



BRITISH SCREEN ADVISORY COUNCIL BRIEFING PAPER

THE VIDEO GAMES INDUSTRY

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Introduction: the Scale of the Market

The total UK retail market for games software grew to £1.6 billion in 2007 – the highest value ever reached. This is a rise of almost 30 per cent over 2006. At a global level, the sale of video games in stores generated over \$25 billion last year.

The games market has become an increasingly mature and major media market in its own right. British consumers spent £435m *more* in stores on games in 2007 than they did on buying music CDs. Moreover, games software spending already exceeds cinema box office takings as well as spending on the rental of DVDs. In fact, the retail games market in 2007 was more than five times the size of the video rental market and almost twice the size of the British cinema box office.

Game Industry Fundamentals

Whilst conventional media markets have been affected by normal fluctuations in consumer demand, they have not been subject to the swings characteristic of the games industry. The latter has always been typified not only by much shorter technological life cycles, but also by multiple proprietary standards existing concurrently. This is in stark contrast to traditional media entertainment markets that have been built on a foundation of relatively stable common technological standards, albeit often established after intense competition between rival formats. The CD in the audio market and VHS cassette and DVD in the home video market became the sole de facto modern standards in their respective fields, established long enough to allow huge markets to be built up around them.

Historically, every new game console machine launched has had a typical lifecycle of four or five years before it is superseded by a new generation of more powerful platforms. The move from one generation to the next must be handled carefully by the industry, which must make the new machines attractive without prematurely killing existing formats.

Console manufacturers generally retail their machines at prices close to, or even below, the cost of goods in the hope of making this hardware investment back from the subsequent sale

of games. This ‘razor blade’ principle is a key feature of the industry, with console manufacturers charging games publishers a ‘per unit’ royalty for the right to sell games based on their proprietary format. The console ‘platform owner’ thus generates revenues both from the sales of self-published games (termed ‘first party’ releases) and from games released by independent publishers (‘third party’ games).

Consoles are categorised in terms of the capacity of their central processing chip to handle information— measured in terms of bits. The earliest chips used in the first games devices could handle only four bits of information concurrently, whilst today the industry is working with a generation of machines built around 256-bit processors.

Console Market Trends

Prior to this one, the last two console cycles were dominated by Sony with the original PlayStation (launched in 1995) and its successor the hugely successful PlayStation 2 first released in 2000. The only serious challenger to the original PlayStation was the industry stalwart Nintendo, but fresh competition arrived for PlayStation 2 in the shape of Microsoft.

Despite the twin-pronged competition from Nintendo’s GameCube and Microsoft’s Xbox, Sony maintained its ascendancy in the last cycle. It achieved a global hardware market share of over 66 per cent at the peak of the market in 2004 – with Nintendo and Microsoft sharing the remainder of the world market more or less equally, albeit with regional variations.

Microsoft was determined to lead the next console race and thus launched its second generation console, the Xbox 360, in 2005 – well ahead of the competition. In fact, Sony’s new machine, PlayStation 3 (PS3), was badly delayed and did not enter the market until the tail-end of 2006. This was because the design of the PS3 was extremely ambitious, being based on two cutting-edge technologies: a radical new advanced central processor called the cell chip, and Blu-ray Disc optical media. Either one of these technologies would have been challenging to bring to market on their own in a timely fashion, but the combination of the two proved too daunting, even for Sony.

Nintendo corporate culture has always been somewhat maverick and the company made a conscious decision to side-step the console technology ‘arms-race’ being waged by Microsoft and Sony. Rather than trying to out-gun the competition with ever more powerful processing and super-realistic high definition graphics, Nintendo took a very different approach with the much simpler and cheaper-to-manufacture Wii console. The key innovation introduced with the Wii was a motion-sensitive controller that provided a user interface that anyone could pick up and use instantly. The simplicity of Wii games, coupled with this new ‘Wiimote’, enabled people new to video games to engage with them right away.

The broad ‘word-of-mouth’ appeal of the Wii took both Sony and Microsoft by surprise. With its head-start, Microsoft’s Xbox 360 led the market in 2006, having close to 8m machines sold globally by the end of that year to claim a 65 per cent market share – versus 3m Wiis and just over 1m PS3s. However, in 2007 the momentum of the Wii became unstoppable and Nintendo could not manufacture enough to meet demand. By the end of 2007, the Wii claimed a 45 per cent share of the world 256-bit console hardware installed base with close to 20m machines sold on a cumulative basis – more than 4m ahead of

Microsoft. Sony found itself in the unfamiliar third place position with a 20 per cent market share. However, helped by an increasingly strong release schedule of games, PS3 has recently been picking up impetus and Screen Digest expects it will end 2008 just ahead of Xbox 360, but still well behind the Wii.

