

Letter to Shareholders

FY 2018

To our shareholders,

As we were preparing for our FY18 annual shareholders meeting, it occurred to us that the standard reporting of our business performance can obscure the underlying principles and view of the world that directed us to our chosen strategy. As investors ourselves, we like management teams that clearly communicate their assumptions and principles, as it helps us evaluate their performance and make a more informed evaluation about our investment.

So to help you understand both our current performance and our vision for the future, we've written a letter in four parts. The first is a summary of 2018. Next is a commentary on our investment philosophy, followed by our views on the industry present and future. The final section is a look at some key initiatives that we believe will make Nexon's next 25 years as innovative and exciting as our first 25.

2018 SUMMARY

Powerful intellectual properties backed by best-in-class live-game operations made 2018 a strong year for Nexon. Our company grew revenue and operating income 8% and 9% year-over-year respectively, and our net income grew 90% over 2017. Our “forever franchises” – those games that have continued to grow for more than 10 years – performed really well:

- *Dungeon&Fighter* (originally launched in 2005) grew at a double-digit rate. *MapleStory* in Korea, launched in 2003, grew 67%. *FIFA Online* in Korea declined, but that was as expected due to the transition from *FIFA Online 3*¹ to *FIFA Online 4*².
- By regions:
 - Japan declined 18%, a disappointment. This was due in part to the prior year “comparable” being a big one, but overall we did not find our footing in the Japanese market in 2018.
 - China, did very well, growing 15%.
 - Korea declined by 8%, largely due to the transition to *FIFA Online 4* mentioned above.
 - North America grew by 77%, based in part by the performance of Pixelberry Studios, which we acquired in late 2017.
 - Europe Others grew by 30% of the strength of new mobile games including *MapleStoryM* and *Darkness Rises* as well as contribution from Pixelberry Studios.
- We strengthened key partnerships. Our relationship with Tencent for *Dungeon&Fighter* and several other franchises is stronger than ever. Together with EA, our team executed a complex transition from *FIFA Online 3* to *FIFA Online 4*. And we have worked closely with Square Enix for the development of *Final Fantasy XI R*. Partnering is hard work, and we are very happy with how our teams executed.

We completed some deals that set us up for a great future. The Pixelberry acquisition, which we announced at the end of 2017, has been smoothly integrated into our operations. In Q3, we announced an investment in Embark Studios in Sweden, and an associated publishing relationship. We think this will be an enormous positive to our business over the long term.

¹ Official titles are EA SPORTS™ *FIFA Online 3* (PC) and EA SPORTS™ *FIFA Online 3 M* (mobile).

² Official titles are EA SPORTS™ *FIFA ONLINE 4* (PC) and EA SPORTS™ *FIFA ONLINE 4M* (mobile).

At our foundation, Nexon has several flagship games which we call “forever franchises” because with careful management by our live operations teams, they offer long-lasting experiences for our players, and a steady stream of annuities for our investors.

One of these, *Dungeon&Fighter* is now one of the largest PC franchises in China and the biggest on PC. Worldwide, *Dungeon&Fighter* is one of the world’s top-grossing game franchises of all time – in a rarified category that includes *Call of Duty* and *Grand Theft Auto*. Life-to-date gross revenues are several billion dollars bigger than Star Wars box office, the biggest movie franchise of all time. Importantly, it is incredibly robust and stable. Several of our other major franchises, such as *MapleStory* have recently seen significant growth (Korea *MapleStory* grew 67% in 2018 as mentioned above).

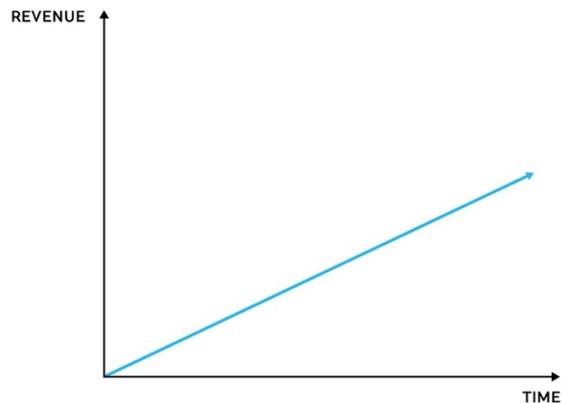
Among the Nexon management team, we often say that the good news takes care of itself, so focus on the challenges. Like any company, we faced our share of challenges and growing pains in 2018, including:

- Our development efforts did not result in major new hit franchises. We had several that got off to a good start but did not retain.
- Partially as a result, our business in Japan, where we are headquartered, did not grow.

