

Funcom NV (FUNCOM NO)

Age of Conan - Crafty or Anarchy?

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Investment Highlights

- *Funcom has disappointed investors in the past and this is reflected in the current valuation*
- *Age of Conan, their new MMO and the key to their future, will launch May 20th*
- *The shares currently price in 250,000 subscribers for the game*
- *We estimate Funcom will achieve 546,000 subscriber by the end of Q2*

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Executive Summary

We are initiating coverage of Funcom NV with a buy rating and a 180 NOK price target.

- Funcom NV, with offices in Norway, the United States, China and Switzerland was founded in 1993 and has released over twenty video games to date.
- Anarchy Online, their most successful Massively Multiplayer Online (MMO) title to date, was launched in mid-2001 after several delays. The game was so error-ridden initially that gamers declared it 'not even playable,' soiling Funcom's reputation.
- Their newest game, Age of Conan, is scheduled to launch on May 20th, 2008 after suffering multiple major setbacks.
- Investors fear a repeat of the Anarchy Online fiasco, but our research indicates the game will enjoy a successful launch.
- At 35 NOK per share, Funcom shares are pricing in only 250,000 subscribers for Age of Conan.
- We believe Funcom will launch the game with over 300,000 subscribers and reach 765,000 subscribers by year's end.

Financial Summary and Statistics

Current Price: 35.5 NOK Book Value/Share: 1.24 NOK
 Price Target: 180 NOK Sales/Share (ttm): .23 NOK
 Market Cap: \$375 mln Forward PE (e): 16.13X

(thousand USD)	2007	2008e	2009e
Revenues	\$6,895	\$87,896	\$261,777
Cost of Sales	\$14,417	\$57,519	\$132,171
Operating Income	(\$7,522)	\$30,377	\$129,606
Financial Items	\$7,685	\$1,400	\$1,400
Taxes	(\$2,001)	\$7,742	\$31,441
Net Income	\$2,164	\$24,036	\$99,564

EPS (Diluted)	\$0.04	\$0.44	\$1.82
Diluted Shares out	54,659	54,659	54,659



Graph Courtesy of Bloomberg



Company Background

Funcom NV, with offices in Norway, the United States, China, and Switzerland, was founded in 1993 and has released over twenty video games to date. At the end of 2007, Funcom had 302 employees. Funcom has largely focused their efforts toward developing online games, particularly Massively Multiplayer Online (MMO) games for PCs. Their popular Dreamfall game, released in 2006, was heralded by management as “probably the last offline PC game for Funcom.”

Anarchy Online is Funcom’s most successful MMO game to date, but it proved a public relations disaster following its release - after several delays - in mid 2001. Many early users declared the game “not even playable,” complaining of up to twenty game crashes an hour. In online forums, Funcom was accused of “selling an incomplete title that does not work properly. Or at all. For almost anybody. Ever” and of making “giant strides in the revolutionary art of fucking over people who buy their products.” Funcom was upright enough not to bill subscribers until the game was deemed complete, but the damage had been done. Anarchy Online’s estimated 60,000 initial subscribers dwindled to 20,000 a few months later, rebounding only modestly to an estimated 40,000 in 2004.

Funcom has focused their efforts during the past four and a half years on developing their new MMO, Age of Conan: Hyborian Adventures. Slated to launch in Q4 2006, its release was initially postponed until the first quarter of 2007. Four subsequent delays pushed the game’s release to its current May 20, 2008 launch date. We should also mention that just weeks prior to announcing the delay from October 30, 2007 to March 28, 2008, Funcom raised 181 mln NOK in a private placement. The day before the offering, the company stated: “The external beta testing for Age of Conan is well underway and Funcom has not identified issues that might impact the launch date.” Many investors felt betrayed.

Funcom soiled its reputation with the botched Anarchy Online launch and investors see the Age of Conan delays as a repeat of the Anarchy Online experience. The share price today reflects the substantial degree of cynicism with which investors regard promises made by management. Before you flip back to the front page of the report to verify that Funcom is a ‘buy idea’ and not a ‘sell idea’, it is important to consider the potential upside from Age of Conan, the current state of the game, and the financial implications of a successful launch.

Funcom at first planned to complete Age of Conan in only three years from the date of its announcement. The earliest delays for the Age of Conan launch were pinned on Microsoft, with whom Funcom had a marketing and development agreement to optimize the game for Windows Vista (the game is also able to run on Windows XP). Vista, originally set to launch in late 2006, debuted January 29, 2007. At the January 2007 CES, Microsoft highlighted Age of Conan in their presentations and displays, using it to showcase the graphics potential of Vista and the new DX10 hardware. There were reports of animation glitches and bugs in the demo, but Funcom claimed the problems were due to overheating computer hardware. In fairness, the game was previewed on PCs with exposed guts, blocking the walk spaces around the booth in an effort to improve cooling.

In retrospect, Funcom management's three-year development projection for Age of Conan was likely overly optimistic and the Vista demo glitches foreshadowed imminent delays. Blizzard Entertainment, a much larger and more experienced gaming firm with over 2,700 employees, spent three years and three months developing their latest World of Warcraft MMO. Funcom had fewer than 150 employees when they began the Age of Conan project, and only 223 employees at the end of Q3 2006 - just prior to the first anticipated launch date. Writing Age of Conan, essentially from scratch, was a much more ambitious effort than the latest World of Warcraft release and industry experts have said that, given the scope, Funcom was understaffed.