In addition to TV-based consoles, there is also a vibrant market for games played on handheld devices. This is a sector that has historically been controlled almost exclusively by Nintendo through its succession of Game Boy products – and most recently a novel dual-screen model called Nintendo DS. However, genuine competition to Nintendo finally arrived in 2005 in the shape of a new handheld product from Sony called PlayStation Portable (PSP) that delivers a gaming experience approaching the graphic quality of PlayStation 2 but on a tiny 3.4-inch screen.

Remarkably, the Nintendo DS handheld has been even more successful than the static Wii console, selling 65m by the end of 2007 – more than twice the 30m unit sales recorded by the Sony PSP.

Alongside the console and handheld sectors is a significant, but flat, market for games playable on PCs. Historically, the core buying group for PC games have tended to be a different set of consumers to those who account for the majority of console game purchases, although this has been slowly changing as consoles have won more and more followers. For games publishers, the attraction of the PC market is that there is no royalty to be paid to a console platform owner.

Globally, PC titles account for about 15 per cent of the market for packaged games sold in stores, but we believe this will now steadily decline as the PC games market itself dwindles. Games for handheld machines are now worth close to twice the value of the PC games market.

The British Games Industry on the Global Stage

The economic structure of the global games industry is not dissimilar to the film business, with a handful of giant publishers (including hardware manufacturers) that control distribution. These are serviced by thousands of smaller studios or developers that actually make the games. Some of these studios or wholly or partially owned by publishers; the majority are independently owned and enter into publishing deals on a project-by-project basis.

The UK really only has one publisher with any pretension to global scale, SCi Entertainment, which acquired fellow UK publisher Eidos in May 2005. However, since that acquisition – and despite an equity investment from Warner Bros. in 2007 – SCi has struggled. Against a backdrop of industry consolidation, SCi now looks like a tiny player. However, Codemasters, another British games publisher with a long history and strong pedigree, has meanwhile been growing its revenues and building an international distribution network.

France has maintained a stronger publishing base, with Ubisoft currently the third largest independent games publisher by market capitalisation. Vivendi Universal Games (VUG) has also been built up into a major force in the games industry, primarily through the success of

its online game *World of Warcraft*. However, VUG is now set to be merged into US publisher Activision. Another former French games publishing force, Atari/Infogrames, has recently appointed a new management team who will take up the daunting challenge of turning it around.

While most of the economically important publishers are either headquartered in the US or Japan, the UK industry continues to dominate Europe in terms of creativity. There are many more employed in the development side of the British games business than in continental European territories. Indeed, the UK game development industry – sometimes referred to as ‘Britsoft’ - makes games that sell well all over the world, generating significant export revenues.

Expanding The Games Industry Business Model and Market

As the technological platforms for gaming have become ever more sophisticated, so the cost of developing – and marketing - games for them has escalated. Making a game for a current generation console typically costs upwards of \$10m and often closer to \$20m. It takes a large and highly skilled team at least 18 months and often longer than two years to complete the most sophisticated titles. This has made publishers far more discerning with their advances to developers and as a result many studios have been economically challenged to the point of collapse.

Creating the large and complex games that the market now demands requires sound financial management, a large commitment to R & D, the spread of risk across multiple projects and platforms and, if possible, some control over intellectual property rights. This is a tall order for many independent studios and publishers, which helps explain the current consolidation and contraction in the industry.

Publishers and developers need to sustain a good hit rate in order to support the rising upfront investment in creating quality games. Yet the basic retail business model is a high risk one. With limited shelf capacity for the entire games category, retailers are increasingly ruthless about ‘pulling’ titles that do not immediately become top sellers. After years of development and millions of pounds investment, a game has only a few weeks to prove itself in the market.

And unlike the film industry, for example, the games industry does not benefit from multiple release outlets from which to recoup initial investment. After a film’s initial cinema release, the real revenue is generated from subsequent distribution via various home video and television outlets. By contrast, the primary games industry business model has been a ‘one-shot’ retail sale, with the possibility of limited rental in some markets and sometimes the later re-sale of the game at budget prices.

A key dimension to future growth for the games industry now lies in improving the core business model. Fundamentally, this means two things:

- [1] reaching new customers, and
- [2] developing new revenue streams.

Many games publishers have become increasingly aware of this need to expand their customer base. One of the means through which they have sought to do this is by exploiting licenses from other media - especially from film properties. The idea is that the public awareness factor of blockbuster movies can deliver a broader audience for the tie-in game. While there is evidence to support this strategy, it is notable that the biggest selling games are often those based on completely original intellectual property (IP) – the latest editions of blockbuster game franchises *Halo* and *Grand Theft Auto* being cases in point.

