industry standard, as many other companies operate in a similar way.

AR: OK, thanks.

AK: Thank you.

Announcer: The next question will be asked by Mr. Grzegorz Suteniec from Puls Biznesu.

GS: Hello, greetings. Can you hear me?

Announcer: You're online.

AK: Yes, we also hear you.

GS: Hi. I would like to ask about the upcoming event – E3. It is almost taken for granted by the public that you will be showcasing Cyberpunk gameplay – perhaps you could comment upon this? Actually, let me rephrase by asking two questions. The first question: will you be organizing a presentation at the Microsoft conference preceding E3? And do you deny that Cyberpunk will be presented at the expo itself?

AK: Sorry, Grzegorz, unfortunately I need to repeat what I did at our last results conference: dodge the question by saying that we do not announce announcements. Sorry, but E3 is close at hand, so I will simply ask you to follow our presence at E3 and everything will soon be clear.

GS: In that case can you at least say whether you will participate in the Microsoft conference?

AK: The PR people are shaking their heads so, unfortunately, I cannot comment upon that either.

GS: *chuckles* OK. I understand that if you were not planning to participate you would be allowed to issue a denial?

AK: No, no, I'm just kidding; we really cannot comment on that. Everything will become clear in due time.

GS: Thanks

Announcer: Ladies and gentlemen, I would like to remind you that in order to ask a question you need to dial 01 on your phone keypad.

Announcer: The next question comes from Mr. Łukasz Kucharski, Polish Press Agency.

ŁK: Good morning, in relation to Grzesiek's question I wish to ask if the company is working on another RPG other than Cyberpunk.

AK: Yes, we are working on Thronebreaker, which has evolved into a fairly sizeable RPG, providing several dozen hours of gameplay.

ŁK: Thank you.

Announcer: The next question comes from Mr. Łukasz Kosiarski, PKO BP.

ŁK: Good morning, Łukasz Kosiarski; PKO S.A. in fact. I have two questions. The first one concerns Strange New Things – has this team already begun working on your projects? The second question is a request for guidance related to the selling costs of GWENT Homecoming and the release of Thronebreaker.

AK: Hi Łukasz. The SNT team has been working on our projects for several months now, so yes, this cooperation has already begun.

PN: Regarding guidance – as you know, we do not provide such guidance. In the case of GWENT Homecoming and Thronebreaker, these are the first such projects in our history, so any potential guidance would be fraught with uncertainty.

ŁK: Okay, thanks.

Announcer: Ladies and gentlemen, to ask a question please dial 01 on your phone keypad.

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Announcer: A question from Ms. Żaneta Marzec, IPOPEMA.

Announcer: Ms. Żaneta Marzec, IPOPEMA. Go ahead with your question.

ŻM: Good morning, Żaneta Marzec, IPOPEMA Securities. I have one question: what do you consider a short or express marketing campaign?

AK: A short campaign would typically take several months. One example is Fallout 4, where the campaign took, I believe, five months between the announcement and the release. That's what we would consider a short campaign.

ŻM: Okay, thank you very much.

Announcer: Ladies and gentlemen, as there are no further questions I will now again turn it over to our speakers.

AK: Thank you very much for participating in our teleconference. The next conference will be a live one, accompanying the publication of our semiannual results at the end of August. I wish to extend an invitation to all of you. The event will be held in the usual place and formal invitations will be dispatched beforehand – so see you at our semiannual results conference.

PN: Good bye.

Announcer: Thank you for participating in our conference. You may now disconnect.