The delays continued and on August 10, 2007 Funcom sent its shares tumbling 42% in a single day by announcing that the Age of Conan release would be pushed back again from October 30, 2007 until March 28, 2008. I remember this day quite well as I, like many investors, was stunned that a delay of this magnitude could be announced so shortly after their June 27th secondary offering. At their Oslo offices a couple of weeks after the announcement, Funcom management demoed the game for me and explained that the delay had been triggered by negative feedback about the user interface from beta testers. Funcom felt it was necessary to redesign the interface to improve the gaming experience, and thus postponed the launch. The improved interface was completed relatively quickly, likely aided by the boost in headcount during 2007, from 231 employees to 302 at year's end. The current launch date for Age of Conan is May 20th, 2008. We believe that there will be no further delays as Funcom has made a substantial commitment to a launch date for the first time, hosting several media events and investing in substantial marketing efforts spotlighting the launch.

In addition to Age of Conan, Funcom has been developing another MMO, The Secret World. Set in the contemporary real world, this game should provide maximum advertising opportunities while capitalizing on the popularity of alternative virtual-communities such as Second Life. The Secret World will be targeted toward Asian audiences, despite its expected global launch in 2010. The increased headcount and Funcom-built proprietary MMO platform used in Age of Conan should speed development of The Secret World and future MMOs and avoid future 'Anarchy'.

Age of Conan: Hyborian Adventures

Age of Conan is an MMO that plays out in Hyboria: a fantasy world that resembles Earth in 10,000 B.C. Based on author Robert Howard's stories of Conan the Barbarian, Funcom will benefit from utilizing characters and a fantasy world that are already familiar to gamers prior to the Age of Conan introduction. In addition, the Spring of 2009 release of Millennium Films' and Paradox Entertainment's \$100 mln production of the *Conan the Barbarian* movie will further promote the Conan name. There is a superb 'Developer's Diary' video, complete with a seven minute overview of the game and the Conan concept at <http://ageofconan.gameamp.com/forum/showTopic/63042.php>.

Dazzling graphics will be Age of Conan's major selling point. Funcom benefited enormously from their marketing and development agreement with Microsoft, optimizing Age of Conan for the newest generation of Application Programming Interfaces (API) called DX10. DX10 boasts cutting-edge 3D graphics capabilities and offers players unprecedented detail. Wikipedia currently lists just twenty two games being optimized for DX10 so far (including Age of Conan) - with only thirteen of them on the market today. The following screen shots contrast the vivid graphics in Age of Conan (left) versus the current version of the best-selling MMO World of Warcraft (right):



When a player begins the game for the first time, they will create characters (avatars) for their journey through Hyboria. The Age of Conan player engine will let players choose their type (class) of character from among twenty choices and then customize features, from hair color to facial proportions, and even add tattoos or scars. The first twenty levels of play will be solo before a player advances to the online world. Some experienced beta testers have estimated that the solo experience involves the first five to six hours of playtime. Funcom management has said publicly that this will help users to learn the game and combat system before venturing online. We suspect it will also effectively stagger the game's launch, moderating the crush of users and minimizing server overload.

Like most MMOs, the Age of Conan experience is built around combat against both human-controlled and computer-controlled enemies. Unlike other MMOs, Age of Conan will carry a 'Mature' rating with some nudity and a lot of gore, including blood splatters and decapitations. In addition, Age of Conan will bring 'real-time' combat to the game, allowing players to actively engage in battles. Existing MMOs restrict player involvement in combat, permitting users to merely choose an attacking character whose fate is then randomly determined by the system based on the combatants' attributes. Age of Conan, on the other hand, enables players to aim weapons, target attacks and select move combinations as the battle rages. This innovation has been very well-received by the online gaming community. In addition, Age of Conan will be the first MMO to offer truly mounted combat. Other games allow players to jump on vehicles and animals for a ride, typically along a predetermined path. Age of Conan allows players to direct a mounted animal to any location in the area and even engage in combat from atop their mount. Movement on the mount, which incorporates details such as character head rotation when reversing and blood that stains a mount's fur in combat, has been hailed by reviewers as 'impressively lifelike'.

In the later stages of Age of Conan there are two key features to keep players engaged. The first is a very well-developed economy. Each of the three main regions of the game will have a dedicated resource-gathering playfield in which players will harvest 'dozens' of resources to craft tools and other items. There will be five main trade professions: armor smith, weapons smith, alchemist, architect and gem cutter. Players can trade and sell items using currencies in the game.

The second feature is the introduction of siege warfare. Players who join together in guilds with a total of thirty players or more can found their own city. Potential building sites in the game are limited, so competition for the spaces will be fierce (literally). Funcom also gives city dwellers the ability to build defenses and walls for their protection. Cities can, however, be breached and in spectacular fashion. Hundreds of players can join together and build siege-works in attempts to overrun the city. The screen shots from Funcom depicting these in-game battles have been very impressive.

Funcom's repeated delays in launching Age of Conan have disappointed both investors and gamers, but the company has used the time wisely, adding details and functions with great appeal to players. Besides the aforementioned features, Age of Conan will have a two-hour day and night cycle, a dynamic weather generator and over 20,000 individual sound effects. While no game ever pleases all users, the feedback on Age of Conan by beta testers and other game players is generally very positive. The key questions for any investors in Funcom are: Will the launch be delayed again? Will Age of Conan be filled with bugs and glitches at the launch as the aptly-named Anarchy Online was? How many subscribers will Age of Conan have?