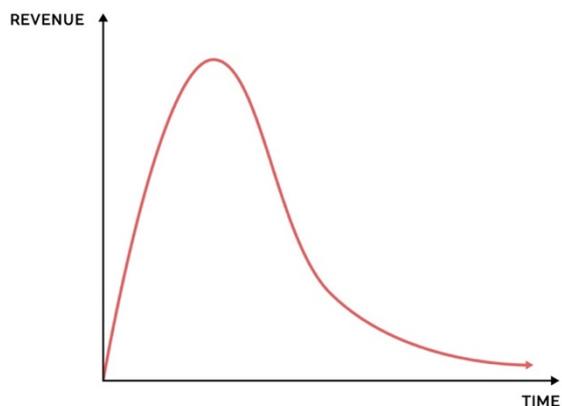
It’s important to note here that this was not a failure on the part of our developers or live operators. The challenges reflected our choice of games to develop and the fact that introducing new IP is, by nature, risky.

Overall, we’re very happy with our performance in 2018. But we want to ensure the next 10 years are as good as the last 10. I will come back to some initiatives we have underway in the last section of this letter. First, I will provide context around how we approach investments in a rapidly changing operating environment.

INVESTMENT PHILOSOPHY



Nexon is very fortunate to have an amazing team that is uniquely successful at creating and growing online games over a long period of time – in many cases, decades. These annuity-like returns are very different from the traditional games business, which usually generate 80% of their lifetime revenue in the first few weeks or months following launch.



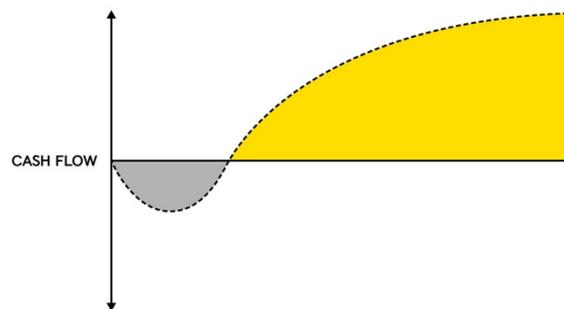
We think of online games as simulated virtual worlds – replete with politics, culture and economy among players who control virtual characters. This means the game world can evolve and grow over time. From a development perspective, this means proper management of the economy and in-game items can be more important to the success of the game than linear storyline or graphics. From a financial perspective, it means our business can resemble a Software as a Service (SaaS) business much more than the traditional hits-driven games business.

The cash flow generated by these franchises represents an enormous opportunity – it provides resources we can invest in development of new ideas, new games, and the talent we need to make them.

Today we have roughly \$4 billion in net cash, and generate almost \$1 billion in additional EBITDA per year. From this, we invest about 7% of annual revenues into designing and launching new games. (R&D plus launch marketing).

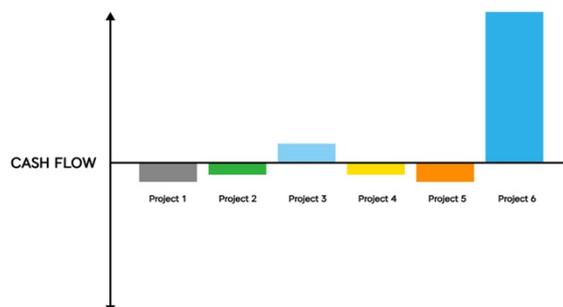
When we invest in a new idea, region, game, or company, our objective is to get an outsized return on that investment over time. This seems obvious, but is often forgotten in discussions of spending.

