

Nintendo (7974)**Rating:**
(01/5/9) 2+ → 2+

Analyst :

Nintendo's future depends on how well GameCube sells among adults.**Summary**

Nintendo announced its next-generation video game console at the recent Electronic Entertainment Expo (E3). Priced at ¥25,000, the new unit is more than ¥10,000 cheaper than the competing models of Sony and Microsoft. This will give GameCube the edge in terms of cost. At the same time, Nintendo announced its latest version of the enormously popular Mario Series. Most significant, however, was the fact that several of the upcoming GameCube games announced at E3 appear to be targeting adults. It seems that Nintendo is planning to extend its audience beyond children to include other age groups. Nintendo's PER has averaged 35 during the past five years as it moved between 17 and 69. Currently the PER is 31.9 based on earnings projections for the March 2002 fiscal year and 23.6 based on the following fiscal year's projected earnings, indicating that the shares are now undervalued. For these reasons, we are reaffirming our investment rating of 2+.

Business Forecasts (Consolidated)

Term	Sales		OP		RP		NP		EPS	CFPS
	¥ Mln	YoY	¥	¥						
01.3	462,502	-12.8	84,697	-41.6	192,247	77.5	96,603	72.3	681.89	592.72
02.3F	637,700	37.9	150,900	78.2	170,900	-11.1	90,812	-6.0	712.24	616.64
Company	580,000	25.4	120,000	41.7	140,000	-27.2	80,000	-17.2	564.70	-
03.3F	744,700	16.8	210,900	39.8	230,900	35.1	122,612	35.0	961.65	873.74

Note: F: ABC Securities forecast

Stock price	6/5	¥22,530
Year-high	5/29	¥23,750
Year-low	1/22	¥16,910
Shares outstanding	6/5	141.67mln
Mkt. Value	6/5	¥3,191.8bln

			Con
P E R	(X)	02/3F	31.7
		03/3F	23.5
P C F R	(X)	02/3F	36.7
		03/3F	25.9
P B R	(X)	01/3A	3.8
R O E	(%)	01/3A	12.1

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1. Sales fall as customers wait for Nintendo's new game consoles

In the fiscal year that ended in March 2001, Nintendo reported lower sales and operating income but higher income before income taxes and net income. The yen's strength was one cause of the lower sales and operating income. Average exchange rates rose from ¥115 to ¥110 in relation to the U.S. dollar and to ¥51.36 in relation to the DM. This reduced sales by ¥16.0 billion. Furthermore, sales of the Nintendo 64 console and software dropped as Nintendo prepared for the transition to its next-generation GameCube. The company reported that Nintendo 64 console sales fell 56% to ¥28.5 billion and software sales fell 36% to ¥359.5 billion. Also hurting results was the absence of releases of major new titles in Japan during the year. Pretax and net income rose, however, mainly because Nintendo was able to generate ¥66.3 billion in foreign exchange gains. This was the result of the fall in the yen's value late in the fiscal year (from ¥115 to ¥123.90 to the U.S. dollar and to ¥55.90 to the DM). Excluding the effects of exchange rate movements, the year's results basically reflected the reluctance of customers to make purchases as they awaited the release of Nintendo's new home-use and portable game units.

2. The GameCube will target users of all ages

Nintendo unveiled its GameCube console at the recent E3 show in Los Angeles. There were four main elements of the presentation:

- 1) The unit will be priced at ¥25,000 in Japan (and probably \$199 in the U.S.)
- 2) Nintendo plans to manufacture 4 million units during the current fiscal year
- 3) Two or three new game titles will be released by Nintendo together with the launch of GameCube in Japan
- 4) Nintendo plans to be selling six titles for GameCube in Japan and the U.S. by the end of 2001. Furthermore, 16 titles for the GameCube were announced at E3 by other companies, including one from Electronic Arts, a major U.S. supplier of video games, one from LucasArts, two from Namco and three from Sega.

Price

We had originally based our projections for Nintendo's results on a price of ¥30,000 for the GameCube console. We arrived at this price because Nintendo's president stated that the company wanted to make money on its hardware as well as software. However, information we subsequently obtained from the company led us to conclude that the ¥25,000 price will keep the console in the red until production levels reach a high volume. Furthermore, we believe that the loss will be less than ¥5,000 per unit. If Nintendo sells 4 million consoles and 10 million game titles, as the company has planned, GameCube would undoubtedly be profitable at the operating income level. We therefore assumed that each console will produce a loss of about ¥4,000. The ¥25,000 price is more than ¥10,000 less than Sony's PlayStation 2 and Microsoft's X-Box. At the design stage, Nintendo eliminated a DVD capability and other functions that were not needed to enjoy games. The company also worked hard to cut the cost of the CPC and

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other chips and components. The result is a price that gives Nintendo a clear advantage over its two rivals.

Production volume

The maximum number of units that can be shipped this fiscal year is about 4 million due to NEC's production capacity for the key chips used in GameCube. The PlayStation 2 has already sold more than 10 million units and 20 million more units are to be sold this year. The GameCube is unquestionably a latecomer. However, Nintendo's target of 4 million units does not include the DVD players for the GameCube that will be produced by Matsushita and generate royalties for Nintendo. Therefore, GameCube results will be affected by the price and production levels for this DVD player, both of which Matsushita has yet to announce.

New Nintendo titles

We expect to see a new Mario Series title go on sale together with GameCube, as was announced at E3. The Mario title that went on sale together with the Game Boy Advance in the spring of 2001 was just a transplant of an existing title. Nevertheless, about 500,000 units of this game have been sold thus far, and all indications point to its topping the one million mark.

Other new titles

The most notable point regarding new titles for GameCube was that several have names indicating that they will target adults. We may see games of a type that are completely new to Nintendo. Examples are NBA from Electronic Arts, Virtua Striker 3 (a soccer game) and Fantasy Star Online from Sega, and the Star Wars Series from LucasArts. Electronic Arts has a solid position in the U.S. as a supplier of sports games for adults. Both of Sega's titles are offshoots of existing mega-hits. The Star War Series is a product line that has become popular worldwide among people aged 30 and over. Nintendo 64 was a product that attracted only children, and Nintendo lost market share to Sony as a result. Having learned its lesson, Nintendo has wisely created a GameCube business model that can reach out to customers of all ages.

3. Investment opinion

Nintendo's average PER over the past five years is 35, a period during which the PER moved between 17 and 69. The PER based on projected earnings in the fiscal year ending in March 2002 is now 31.9 and the PER based on projected earnings in the following fiscal year is 23.6. This indicates that the stock is currently undervalued. For the reasons outlined in this report, we believe that the GameCube will be an effective business model. Consequently, we are reaffirming our investment rating of 2+.

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