When Age of Conan was delayed the previous five times, the company had not yet begun a substantial marketing and media campaign. Since March, however, Funcom has been marketing Age of Conan with the game, and now subscription cards, available for sale on major gaming retailer websites. Funcom has publicly - and financially - committed to the May 20th launch date to a greater extent than to any prior Age of Conan launch. Further delays, while unlikely, are possible. Indications are that any subsequent postponement would be relatively brief (a few weeks), and most likely caused by a lack of stress testing and server capacity.

Investors would probably view this type of delay as less severe than previous delays and it would present a great buying opportunity for those looking to become involved. When the Age of Conan launch date was delayed by eight weeks on January 21 of this year, in order to ‘stress the game systems and sort out bugs’, Funcom shares fell 14% over two days (to 19 NOK). Shares recovered and were trading above the pre-delay share price mere days after the announcement and more than 10% higher the following week.

Will Age of Conan be filled with bugs and glitches at the launch as the aptly-named Anarchy Online was? This is a much more difficult question to answer. One of the most important things for investors to realize is that any software of this magnitude will have bugs when first launched. Video games, particularly MMOs, tend to be even more error-prone. There are numerous web forums dedicated to Age of Conan and beta testing in general. Despite the current Non-Disclosure Agreement (NDA) that all beta testers for Age of Conan must sign, it is fairly easy to find some, among the 10,000 participants, willing to discuss their experiences. Many of these beta testers have been through upwards of seven to ten major game beta tests and are well-versed in the timelines and level of polish of MMO games at each stage. The early feedback was filled with reports of glitches, ranging from minor items to some fairly major graphics issues including players walking around headless, weapons floating in space and uneven scenery scrolling. A major update at the beginning of April seems to have corrected many of the pressing issues and some testers who previously felt the game may not make the May 20th deadline are now optimistic. One tester wrote on April 16th: “Tons of fixes have been applied to the game, the game is not what it was 2-3 weeks ago. they [sic] have done an amazing job at fixing this game.”

Funcom performed a beta server stress test on April 13th. During the first thirty minutes, screens were blank and the game did not work at all. Afterwards, users reported frequent problems and slow connection times. That said, once users were able to log in - despite delays and lag - they were able to make it through several levels and reportedly enjoyed the game play. It is unknown to what degree Funcom was trying to stress test the system. Were they attempting to put all 10,000 beta testers on a single server? Were they intentionally overloading the system to see if the system remained stable in overload? Without knowing the details behind the test, it is impossible to know just how worried we should be.

One reassuring fact is that Funcom brought in 15,000 new beta testers for a Peer-Vs-Peer (PVP) game test from Friday, April 18th to Sunday, April 20th. Funcom formally told the beta testers that they were free to discuss their experiences. This was a great relief as industry insiders had been cautious about Funcom’s insistence on maintaining their non-disclosure agreement this near to the launch date. The PVP beta-test was held in association with GameSpot.com, which even hosted their own message boards for discussion. There were surprisingly few reports of bugs during the test, with the exception of some character mismatches at lower levels. Most telling, in the days following the test, Age of Conan pre-orders were so strong that the game was consistently among the top five selling video games in the U.S. So far, this strong trend in sales is continuing.

Funcom announced on April 22nd that they had passed the ‘golden’ master CD milestone - the production of the CD that will be used to create the discs to be shipped to players. The ominous ‘golden CD’ deadline is not quite as draconian as it sounds. One benefit of publishing online subscription games is that users have to log in to the servers to play. All online game operators take advantage of this to push software updates to their players. It is possible (and likely) that Funcom will send an update to their users when they first log in on the May launch date, to correct errors uncovered since the creation of the ‘Golden CD’.

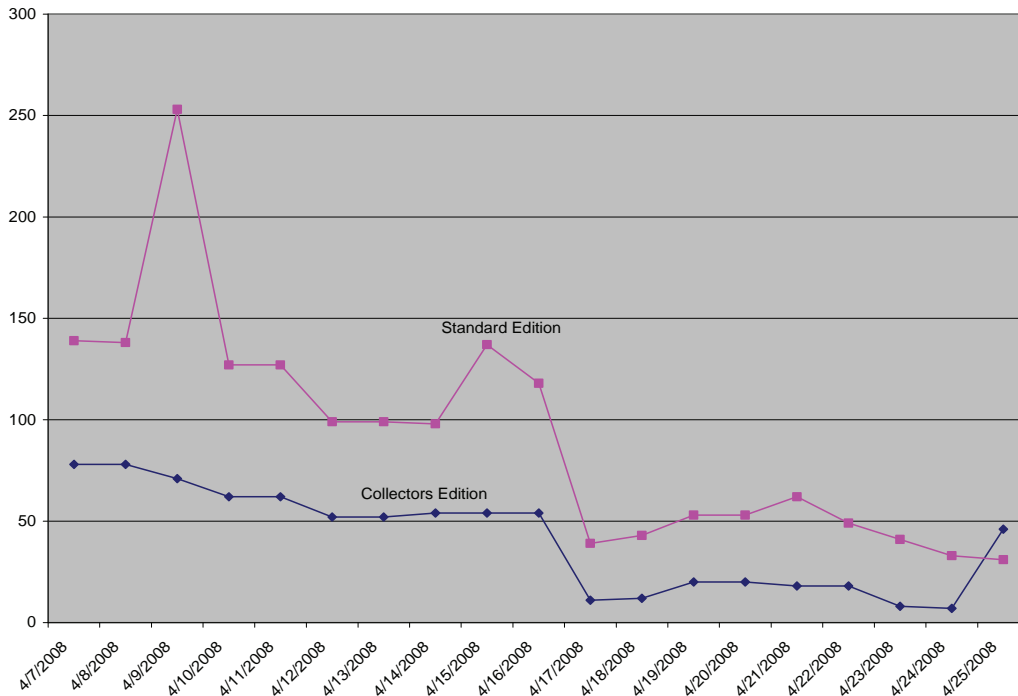
The next major milestone will be May 1st, when the Age of Conan Beta opens to 50,000 new “aspiring barbarians.” The primary function of the open beta will be ‘to stress test Age of Conan prior to launch.’ This should be a more realistic test of the server capabilities than any prior beta. We very much anticipate the wave of feedback on the state of the game that the test will generate.