Investment Objective

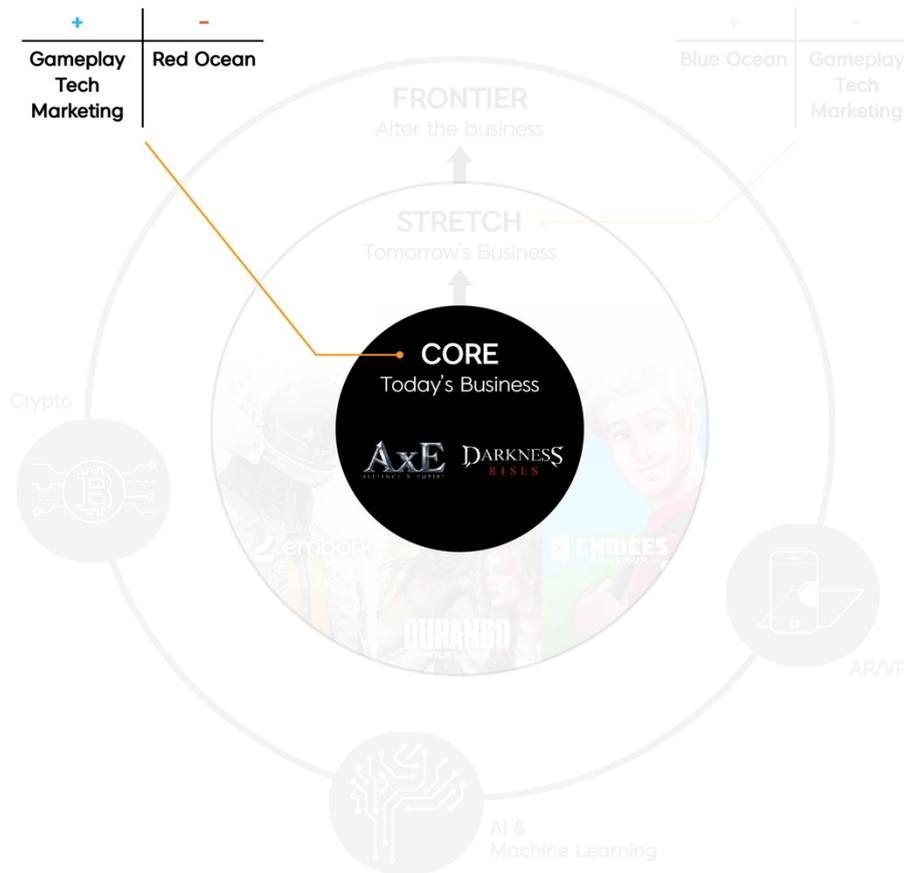


Importantly, not every investment with a good thesis will deliver the value that developers, players and investors hope for. In new game development, like venture capital, “power law” dynamics determine investment returns. That is, only a small percentage of new game ideas will actually find a large audience and generate substantial returns.

Expected Returns



Given this dynamic, it’s important to continuously reexamine and refine what we are trying to achieve with our investments in both game development and M&A.

