DYNASTY PERSPECTIVES
INSIGHTS IN BUSINESS, TECHNOLOGY & FINANCE

Mobile Gaming: The Motown / Microsoft Dilemma

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Introduction

The video game industry is currently at a crossroads. Long thought of as an extension of the toy market, the market for video games in the U.S. today is over $10 billion, exceeding sales of movie tickets and movie rentals. The demographics of the market has also expanded with over 60% of game players now over 18 and 17% of game systems residing in adult bedrooms[1].

While there are many reasons for optimism in the video game industry, most publishers still feel under constant pressure to develop the next hit game. In many ways video game publishers face the same challenge as record labels in that they are both combatants in hit-driven industries. At Dynasty, we call the need to move from a hit driven business (Motown) to a business with recurring revenue (Microsoft) the Motown / Microsoft Dilemma. In this issue of Dynasty perspectives we describe a strategy to use the unique powers of networked gaming to address the Motown / Microsoft Dilemma.

Music and games

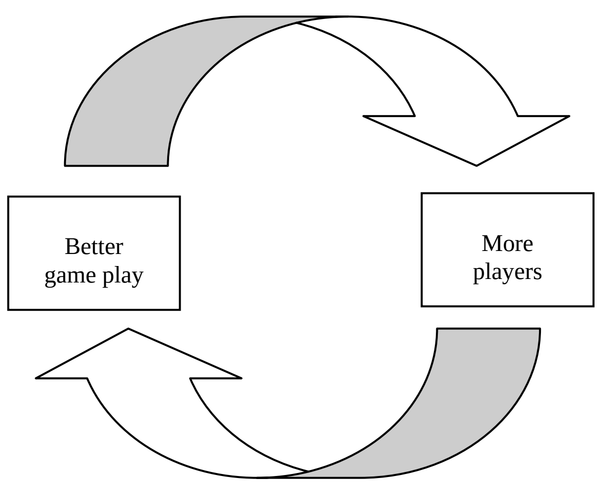
While video game publishers have similar strategies to record labels, the industries have evolved much differently. In the music industry five companies control 80% of the world-wide market for music. In the latest hardware cycle the top ten console publishers accounted for approximately 70% of all video game publishing revenue. However only Electronic Arts (“EA”) has been able to consistently achieve above 10% market share (see exhibit 7-8). In 2002, EA claimed a 19% market share of video game publishing revenue more than double Take2 Interactive’s second place share of 8%. By the end of 2003 EA was able to increase its market share to 25%.

In the context of a cyclical business, most video game publishers have followed a simple strategy that we call the Motown strategy. Publishers attempt to develop a hot new game, either by employing in-house development, licensing an establish brand or partnering with a third-party development studio. Although an estimated 60% of all games fail to recoup their cost of capital, those few hit games create “franchises” drive the profitability of the industry[2]. Each year, the publisher releases new version of franchise games with incremental improvements to generate recurring revenue. Likewise, in the music industry it is the few hit artist that support many unsuccessful groups.

One common strategy employed by video game publishers to mitigate the risk of game development is to invest in a development studio in return for a percentage of future game sales. In a sense, the publisher is paying for a call option on the future success of the game. If the game is successful, the publisher will sometimes acquire the development studio. Yet even once development studios are brought in-house they tend to be run separately in order to maintain a unique identity and maximize the creative effort of the group.

Gamers play together

The interactivity of video games sets it apart from the largely passive media of pre-recorded music. As shown in the diagram below, the “playing together” aspect of video games creates a positive feedback loop where the more players that play the game, the more attractive the game becomes.



No company has better exploited this positive feedback loop than Electronic Arts. The company built its success around sports with approximately 35% of EA’s current revenue coming from this genre. Why build around sports? Because sports games exploit this positive feedback loop better than any other genre. Games like *Madden Football*, *NBA Live*, and *FIFA Soccer* are all designed to allow players to compete with each other. These games effectively create a language in which to compete. Although a gamer may know how to play football on a particular system, if a player does not understand the intricacies of *Madden Football* he or she will inevitably lose in competition. Once a sports game reaches a tipping point, there is really no choice to be made. You must play what your friends play in order to compete. The competitive nature of sports games make for a defensible position in a hit-driven industry.

Network gaming changes the landscape

Traditionally we believe the following game genres have the greatest positive feedback loops:

- Sports games
- Party games
- Multi-player strategy games
- MMOGs (Massively Multiplayer Online Games)

Of these games, the strongest positive feedback loop is in the so-called MMOGs (Massively Multiplayer Online Games). MMOGs place players in a virtual world where they can interact with other geographically dispersed players. When only a few players are online, playing an MMOG is an uninspiring experience. But as more users join the game, the positive feedback loop becomes stronger and players become immersed in cyberspace. Examples of current successful MMOGs in the U.S. include Sony's *Everquest* (400,000+ subscribers), *Star Wars Galaxies* (300,000+ subscribers) and EA's *The Sims Online* (100,000+ subscribers) and *Ultima Online* (200,000+ subscribers)[3]. Outside of the U.S., *Lineage* in Korea has been able to capture over 2mm subscribers in a population of only 46mm[4].

To date, all of the successful MMOGs have been launched on PCs. However, advances in computing and communications will make networked gaming soon ubiquitous on consoles and mobile phones. Company's that successfully execute on these new platforms with their unique development characteristics will have the opportunity to create long-term recurring revenue.

Conclusion

While it may be intuitively obvious to note that the future is in online gaming, it is quite difficult to fully execute the Motown / Microsoft strategy. Some organizations find it necessary to change their culture and their structure in order to properly execute this strategy. Dynasty Capital Services helps companies to craft appropriate strategies that utilize their strengths to build long-term recurring revenue. For more information on how Dynasty can help build a long-term strategy contact dynasty@dynastycap.com.

Endnotes

[1] “Essentials about the computer and video game industry,” Interactive Digital Software Association, <http://www.theesa.com/EF2003.pdf>, accessed December 2, 2003.
[2] Darran Gardner, “Why video games are proving to be hard work for developers,” Sunday Herald, October 20, 2002, available from Factiva, <http://www.factiva.com>, accessed December 6, 2003.
[3] *Ultima and Sims* statistics from Gary L. Cooper, Banc of America Securities, “Electronic Arts: It’s Still in the game,” March 13, 2003, p22, available from Thomson Research, <http://research.thomsonin.com>, accessed December 2, 2003.
Everquest statistics from “Massively Multiplayer Online Games,” *Gamespy.com*, November 14, 2003, available from <http://www.gamespy.com/amdmmog/> accessed on December 6, 2003.
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[4] Michelle Levander, “Where does fantasy end?,” *Time Magazine*, June 4, 2001, <http://www.time.com/time/interactive/entertainment/gangs_np.html>, accessed December 3, 2002.