The third key question is how many subscribers will Age of Conan have? Given our initial concerns about the April 13th stress test, the answer may be ‘too many!’ When the beta was first opened for applications on Easter weekend in 2007, 50,000 users went through an extensive application process in the first twenty-four hours. By the end of the weekend, Funcom had received over 100,000 applications. Its popularity was presumably fueled by the numerous awards the game had received a year earlier, including E3’s ‘Best Game of Show’ in the MMO category from IGN, GameSpot and GameSpy. GameSpy crowned Age of Conan the ‘Best MMO’ of E3 stating “every time we see it, it manages to look better and better.” Age of Conan has graced the covers of more than twenty gaming magazines, to date, and as many as ten more are expected by the end of May.

On a March 21st episode of “X-play”, a video game-based TV show, they highlighted March sales data from GameSpot showing Age of Conan as the top-selling PC game, ahead of World of Warcraft. Industry experts that we have talked to believe World of Warcraft sold 80,000 copies in March in the U.S. and Europe. Amazon.com, which provides hourly updates of their top-selling PC games, showed the Age of Conan: Collector’s Edition ranking in 12th place for all PC games in March, and the Standard Edition in 35th place. These rankings confirm that Age of Conan was likely among the top five selling PC games for March. We estimate that Funcom sold 88,000 pre-launch copies of Age of Conan in March.

At the beginning of April, the Collector’s Edition ranked #78 in Amazon.com overall game sales, and #5 in PC games sold. By April 18, it had rocketed to #12 overall - and #1 among PC titles. By the same date, the Standard Edition which began the month ranked #139 in overall sales was catapulted to #4. A chart of the Amazon rankings in April follows on the next page.

Amazon.com Overall Video Game Sales Rank



GameSpot currently ranks Age of Conan as the #1 PC game in terms of unit sales and, amazingly, the #2 overall video game overall. Combining March video game sales data from the NPD Group (released Friday, April 18th), with sales projections from The SimExchange (www.thesimexchange.com), we can estimate that based on April rankings to date: Age of Conan will likely sell 136,000 copies of the Collector’s Edition and 55,000 copies of the Standard Edition this month, for a total of 191,000 units in April. Recent sales data from the past few days could indicate further upside, as we estimate that some 16,000 total copies of Age of Conan per day were sold on April 17th and 18th.

With the media hype building and beta tests growing, our estimate of 250,000 units sold in May (135,000 by the May 20th launch) will bring the total number of units sold prior to launch to 414,000. We very conservatively estimate that only 80% of those purchasing the game prior to launch will become subscribers, so the actual number of online subscribers at launch will be 331,200. If Funcom can handle the initial stampede of barbarians, Age of Conan can reach the ‘critical mass’ of 500,000 subscribers by the end of June. In a press release dated April 22, Funcom management stated that the server park for Age of Conan has been scaled initially to handle 500,000 to 600,000 active subscribers at launch period. This should provide ample processing capacity, but we would like to see more of a buffer. Naturally we will be among the very first to log in when our pre-ordered copy arrives and will provide an update after the critical first weekend of game play.



The 'Unit Economics'

For the past four quarters, Funcom has had total revenues of \$1.6 mln to \$1.8 mln per quarter from existing games. Operating losses before taxes have grown from a loss of \$1.01 mln in Q4 2006 to a loss of \$3.07 mln in Q4 2007, despite total capitalized costs of over \$16 mln during the past year. The increasing expenses represent pre-launch outlays for the development of Age of Conan, including a 31% increase in employee count from 231 to 302 during 2007.

Obviously the revenues for Age of Conan will be the primary driver of earnings for the next two years, prior to the introduction of their next MMO, The Secret World. We expect non-Conan revenues to hold steady at \$1.5 mln per quarter for the rest of 2008. Current operating expenses are running at an annualized rate of \$16 mln, with another \$14 mln per year of expenses being capitalized, for a total adjusted annual operating expense rate of \$30 mln. While Funcom did have \$52 mln in cash on hand at the end of Q4, the current burn rate shows how important Age of Conan is to the company.