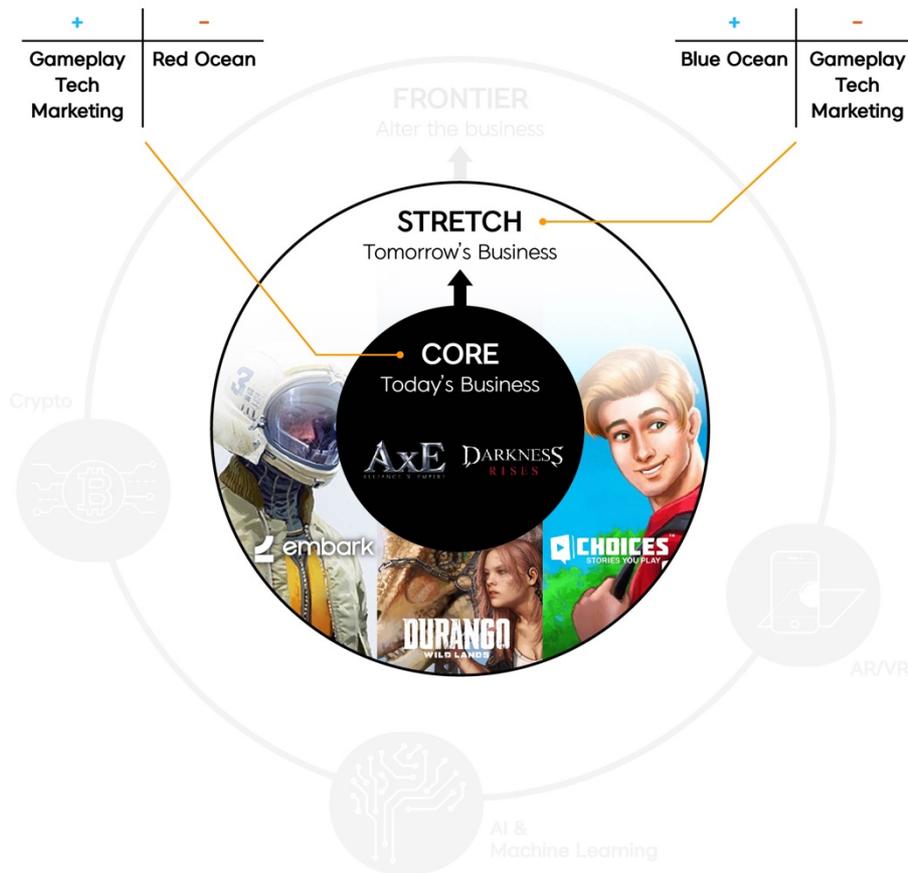


Our investments usually fall within one of 3 categories:

Core:

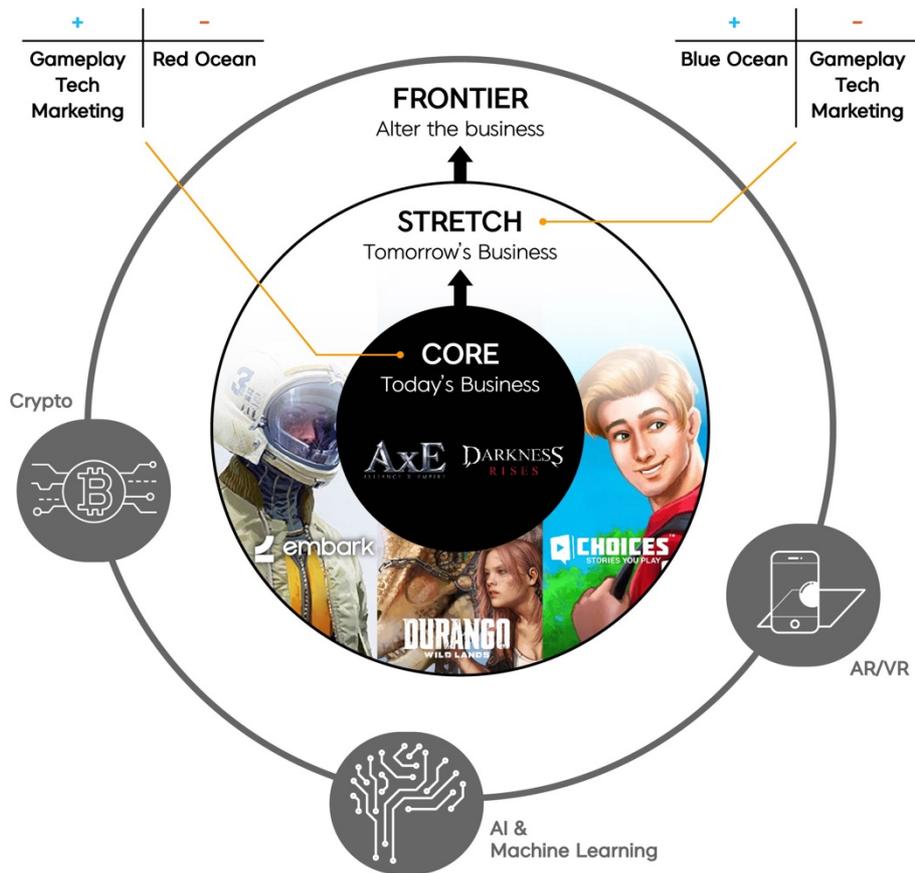
These are games that fit firmly within their established genre, such as an Action Role-Playing Game or First Person Shooter. Some examples from the last year have been *OVERHIT*, *AxE* and *Darkness Rises*. The good news in this category is that even when you are innovating around a chosen genre, a developer knows what kind of user experience they need to build, what kind of tech issues they will face, and how to gather users at launch.

The problem is, so does everyone else. Some would describe this situation as a “red ocean.” Like opening a new café in San Francisco or sushi restaurant in Tokyo, if it isn’t clearly differentiated with a superior product, it’s going to fail. In videogames, sequels are like restaurant chains – they capture a familiar audience without the added expense and risk of breaking new creative ground.



