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## THQ Management Discusses Q2 2013 Results - Earnings Call Transcript

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## **Executives**

Lisa Mueller

Brian J. Farrell - Executive Chairman and Chief Executive Officer

Paul J. Pucino - Chief Financial Officer, Chief Accounting Officer and Executive Vice President

Jason Rubin - President

THQ (THQI) Q2 2013 Earnings Call November 5, 2012 5:00 PM ET

## **Operator**

Good afternoon. My name is Kerry, and I will be your conference operator today. At this time, I would like to welcome everyone to the THQ Inc. Fiscal 2013 Second Quarter Results Conference Call. [Operator Instructions] I would now like to turn the call over to Lisa Mueller, Director of Investor Relations. You may begin your conference.

**Lisa Mueller**

Thank you, and good afternoon, everyone. On today's call, we will be making forward-looking statements. These statements are based upon management's beliefs and certain assumptions made by management and are subject to risks and uncertainties that may cause actual results to differ materially from today's forward-looking statements due to the discussion of trends, risk factors and other cautionary statements that are described in our March 31, 2012, Form 10-K and subsequent filings with the SEC. A copy of these filings may be obtained from our website. Unless otherwise required by law, THQ disclaims any obligation to update its view on any such risks or uncertainties after the date these statements are made.

In describing THQ's financial performance on our call today, we will discuss non-GAAP measures including net sales and EPS. These non-GAAP measures exclude the following: stock-based compensation expense, the certain deferred revenue and related costs, business realignment and related expenses, capitalized interest and other significant charges and benefits.

Non-GAAP results also include the impact of any foreign currency fluctuations on our available-for-sale investment securities. Please refer to the reconciliation of these measures to GAAP results in the tables provided in today's release and on our website.

On today's call, joining us from management are Brian Farrell, Chairman and CEO; Paul Pucino, Executive Vice President and CFO; and Jason Rubin, President. To begin, I would now like to introduce Brian Farrell, our Chairman and CEO. Brian?

**Brian J. Farrell**

Thank you, Lisa, and good afternoon, everyone. In our fiscal second quarter, we reported non-GAAP net sales of \$92 million compared to guidance of \$75 million to \$85 million, and a net loss of \$1.76 per share compared to guidance of a loss of \$3.50 to \$4.50 per share.

Darksiders 2 was our only key release during the quarter. While we are pleased with the quality of the game with a Metacritic of 83, sales of the title were below our expectations. Revenue upside in the quarter was a result of better-than-expected catalog sales led by Saints Row: The Third and digital sales of catalog titles. We have now shipped over 5 million units of Saints Row: The Third, which is a hit by any standard.

Our gross margin increased from 12.4% to 37.6%. Additionally, the significant measures we have undertaken to reduce our cost structure across the company are reflected in the sharply lower operating loss in the quarter.

In the last year, we have made significant strides to transform THQ into a producer of high-quality games -- game titles targeted at the core gamer, but perhaps more importantly, in the months ahead, we faced a number of challenges and opportunities. I want to assure you that we are working diligently to resolve those challenges and to maximize our opportunities.

On today's call, Jason Rubin will discuss the opportunities we believe exist in our game pipeline and in our studios. We are truly excited about our slate of games targeted at the core gamer, but we also face challenges operating with limited capital resources in the highly competitive market for games. I will provide more color on our plans in a few moments.

Now Paul will discuss our quarter in more detail. Paul?

**Paul J. Pucino**

Thank you, Brian, and good afternoon. To recap the second quarter, net sales were led by our new release, Darksiders 2, and followed by our most recent catalog releases Saints Row: The Third, WWE '12 and UFC Undisputed 3. Digital revenues in the second quarter were \$19 million. Net sales were lower than the year-ago quarter due to a smaller number of releases now that THQ is out of the Kids, Family and Casual segment.

Catalog sales were 37% of second quarter net sales this year, the same as the year-ago quarter. Our Q2 product cost as a percent of net sales decreased to 32% from 43% in Q2 of last year, due primarily to the higher average selling price of Darksiders 2 compared to the mix of new releases in the prior year quarter.

Software amortization as a percent of net sales was 30%, lower than 37% in the year-ago quarter due to titles with lower capitalized development cost relative to net sales. License amortization and royalties at 1% of net sales decreased approximately 6 percentage points from 7% in the year-ago quarter. On a dollar basis, license amortization and royalties of \$700,000 were 92% lower than the year-ago quarter due to the lower level of sales of licensed titles within the quarter.

As Brian mentioned, gross margin in the second quarter of fiscal '13 improved to 37.6%, which is more than triple our gross margin in the year-ago quarter.

Turning now to operating expenses. Product development expense decreased to \$12 million from \$23 million in the year-ago quarter due to previously announced reductions in product development expenditures as a result of our more focused product slate. Selling and marketing expenses of \$27 million were significantly lower than \$38 million in the year-ago quarter, reflecting a reduction in spending in support of future releases and lower personnel-related costs.

G&A of \$9 million was \$2.5 million lower than the year-ago quarter. We reported an operating loss of \$12 million compared with an operating loss of \$57 million in the year-ago quarter. Interest and other expense of \$2 million consisted primarily of interest expense on our convertible notes. Income tax benefit of \$2 million reflects our estimated non-GAAP tax rate. As a result, we reported a second quarter net loss of \$1.76 per share compared with a net loss of \$6.86 per share in the year-ago quarter.