A more innovative approach to expanding the core games market has been to make the game-play itself more accessible to so-called casual users. Sony pioneered this with the introduction of the award-winning EyeToy peripheral for its PlayStation 2 console in July 2003. By doing away with the traditional handheld controller, this plug-in camera device revolutionised the way that gamers interacted with the console. In so doing, EyeToy enabled the design of games that are very much simpler and far more instantaneous in their appeal than traditional console games. Sony followed this up with other games with casual appeal like the karaoke-themed *Singstar* and the quiz game *Buzz*.

Despite Sony's pioneering efforts, it is Nintendo that has really captured the imagination of the non-gaming public with the immediacy and simplicity of the Wii console experience. The broad-based appeal of games like *Wii Sports* has driven take-up of the device by many families who would not previously have considered themselves 'gamers'. Moreover, Nintendo has also successfully extended the casual games concept into the handheld sector with games for its DS like *Brain Training*, that appeals to an older user, and a series of virtual pet titles, *Nintendogs*.

Online Gaming

Internet gaming has been around for many years. The first text-based MUDs (multi user dungeons) appeared in the early 1980s, while the boom in peer-to-peer gaming began with *Doom* as long ago as 1993. These events prompted their own mini booms, with venture capital backed companies rushing in to the sector.

The online games market can be broadly divided into two segments: 'casual' and 'hard-core' online gaming. The two have highly distinct demographics, as well as different business models and game types. Whilst hard-core online computer games are usually played in a stand-alone environment and often reliant on a game disc, casual games are more often than not played in a web browser and served from a website. Examples of popular casual online games are *Solitaire* and *Bejeweled*.

Some forms of hard-core online gaming (such as the basic multi-player features of many boxed product games) are not revenue generative, although a subscription-based model is used for most massively multi-player online games (MMOGs) and, where successful, this is still the most lucrative form of online gaming – at least in Western markets. Screen Digest estimates that the stand-out MMOG success story, *World of Warcraft*, has generated more than £700m in subscription revenues since launch. MMOGs as a category generated about \$1bn in subscription revenues last year. However, the number of profitable MMOGs remains

rather small and it remains a high-risk sector.

For a long time, casual online games service providers were reliant on just a single revenue stream: advertising. However, over the last few years they have fostered a range of new business models. Amongst these has been the emergence of pay-per-play casual gaming in which gamers pay to enter skill-based games tournaments that allow cash and merchandise prizes to be won.

From a market expansion perspective, it is notable that female gamers now dominate every form of casual online games playing. Women typically comprise over 60 per cent of all visitors to the larger casual games websites and represent the majority of those willing to enter pay-per-play tournaments, subscribe to casual online games services and buy downloadable casual games.

Historically, the PC has been the primary device for online gaming. However, all three present-generation consoles are broadband-enabled and this has allowed the console to become an increasingly important online gaming platform. Microsoft has led the way with its Xbox Live service that has enticed around 60 per cent of console owners to connect.

By inviting console consumers to enjoy all the benefits of online play - multi-player functionality, tournaments, league ladders, downloadable demos – the manufacturers hope first and foremost to improve brand loyalty. However, the ultimate aim of this online migration is to generate extra revenues on top of those gained from retail sales and third party publisher licence fees. Microsoft has earned significant subscription revenues from charging online membership fees, but has also started to make money from downloading of paid-for game content, as well as full-length movies and TV shows.

However, enabling online console gaming is not easy or cheap. Hosting online services is extremely complex. And aside from the technical challenge, there are a myriad of issues that are challenging to a business traditionally steeped in retail. These include customer service, billing, piracy, hacking, content control (age segmentation) and more.

Mobile Gaming

Mobile phones have become a viable platform for games publishers to target, but the market for mobile games has not grown as rapidly as many observers and industry players anticipated. It does, however, represent another key platform for the expansion of casual games.

Two factors were key in the emergence of the mobile gaming sector in the early 2000's. First, mobile phone penetration started to reach saturation, meaning that network operators had to look towards non-voice content-based services to increase revenue and act as a differentiating point to reduce subscriber churn. Second, downloadable technologies (and enabled handsets) – primarily Java-based - emerged to offer a compellingly simple (and billable) platform for the delivery of games. Against this, it soon became clear that the business of making and distributing engaging games for the hundreds of different and ever-changing mobile handset models in use around the world was a daunting challenge that only a select few companies would successfully meet.

Although games are still only downloaded by a relatively small proportion of phone owners, the huge scale of the mobile-owning population means that significant revenues can be generated. Screen Digest estimates that the global market for mobile games was worth \$2.6bn in 2007. This is large enough to attract the attention of some of the games industry's biggest players. Electronic Arts, for example, paid \$680m in December 2005 to acquire specialist mobile games publisher Jamdat. Other key mobile games publishers are Gameloft (market leader in Europe), Glu and THQ.

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