Stretch:

As the name implies, these are games that stretch the boundaries and genre definitions – they also stretch the development team. Unlike games in the Core, developers start without fully understanding the required technology or what the final user experience will be. If the team gets those issues right, you capture a new market and everyone else is chasing you. This is where the “breakout” hits come from in our industry, including *Minecraft*, *Grand Theft Auto*, *Battlefield*, *Mario Brothers*, and of course Nexon’s *Dungeon&Fighter* and *MapleStory*. Each of these franchises broke major new creative ground and reaped the benefits. Nexon’s investments in Pixelberry and Embark Studios reflect this thinking.



Frontier:

These are investments that have the potential to change the competitive landscape and the fundamental way games are made, delivered and experienced by players. They tend not to be about games themselves but about platforms or fundamental technologies that power the development and delivery of games. Some companies have been focused on cloud delivery and subscription games, VR, or Crypto. Our focus is on Artificial Intelligence, since we think that on multiple levels it will change the development, operation and user experience of online games.

Our approach has been to invest in all three categories, Core, Stretch and Frontier. Internally, we have healthy ongoing debates about constantly evolving technology and consumer expectations. How do we balance between Core and Stretch? If a Stretch game fails, should we try again? What did we learn from the experience?

The biggest challenge is how to innovate. Innovation doesn't appear spontaneously – it requires forethought, risk-taking, and a willingness to accept failure. In Silicon Valley, leading companies have built a culture that encourages a willingness to fail with terms like “fail fast” and “move fast and break things” in pursuit of a breakthrough idea. Companies like Apple, Intel and Uber reflect this – each has faced failures that threatened the future of the company. In the 1990s, Nexon exhibited this same spirit when we risked failure on a big, industry-changing idea – multiplayer games played on the internet. The investment was large and the thesis was untested. Today, Korea has become the Hollywood of online games. The courage it took to introduce that concept has had a bigger impact on global entertainment than another popular export, K-Pop.

But in the global games industry, there are powerful forces arrayed against innovation. Gamers are some of the harshest critics in consumer media and quick to revolt when a game company does not deliver a great game. Many analysts and investors have adopted a Hollywood model over the Silicon Valley model and fixate on short-term revenue catalysts.

In the short term, innovating and investing is one of the most hazardous actions a management team can take. In the long-term, innovation is a matter of life or death.

INDUSTRY DYNAMICS

The games industry is already much larger than linear entertainment (the combination of movie box office, streaming, and DVD's combined). This is surprising to people even in the games industry, who still often speak of Hollywood as the games industry's cooler older brother. In 2018 the games industry reached \$143 billion³ in worldwide revenue, while the entire linear entertainment industry (including Hollywood box office, Netflix, Amazon's movie revenue, DVD's etc) was only \$90 billion⁴.

But this operating environment is changing rapidly, and at a clearly accelerating pace. Among this noisy and changing environment, three developments stand out for their likely impact on online games.

- **Convergence of mobile, PC, and console:** Until recently, mobile devices were only capable of rendering very simple,

³ Source: Morgan Stanley Research Estimates

⁴ Source: Statista

mostly single-player games – primitive compared to the richness of PC games. Today however we can deliver a PC-quality game on the phone. *Fortnite* and *PUBG* have shown what platform convergence looks like. For Nexon’s strength in deep multi-player worlds, this presents an order-of-magnitude increase in the addressable market.

- **Platforms in the cloud:** High speed internet and massive server tech now enables game platforms to exist solely in the cloud, delivering high-definition gameplay to any device that can render a basic video stream. One implication is that online game worlds can be truly massive, with persistence for all gamers (previously each PC or console in an online game had to hold the virtual world in its own local memory, so the worlds were necessarily small or limited). Another implication is that Google, Apple, Amazon, Microsoft have each announced streaming distribution services, in a desire to be the “Netflix for games”. Of course, in the Netflix case, content developers (writers, directors, actors, etc), have thrived while content owners (movie studios) have seen their leverage reduced. The situation is different with online games, which are not “fire and forget” affairs. Online games require the developer and operator to constantly develop live content, operate live events, manage the economy and the in-game community. Unlike simple IP holders of linear entertainment, this ongoing role is required for the continuing operation of the game and cannot be handed over to anyone else. While it is still unclear how the competition among cloud distributors will play out, it is almost certainly great news for game developers, as each of the platform providers has massive scale, huge resources, and high desire to win in order to expand its user base.
- **Arrival of Artificial Intelligence:** One application of AI (among several) is in the operation of our live online games: AI enables us to tune the gameplay experience for each individual player. As one example, Nexon is implementing AI tech in our first-person-shooter games to determine within a few second how capable an individual player is, so that it can match-make that opponent to other similarly-capable players. This results in a vastly improved player experience, which means higher player retention over time, which leads directly to improved economics for the game company. Putting the machines to work in this way liberates our operations teams to do higher

value-added tasks.