Under the distribution agreement for Age of Conan in place with SCi/Eidos, Funcom will not receive any of the proceeds from the physical-world sales of the game. Funcom will receive the monthly subscription fees, which will be \$14.99 in the United States and 12.99 EUR in Europe. At current exchange rates, and assuming a 50/50 United States/Europe subscriber distribution, the average subscription price will be \$17.56 per month.

Funcom will pay a royalty for the use of the Conan name, estimated to be 6% of subscription revenues, which will be included in operating expenses. In addition, Funcom has outsourced server farms for the game to IP-soft, a global outsourced network and systems infrastructure support company whose client list includes Time, Canon, Revlon and Macy's. The cost for server outsourcing is believed to be \$2.00 per subscriber per month. In addition, Funcom is outsourcing customer service and support functions for Age of Conan. This 'Live Team' is expected to cost just over \$2.00 per subscriber per month. Marketing costs for Funcom are expected to be 14% of total sales. The total variable costs for Age of Conan subscribers should be \$7.50 per subscriber per month.

Age of Conan will be initially launched for PC users, with a version for the Xbox expected about a year later. The terminal subscriber number will be the key driver of earnings. In January, the Age of Conan gaming sites drew more than 600,000 unique visitors. In February Funcom announced that 500,000 gamers had joined the Age of Conan community by either signing up for the beta program or by joining the fan club. GameSpot has 36,200 users tracking World of Warcraft news on their site, Age of Conan has 8,200. With 10.5 mln estimated World of Warcraft subscribers, the ratio of users tracking Age of Conan to World of Warcraft would point toward 2.4 mln total subscribers for Age of Conan.

Alexa (www.Alexa.com) is a site that tracks the number of pageviews for major websites. Their traffic counts are of questionable value, but they are good at monitoring changes in traffic and providing traffic comparisons. The link for the Age of Conan forums, http://www.alex.com/data/details/traffic_details/ageofconan.com, shows the Age of Conan site generating 36 pageviews per million users per day vs 340 pageviews per million users for the World of Warcraft site (http://www.alex.com/data/details/traffic_details/worldofwarcraft.com). Using the current estimated number of World of Warcraft subscribers (10.6 mln) and this ratio of Alexa pageviews, we can estimate 1.12 mln AOC subscribers.

The SimExchange futures market (<http://www.thesimexchange.com/search.php?string=age+of+conan>) estimates that the PC version of Age of Conan will sell 854K copies and the Xbox 1.46 mln copies. Based on our initial subscriber estimates, presuming no major glitches in the launch, Age of Conan should generate 1.1 - 1.6 mln subscribers on the PC version and 1.5 mln Xbox subscribers.

The following table shows the rough earnings estimates in NOK for Funcom, for each given level of total subscribers and our estimates of the share price that would result using a 20X PE multiple:

<u>Users</u>	<u>EPS (NOK)</u>	<u>Target Price (NOK)</u>
50,000	(0.19)	(3.79)
100,000	0.26	5.16
150,000	0.71	14.10
200,000	1.15	23.05
250,000	1.60	32.00
300,000	2.05	40.95
350,000	2.49	49.90
400,000	2.94	58.84
450,000	3.39	67.79
500,000	3.84	76.74
550,000	4.28	85.69
600,000	4.73	94.64
650,000	5.18	103.58
700,000	5.63	112.53
750,000	6.07	121.48
800,000	6.52	130.43
850,000	6.97	139.38
900,000	7.42	148.33
950,000	7.86	157.27
1,000,000	8.31	166.22
1,050,000	8.76	175.17
1,100,000	9.21	184.12
1,150,000	9.65	193.07
1,200,000	10.10	202.01
1,250,000	10.55	210.96
1,300,000	11.00	219.91
1,350,000	11.44	228.86
1,400,000	11.89	237.81
1,450,000	12.34	246.75
1,500,000	12.79	255.70
1,550,000	13.23	264.65
1,600,000	13.68	273.60
1,650,000	14.13	282.55
1,700,000	14.57	291.49
1,750,000	15.02	300.44
1,800,000	15.47	309.39
1,850,000	15.92	318.34
1,900,000	16.36	327.29
1,950,000	16.81	336.23
2,000,000	17.26	345.18
2,050,000	17.71	354.13
2,100,000	18.15	363.08
2,150,000	18.60	372.03
2,200,000	19.05	380.97
2,250,000	19.50	389.92
2,300,000	19.94	398.87
2,350,000	20.39	407.82
2,400,000	20.84	416.77
2,450,000	21.29	425.71
2,500,000	21.73	434.66

We are estimating that 414,000 total copies of Age of Conan will sell prior to the May 20th launch and that 80% of these initial buyers will turn into paid subscribers beyond the first few days. This will provide a net paid subscriber base of 331,200 from the pre-launch purchasers of the game. We also expect game sales to increase in the days following the May 20th launch, resulting in a total of 250,000 games sold in May and 200,000 in June. Based on our estimated initial churn numbers, we expect Age of Conan to have 546,750 subscribers at the end of Q2. Our earnings estimate for Q2 is for a breakeven result, as Age of Conan is launched more than midway through the quarter.

We project that 10% of the initial subscribers will stop their subscriptions in Q3. This will be more than offset by expected game sales of 120,000 in July, 80,000 in August and 60,000 in September. Once again, we expect that only 80% of the purchasers of the game will become subscribers past the first thirty days of their purchase. On the basis of these assumptions, Funcom should earn \$.208 (1.04 NOK) in Q2. This should support a share price of 80 NOK using annualized Q2 earnings and a 20X PE multiple.