Turning now to the balance sheet. As of September 30, 2012, we had \$36 million in cash and equivalents, \$21 million drawn against our credit facility. Our intention is to utilize the facility to help us fund working capital throughout the year, and we ended the quarter in line with our internal expectations.

Net accounts receivable of \$7 million decreased from \$16 million at the end of fiscal '12, reflecting lower sales volumes in the current quarter compared to the quarter ended March 31. Accounts receivable reserves of \$48 million at quarter end compared with \$70 million at March 31, 2012. Inventory was \$12 million compared with \$18 million at March 31, 2012. Our investment in licenses of \$48 million compared to \$65 million at March 31, 2012, primarily due to the recognition of previously deferred license amortization and royalties expense. Capitalized software development of \$104 million is down \$27 million from March 31, 2012, due to amortization of titles that hadn't been released and the recognition of previously deferred software amortization and royalties

expense. Accounts payable of \$57 million at quarter end compared with \$43 million at March 31, 2012. Accrued liabilities of \$50 million at quarter end compared with \$84 million at March 31, 2012.

As mentioned in today's press release, we are no longer providing net sales and earnings guidance. And we are withdrawing our previous guidance for fiscal '13 in our projected operating model.

And with that, I'll turn the call over to Jason.

### **Jason Rubin**

Thank you, Paul. I'd like to take a moment to update you on the state of our games. As I said last quarter, an ongoing part of my job is to evaluate titles to determine if there are opportunities to improve them or to better their competitive positions. When I joined the company, there were a certain number of titles already too far along in the development cycle for me to have much of an impact. Fortunately, these titles are on schedule, have now been released and were well received by the press and gamers.

Having said that, Darksiders 2 did not perform to our expectations or live up to its generally favorable reception. Observing this and other recent industry releases, one is left with a firm understanding that in the current marketplace, only the absolute top tier of releases is making impact on the game consumer. I now have an opportunity to start impacting our next slate of products and positioning them to compete in this marketplace.

Unfortunately, when I joined THQ, I did not find the 3 titles that had been in -- scheduled for the release in the fourth quarter of this year in the same strong state of production as Darksiders 2. Company of Heroes 2, Metro: Last Light and South Park: The Stick of Truth were all challenged and were guaranteed to fall significantly short of their design specs if they were forced to make their announced release schedules.

Additionally, in light of the aforementioned marketplace changes, even if completed, it would not have had the extra time dedicated to the polish needed to make them shine in this competitive environment. The resulting 2-month delay on each title is almost de minimis by game industry standards. But unfortunately, this delay places South Park outside of our fiscal year. Additionally, the delay in revenue generated on the 3 titles has further risk for the company.

None of the above should lead one to believe that I have any less confidence in the slate. Given the appropriate resources, THQ is as strong as ever.

The opportunity for South Park is massive. As one of the most anticipated titles of calendar '13, it richly [ph] deserves the anticipation. We believe the sheer size of the game, which is comparable to multiple seasons of show, and the incredible dedication and high standards of the creators will make the title worth the wait. I can personally say that I have probably had more "laugh out loud" moments in the last 4 months than in my entire game career to date.

Likewise, Company of Heroes 2 is testing as high a levels as its first incarnation, which happens to be one of the highest-rated RTS games of all time. I believe the extra time Relic plans to spend on content and balance will ensure that this title has a successful and long career as the first title.

And Metro: Last Light should set standards for PC graphics and atmosphere. The title not only takes advantage of the latest DX 11 tricks, the developer, 4A Games, manages to bring a good deal of this

graphic fidelity to the consoles as well. I'm excited and satisfied with the content size, positioning and our slate going forward. The 10 projects in production within THQ are as good a lineup as we could hope for.

And with that, I will return the call over to Brian.

### **Brian J. Farrell**

Thank you, Jason. When considering the video game market we operate in today, it is clear that the only viable path for THQ to succeed is to deliver to consumers high-quality, highly rated, truly exciting game experiences.

As Jason discussed, we decided to move Company of Heroes 2 and Metro: Last Light to March release dates, which is later than we had planned initially, and to move South Park: The Stick of Truth from March to early fiscal 2014. The new release timing and our limited financial resources have created a need for additional capital. And as you know, we also have \$100 million of face value of convertible notes outstanding that are due in less than 2 years.

In order to help us address these challenges, we have hired Centerview Partners to evaluate our strategic alternatives. We will discuss the results of that engagement at the appropriate time. And because of this process, we have been advised not to conduct a Q&A session following our prepared remarks today. We acknowledge many of you will have questions, and we hope that you understand that we are not in a position to answer those questions until our work with Centerview has run its course.

I would like to close today's call by thanking our dedicated employees for their tireless efforts in moving THQ forward. We appreciate your continued interest in THQ and for joining us on the call today.

### **Operator**

This concludes today's conference. You may now disconnect.

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### [Brian J. Farrell](#) - Executive Chairman and Chief Executive Officer

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**Paul J. Pucino** - Chief Financial Officer, Chief Accounting Officer and Executive Vice President

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|                          |      |       |       |       |
|--------------------------|------|-------|-------|-------|
| <a href="#">RWJ</a>      | 0.7% | 11.5% | 15.8% | 12.0% |
| <a href="#">SLY</a>      | 0.6% | 12.0% | 14.6% | 11.6% |
| <a href="#">UWM</a>      | 0.4% | 26.1% | 29.9% | 24.8% |
| <a href="#">PRFZ</a>     | 0.3% | 12.5% | 14.3% | 11.8% |
| <a href="#">IPK</a>      | 0.1% | 3.7%  | 6.6%  | 0.7%  |
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