Our AI labs are also working on applying AI to automate the content creation process, which vastly lowers the most expensive part of online games. Finally, AI will power self-learning non-player characters (“NPCs”) that makes for a much-improved user experience. AI is the next generation of game development and operation tools, and will be embedded in everything we do.

In short, technology, distribution channels, and massive investment capital are appearing on the scene at unprecedented levels. What remains very scarce is:

- The ability to make a multiplayer online game that is both fun and unique (development)
- The ability to make a game continue to grow for a long time (live game operations)

KEY PRIORITIES

The explosion in technology, Nexon’s unique cash-generation ability, and our willingness to take risks and accept failure creates tremendous growth opportunities along several themes:

- **Wholly-owned IP:** Nexon owns some of the most enduring and successful franchises in the industry, and we are increasing our internal development focus on generating new, wholly-owned properties. We are currently developing *Dungeon&Fighter 2D Mobile* and, a little farther down the road, the sequel to *Dungeon&Fighter* on PC. We are also developing a mobile version of *Mabinogi*. There will be more announcements in the coming quarters.
- **More development of “stretch” games:** We believe it is important to break new creative ground – more than in the recent past. Some of our recent attempts to do so, such as *Durango* and *MapleStory 2*, have not yet resulted in success, but the nature of innovation is the first try often does not work (even though it usually provides highly valuable lessons). More of our games in the future will be in the Stretch category. Our recent investment in the Embark studios and appointment of

its leader, Patrick Söderlund, to our board of directors, reflects our commitment to Stretch into big ideas. Patrick is one of the world's most accomplished creative leaders and we expect that his direct involvement in our company will help push us to innovate and to take creative risks without excessive fear of failure.

- **AI:** Two years ago we set up “Intelligence Labs” within Nexon – a team wholly focused on applying AI tools to online games. We have already seen significant benefit on the Key Performance Indicators of games where we have applied this new tech, so we have grown that team to its current size of 150 people and begun spreading it across our live games. Additionally, Embark is pioneering the use of AI in both game development and gameplay itself.
- **Platform Convergence:** Deeply immersive online games can now be rendered across consumer devices: mobile, PC, and console, and those powerful devices are now in the hands of nearly all consumers, not just high-end gamers. Meantime, heavy investments in streaming services by Google, Microsoft, Amazon, and now Apple are designed to even further lower the price point for access to high-end games, to the clear benefit of consumers and developers. *Mabinogi Mobile* (mentioned above) is one example that leverages this new platform convergence. We will be announcing others.

BACK TO THE FUTURE

The temptation for game developers and game publishers is to try to avoid risk, to try to not fail, to put out something that makes a little bit of money. But the opportunities in the games industry are massive, and getting a lot bigger, for those that can embrace the nature of artistic and economic risk.

Nexon is in a unique position to build a bright future. Our flagship games have shown incredible stability, and generate investment capital to invest in new, high-growth opportunities.

But as importantly, our willingness to take risks in the pursuit of breakthroughs goes all the way back to our founding. Nexon produced the first graphic MMORPG with *The Kingdom of the Winds* in 1996, and the first free-to-play game, *Quiz Quiz* in 2001. There are many

other examples of that kind of playful innovation throughout Nexon's history.

In reviewing the successes and the challenges of the last few years, the executive team and I concluded our most important priority is to stretch ourselves harder on innovation, regardless of the near-term challenges. In pushing ourselves to innovate more, we are going back to our strongest roots. Our history is in being most comfortable when we do things that seem crazy at the time, and that ignores what the companies around us are doing. Playful innovation is a worthy legacy, and a worthy guidepost to our future.



A handwritten signature in black ink, appearing to read 'O. Mahoney'.

Owen Mahoney, CEO and President

Tokyo, Japan
March 25, 2019