Monthly sales should begin to stabilize at 50,000 and monthly churn will be 4.8%, conservatively above the 3%-4% seen by other MMOs. At the end of Q2 2009, everything should change. Funcom is expected to release their first expansion pack, launch the Xbox version of the game (which SimExchange expects to outsell the PC version) and formally launch in Asia. We expect 200,000 new unit sales in July 2009 for the PC, followed by 90,000 in August and 60,000 in September - ending the quarter with 1.05 mln PC subscribers. We do not forecast expansion pack sales, we believe these revenues will primarily go to the distributors, as initial game box revenues do. In addition, we expect the Xbox version to sell 400,000 copies pre-launch, followed by 200,000 in July 2009, 90,000 in August and 50,000 in September - ending the quarter with 680,000 paid Xbox subscribers. The true earnings potential of Funcom will be realized if everything goes according to plan, with \$.57 (2.85 NOK) EPS in Q3 and \$.698 (3.48 NOK) EPS in Q4.

The full year, 2009 earnings estimate is \$1.82 (9.1 NOK) per share. We expect that Funcom will trade at our formal price target of 180 NOK/share, based on 20X 2009 earnings.

Financials

Funcom NV

Launch: 331,200 Subscribers

Model Inputs

AOC PC Subscribers (end of Q)	1,077,362	1,055,720	830,259	800,304	765,064	700,075	546,750
AOC XBOX Subscribers (end of Q)	728,000	680,000	400,000				
Subscription Price Per Month	17.56	17.56	17.56	17.56	17.56	17.56	17.56

Income Statement

(Figures in thousand USD)

	Q4 09(e)	Q3 09(e)	Q2 09(e)	Q1 09(e)	Q4 08(e)	Q3 08(e)	Q2 08(e)	Q1 08(e)	Q4 07	Q3 07	Q2 07	Q1 07
Revenues, PC/Desktop	94,272	79,124	43,949	42,232	39,592	33,841	11,203	1,050	1,167	1,176	1,084	1,194
Revenues, Mobile	550	550	550	550	550	550	550	560	578	588	509	599
Total Revenues	94,822	79,674	44,499	42,782	40,142	34,391	11,753	1,610	1,745	1,764	1,593	1,793
Cost of Sales												
Operating Expenses	42,239	36,353	22,274	21,312	20,136	17,722	9,793	3,330	4,616	3,133	2,705	2,619
Depreciation and Amort	3,377	3,109	2,828	2,531	2,219	2,039	2,000	350	204	405	348	387
Operating Income (EBIT)	49,206	40,212	19,398	18,938	17,787	14,631	(40)	(2,070)	(3,075)	(1,774)	(1,460)	(1,213)
Net Financial Items	350	350	350	350	350	350	350	350	197	5,440	1,139	909
Income (loss) before Taxes	49,556	40,562	19,748	19,288	18,137	14,981	310	(1,720)	(2,878)	3,666	(321)	(304)
Taxes	11,893	9,735	4,739	4,629	4,353	3,595	87	(310)	(547)	(276)	(1,097)	(81)
Earnings After Tax (EAT)	37,663	30,827	15,008	14,659	13,784	11,385	223	(1,410)	(2,331)	3,942	776	(223)
Minority Interest	(30)	(30)	(30)	(30)	(30)	(30)	(30)	(30)	(22)	(71)	(43)	(19)
Earnings per Share												
Basic	\$ 0.714	\$ 0.584	\$ 0.285	\$ 0.278	\$ 0.261	\$ 0.216	\$ 0.004	\$ (0.027)	\$ (0.044)	\$ 0.076	\$ 0.016	\$ (0.005)
Diluted	\$ 0.689	\$ 0.564	\$ 0.275	\$ 0.268	\$ 0.252	\$ 0.208	\$ 0.004	\$ (0.026)	\$ (0.043)	\$ 0.073	\$ 0.016	\$ (0.004)
Weighted avg Shares Outstanding												
Basic	52,746	52,746	52,746	52,746	52,746	52,746	52,746	52,746	52,746	52,177	47,881	47,745
Diluted	54,659	54,659	54,659	54,659	54,659	54,659	54,659	54,659	54,659	54,152	49,856	49,995

Balance Sheet

ASSETS	Q4 09(e)	Q3 09(e)	Q2 09(e)	Q1 09(e)	Q4 08(e)	Q3 08(e)	Q2 08(e)	Q1 08(e)	Q4 07	Q3 07	Q2 07	Q1 07
Intangible Assets	72,619	67,536	62,185	56,553	50,624	44,383	40,782	40,000	35,697	30,812	26,767	22,850
Deferred Tax Asset	-	-	-	-	-	1,137	4,732	4,819	4,509	4,121	3,781	2,661
Tangible Fixed Assets	2,700	2,580	2,460	2,280	2,160	2,160	2,040	1,920	1,661	1,444	1,320	1,157
Investment in Associate	-	-	-	-	-	-	-	-	-	-	-	-
Long-term receivables	500	500	500	500	500	500	500	500	469	471	435	423
Trade Debtors	9,482	7,967	4,450	4,278	4,014	3,439	1,175	966	977	1,007	826	900
Prepays and Other Receivables	18,964	15,935	8,900	8,556	8,028	6,878	2,351	1,932	2,067	1,953	2,075	1,939
Cash and Cash Equivalents	147,684	118,666	95,106	79,055	70,738	62,642	55,601	45,341	52,366	58,533	29,859	33,201
Total Assets	251,949	213,184	173,601	151,222	136,064	121,139	107,182	95,478	97,746	98,341	65,063	63,131
EQUITY AND LIABILITIES												
Paid-in Capital	124,384	124,384	124,384	124,384	124,384	124,384	124,384	124,384	124,384	124,406	94,772	94,492
Retained Earnings	88,863	51,321	20,613	5,785	(8,754)	(22,538)	(33,805)	(33,938)	(32,299)	(30,086)	(34,591)	(35,423)
Equity Attributable to Minority Interest	-	-	-	-	-	-	2	32	62	34	116	202
Long-Term Liabilities	-	-	-	-	-	-	-	-	87	158	-	-
Short-Term Liabilities	38,702	37,479	28,603	21,053	20,435	19,293	16,601	5,000	5,512	3,829	4,766	3,860
Total Equity and Liabilities	251,949	213,184	173,601	151,222	136,064	121,139	107,182	95,478	97,746	98,341	65,063	63,131

Cash Flow Statement

	Q4 09(e)	Q3 09(e)	Q2 09(e)	Q1 09(e)	Q4 08(e)	Q3 08(e)	Q2 08(e)	Q1 08(e)	Q4 07	Q3 07	Q2 07	Q1 07
Cash Flows from Operating Activities	37,598	32,140	24,691	16,897	16,556	12,801	13,163	(2,026)	(1,945)	(425)	225	(733)
Cash Flows from Investing Activities	(8,580)	(8,580)	(8,640)	(8,580)	(8,460)	(5,760)	(2,902)	(4,912)	(4,984)	(4,429)	(4,552)	(4,090)
Cash Flows from Financing Activities	-	-	-	-	-	-	-	(87)	33	29,335	161	-
Change in Cash and Equivalents	29,018	23,560	16,051	8,317	8,096	7,041	10,261	(7,025)	(6,896)	24,481	(4,166)	(4,823)



Critical Accounting Policies

From 2006 10K:

Associates - Associates are entities where the Group is able to exercise significant influence, but not control, over the financial and operating policies. Investments in associates (normally between 20% and 50% of an entity's equity) are accounted for by under the equity method. The consolidated financial statements include the group's share of the income and expenses of associates, from the date significant influence commences until the date it ceases. When the Group's share of losses exceeds the carrying amount of the associate, the carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the group has an obligation or has made payments on behalf of the associate.

Inter-Company Transactions - Inter-company balances and unrealized income and expenses arising from intra-group transactions are eliminated in full.

Foreign Currency Transactions—Transactions in foreign currencies are translated at the exchange rate at the date of the transaction. Monetary assets and liabilities in foreign currencies are translated at the exchange rate at the balance sheet date. Non-monetary assets and liabilities in foreign currencies that are stated at historical cost are translated at the exchange rate at the date of the transaction. Non-monetary assets and liabilities in foreign currencies that are stated at fair value are translated at the exchange rate at the date the values were determined.

Revenue Recognition - Revenue is recognized when it is probable that the economic benefits of a transaction will flow to the entity, the revenue can be measured reliably. Revenue is measured at the fair value of consideration received or receivable, net of value added tax, discounts and returns. Subscription income is generated when customers purchase upfront access time for online games. Revenue from subscriptions is recognized over the subscription period which is from the date of subscription purchase until subscription end, normally 1 - 12 months. At balance date revenue not recognized in the income statement is recognized as deferred revenue and presented in the balance sheet as a liability. Revenues from license and royalty agreements with a minimum non-refundable guaranteed advance is recognized at the delivery of the product. Revenue from mobile phone services is recognized upon the service.

Operating Lease Payments - Leases where substantially all the risks and rewards of ownership are effectively retained by the lessor are classified as operating leases. Lease payments are recognized in the income statement on a straight line basis over the term of the lease. Lease incentives received are recognized in the income statement as an integral part of the total lease expense.

Income Tax - The tax expense consists of current and deferred tax. Income tax expense is recognized in the income statement except to the extent that it relates to items recognized directly in equity, in which case it is recognized into equity. Deferred tax is recognized using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets are recognized only when it is probable that an entity will have sufficient profits for tax purposes to utilize the tax assets. Deferred tax assets and liabilities are recognized at their nominal value and classified as non-current assets and liabilities in the balance sheet.

Intangible Assets - Intangible assets are recognized in the balance sheet if it is probable that the future economic benefits that are attributed to an intangible asset will flow to the group and the asset's cost can be reliably estimated. The group does not have any intangible assets with indefinite lives, other than goodwill.

Goodwill - Goodwill represents the excess of the cost of the acquisition over the group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree. When the excess is negative (negative goodwill), it is recognized immediately on the income statement.

Research and Development - Costs relating to research are recognized in the income statement when incurred. Expenses relating to development, such as labor cost, materials costs and directly attributable overheads are recognized in the income statement when they are incurred unless all of the following criteria are met:

- The product or process is clearly defined and the cost elements can be identified and measured reliably
- The technical solution for the product has been demonstrated
- The product or process will be sold or used in the company operations
- The asset will generate future economic benefits
- Sufficient technical, financial and other resources for completing the process are present

Patents and licenses - Patents and licenses that are acquired by the group are stated at cost less accumulated amortization and impairment losses. Amortization is recognized in the income statement on a straight-line basis over the estimated useful lives, ranging from 2 to 11 years and begins when the acquired assets are available for use.

Depreciation - Depreciation is charged to the income statement using the straight-line method over estimated useful lives of the equipment. Computers are depreciated using 3 year useful lives and office equipment using 5 year useful lives.

MMO Market

Massively Multiplayer Online games, or MMOs, are video games that allow large numbers of players (usually several hundred to tens of thousands or more) to simultaneously play online with other players via the internet. The games generally involve a 'persistent world' that is hosted on servers by the game-makers and available for play 24/7/365. In exchange for providing the game, updates and hosting service, the game makers earn revenue by charging players a monthly fee. The current 'standard' fee for large games is \$15 per month. Monthly churn typically ranges from four to eight percent, with the largest games ranging from four to five percent.

There are an estimated 16.90 mln active MMO subscribers globally with roughly fifty five percent of subscribers located in Asia, twenty percent in Europe and twenty five percent in the United States. Over ninety percent (94.2%) of all MMO subscriptions are for Fantasy Role-playing Games (FRGs), the genre Funcom is targeting with Age of Conan. Fantasy role-playing games are offshoots of the popular Dungeons & Dragons games of the 1980s in which players create a character from a particular class or race, such as magicians, warriors or elves, and then spend countless hours developing the character on missions (or quests) with groups of their friends: slaying dragons, overcoming obstacles and rescuing maidens from castle towers. As a player engages in battles they gain experience points and collect tools, including new swords and magical rings. Experience points allow players to advance to higher levels, ultimately reaching some peak level (such as level 80 in Age of Conan) where the game shifts focus to Player versus Player (PvP) action, rather than quests. Advanced players spend their time fighting each other online, trading goods, accumulating cash, building their own cities and laying siege to cities founded by other players.

In the days of Dungeons & Dragons, players rolled dice to determine who won or lost a battle. Largely due to the Dungeons & Dragons lineage and the latency of the internet, MMO player battles have been based on formulas that, combined with random outcome generators, use probabilities to determine the winner. A Funcom head put it best when he said in an interview that current MMO battles are 'like two spreadsheets fighting.' As internet technology and speeds have blossomed, Funcom has taken on the ambitious task of assigning 'real time' battles to Age of Conan. Players no longer must approach an opponent, hitting a key to fight them with a certain weapon and then await the outcome, as in other MMOs. The Age of Conan player uses real-time keystrokes to target, strike, block, and dodge an adversary's blows. 'Distance weapons,' such as a bow and arrow require actual aim and a degree of skill to hit an intended target. This innovation will begin to bridge the gap between MMOs and First-Person Shooter (FPS) games which have been very popular in the past few years.

World of Warcraft, published by Blizzard Entertainment, is the dominant MMO game with an estimated 10.5 mln active subscribers. The next closest competitors are RuneScape, Lineage and Lineage II, each with roughly one mln active subscribers. In late 2004, World Of Warcraft III was introduced at the same time that Asian players were joining the realm of MMOs en-masse. Blizzard Entertainment watched their World of Warcraft subscriber base grow from just over one mln at the beginning of 2005 to six mln by January of 2006. It is estimated that some sixty percent of the subscription growth in 2005 came from Asian markets. The growth in all regions continued and on January 22, 2008 Blizzard Entertainment heralded that they had

reached the ten mln subscriber mark. At \$15 per month, this is a stunning \$1.8 bln in annual revenue business for Blizzard!

There are significant barriers to entry in the MMO market. The main barrier being the massive amount of time it takes to develop a game. Blizzard Entertainment first introduced a Warcraft game in 1994. Blizzard was a very experienced developer when they announced on Sept 2, 2001 that they would create World of Warcraft III. The game debuted more than three years later, on November 23, 2004. Funcom has spent four and a half years developing Age of Conan.

World of Warcraft caught the industry's attention when it first hit the one mln subscriber milestone in early 2005 - a slot previously occupied by then "one hit wonder" Lineage - validating the MMO market as a major market. A game developer surely would have noted the potential of the MMO segment by late 2005, but development times would have prohibited a response until mid-to late 2009 at the earliest. An influx of new games is unlikely to occur until 2010. The MMO space is currently very undeveloped, with only other highly-anticipated 2008 release being EA's Warhammer, due out in the fall.

In many ways, the MMO space today can be compared to the early days of the internet. Few key players participate in the MMO segment and there appears to be a massive advantage to game-makers reaching a critical mass of a half-million subscribers. Of the twenty eight MMOs released since 1997, only six have reached the half-million subscriber mark. Of those six, three went on to surpass the two mln subscriber mark: World of Warcraft, Lineage and Lineage II. RuneScape, the sixth game, is currently on a growth trajectory to surpass the two mln subscriber mark in late 2009. Revenue models are still adapting as subscription fees continue to dominate (much like AOL and Compuserve charged for access in the early day of the market). In-game advertising is growing (think banner ads) and new revenue models - such as the selling to gamers of magical items, buildings and characters - are beginning to emerge.

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